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Base metals to shine

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Summary: An expected pick-up in industrial production this year, particularly across Asia, will increase demand for the base metals needed as the core feeder fuels for manufacturing. Don't expect a boom, but there will be steady upward momentum over time.

Key take-out: Getting exposure can be as easy as investing in the major mining stocks with the largest base metals operations, but other entry points with potentially bigger upside are small mining stocks with operations focused on copper, nickel, aluminium, lead and zinc.

Key beneficiaries: General investors. **Category:** Shares.

Recommendations:
Hot Chili: Outperform
Rex Minerals: Outperform
Sirius Resources: Outperform
Ironbark Zinc: Outperform

If 'resources are ready for a rebound' then where does an investor turn? The short answer is lead, zinc, copper and nickel in that order. A shorter answer still is BHP…one of the world's greatest miners is trading at very attractive levels just now.

Of course *Eureka Report* readers may well have surmised as much already, that's why today I'm pinpointing four lesser known companies (see below) that I believe can ride the rebound ... it goes without saying they're riskier than BHP, it also goes without saying that they carry the possibility of exceptional returns in the year ahead.

What of iron ore or gold, I hear you ask? Apologies, for now iron ore is still too hot, and gold is too cold which, in what might be called a "Goldilocks" market, that's why my call for 2014 is 'base metals' the formal description for aluminium, copper, lead, nickel and zinc.

A pre-Christmas rise in the price of most base metals was an early hint that improvement in the global economy will drive increased demand for industrial metals, which might not be sexy but which are essential building blocks for manufacturing industries.

As for iron ore, a long-overdue reminder of what goes up must come down, was delivered on Friday (January 10) when some of the big names in that space dropped by an alarming 10% and more.

Gold crept higher on news of a slowdown in US job creation but it will have another tough 12-months as the global economy "normalises", US interest rates rise, and the central-bank money printing is phased out.

Changes in the mining market also created an opening late on Friday for the first "base metal surprise of 2014" when the nickel price jumped by 3% to $US3.32 a pound as speculation grew that Indonesia will enforce an export ban on unprocessed ore, though whether such a move will have long-term consequences is uncertain.

The move has since been confirmed though the exact details of the plan are unclear – for the moment all we know is that Indonesia intends to ban the export of unprocessesed resources. As the world's biggest nickel producer and a key producer of bauxite for aluminium the news can only be useful for Australian and other offshore producers.

The nickel event, which included reports of 10 Chinese ships being refused the right to sail from Indonesian ports with cargoes of low-grade ore, could be a precursor to other developments which we will follow closely in the months ahead.

The metals wheel turns

For investors, the metal-wheel is turning full circle to re-connect with base metals. But it would be wise to not expect a “gold-like” boom. The upward trend is likely to be more of a slow grind, with plenty of time adjust over the next few months ahead of a stronger second half as the pace of industrial production picks up in the major manufacturing centres of Asia.

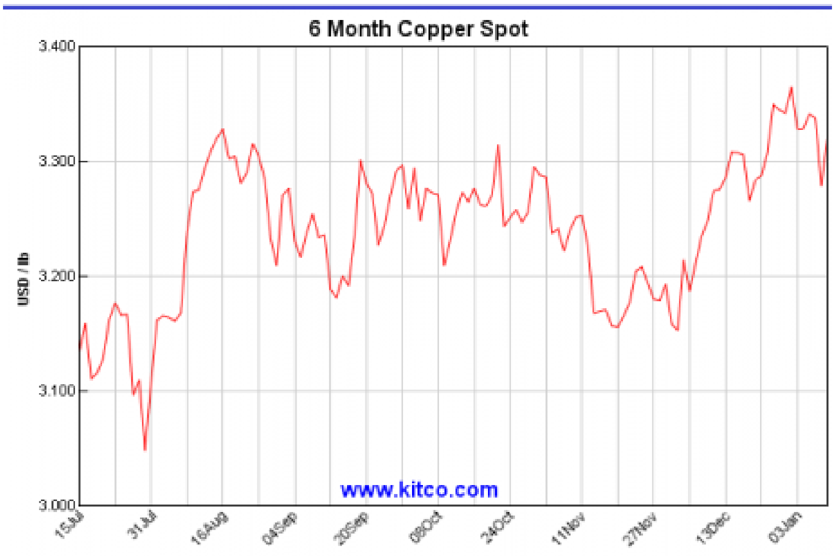
In effect, copper, nickel, lead and zinc win the title of most likely to succeed in 2014 because other metals are likely to underperform. Even aluminium, the sickest of all base metals over the past few years, might finally start to stir.

