TRENDS AND OBSERVATIONS

No resources bubble

BY RAUNO PERTTU

I was recently told that someone who reads my column wanted to know if we are in a resources price bubble. I froze at, "Someone who reads my column?" After the shock wore off, I considered the question. It's a complex issue, but the short answer is "No." If anything, we're likely in a resources dip before another rise, at least in U.S. dollars, if not in some other currencies. This may not sound like an interesting topic, but the resources question is tied into bigger issues that will affect even us Applegaters, so I'll try to summarize some of the key elements at play. Much of the following is probably old information to you, but the summary is important to explain my answer.

For many years, metals, industrial minerals and, to some extent, energy were in a price slump. This slump was partly the result of third world countries, particularly China, selling their mineral resources at any price to North America and Europe to obtain money to fund their internal industrial development. Another contributor to the minerals glut was the collapse of communism and the opening of vast new areas for exploration and development. The former state-run minerals companies had been very ineffective and inefficient at minerals discovery and development. With the collapse, western companies swarmed into newly open countries with exotic names and made new discoveries that were fast-tracked to production.

By 2002, the resources market was beginning to change. China's internal industrialization was consuming more and more of its own raw resources that it had been selling to other nations. It replaced exporting of raw minerals and metals with a growing flood of exported manufactured products. To feed its new factories, China was soon a major importer of raw resources from other countries. Industrialization in India and smaller Asian countries followed China's. Asia soon became a major resource consumer for the new factories that produced all the Costco and Wal-Mart goods they started selling to us at bargain prices.

China and its neighbors were soon awash in our money because, while they were replacing U.S. jobs with Asian jobs and selling us an exploding share of our purchased goods, we had much less to sell them in return. To put all those dollars to use, China surpassed Japan's earlier example and bought large quantities of our government securities, effectively buying our debt. Today, China is the largest foreign holder of U.S. securities.

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When the worldwide economic nosedive happened last year and foreign sales of its goods slowed, China began to create its own internal markets, in a move to hasten its economic expansion that will eventually surpass our economy. China worries about the value of all those US securities it still holds. Several Chinese officials have expressed concern that our announced major new spending for job creation and for new social programs could lead to devaluation of the dollar. Many analysts worldwide share that concern.

Outside of printing far more money or dramatically raising taxes, our ability to finance all of the newly announced programs is dependent on our ability to convince others to buy all the securities that will cover the cost of those programs. These are effectively IOU's on a grand scale. If people and countries are reluctant to buy the IOU's, the interest on the newly offered securities will have to be raised until willing buyers are found—resulting in inflation and devaluation of the dollar. In turn, the devaluing dollar becomes a less attractive investment, and even more incentives are needed to attract securities buyers, creating a potential devaluation spiral.

We are looking at China to buy many of these new IOU's. However, rather than expanding new purchases of our securities, China appears to be looking for safer ways to maintain the value represented in the securities it already owns.

One way it appears to be hedging its bets is by using those securities to buy mineral and energy resources, including both unmined deposits and refined metal, which China appears to believe will maintain higher value than the dollar. These resource inventories will serve the additional benefit of guaranteeing continuing supplies for China's factories. India is pursuing a similar strategy. China continues on an international resource buying spree that has helped to support and even to increase the prices of various commodities in the middle of the worldwide economic downturn.

Other intertwined factors that will also continue to strengthen resource prices are the depletion of higher profit margin ore deposits and increasing demand from growing populations and economies.

To be clear, we are in no near-term danger of "running out" of resources. The concerns that we will soon run out of this or that commodity are based on misconceptions. Most minerals are currently produced from ore bodies. An ore body is a concentration of metals or minerals at a high enough recoverable grade and volume to be economically extractable. Advancing technology keeps allowing new methods of economic extraction, and increasing commodity demand and prices redefine new ore bodies. As the currently richest ore bodies are mined, mineral concentrations that were previously too small or low grade become economically minable.

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The rate at which resources can be produced to meet demand is critical to price. As the world economy begins to recover, and demand again accelerates, resource prices will again begin to rise.

I'll mention one additional factor in resource prices—government regulation. Part of the cost of mining must be the cost of reclamation and environmental protection. As mines become bigger and lower grade, and as regulations get more stringent, mining mitigation costs are rapidly increasing. These costs have to be passed on to the cost of the sold minerals. Additionally, the number and size of areas that are closed to mining are increasing, limiting new development. Further, in the past few years, a number of countries in search of additional revenue have passed new tax structures and regulations that would make mining economically difficult, resulting in an unintentional mining freeze in those countries, further limiting new areas for production and development.

The factors I discussed above are some of the reasons why I believe that resource prices are actually in a dip on an overall up-slope, rather than in a bubble. As the world economy recovers, probably in conjunction with a devaluing dollar, we can expect price inflation that will in turn slow the economic recovery. In a worst case scenario (to which I don't subscribe), we could revisit the high interest rates and high unemployment that we older coots saw in the late 1970's and early 1980's—or worse. As for my reader who asked the question—Thank you! Reading these may be a lonely job, but I'm glad you're willing to tackle it.

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