

Aluminum, Markets and Global Growth

Consider your reaction to the following two sentences. First, “I am going to miss the Cold War.” Second, “I am going to miss the simplicity and clarity of the Cold War in comparison to what will follow.”

You might regard the first speaker as something of a Dr. Strangelove-type menace to humanity. You probably would regard the second speaker as a thoughtful analyst of strategy and geopolitics. So it is with international economics. For more than a half-century following World War II, an economist or market analyst had to get the American market right and then add or subtract developments and trends outside of the U.S. In geopolitical terms, the U.S. was hegemonic, a fancy term for the big kid on the block.

Once China’s remarkable rise began in the 1990s and accelerated in the past decade, the postwar simplicity went out the door with it. China’s pegging of the yuan to the dollar between 1994 and 2005 and then again from July 2008 onwards effectively made China the permanent low-cost supplier in the dollar bloc (see “The Mighty Yuan: Will It Produce Inflation? March 2008). Each and every time the Federal Reserve lowered interest rates in an attempt to stimulate the American consumer, an increasing share of the resulting demand was satisfied by Chinese producers.

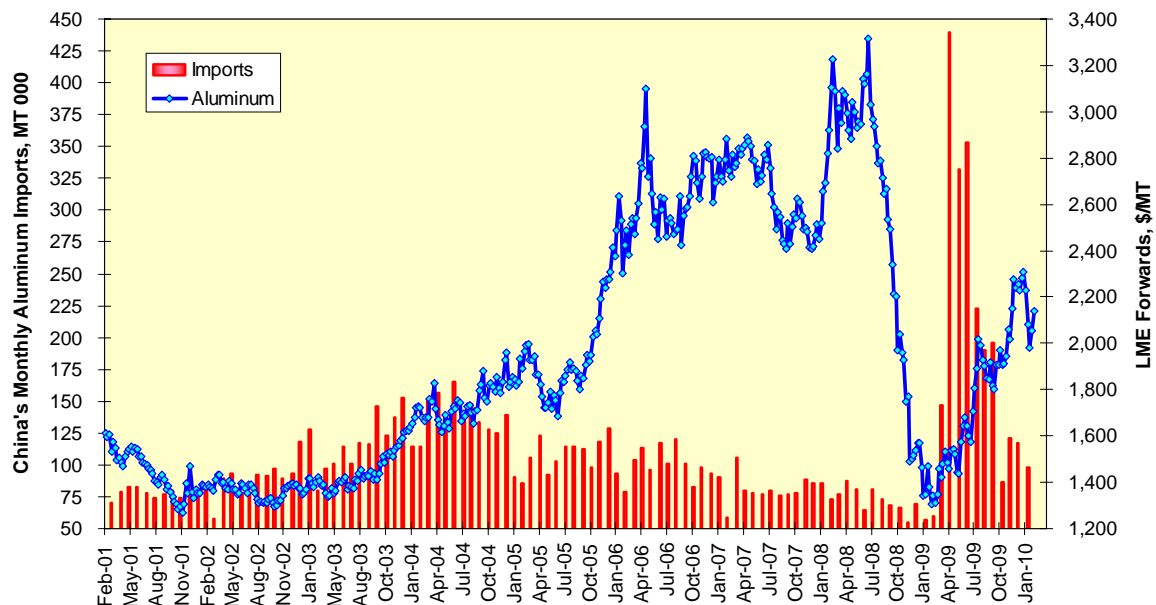
The net result was China became both the marginal buyer of raw materials in the global market and the marginal creditor to the U.S. Moreover, as transparency in both politics and economics is not a hallmark of the Chinese system and as the U.S. has drifted more and more to a state-directed version of capitalism, the supply and quality of information needed by analysts fell at the very time it was needed most.

The Case of Aluminum

Everything noted above intersects nicely in the aluminum market. As we can see in Chart 1, the metal had enjoyed a strong bull market between the start of the Federal Reserve’s first intrepid war on deflation beginning in May 2003 and an interim peak coinciding with Bank of Japan’s first attempt to end its quantitative easing policy in May 2006. It then shot higher again in 2008 under the Federal Reserve’s second war on deflation, a remarkable event considering how they won the first war, before it crashed along with everything else in late 2008.

China then embarked on its own stimulus program in early 2009, and before you could disbelieve change, it started buying aluminum like there was no tomorrow. Imports jumped from 56,000 metric tons in January 2009 to 440,000 metric tons in April 2009. This sudden surge in demand for aluminum – a similar chart can be drawn for copper – succeeded in pulling global aluminum demand and hence prices higher. In contrast, the U.S. stimulus program launched shortly thereafter focused on transfer payments to states and individuals along with a few pork-barrel projects and had little discernible impact on the aluminum market.