The lazy but perfectly acceptable way to play the start of the recovery in base metals after several lacklustre years is to stick with the big diversified miners such as BHP Billiton and Rio Tinto.

A more exciting, and risky, approach is to look for small players in the base metal space, which should enjoy an outsized benefit from a steady rise in price because either (a) they have a new and low-cost project on their books, or (b) they’re a prime takeover target for a bigger miner looking for easy pickings.

Such a strategy means looking at smaller stocks, with my picks of the emerging players in the base metal space being:

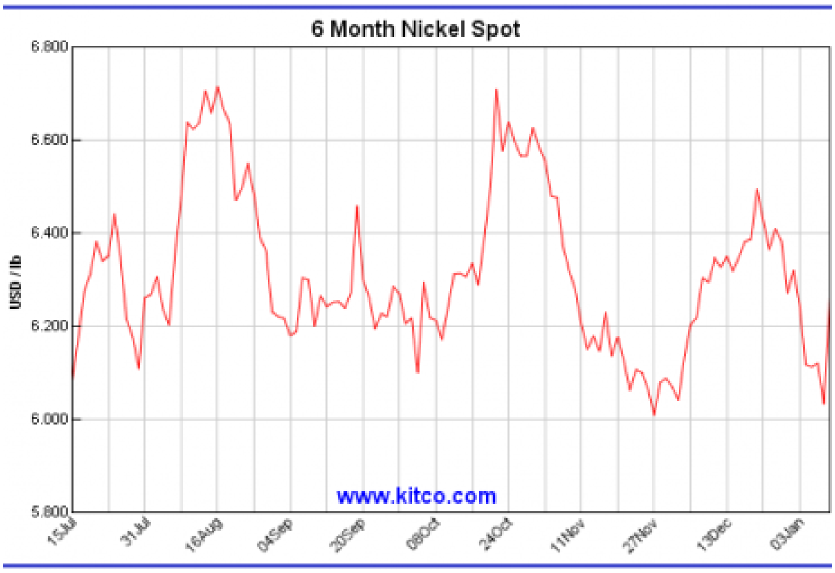
1. Copper: This is a toss-up between two stocks I have mentioned in the past: Hot Chili (HCH) and Rex (RXM). Both have emerging projects which would look better in the hands of a big miner, making them susceptible to takeover raids. Hot Chili is making solid progress with its Productora project in Chile, and expects to soon lodge a resource upgrade and details of an infrastructure-sharing agreement with that country’s biggest iron ore producer, CMP. Rex is also getting closer to a development decision on its Hillside project in South Australia, with Korean and Chinese companies competing for the right to build and/or partner Rex in the development. On balance I lean towards Hot Chili because it is in a major copper producing region and will appeal to North American investors. The last time I looked at Hot Chili was on October 23 last year [1] when it closed at 48.5c and the copper price was $US3.25 a pound. The stock has since slipped to 42c, while the copper price has moved up to $US3.30/lb.



[2]

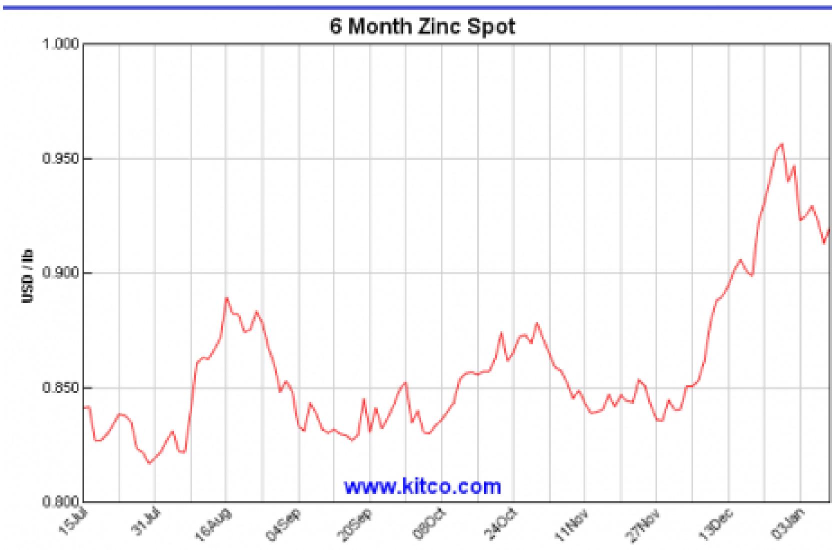
2. Nickel: The easy entry points are the existing producers such as Mincor, Western Areas or Independence, but my favoured stock is Sirius (SIR), which was the subject of a detailed pre-Christmas look (*Sirius worth a serious look* *[3]*, December 18) when the stock was trading at around $2.02. Since then it has crept up to $2.12

