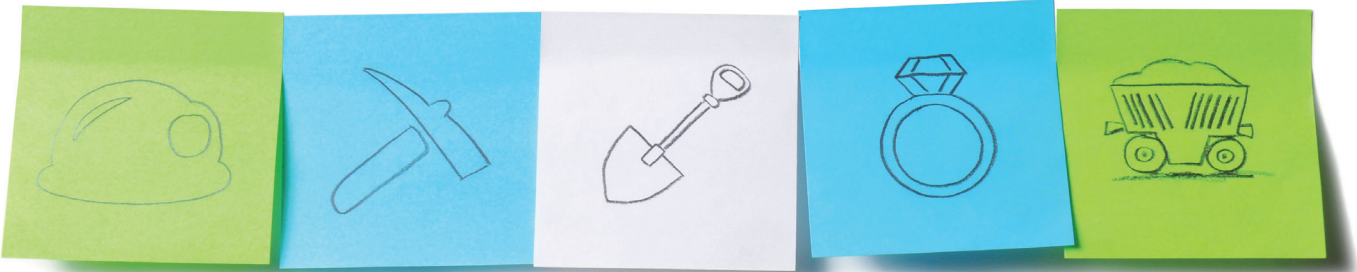


## Mining spotlight on: Commodity market imbalances

Strategies for managing volatility



# Mining spotlight on: Commodity market imbalances

## Strategies for managing volatility

It's an age-old cycle in the mining industry: strong commodity demand pushes up prices which, in turn, impels companies to ramp up production. As long as demand remains high, the cycle continues. When demand drops, however, prices plummet, supplies build up and marginal projects become considerably less attractive.

It's no wonder, then, that the mining sector is buoyed by evidence of a tentative financial recovery. So here's the burning question: is it sufficient to overcome the structural weaknesses that persist in today's commodity markets?

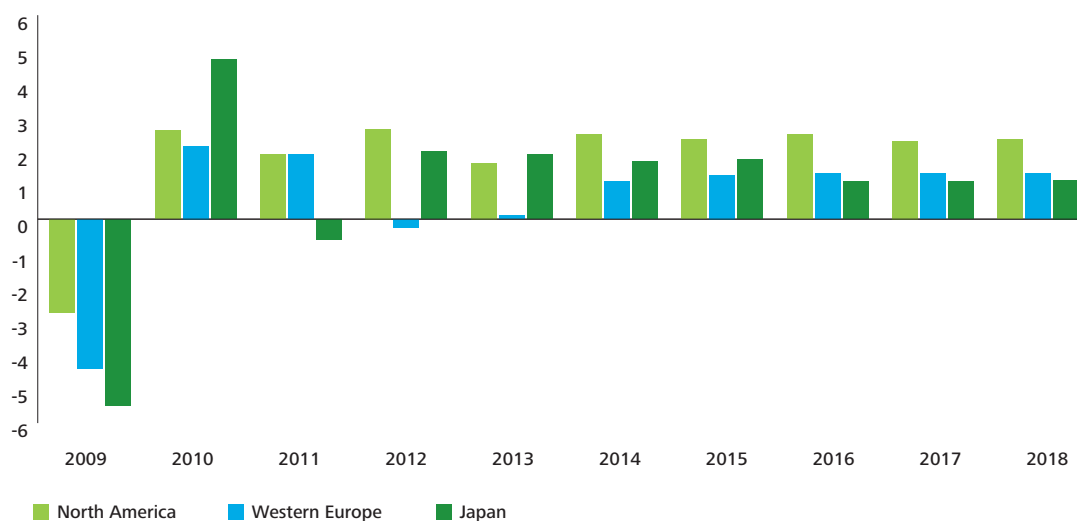
## The macroeconomic picture

As industry players know, the global economy plays a crucial role in commodity supply and demand dynamics. That explains why companies are paying close attention to global economic trends.

