Living In A Material World

"I find it harder and harder every day to live up to my blue china."…Oscar Wilde

Just as Oscar Wilde found it harder to live up to his blue china while at Oxford, the world is finding it harder and harder to live up to what those of a certain age remember as "Red China." Surely the mainland was going to rescue all those who invested in commodities, energy and basic materials by growing at 9% *ad infinitum*. To do otherwise would ruin a perfectly good sales pitch for the "hot commodities" crowd, would it not?

It would be both rude and unworthy of Victorian gentility to interject the woeful state of China's banking system at this point; some estimate no bank in China is solvent by Western standards. Any business operating without intention to pay its bills can put up some pretty gaudy growth rates. Given the history of various emerging market crackups, including the regular 20-year cycle of banking panics in the 19th century United States, we can expect to hit a major air pocket from China soon. Here's their choice: Either they continue to accept our increasingly tight monetary policy by virtue of the yuan's peg to the dollar or as postulated here two weeks ago they let the yuan float and watch good funds flee the country to avoid the inevitable banking, um, adjustment. Let's bet on the former.

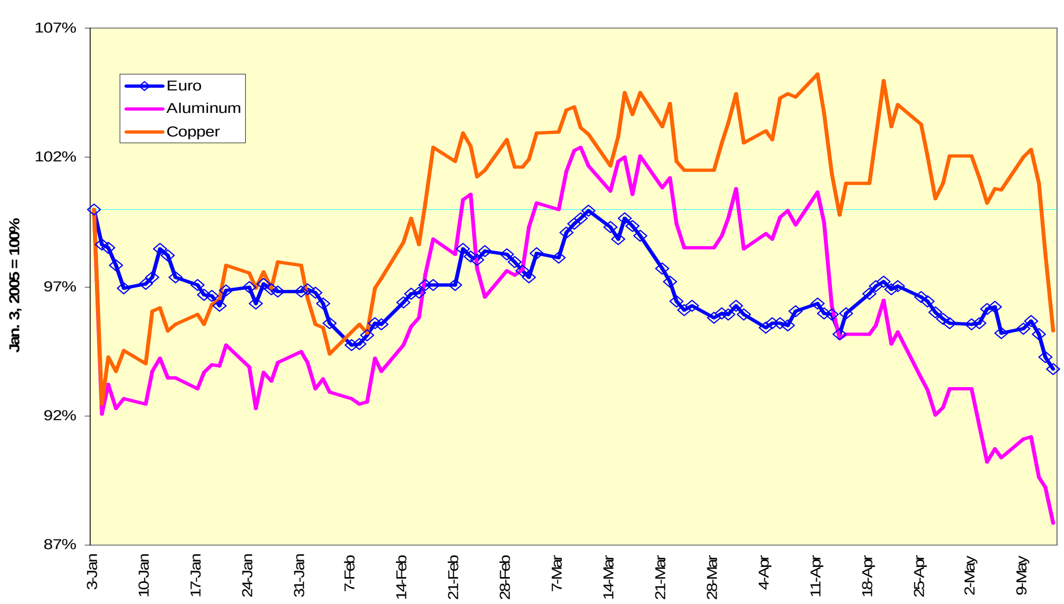
Basic Materials
The linkage between monetary policy, the dollar, commodity prices and commodity-linked equities should not, as some high-ranking officials would say, be mis-underestimated. We can isolate the following equations out of an econometric model designed to describe the stock market's economic sectors:

- Two-year note yield = f(euro)
- Euro = f(copper, two-year note yield)
- S&P 500 = f(copper)

