Commodity prices: the worst is yet to come

by
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"Well, there's at least one good thing about this recession – it has moved commodity and oil prices back to normal." Raise your hand if you've heard (or said) this some time in the last year.

But let's not fool ourselves. One plus one still equals two, and a new take-off in commodity and oil prices is likely in a few years if emerging economies, especially China, continue to grow strongly. It is even likelier if more mature economies grow sluggishly.

The steep surges in commodities in 2006 and 2007 were followed by very sharp drops in 2008, which coincided with the beginning of the contraction in the global economy and general destocking, particularly in China.

And yet, this (undesirable) correlation masks two very different trends: the investment cycle in mining and the unstoppable rise in crude oil prices.

Two different situations

Rising mining prices in late 2003 restored some lustre to an industry that had not truly invested for at least the previous 10 years.

Six years ago it was impossible for existing mines to meet surging demand, which was being driven mainly by China's growth. Prices therefore rose and after a few months of looming undercapacity, mining companies began to invest aggressively, aided by exceptionally low interest rates.

It takes three to six years for an investment to extract its first tonne of ore. The new volumes hit the market between 2006 and 2008, at a staggered pace for various ores and mines. In 2007 and 2008, new capacity was operating flat-out – and prices came back down to earth after skyrocketing in 2006 and 2007.

The 2008 crisis was merely the final blow to ore prices that were already destined to plunge.

Things played out differently for oil. Surplus demand up until 2008 (amounting to several millions of barrels per day out of total daily consumption of about 83-85 million) generated heavy pressures and prices surged accordingly.

Until autumn 2008 oil companies invested in exploring and developing new fields, especially in deep offshore, where there are still some undiscovered and unexploited reserves, and in new types of extraction (Canadian oil sands, in particular). Rental costs for offshore platforms and the ships that service them tripled between 2005 and 2008, and operators generated 50%-plus EBIT margins.

Making these investments pay off will require far higher prices than in 2004-2006. Fields are under more than a kilometre of water or several kilometres of crust (Brazil, Gulf of Mexico), in very challenging environments (under the Arctic icecaps) or use up the equivalent of one third of the energy that they ultimately generate (Canadian oil sands).

This is radically different from the situation faced by new mines (whether cobalt, zinc or other minerals), where costs for new capacity are close to those of mines already operating, because there is not (yet?) any shortage of minerals but simply a bottleneck in exploiting them. In

other words, ore extracted from a new mine will, on average, cost no more than ore from a mine that has long been in operation.

While it is true that, in reality, mining resources are finite on a human and economic timescale of a few decades, very few ores are in short supply or in a situation where new capacity will be significantly more expensive than old. The two notable exceptions are uranium and lithium, recoverable reserves of which are few in number and small in size compared to projected demand.

As for iron, coal, cobalt, nickel, copper, zinc, aluminium and their upstream value chains, future mines will be no more costly than existing ones, and prices will track supply-demand equilibrium without structural increases.

What about tomorrow?

Assuming, realistically, that growth is strong in emerging economies (in particular China, India and Asia) and weak in Western economies (Western Europe, in particular), pressures on ore prices could very well re-emerge within five years, depending on specific assumptions and ores.

Oil prices, meanwhile, will continue their inexorable rise, especially as demand increases; $30-$50 oil could very well be relegated to the history books, barring a prolonged global depression or a technological breakthrough that today looks unlikely.

A new storm could very well be in the offing for our Western economies, and they will be less prepared to weather it than in recent years. In fact, the following can be realistically expected within five to 10 years:

- Oil will approach $100/bbl (or higher if the dollar were to lose value on global currency markets);
- Ore prices will move back up, as mining companies invest too little, too late (some of them are heavily in debt from acquisitions, and have no plans to invest heavily in developing operations);
- Little or no economic growth;
- Public debt levels that will make it impossible to borrow billions to be injected into the economy: national debt will not fall back to levels making this possible.

The competitive landscape will be altered. Asian manufacturers will be able to at least partly offset higher commodity prices by expanding their size and their experience, which will automatically lower their costs. European manufacturers will not be able to do this and will be hit head-on by the rise in commodity prices.

Core consumers and some low-cost segments (those who are overly dependent on energy prices, such as airlines) will come under heavy pressure and will lose market share. Other low-cost segments, particularly those based on Asian production, and the high end will do well.

With the exception of Australia, the beneficiaries of high commodity prices will not be developed economies, but rather Sub-Saharan Africa, Russia and South America.

While the recent strong Chinese economic growth figures are an encouraging sign for developed economies, they also carry a medium-term threat to commodity prices and, hence, to the more mature economies.

Companies and governments must begin to plan for a world of permanently high commodity prices. Cycles are predicted in the facts and data. A new storm is gathering strength.

