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First State Investments

# a three speed global economy

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**Dr Joanne Warner reassesses the main issues impacting the outlook for the global resources sector.**

Following very strong performance in 2009, global resources have been more subdued in 2010 as investors have focused on concerns about the strength of the global recovery. Commodity prices have recently been under pressure and share prices have fallen back as worries about a sovereign debt crisis in the eurozone unsettled markets. The introduction of a new tax on mining companies in Australia also dented confidence in the sector.

## economic backdrop

We believe that a three-speed global economy has emerged, led by strong growth in Asia and other emerging economies. The US and Japan have surprised on the upside in terms of economic growth, led by manufacturing in the US and Japanese exports to Asia. However, the UK and Europe have lagged and we anticipate that they will continue to record anaemic growth due to fiscal retrenchment measures to reduce government debt and the tighter credit conditions which this is likely to bring.

Chinese economic growth continues to be buoyant. In the long term, it will be driven by urbanisation and infrastructure investment. The recent investment in infrastructure (roads, railways, property) which is now moving into research and development has both a short-term positive growth impact, and also drives long-term growth by raising productivity, increasing productive capacity and stimulating domestic demand through lifting income levels and improving the competitiveness of the Chinese economy.

Policy tightening continues to be the main risk to the global outlook, particularly in the emerging economies. Expectations of further tightening in China are high with a third increase in the reserve requirement ratio (RRR) occurring in early May. Higher official interest rates and a possible revaluation of the Yuan are widely anticipated. China continues to tighten policy at the micro level through curbs on property speculation and also plans to close out-dated production capacity in power and steel. Greater emphasis on occupational health and safety at coal mines has resulted in closures and consolidation within the industry.

## Australian super profit tax

At the beginning of May the resources market was impacted by the announcement of a new Resources Super Profits Tax (RSPT) in Australia. It is proposed that the tax will be introduced on 1 July 2012 after a period of public consultation and approval in the Australian Senate. At the same time, the corporate tax rate will be reduced from 30% to 28%, an exploration rebate will be

introduced and further assistance given to small mining companies.

The announcement of the tax has provoked a vigorous debate among mining companies, economists and the Australian Federal Government. There seems general agreement that the shift from a State-based royalties system to a Commonwealth-based tax framework is a move towards a more efficient taxation system.

However, some resource companies have argued that the proposed RSPT will lead to lower investment in Australia and fewer mine expansions. Some companies have placed investment plans on hold in light of the proposed tax and highlighted increased difficulty in raising finance to complete projects. They argue that if investment plans do not occur it would be negative for the Australian economy and future jobs. We expect continued uncertainty as the RSPT is publicly debated and as this bill is passed through the Senate. To further complicate things, an Australian federal election must also be held within the next 12 months with the RSPT likely to be a point of differentiation between Australia's two main political parties.

The Australian tax controversy highlights a clear risk for the resources sector as governments step in to take a larger cut of profits made during a period of high commodity prices. India recently announced it would lift export duties on lump iron ore from 10% to 15% in an attempt to discourage export of the commodity. Chile has also temporarily lifted corporate tax and royalty rates for copper miners to help pay for the recent earthquake damage in the country. This could be a significant theme in other resource-producing countries in the future as they attempt to recoup additional revenue and benefit from the resources boom.

## outlook and strategy

During the year, mining and energy companies have announced large exploration and investment programmes to expand production. We anticipate that cost pressures are likely to emerge as demand for labour and materials escalates and, as was the case in 2007, a slowdown in supply increases could lengthen the investment cycle. This raises execution risk for new projects as companies compete for materials and skilled labour, and could result in disappointment on production coming online.

Mergers and Acquisition (M&A) activity continues to be a feature in the sector. Newcrest Mining made a bid for Lihir Gold in April which the board of Lihir accepted in early May. M&A activity has been driven by higher commodity prices, stronger balance sheets and attractive valuations.

Global resources is a higher risk, higher return asset class than others. The higher risk nature of resource investments is why we have adopted a conservative investment approach by focusing on investing in world-class, low-cost companies with production growth and proven management. The First State Global Resources Fund is a good diversifier given its low correlation to other asset classes and has shown the potential to make strong investment returns over the cycle.

We have always emphasised the need to invest in quality companies at the low end of the cost curve. We continue to monitor the balance sheets of companies and stress test their ability to meet financing obligations at lower commodity prices. The portfolio remains invested in large cap companies with strong balance sheets and cash generating abilities. We have selectively retained and built positions in some higher growth, smaller companies where they have addressed balance sheet risk.

We maintain our investment philosophy of not speculating on the direction of commodity prices. Rather we maintain our focus on quality companies which are able to deliver growth at relatively low cash costs. We believe this will deliver excess returns over the full commodity price cycle.

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**The First State Global Resources Fund is available through the Skandia Investment Solutions platform and Skandia's Life and Pensions fund ranges.**

The performance of the Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process. Past performance is not a guide to future performance.