Chart 1: China's Imports And Aluminum Prices



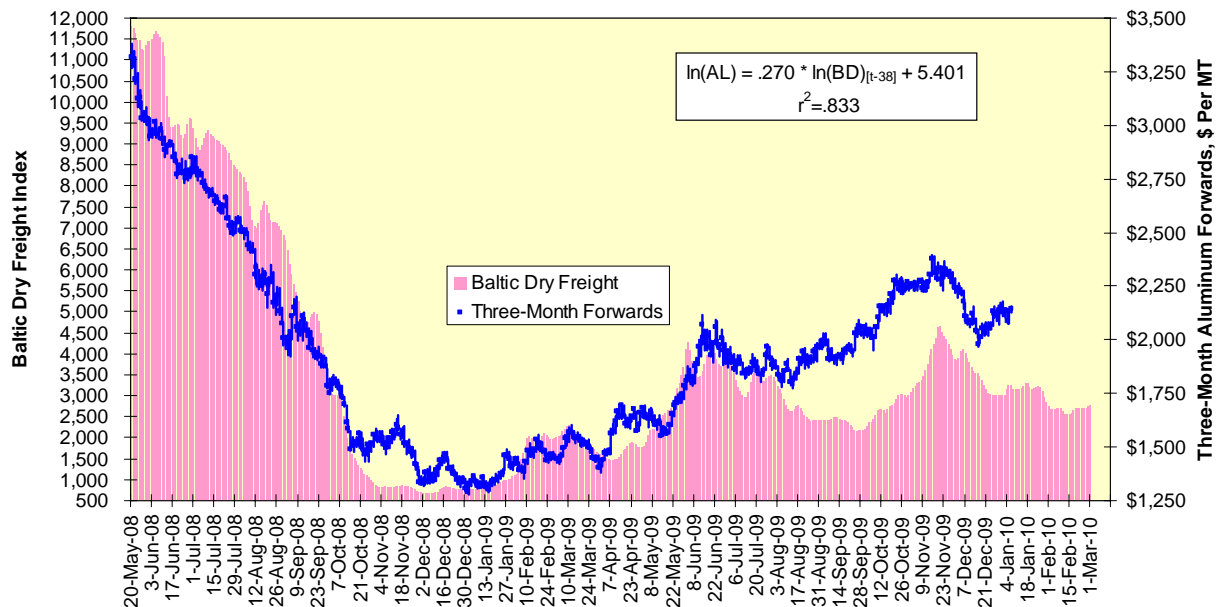
One Ore In The Water

While China has a history of colossal building projects, there was no reason to believe they were going to coat the Great Wall in aluminum foil or line the Grand Canal similarly. Imports fell by half to 223,000 metric tons in July 2009.

We should expect all of the activity related to the various raw materials booms and busts associated with China to be reflected in ocean freight rates, and they have been (see “Keep One Foot Firmly On The Ocean,” May 2005). Unlike financial assets that can be transmitted instantly and at virtually no variable cost, ores and other bulk materials take both time and money to get from their origin to their destination. No matter how high-tech we get, this will be true until the end of commerce; teleportation is a science fiction concept.

We can see in Chart 2 how ocean shipping rates as measured by the Baltic Dry Freight index have led aluminum prices by almost two months, thirty-eight trading days to be exact, since freight rates peaked in May 2008. The logic is very direct and straightforward: As importers nominate vessels, the freight index rises, and as the aluminum is purchased, prices are pulled higher. Once again, a similar relationship can be demonstrated for copper.

