UPDATE - THE END OF THE MINING BUBBLE

Russell Clark's
Market Views

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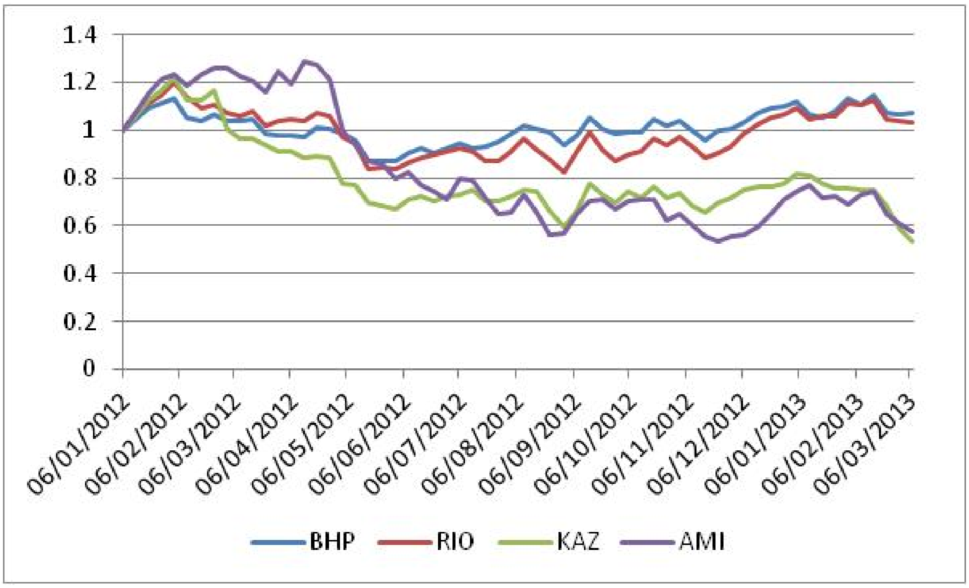
I wrote my first piece called "The End of the Mining Bubble" in February 2012, followed by an update in June 2012. Now, I believe, is the time to revisit this topic.

Sentiment towards mining stocks has noticeably soured in the last 12 months as earnings from mining companies have underperformed analysts' estimates. Small and mid-cap mining stocks have performed very badly and in some cases posted huge declines, which have been particularly noticeable during a period of otherwise bullish stock markets.

Intriguingly, the largest mining companies, Rio Tinto and BHP Billiton, changed CEOs recently and have moved their commentary of the markets from one of unfettered expansion to that of reduced capex and greater cash flow distribution back to shareholders. This has led to the large cap miners to continue their significant outperformance relative to small and mid-cap miners, as seen below.

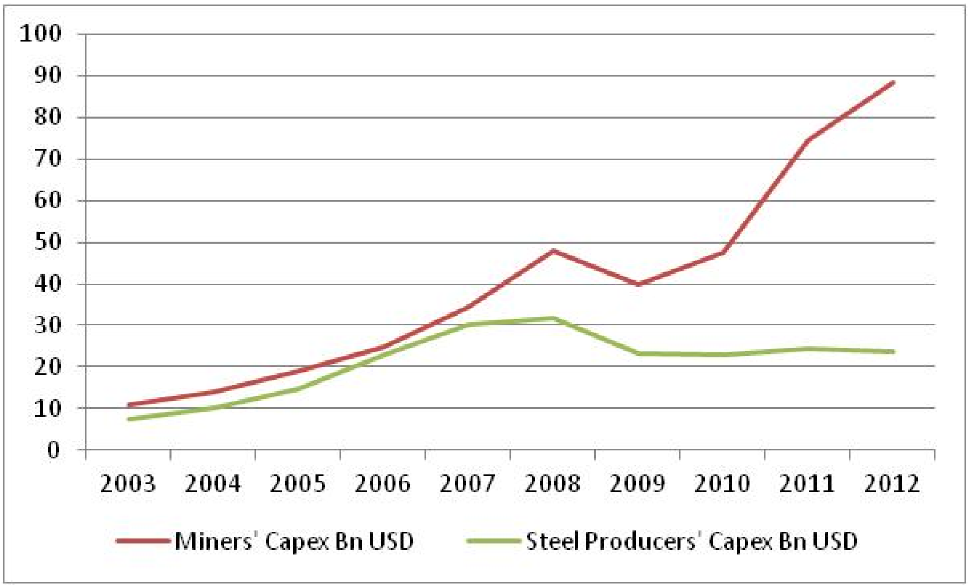


Whilst most readers are probably familiar with the large multi-commodity miners BHP and RIO, less well known are KAZ, which is a Kazakhstan based copper miner, and AMI which is a West Africa based iron ore miner. Both KAZ and

