

Aluminum Miners Mirroring Price

Dante's *Divine Comedy* was written as a religious allegory and not as a comment on the distribution and ease of extraction of mineral resources, but the title certainly applies. How else could we explain the incredible rarity of the extremely useful platinum group metals, the overwhelming abundance of highly useful silicon, the location of much of the world's petroleum reserves in, um, inconvenient places and so on.

The Good Lord certainly had a sense of humor, and it was used for aluminum as well. The element itself is literally as common as clay as these minerals are composed of aluminosilicates, but the metal is bound so tightly to silicon and oxygen and requires so much energy to free you literally have to build aluminum plants on top of hydroelectric dams.

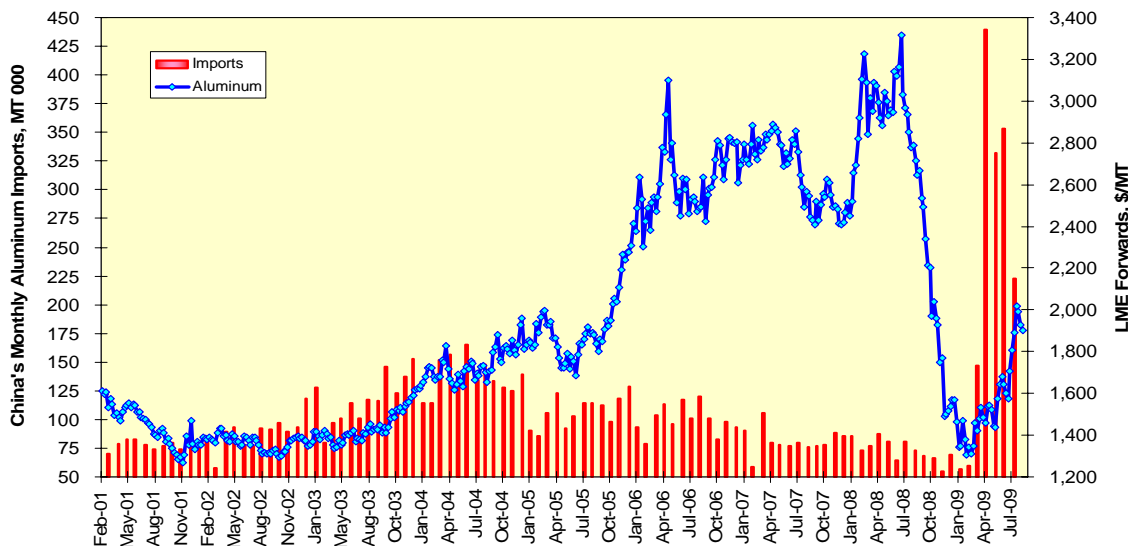
As I mentioned aluminum in a [Columnist Conversation](#) posting last Thursday in the context of Chinese imports thereof, I thought it might be useful to take a broader and deeper look at the topic.

Buy Me Some Aluminum

Bond futures veterans of the 1980s always could distinguish Japanese buying from anyone else's. While American bond buyers often traded gingerly in bull markets and especially when new highs for any move were being approached, the Japanese simply would plow through and scatter the timid in their wake. I asked a friend at a Japanese bank why this was so, and his reply was telling: "Some junior clerk gets a telex telling him to buy bond futures. So he just starts buying bond futures. Price is not his objective, getting the order filled is."

Look at the chart below of monthly Chinese aluminum imports and tell me the same phenomenon did not apply. Once the Chinese stimulus plan began, imports jumped from 56,000 metric tons in January to 440,000 metric tons in April. You can make a lot of beer cans with that.

