BHP less than a surefire thing

BY: ROGER MONTGOMERY

From: The Australian
May 26, 2012 12:00AM

ROILED global stockmarkets have produced some surprising results, not least of which is the impact on one of the most widely held and most widely inherited stocks in the market. BHP Billiton traded at three-year lows this week, Fortescue Metals has fallen 27 per cent from recent highs and Rio Tinto's share price has fallen to the same level it traded at in January 2006.

If, like many thousands of investors, your BHP holding has been handed down to you from Great-Aunt Mertle and it owes you nothing, then press on with the rest of your weekend and hope that China restarts its engines. If, however, you have bought in more recently amid all the hype about China and the GRB (Great Resource Boom), you may need to have a chat with your adviser.

When it comes to mining companies, I have been erring on the side of caution for a while, and that caution has prevented us from buying BHP, even though it ticks some of the boxes I have described in previous columns as being a prerequisite for investment.

At Montgomery Investment Management, what we have seen building is a stronger case that iron ore prices could come under increasing pressure and, with it, the margins of large mining companies and their capital expenditure plans.

Last year, world iron ore production grew by an astonishing 8.1 per cent, or 227 million tonnes to 2.8 billion tonnes.

If we assumed the same growth this year, production would grow to 3.02 billion tonnes. The problem is that iron ore prices have risen astronomically since 2004. Did you know that between 1982 (30 years ago) and 2002, iron ore prices traded between $US11 and $US15 a tonne? Since 2004, however, prices have first risen to $US187 (2011) then fallen back to a range of $US130-$US150.

That 1200 per cent rise in prices has had two effects. The first is it causes people to believe the new price level is permanent. Comments from experts such as "stronger for longer" or "we don't see China slowing" are merely evidence of history repeating. Second, the price rise causes businessmen (and women!) to respond by producing more of the stuff.

It is a classic supply response that renders commodities permanently cyclical. BHP production is forecast to grow by 20 per cent, Rio's by 30 per cent and Fortescue's 25 per cent. Globally, production is expected to grow by much more than 8 per cent. So that's the supply side. Higher supply tends to lead to lower prices.

In the recent past, China has consumed 60 per cent of global production. If global production grew by just 8 per cent and China consumed another 60 per cent, it would require an additional 136.2 million tonnes.

Moderating economic growth in China means present estimates for its iron ore requirements are half this level. And, remember, we think production will grow by more than 8 per cent. So, what happens to the extra stuff produced that China doesn't need?

Who knows? What we do know is that, under such scenarios, prices fall.

By 2015, it's possible that two entire Pilbara regions (700mt) of additional supply will hit the market. And given our belief that China's property bubble (construction) has a long way to go on the downside, it is a big stretch to expect China to absorb 420 million tonnes, or 60 per cent of that.

The market price of China's total residential real estate at construction cost is equal to 350 per cent of that country's gross domestic product. Only Japan in 1989 and Ireland in 2007 had similar numbers and both subsequently suffered monumental collapses. Australia, Canada and Brazil, under this scenario, would be hardest hit as commodity prices plunge and our big iron ore miners could be in the firing line.

Remember, iron ore traded at $US14 a tonne as recently as 2004 and while those prices may not be seen again, prices of less than $US150 are certainly possible.

We have heard all the arguments against this view but many come from vested interests, and while we may yet be proved completely wrong, one of the best pieces of investment advice I have ever heard is: don't ask the barber whether you need a haircut.