Resource Stocks Star in Next Leg of Market Advance

Students of the market know that asset prices are cyclical and governed by heuristics (animal spirits) and the phases of the liquidity cycle. Typically, cash performs, then bonds, stocks and finally commodities and emerging stock markets before resetting.

It appears the economic cycle is playing out broadly as expected and developed stockmarkets are performing in accord with the liquidity cycle.

Just to recount, the current bull market got started when global economies and stock markets troughed in crisis in March quarter 2009. Seeds for the 'early bull' market in both bonds and equities, germinated, fuelled by QE-engineered liquidity and repairing investor sentiment. Financial stocks, here and in the US, started to revive, technology names moved higher and large cap equities began to find support.

The period between the third quarter 2014 and December quarter 2016 marked the markets 'middle bull' stage. Disguised as a hidebound period for US equities, it was in fact a massive consolidation or re-energising event for the market that yielded in December 2016, with the market shifting into its 'late bull' stage.

The US 10 year bond rate bottomed at 1.36% in June 2016 and this turning point had ramifications for equity sectoral positioning and meant new stock leadership. Investors shouldn't underplay the significance of this event.

Simply put, weaker bond markets (higher rates) tend to be positive for liquidity flows into physical commodities and resource equities. Typically this happens late in the equity market advance.

More broadly, rising rate momentum is positive for cyclical sectors. Witness the strong rallies from basic industrials, Bluescope, and Sims Metal and most mining service company names in recent times.

It is no coincidence that the bond market watershed aligns nicely with synchronizing global growth. Since mid 2016 global purchasing manager indices, or PMI's, have been registering expansionary settings across the globe albeit cooling a little of late.

Commodity demand has strengthened since this time but the supply-side has been piecemeal in its recovery, following 4 years of mining sector privation and disinvestment. Among base metals, copper demand/supply is finely balanced, aluminium is enjoying cost support via high alumina prices and Nickel has moved into a deficit market setting. Zinc continues to enjoy the positive effects of low exchange inventories and strong consumption.

Despite significant production expansions, the market for 62% grade iron ore remains well bid by Chinese steel mills. The real star of late has been oil, rallying largely on OPEC/Russian production cuts and the restoration of global crude inventories to levels closer to historical averages.

I couldn't help but notice a recent presentation from US-based investor DoubleLine Capital. They highlight that since the global financial crisis peak in early 2008, the price of commodities relative to equities has declined by more than 75%. Relative to the S&P 500, commodities are approaching a 50 year low. This depressed level broadly lines up with commodities relative appeal last sighted near the top of the dot.com blow-off in March 2000.

For the Australian stock market the recent hard commodity price impulse has resulted in analyst commodity assumptions falling modestly behind spot and future pricing in copper and iron ore but appreciably behind in the case of nickel, oil and thermal coal. This means earnings upgrades are in the offing and as a consequence higher share prices.

What will be the duration of the current commodity upswing? This time around it feels like loss of economic momentum rather than underlying commodity fundamentals will be the trigger for eventual commodity weakness. The US yield curve (US 10 Year bonds less 90 day bills) is regarded as a lead indicator of economic expansion or recession. It has been flattening at pace since December 2016 and, although still positive, will be an important portend for investors when it inverts, signalling recession henceforth 5-9 quarters.

You can be sure I will be alert to announcements that major mining assets are starting to change hands . Significant transactions are a fail-safe indicator that resource markets are in a topping or bottoming phase. Not many have forgotten Barrick Gold's $7bn bid for Equinox or Rio's $4bn Riversdale coal folly towards the resource market zenith in 2011. Are US gas market lows about to be confirmed by BHP's pending US onshore gas assets divestment?

We seem to be a long way from the manic behavior of 2011 but not so far from the 2016 bottoming in interest rate markets. Consensus commodity assumptions are lagging the market, base metal supply/demand equations are tightening and investors domestically and globally seem apathetic towards the revival presently unfolding,