Aluminum Foils Nothing

"There are two words I never want you to use. One is lousy and the other is swell." -- Professor
"What are they?" -- Student

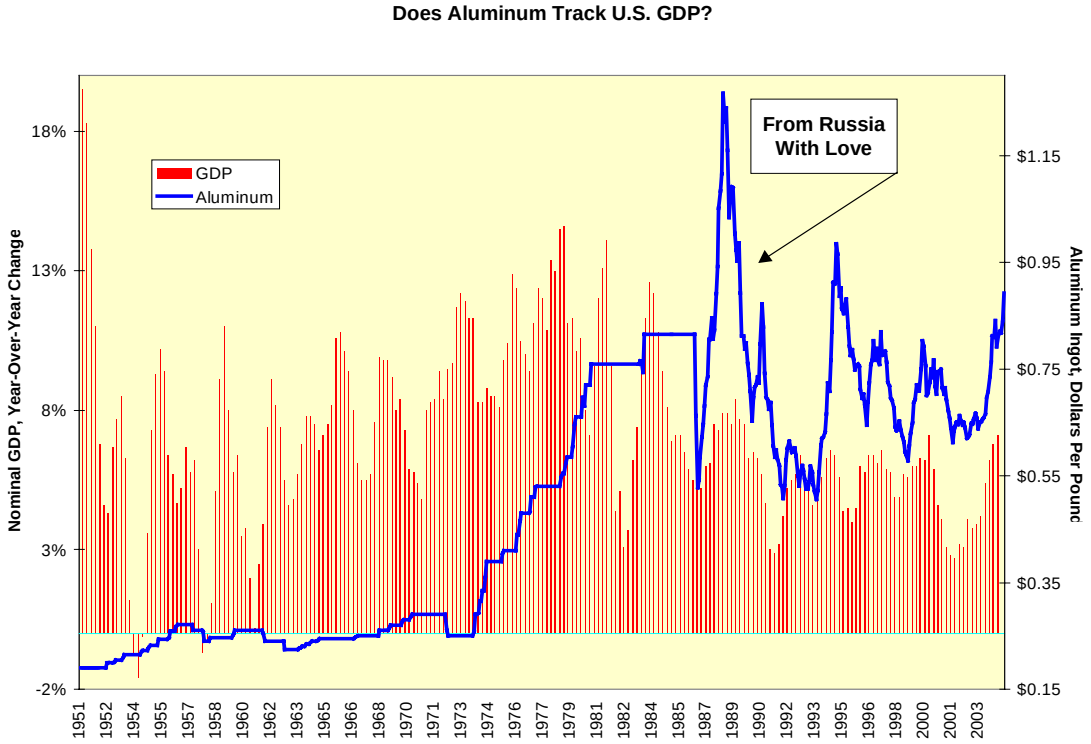
Hang around Wall Street long enough, either literally or figuratively, and the three little words you should really want to hear are "I don't know." That would solve a lot of problems, including much of the effluvium poured out last Wednesday when the world's metals markets got bent, both literally and figuratively.

The logic - and I do use that term with unnecessary generosity - ran along the following path:

1. Chinese imports of various industrial metals, copper and aluminum in particular, slowed.
2. A number of large sell order hit various commodity markets, including those with dubious reputations for regulatory probity, knocking prices down
3. The lower prices must be signaling an impending collapse in Chinese demand, and by extension world economic growth, so
4. Better go sell firms like Alcoa right now

There are a number of testable propositions embedded above. I have written several times over the years that base metals are excellent *short-term* macroeconomic indicators, and I continue to believe that is true for the important reason they are - or perhaps more properly stated, have been - largely devoid of speculative content. But I also have emphasized that commodity-linked equities are a poor way to play the underlying commodity. Trading a stock such as Alcoa on the basis of one-day gyrations in aluminum prices presumes a level of both causality and correlation that cannot be demonstrated over any length of time.

Economic Cycles, Aluminum Recycles
While aluminum may be a short-term economic barometer, it has almost no long-term connection with macroeconomic growth. We cannot take a long-term history of Chinese growth, as China's integration into the world economy still a work in progress and their economic history is impossible to measure reliably. We can, however, compare nominal aluminum prices to nominal GDP growth rates in the U.S.



Several features stand out on this chart. The first is the prolonged nominal price climb between 1974 and 1982, a period not remembered for strong real growth. The second is the price spike and subsequent collapse in the late 1980s and early 1990s. The collapse could be attributed to the fall of the Soviet Union. The Soviet military had large stockpiles of aluminum for usage in aircraft, and they dumped these supplies onto the world market in an effort to raise hard currency.