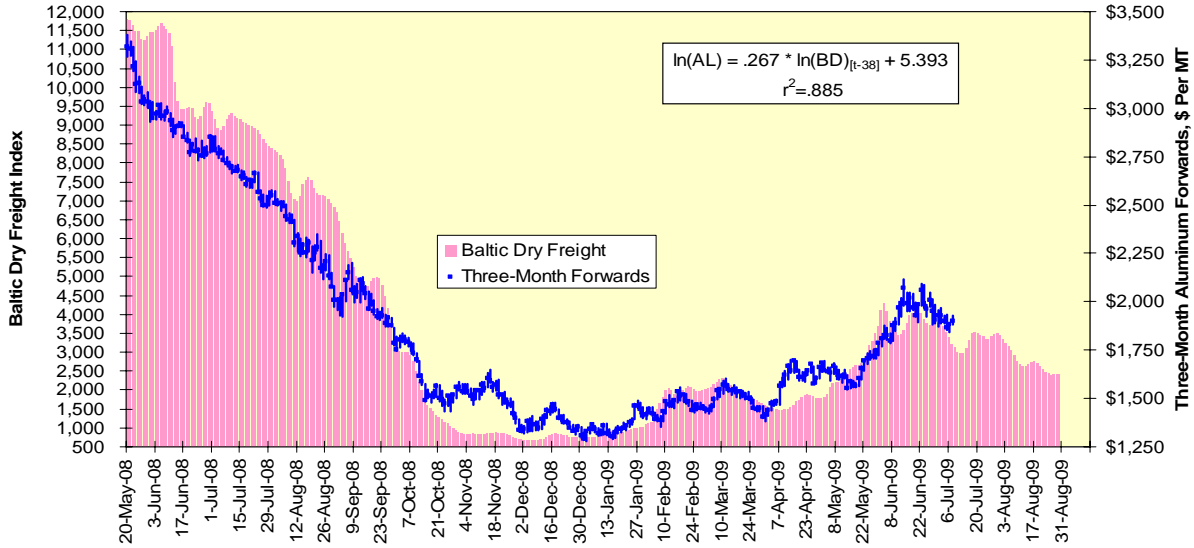
China's Imports And Aluminum Prices



However, those imports fell considerably in the last two months to 223,000 metric tons in July. The upwards pressure on prices was not as high as we might have thought in advance, but this is attributable to the suddenness and severity of last year's price plunge and the resultant over-capacity in the market.

If the very strong relationship between the Baltic Dry Freight index and aluminum prices seen over the past year holds, we should be expecting further downward pressure on aluminum prices over the next two months. The shipping index leads prices of three-month forwards by almost two months, thirty-eight trading days to be exact.

Freight Rates Pressuring Aluminum Lower

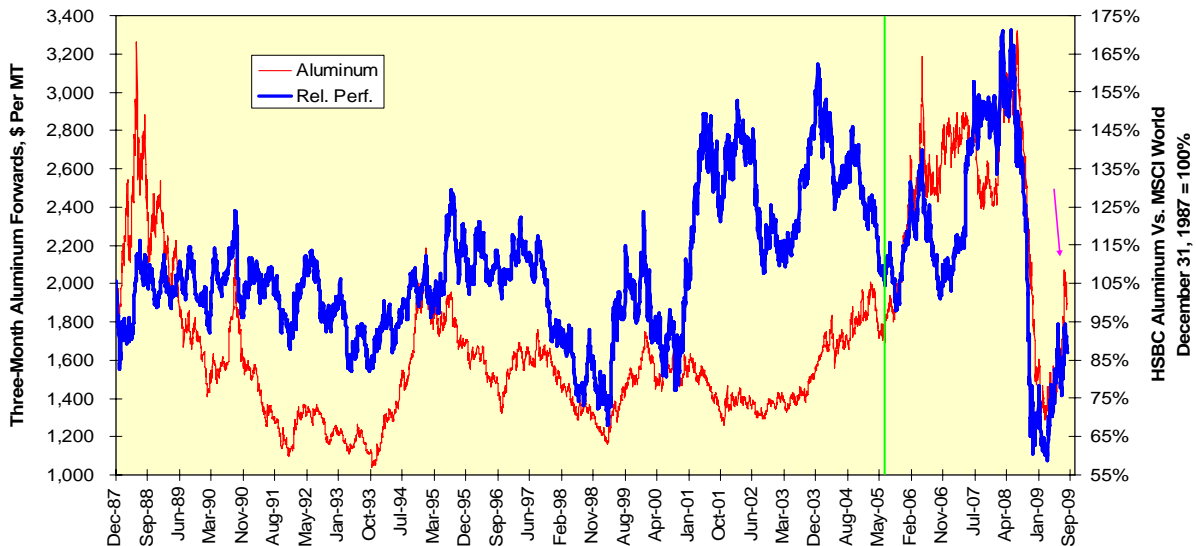


Prices And Mining Stocks

A longstanding principle has been commodity-linked equities and commodities are different things. However, if a wall of money persists in trading the stocks of commodity producers as a proxy for the commodity itself, it can start to force a commonality of behavior.