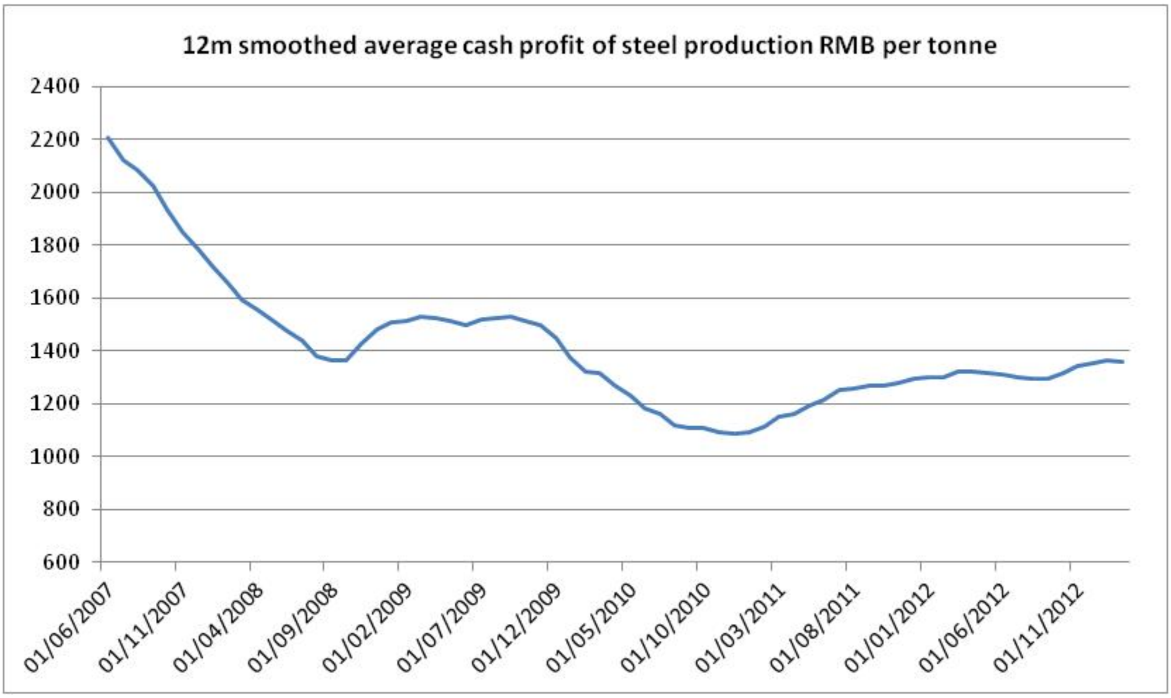
AMI are small miners with large projects due to come on stream in the future. To my mind the market is sending an obvious signal about future prices for commodities, and that signal is negative.

That the large cap miners are talking about capital discipline is very interesting. Unfortunately for mining companies, capital expenditures have a very long lead time, where many years can lag between the initial investment and when the commodity is actually brought to market. If demand for the commodity falls before the mine comes on line then miners can face a very painful choice of either running their mine at a loss or writing off their investment.

On the following page is an updated graph that compares the combined capex of large mining companies to the combined capex of large steel companies. As can be seen for years to 2006 the capex of miners and steel companies were broadly balanced. However recently capex at mining companies has surged.



Chinese steel capex peaked in 2007/8 in line with a precipitous collapse in the cash spread that they could earn from producing steel.



While it may seem that the above graph is hinting at improved outlook for margins for Chinese steel makers, the most recent spot spread has dropped to close to an all-time low.

Basic economics of the supply and demand curve is indicating that mining is headed for a severe pricing downturn, caused by increased production from excessive capex and demand constrained by falling emerging market growth. While the mining index and mining related stock markets are struggling, the debt markets, in their greedy search for yield, seem to be in denial of any of these problems and continue to treat emerging market sovereign debt issuers that are highly reliant on mining profits and thus revenues for the tax income, as excellent credits. It is extremely hard to ignore the similarities to the US housing crisis, where the share prices of US house builders indicated trouble well before the credit markets moved.

While mining is still a short in my mind, certain emerging market debt is also beginning to emerge as a huge shorting opportunity.

INFORMATION

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