Chart 2: Freight Rates Pressuring Aluminum Lower



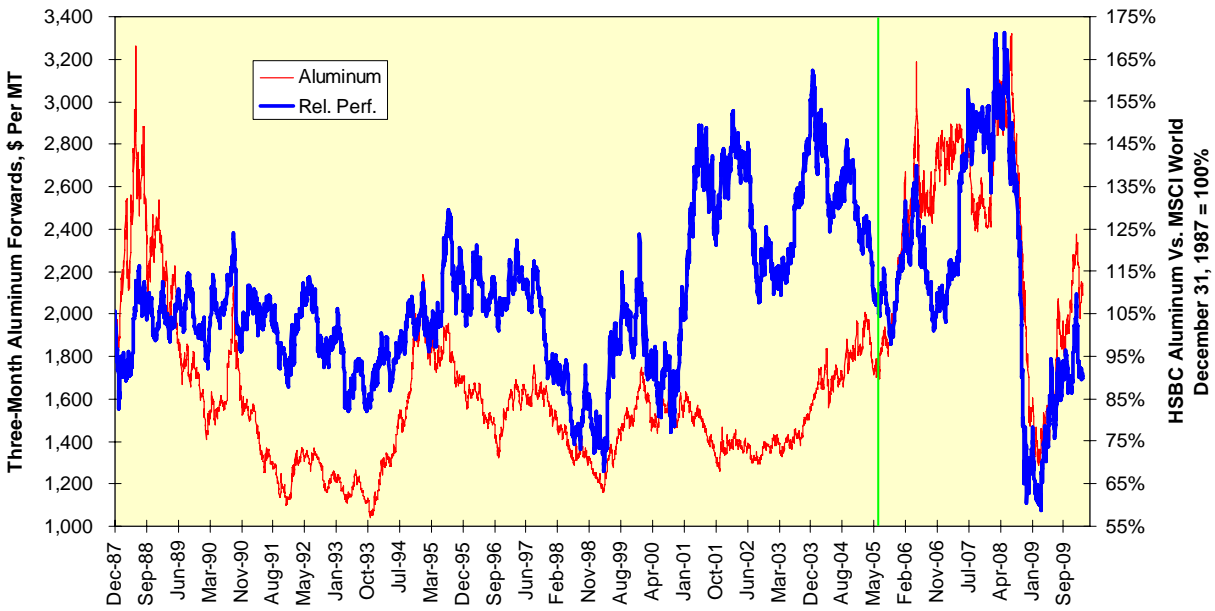
The Stock Market Response

Two of the easiest traps to fall into are the notion stocks are in essence GDP futures as opposed to risk-adjusted discounted claims on corporate cash flows and the interchangeability of commodity-linked equities with their underlying commodity (see “Chicken Or The Egg: More Fun With Commodity-Linked Equities,” April 2007).

However, everything in markets can and does move in a fashion. The dual growth-cum-low interest rate story beginning in May 2003 helped ignite a boom in long-only commodity index funds and related instruments. What had been a secondary market on Wall Street for years suddenly became the hot playground. As individual commodity markets themselves are too small to absorb the kind of money thrown at them without distortions in the price, the forward curve or both, quantitative investors turned to commodity-linked equities to execute their decisions. As an aside, the distortions produced by these investment strategies were blamed, rightly or wrongly, for many of the huge commodity price increases seen in the first half of 2008 and for the subsequent price collapses. Incoming CFTC Chairman Gary Gensler wasted little time in letting the world know he was not amused.

How has this played in the stocks of aluminum mining firms, not only in the U.S. but worldwide? As we can see in Chart 3, the relative performance of the HSBC aluminum mining index to the MSCI World Free index had been random prior to the revaluation of the Chinese yuan beginning in late July 2005, marked with a green vertical line. This conforms to the principle above.

Chart 3: Global Aluminum Miners As Function Of Aluminum Prices



After 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. This is consistent with the observation sufficient money flow can force commodity-linked equities to start behaving like their underlying commodity.

The data in Chart 3 can be rearranged into a Chart 4's scatter diagram. In addition, we can illustrate the same split for U.S. equities only in Chart 5 for the relative performance of the S&P 1500 Aluminum index to the S&P 1500 Supercomposite itself. Both of these charts are split on October 10, 2005, a low point reflecting the time lag between the revaluation of the Chinese yuan and the upturn in aluminum prices. Prior to this date, the relative performance of the stocks was random; after this date, relative performance became a linear function of aluminum prices.

Chart 4: Aluminum Miners Became A More Linear Function Of Aluminum Prices After Yuan Float Began

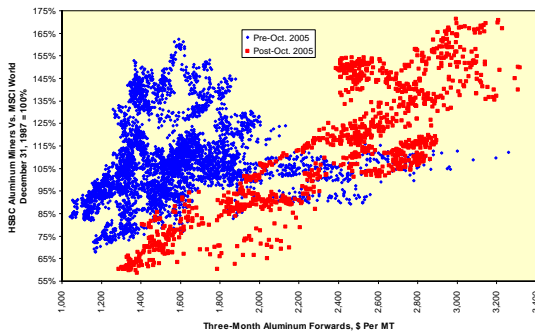
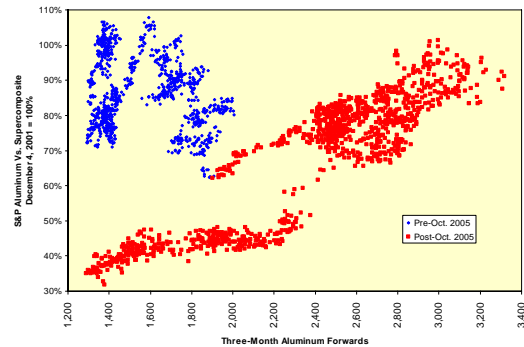


Chart 5: U.S. Aluminum's Relative Performance Also Increased As A Function Of Aluminum Prices



What about the first logical trap noted above, confusing stocks with GDP futures? Basic materials such as aluminum and copper are influenced by two cycles. The first is their own investment cycle; like all such industries, their constituent firms over-invest at the top of the price cycle only to watch prices crater in the ensuing over-capacity. This is followed by under-investment at the bottom; such is the human condition.

The second cycle is macroeconomic. No matter how much someone might want to call a hunk of aluminum an investment, it is really nothing more than an input into some other good. We can be reasonably confident aluminum demand and therefore aluminum prices will not rise in a weakening global economy and vice-versa for a strengthening economy.

As so much of the global growth story in recent years has centered in Asia, a trend unlikely to reverse in the near-term, each and every investor and trader must focus on this demand story over and above what is occurring in the

U.S. This is more difficult than what our predecessors had to endure, but that is the world in which we live. The old one is not returning; now you know why there are some people in high places who actually miss the Cold War.