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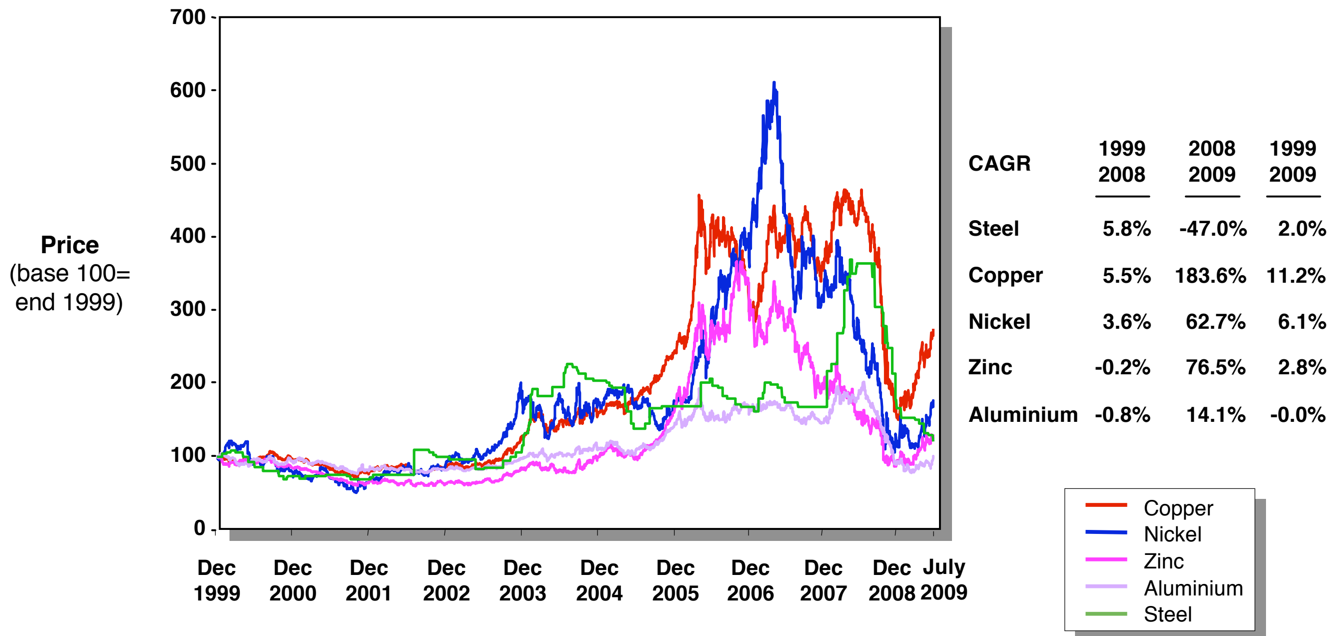
Estin & Co is an international strategy consulting firm with offices in Paris, London, Geneva and Shanghai. The firm helps senior managers at large European and North American companies develop and implement growth strategies, and works with private equity funds to assess and value their investments.

