Weaker Chinese demand a worry

BY: ROGER MONTGOMERY From: The Australian July 21, 2012 12:00AM

WITH BHP Billiton's share price 30 per cent less expensive than it was 12 months ago, it is easy to say the shares are now cheap. But does BHP represent value or is it a value trap?

Geologists who spend their days planning exploration programs for major miners are in no doubt about whether we have seen the peak of the resources boom.

Six months ago, these experts were being told by their multi-billion-dollar clients that money was not an issue, that the issues were finding labour and drill rigs.

"Just make it happen," the geologists were being told. "There's $80 billion of planned infrastructure spending in the pipeline."

Today there are no such issues. Why?

Because unless the mine is under construction already, the project has been shelved.

It's particularly evident in the coal sector. BHP has already shut down a coalmine in the Bowen Basin with costs blowing out and prices coming down.

Contractors and drillers are being sacked and those projects that just six months ago were moving forward "no matter what" may now be looked at again "in a couple of years".

I have been convinced of a weak materials sector for a year and have written extensively about the subject. The reason is simple: China.

Back then, I described a commercial office construction boom that was producing 60 billion square feet or an office cubicle for every man, woman and child in China.

All that has been completed and even more is under construction. But they don't need it and the returns for the developers are diminishing.

Add to this the fact Europe is experiencing record unemployment, the International Monetary Fund has just downgraded global growth and Japan (China's major customer) just reported a 14.8 per cent decline in May machinery orders.

The impact on Chinese steel demand, cement demand and iron ore is inescapable.

This week Macquarie analysts wrote: "We have downgraded all the FY12 earnings forecasts for the Chinese cement stocks under our coverage given the recent first-half profit warnings and a weaker demand outlook.

"On average we have downgraded FY12-13 earnings by 20 to 30 per cent and we are now 30 per cent below the market."

While everyone's attention regarding China has been on the macro picture - the

broader economic slowdown - few analysts are looking at the micro level where the picture is far worse.

Individual Chinese companies are experiencing negative and deteriorating cashflows, and uncollectable receivables, and have ceased earning their cost of capital.

China's biggest maker of construction machines, Sany Group, recently announced a cut to its 60,000 workforce, on the back of falling demand. Sany produces concrete machinery, excavators, cranes, pile drivers and road machinery. Its annual revenue exceeds 80 billion yuan or $12bn. But Sany has been selling machines on generous credit terms and last year its net receivables doubled.

My conviction of a weak materials sector has been reinforced by these recent developments. This does not bode well for the Australian sharemarket because the combined materials and energy sectors account for 29 per cent of the market. And they have a large influence over its direction as the marginal foreign institutional buyers and sellers come and go, depending on their views about global growth.

The domestic mining sector also accounts for 7 per cent of GDP and contributes 50 per cent to the value of exports. The recent boom in the mining sector single-handedly saved the nation from recession. But now the tide is going out, we are about to find out who has been swimming naked.

Eventually prices get so cheap that even the worst-case scenario does not seem that bad. Remember, the Depression lasted a decade bt the stockmarket bottomed in 1932, which was well before any recovery in the economy was glimpsed by even the most optimistic.

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