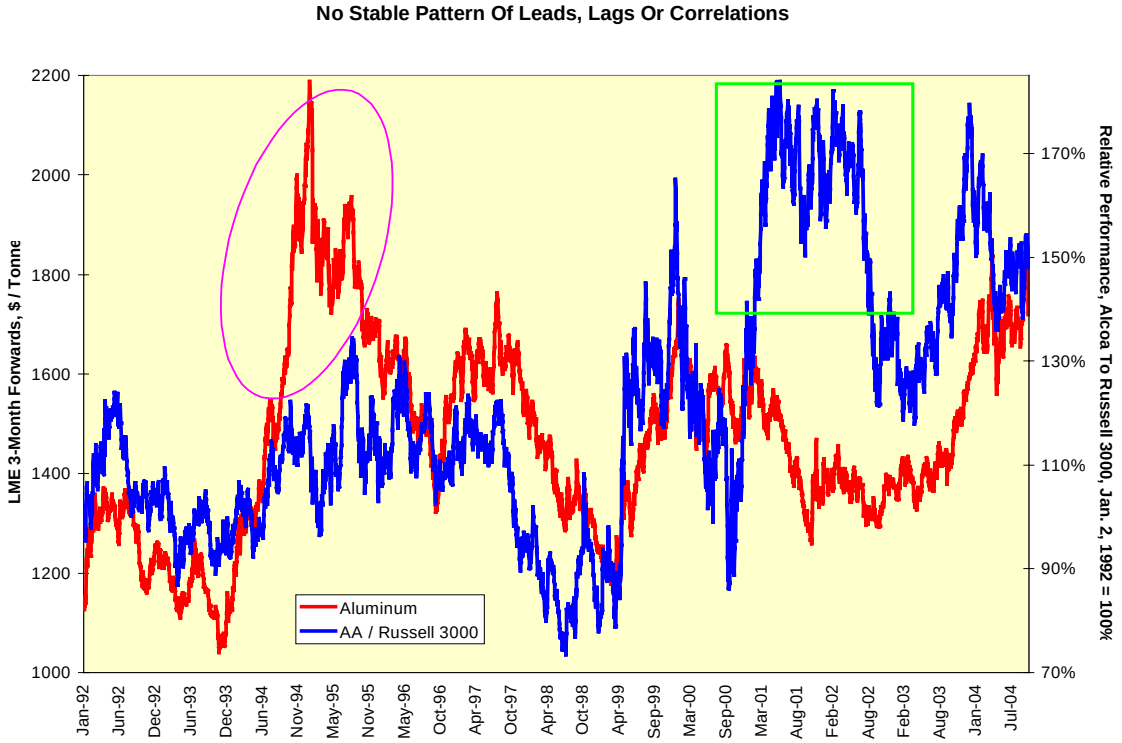
A worldwide aluminum pact was concluded in early 1994 between Canada, Russia, the European Community, the U.S., Australia, Canada and Norway. Paul O'Neill, then of Alcoa and President Bush's first Secretary of the Treasury (and quite possibly one of those "mistakes" he did not want to embarrass during the second debate) helped bring this agreement to fruition. Prices nearly doubled after the aluminum pact was established, which set the stage for another downturn in prices coincident to the Asian and Russian crises in 1997-1998.

None of these major changes in aluminum had any apparent effect on nominal U.S. GDP. The post-Soviet price collapse preceded the stable growth of the early 1990s, and the post-Asian crisis collapse preceded the late 1990s global boom. You cannot make any parallel statements about good times following any aluminum price increases, so maybe falling aluminum prices are not to be feared.

What About Alcoa And Aluminum?

Aluminum is a global industry whose economics are defined by either government controls over bauxite production or by proximity to and cost of hydroelectric power. In one of nature's many cruel jokes, aluminum is the fourth most common element in the earth's crust by weight, but it requires two different high-energy processes, smelting into alumina and electrolytic reduction into metallic aluminum, to become useful. These two factors help drive the operating margins for Alcoa and other smelters as much as the raw prices for final aluminum.

If we compare the relative performance of Alcoa to the Russell 3000 index to the price of three-month aluminum forwards on the London Metals Exchange, we cannot see a stable relationship. We certainly do not see the classic pattern for a primary commodity producer, one where the relative performance of the stock moves further and faster to the upside than it does to the downside and moves in advance of the commodity itself. Alcoa's relative performance is more akin to that of a margin processor, one that can prosper when the price of the commodity falls as well as when it rises.



Two periods are highlighted on the chart. The first, highlighted by the oval, is the aftermath of the aluminum production pact. Alcoa stock did not outperform the broad market in this period in correct realization that the high price was artificial. The second, highlighted with the square, occurred during the equity bear market in 2001-2002. Alcoa greatly outperformed the broad market in a period of slack aluminum prices. As noted above, neither period of divergence is consistent with the trading pattern of a primary commodity producer.

The most recent period, beginning in 2003, demands comment as well. Alcoa rose further and faster than did the price of aluminum into December 2003 - a commodity producer's pattern - and then retreated back to the broad market for all of 2004. It has been underperforming all year: Its 2004 total return through October 12th, the day before the big metals plunge, was -11.4% while LME three-month forwards were up 17.5% over the same period.

So, the moral of the story remains: Commodity-linked equities are a lousy way to play swell commodities. If you want to buy aluminum, buy aluminum, and do it for reasons unrelated to your opinion on GDP. And if you want to buy or sell aluminum, simply buy or sell aluminum, and do not take it out on Alcoa. You will be foiled again.