According to the Economist Intelligence Unit, global GDP is forecast to grow at 3.6% in 2014, its best showing since 2011.<sup>1</sup> In fact, the U.S., the Eurozone and Japan are set to experience their first synchronized upturn since 2010. As the three biggest importers in the world, an improvement in these economies may spark positive global growth.

Yet, while advanced economies are slowly recovering, emerging markets have not fared so well. While long-term fundamentals remain attractive, many of these countries sustained significant currency losses and are plagued with ongoing structural challenges.

Figure 1. Improving economic outlook for advanced economies (YoY change in real GDP, %)



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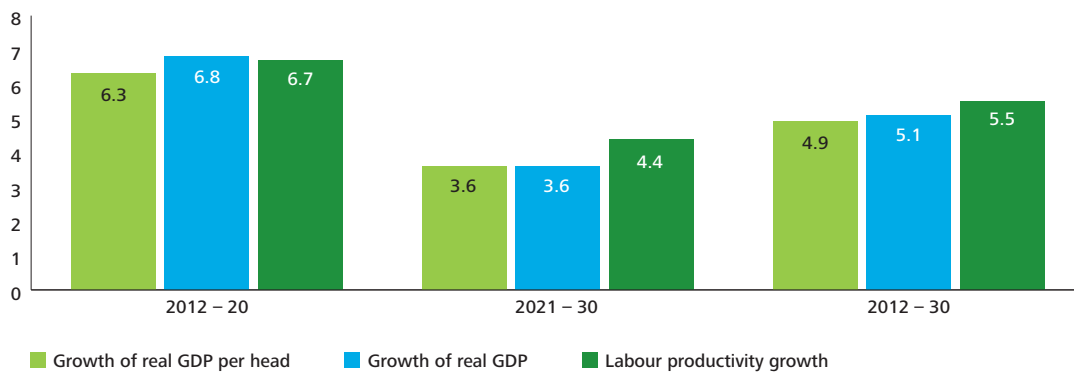
### The China constant

Of course, China remains the economy that everyone is watching most closely. In 2013, the country's GDP growth slowed to 7.7%, down from its double-digit growth rates at the height of the mining boom. Structural cracks are also appearing across the economy, ranging from industrial overcapacity, an over-reliance on investment, excessive credit and diminishing export competitiveness to fault lines in China's labor market.

To counter these weaknesses, China is transitioning away from investment-driven growth towards a more sustainable growth rate based on domestic consumption. As a result, demand for commodities used in construction (e.g., iron ore, met coal) is falling off, while demand for commodities used in power generation and distribution (e.g., natural gas, copper) is rising. In light of these shifts, the U.S. Federal Reserve estimates that China's economic growth could slow to 6.5% by 2030.<sup>2</sup>

Yet, while this may be slower than traditional growth rates, it is by no means insignificant. As China's middle class continues to burgeon – and similar trends sweep across Asia – absolute demand levels for commodities are set to rise over the long-term.

Figure 2. Long-run economic growth indicators for China



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### Which begs the question: where will China source its commodities?

In an attempt to bolster domestic production, China's government is already funding aluminium production, pushing the country's aluminium costs down to a level that other producers can't match. Higher domestic production of commodities such as gold and coal could also ultimately enable China to reduce its out-sized reliance on global imports.

As of yet, however, China has not been able to produce the level of commodities it requires to maintain its growth. The key for global miners will be to balance China's current demand against the potential for a future fall-off in demand should the country become more self-sufficient and/or continue its practice of subsidizing domestic production at margins that are unfeasible for global competitors.