but should enjoy a fruitful year as exploration continues at its high-grade and potentially low-cost Nova discovery east of Kalgoorlie and plans are finalised for a fast start on mining, and interest in nickel is stimulated by events in Indonesia.



[4]

3. Zinc: As was mentioned several times last year, zinc is a metal overdue for a big recovery thanks to the planned closure of several world class mines over the next few years (*Stirring in the zinc pot* *[5]*, November 22). Entry points for Australian investors interested in producers rather than explorers have largely dried up, but there are a number of quality exploration stocks worth following. These include Ironbark (IBG), which has its foot on the world-class Citronen zinc deposit in Greenland, and Triausmin (TRO), which is redeveloping the Woodlawn project in New South Wales. On balance, Ironbark is the stock to follow because it is a plum takeover target with a project that is far too big for its balance sheet, and with two big zinc specialists (Glencore and Nyrstar) dominating its share register. At some point one of the major zinc producers will make a move on Ironbark, or help fund development of the Citronen project.



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The hottest metals spots

On the metals market, the two commodities likely to perform best in 2014 are lead and zinc. The prospects for zinc are a classic supply/demand squeeze, with years of surplus giving way to years of deficit. The latest zinc price forecasts point to a rise from around the current US92c a pound to $US1.08/lb by next year, and then up to around $US1.13/lb.

Lead, often mined in association with zinc and silver, has an even more promising supply/demand outlook. A period of surplus production is giving way to a modest deficit this year, which will start to absorb stockpiled material. This should help the lead price rise from its current US95c/lb to around $US1.13/lb this year, and then up to $US1.25/lb in 2016.

[7]

Copper, the bellwether metal and oft-mentioned predictor of economic trends, is also likely to incur a deficit in supply from freshly-mined material this year (with scrap making up the shortfall). But new mines will plug the gap from next year, with the overall result being a steady price not far off its current $US3.30/lb for several years.

Investment banks are warming to the idea of a mining sector revival in 2014, with widespread cost-cutting and project deferrals introducing the potential for supply shortfalls being the price driver.

Offsetting the supply effect will be the need to work through stockpiled material and the potential for rising interest rates, particularly in the US having a deadening effect on demand.

On balance the trend is for steady improvement, with the key measure being global industrial production. This is expected to rise from last year's anaemic 1.7% to 3.6%, with that recovery boosting confidence and effectively ensuring that gold should be off the investment agenda for at least another year.

Greater price stability

J.P. Morgan Cazenove, the London arm of the New York bank, told clients last week (January 8) that "base metals will be more stable" in 2014 than the bulk materials such as iron ore and coal.

"Copper remains our preferred exposure," J.P. Morgan Cazenove said, with current prices to persist into the next decade.

Like several other investment banks, the advice from J.P. Morgan Cazenove is to focus at this stage of the recovery on the major diversified miners such as BHP Billiton, Rio Tinto, Glencore and Anglo American.

The problem with that advice is that it's too easy, with none of the big diversified stocks likely to show any signs of market outperformance because the nature of their widespread portfolios tends to smooth out mineral price moves.

Credit Suisse is on the same page as J.P. Morgan Cazenove in terms of the general thesis that 2014 will be the year of base metals, also telling clients last week (January 6) that in terms of overall commodity prices there is "light at the end of the tunnel".

The core Credit Suisse argument is that pricing pressure on commodities is easing, with "average" global economic expansion of around 3.5% correlating to "broadly flat commodity prices over the medium term".

Over the course of 2014 Credit Suisse expects a year in two halves, with the first six months relatively flat and the second half being a period of healthier growth.

"Looking into the second half (of 2014) the outlook becomes more positive," Credit Suisse said. "We expect healthier growth to underpin demand, with the risks beginning to move to the upside for a number of industrial commodities."

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