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## Oil and Iron Ore Will Soon Uncouple

It has been a horror 18 months for commodities of all stripes and types. Iron ore, coal, copper and oil are all trading at fractions of their highs a few years ago. Share prices have fallen more than the underlying commodity prices and many smaller, high-cost producers are either already broke or soon to be.

The culprit is easy to identify: China's slowing economy. For investors, however, the task is to look forward, not back. Should we be buying beaten-down miners in anticipation of a recovery?

Our answer depends on the commodity. Oil markets will almost certainly recover over the next few years. Iron ore could be in for a 20-year bear market.

The reason is that the supply and demand dynamics vary wildly.

First, demand for oil is a lot more resilient and less dependent on China's construction binge than is demand for iron ore. Oil consumption has roughly tracked GDP growth and, even in a global recession, the amount of oil consumed falls a few percentage points at most.

More than half the world's consumption of iron ore is accounted for by China and China's demand is, in turn, dependent on its lopsided, credit-funded infrastructure-dependent growth model. While the market is now anticipating much slower growth in China's demand for iron ore, I don't see any reason it couldn't fall significantly. After all, zero growth would mean building the same amount of ghost cities, railway lines and airports as last year, adding more excess capacity to a market already drowning in it.

Demand for oil is more robust and less volatile than that for iron ore.

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Second, the long-term price for oil clearly needs to be higher than today's level of \$US44 a barrel. The price of any commodity will eventually trade at a level that encourages new investment. For oil, it's pretty clear that this incentive price is above the current price. Capital expenditure plans have been slashed by 25 per cent this year and the spending is expected to fall another 10 per cent in 2016, according to Norwegian broker Pareto Securities. The market is sending a very clear signal that it doesn't make sense to commit capital at today's oil price. I don't know if the "right" price for a balanced market is \$US75, \$US85 or \$US100, but it's clearly higher than the current level.

That's not necessarily the case for iron ore. Sure, the high-cost players are bleeding red ink at today's prices but they are minnows. The big players, Rio Tinto, BHP Billiton and Vale, are still making excellent returns on capital. BHP Billiton has \$US24 billion of assets in its iron ore division and, in the last financial year, generated almost \$US7 billion of profit from those assets, a return on capital of 29 per cent. The company would still be making good money at prices well south of \$US40 per tonne.

Finally, even if the long-term price for iron ore was above today's levels, it could take decades to clear the current market oversupply.

Iron ore projects are generally long life. Once you have built the infrastructure, iron ore projects can last for decades and mine owners can keep digging up dirt without committing significant

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new capital. The adjustment required for supply to meet demand can take a very long time. Consultancy WoodMackenzie reckons "there is no requirement to incentivise additional supply [in the iron market] prior to 2030".

In the oil market, on the other hand, equilibrium is reached reasonably quickly. In the absence of new projects or expansions the amount of oil produced every year would decline by an estimated 7 per cent a year. The rate at which oil gushes from a well declines from the day it starts to flow (this is because the oil is forced out by pressure and pressure falls as the well empties). These decline rates are particularly pronounced in US shale production, the largest source of global supply growth over the past decade.

So, while the price is flashing red to anyone thinking of allocating capital to the space, it is going to have to flash green within the next few years or the current glut is very quickly going to turn to a shortage.

Cycles in oil can be brutal, but the market returns to equilibrium relatively quickly. In iron ore, we might not see balance for decades. While the price of these two important commodities have tracked each other over the last year or so, they won't be joined at the hip for long.

*This article was first published in Smart Investor in the Australian Financial Review as [Why oil is set to outshine iron ore](#).*