- Table 1 -
Historical price trends for some representative metals

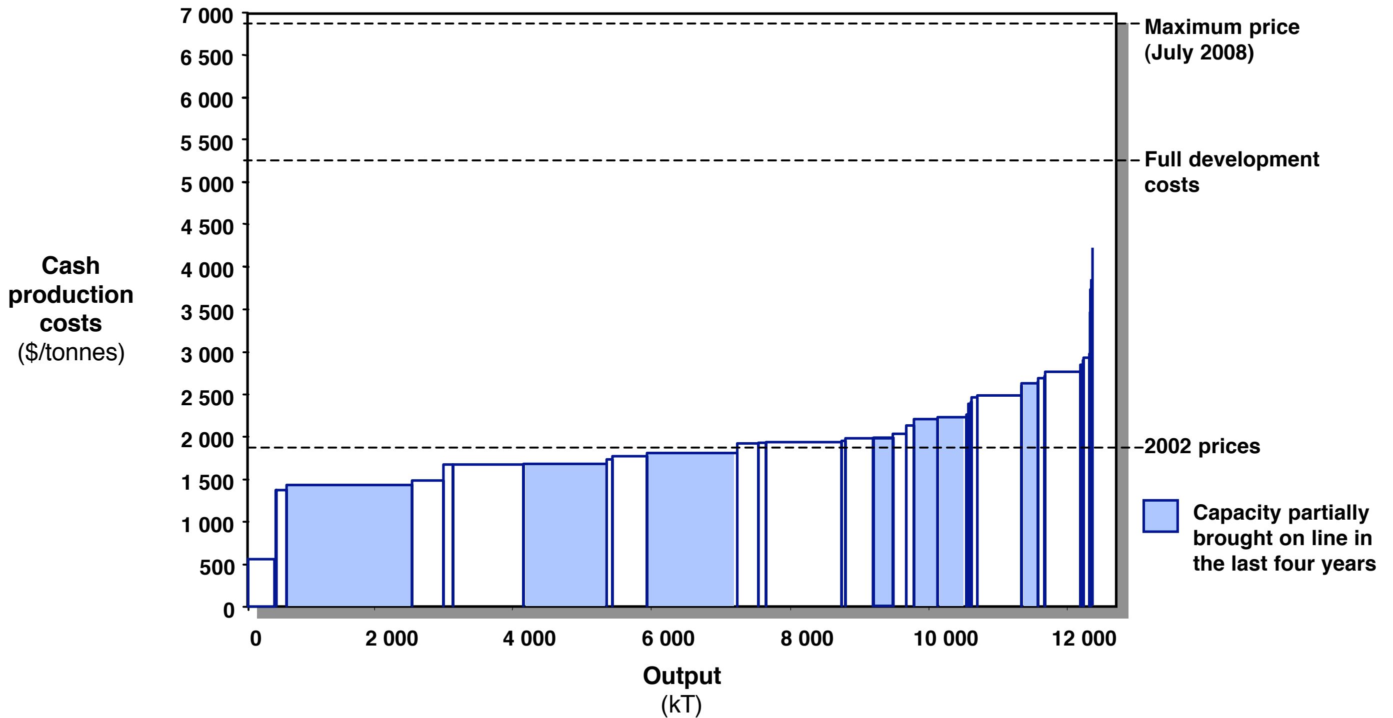


CAGR	1999 2008	2008 2009	1999 2009
Steel	5.8%	-47.0%	2.0%
Copper	5.5%	183.6%	11.2%
Nickel	3.6%	62.7%	6.1%
Zinc	-0.2%	76.5%	2.8%
Aluminium	-0.8%	14.1%	-0.0%

Source: Bloomberg, Estin & Co analysis

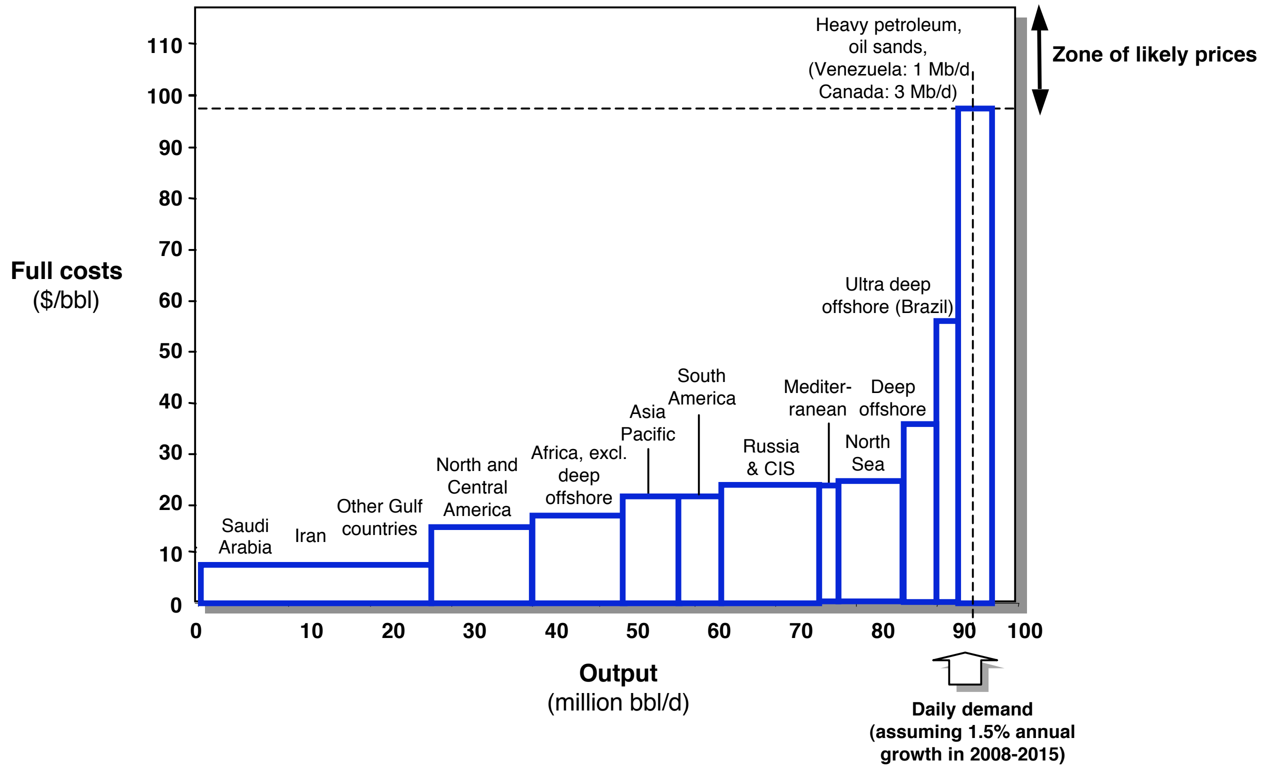
- Table 2 -
Copper extraction prices
(each bar represents a competitor)

- Scope: 85% of supply / 100% of supply excluding captive markets -



Source: World Mine Cost Data Exchange, LME, annual reports, Raw Material Data, and Estin & Co analyses and estimates

- Table 3 -
Oil production costs in 2015



Sources: OPEC, China CGA, IEA, Estin & Co