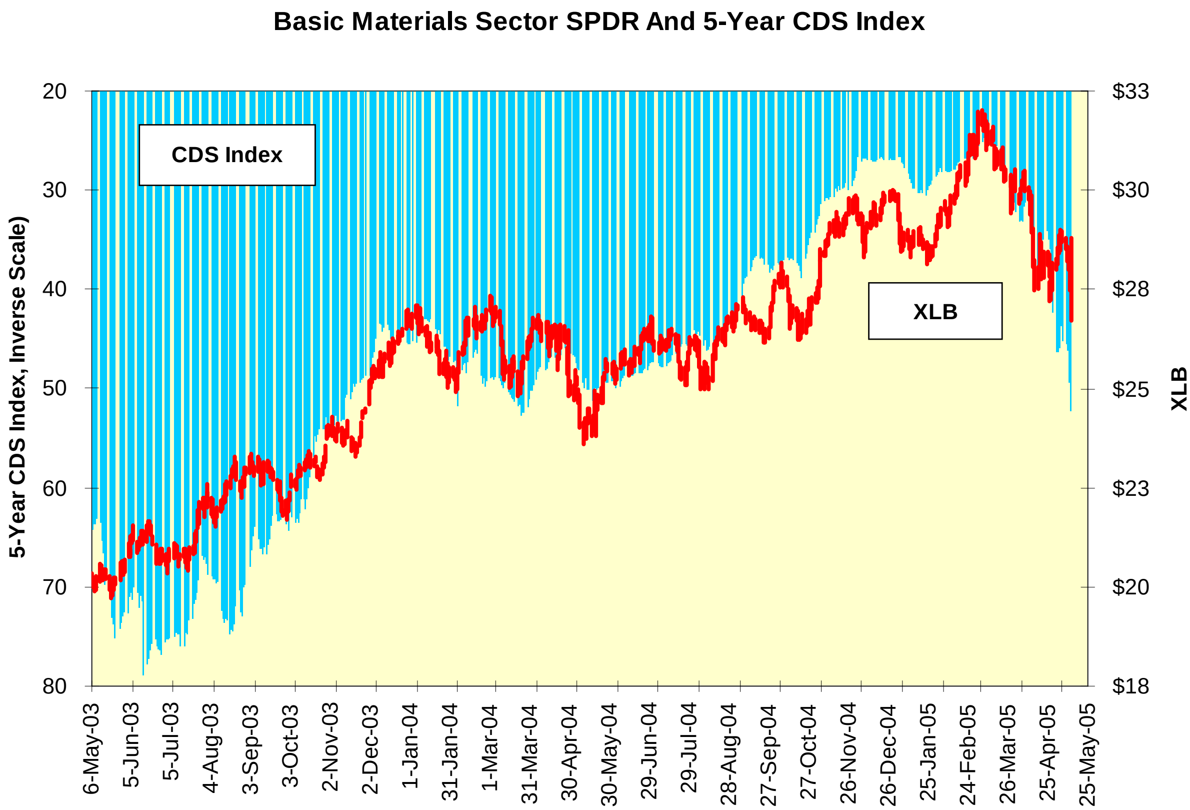
Leaving a lot of steps out of the picture, what this shows is how the dollar-euro exchange rate and two-year note yields must be solved simultaneously, that the solution to the euro equation requires copper prices and that the solution to the S&P 500 equation requires copper prices. Copper, important since the Bronze Age, is central to the world's financial markets today.

The prices of copper and especially of aluminum have retreated sharply since the euro failed to exceed its end-of-2004 high on March 11. While the euro has fallen 6.1% since that date, three-month copper forwards on the London Metals Exchange have fallen 7.4 and three-month aluminum forwards have fallen 13.6%.

Base Metals Get Bent By Euro



Of course, as we all find out sooner or later in our lives, money is the most basic material of all. Let's overlay the price of the Materials Select SPDR (XLB) against an index of all traded credit default swaps (CDS) for stocks within the S&P 500 Basic Materials sector. A CDS is nothing more than an insurance contract against a default or other stipulated credit even affecting an issuer's bonds; if exercised, the owner gets to put the bonds back to the CDS writer at par. These contracts are not guaranteed by any clearinghouse, so they carry the full faith and credit of a piece of paper with the writer's picture on it. The relationship between CDS and stock prices, including specific issues within the Basic Materials sector, was discussed here last week in the context of identifying trouble spots.

