INDUSTRIALS

Last Sale	Move	Buy	Sell	12 month High	Low	Sales 100	Div Yield	P/E

THE SHORT CUT

with Roger Montgomery

THERE has been increasing talk of "green shoots" emanating out of the United States. It's a term used to indicate signs of an economic recovery after a long downturn.

However, we are somewhat sceptical, given the constant jawboning by Ben Bernanke "predicting" a strong recovery ever since his first TV interview in 2009.

Despite this, an improving housing industry, improvement in factory utilisation (now at 80 per cent), the purchasing managers index (PMI) signalling expansion since August 2012, and signs of an improvement in US employment and the participation rate, mean that this recovery may in fact have some legs.

Given the US is an economic powerhouse in terms of Gross Domestic Product — representing about 24 per cent of the world economy — if it is in a recovery phase, with more houses and infrastructure being built and factories running closer to capacity, this should support commodity prices.

A growing economy needs more raw inputs, materials and refined products to support its growth. Despite this, commodity prices (and hence the price of shares in Australian resource businesses, as represented by the S&P Small Resources Index) are down almost 50 per cent in the past 12 months.

We at Montgomery Investment Management believe even if we see green shoots and an economic recovery in the US, we remain cautious on the prospects for commodities and Australian miners.

A lot of people clearly disagree with our wary view. We have watched from the sidelines as price falls have been followed by an increase in calls by activity promoters to re-allocate portfolios into the resource sector, given the apparent value on offer. While we may appear overly cautious, we consider the fact that over the past decade China has accounted for a large proportion of the increasing demand and prices in pretty much everything resource based.

In 2012, China's share of global demand for steel sat around 50 per cent. Furthermore, between 2001 and 2011 China accounted for a high proportion of the growth in energy and metals and nearly all the global demand growth for oil, iron ore and coal.

As the rest of the world fell into an economic hole driven by the GFC between 2007 and 2011, Chinese demand picked up the entire surplus and additional supply in aluminium, nickel and copper. Not bad for a country that represents just 11.5 per cent of the world's GDP.

This demand, over the space of approximately 10 years, resulted in resources growing to occupy 45 per cent of the Small Ordinaries Index. Before their decade-long run, resource businesses made up just 10 per cent of the index. A return to historical weightings would mean that despite having already halved in price, they could halve again.

Australia was a clear beneficiary of demand, driven by an economic growth model that was heavily dependent on virtually uninhibited fixed investments (land, buildings, and infrastructure installations). The huge apparent investment overhang in the Chinese property sector now — roughly 30 per cent of apartments are uninhabited and another 60 million are slated for construction — coupled with industrial overcapacity, means China won't require more fixed-asset investment for some time.

China's economy is going through a transition from investment-led growth to consumption-led growth — not dissimilar the US in the 1930s.

Our concern is this: despite a likely pickup in demand from a US-led recovery, the falls in commodity (and related resource company) share prices stems from the slowdown in demand from China, which is greater than gains from the US.

Meanwhile, despite the recent shelving of billions in CAPEX expansion projects, global commodity supply continues to expand at an alarming rate.

The result of higher supply and net declining demand are lower commodity prices — until all but the highest cost producers are shaken out. Until this well-trodden path has run its course, the pendulum has well and truly swung. And not in Australia's favour.

Roger Montgomery is the founder of Montgomery Investment Management

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