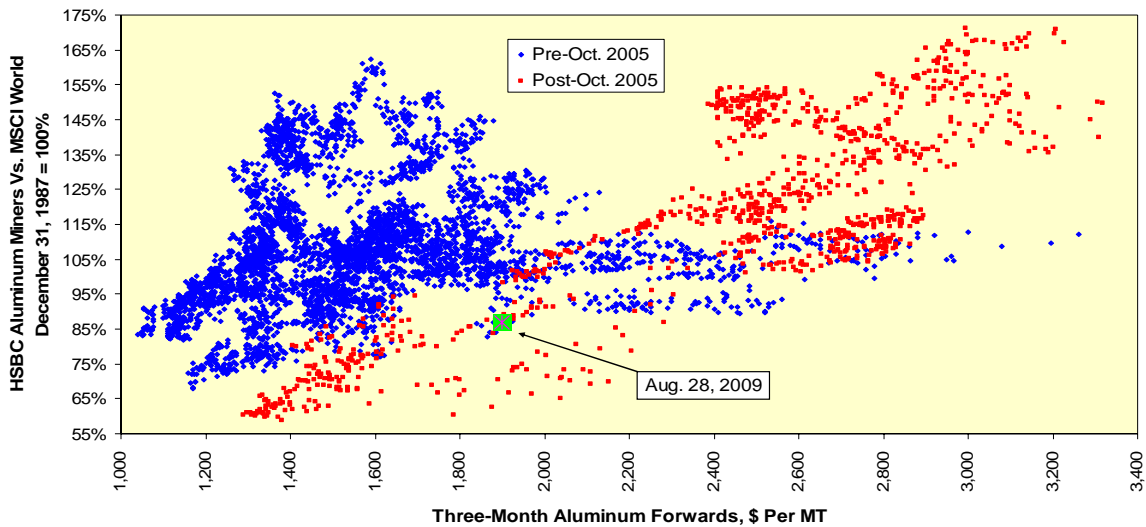
Prior to the revaluation of the Chinese yuan beginning in late July 2005, the relative performance of the HSBC global aluminum mining index to the MSCI World Free index had been duly random. This is exactly what we should have expected. Once the boom in commodity index investments took off and a steadily rising yuan made aluminum cheaper for Chinese importers, the relationship started to change. By the late 2008 price collapse, the relative performance of the miners was matching the forwards' price rather closely. However, as highlighted with an arrow, the stocks have underperformed the metal in recent weeks.

Global Aluminum Miners As Function Of Aluminum Prices



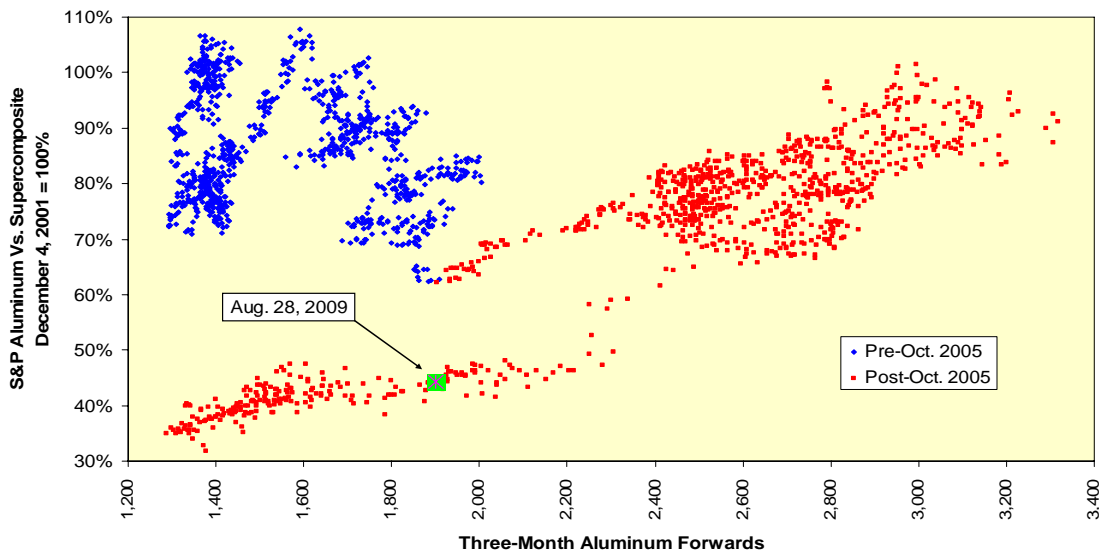
We can split this view in another way by mapping relative performance pre- and post-October 10, 2005 as a function of three-month forward prices. The blue markers are random; the red markers are linear with an expanding variance at higher prices.

**Aluminum Miners Became A More Linear Function Of Aluminum Prices
After Yuan Float Began**



The same observation applies to a comparison of the S&P 1500 Aluminum index', which now consists of Alcoa and Century Aluminum, total return to that of the S&P 1500 itself. After October 10, 2005, a previously random relationship turned linear.

U.S. Aluminum Also Increased Function Of Aluminum Prices



A Cyclical Bet

The issue joins neatly. While stocks are not GDP futures, a point underscored once again by the stock market's strong rebound since March in contrast to an uncertain economic rebound, we can be reasonably confident aluminum demand and therefore aluminum prices will not rise in a weakening global economy. We must emphasize "global" as well; it is not enough simply to get the U.S. right and assume the rest of the world will move in parallel.

Declining prices will pressure the relative performance of all aluminum-related equities. Unless you believe there will be a strong and sustainable rebound in the global industrial economy and therefore in aluminum demand and prices, avoid these stocks. Otherwise, Dante might have a slot for you in *Inferno* or *Purgatorio* but not in *Paradisio*.