2. Board of Governors of the Federal Reserve System. International Finance Discussion Papers, #1072. "Challenges for the Future of Chinese Economic Growth," January 2013, by Jane Haltmaier

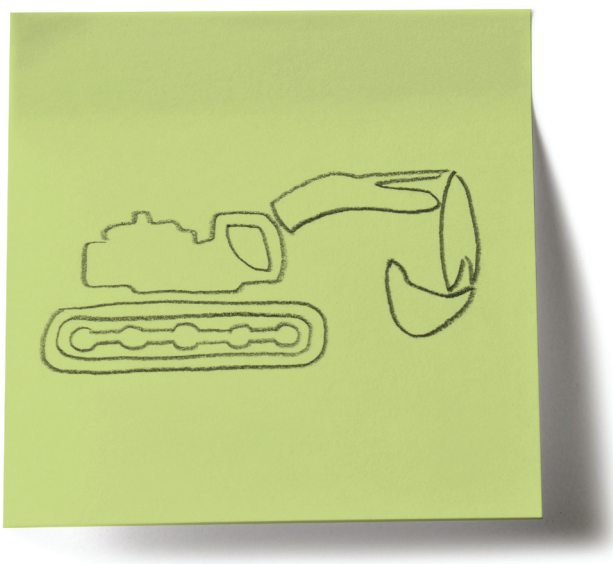
# Commodity market impacts

With the global economic recovery still in its infancy, it's too early to expect a major demand-side uplift for industrial metals. Instead, supply side factors will likely exert the biggest influences on commodity prices. Most industrial metals and bulk commodities are either finely balanced, heading into surplus or already deep in surplus. Absent a major supply disruption or an unexpected positive demand shock, excess supply is likely to cap near-term commodity price growth.

Although there are a few exceptions, the start of 2014 saw commodity prices continuing their downward trend. Both nickel and aluminium are in structural oversupply, with copper also now swinging into surplus. Gold and silver also continue their severe declines. For its part, iron ore's decline has been partially offset by ongoing Chinese demand, although a flood of new supply into the market will likely exert downward price pressure.

Coal producers also continue to struggle. With Queensland met coal production returning to full capacity and the U.S. shale gas boom diverting U.S. coal to seaborne markets, the met coal market is in a global supply glut. Thermal coal is also suffering from challenging fundamentals. While 450 GW of new coal generation is expected to come on line in the next five years, the long-term prognosis for coal remains shaky.

The only commodities currently bucking the trends are zinc, which is moving into deficit; tin, whose resurgence is being fueled by new uses for the metal; and platinum, which is also approaching a deficit but remains plagued by structural challenges.



# Strategies that buck the trend

While mining companies cannot hope to consistently predict commodity demand or price movements, there are some strategies they can use to manage market volatility:

## **Strengthen portfolio management**

Traditional portfolio valuation tools largely focus on past valuations. While this provides insight into historical price movements, it often fails to uncover longer-term strategic advantages. To shift this equation, mining companies can:

- Leverage synergies across their portfolios to ensure they remain robust in various market scenarios.
- Inform investment decisions by matching supply to the demand forecasts of particular commodities.
- Gear portfolios towards the growth areas of the future.

## **Link value to price**

Many mining companies have strong projects whose value is not reflected in their stock price. An audit review can help companies recognize full asset values on their balance sheets to solve the disconnect between value and price.

## **Integrate**

To generate greater end-value and better control prices:

- Large diversified majors can more fully integrate their production and trading operations.
- Mid-tier operators can achieve similar advantages through strategic joint ventures and consolidation.

## **Become more disciplined**

In coming years, resource-intensive economies will need to learn to adjust to a sustainably lower Chinese economic growth rate and to a less commodity-intensive global economic growth cycle. To prepare, mining companies can:

- Focus more actively on productivity, cost management and supply discipline.
- Cut production, slow or delay expansion projects, and/or close marginal operations.
- Prioritize shareholder returns and productivity improvement over capital expansion.
- Improve productivity through supply chain management, working capital management and better contractor management.
- Restructure mine portfolios to favor higher-return, lower-cost assets.
- Use mine sequencing to optimize mine sites.

# How Deloitte can help

For more information, please contact a Deloitte mining professional: [www.deloitte.com/mining](http://www.deloitte.com/mining)

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