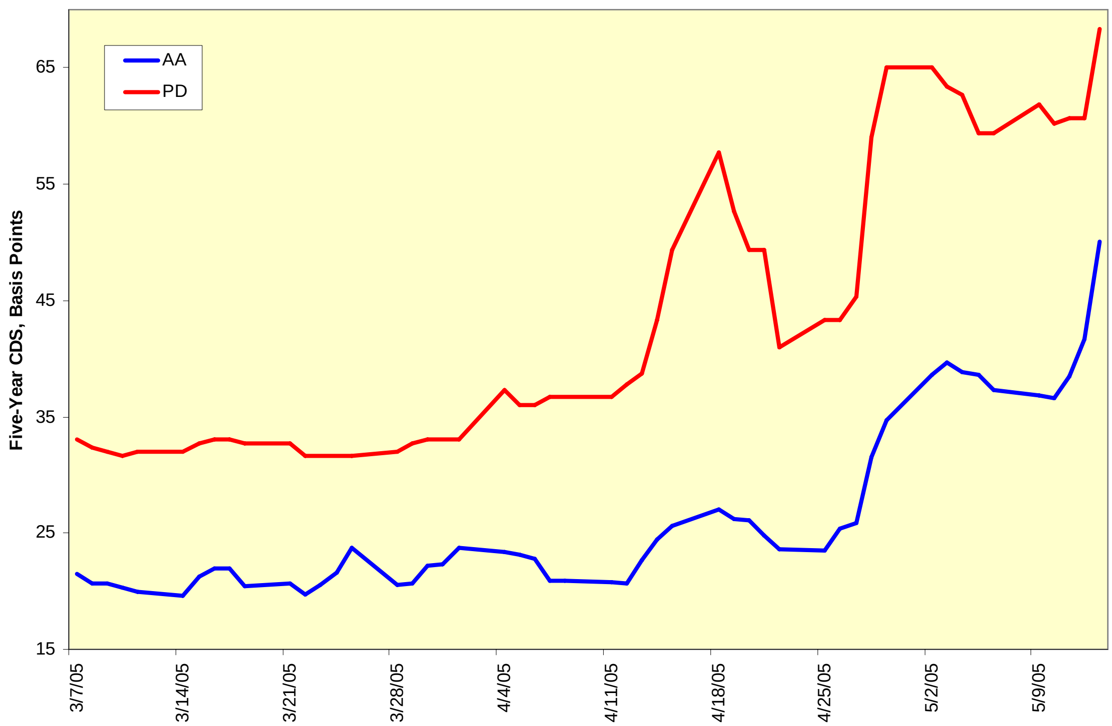


The Basic Materials Sector enjoyed two periods of steadily improving credit quality, the second half of 2003 and the last third of 2004. The XLB rose in near-parallel fashion to the sector's credit quality during those periods. The opposite has occurred since the March reversal. Both the CDS index for the sector and the XLB's price have fallen, with the CDS index indicating there is more work to do on the downside.

We saw last week how the highest CDS costs within the Basic Materials sector belonged to the forest products companies, including Bowater, Weyerhauser, Georgia-Pacific, Temple-Inland and International Paper. If we move outside of the forest products group, which accounts for only 16.4% of the Basic Materials sector, do we see any warning signs from the CDS market?

Let's take Alcoa and Phelps Dodge as representatives of aluminum and copper. Respectively, they account for 7.395% and 2.455% of the Basic Materials sector. Their CDS costs have jumped since mid-April. While their absolute levels are not great in comparison to the 100 basis point-plus CDS costs for the forest products industry, their extreme responsiveness to short-term downturns in the prices of copper and aluminum should give pause. That 13.6% drop in aluminum prices was good enough for a 150% increase in Alcoa's CDS cost, from 19.99 to 50.04 basis points, and that 7.4% drop in copper prices produced a 113.5% jump in Phelps Dodge's CDS cost, from 32 to 68.3 basis points. If commodities are considered volatile, what word should we use to describe CDS?

Credit Risk Follows Commodity Price



Chain Of Fools

The credit contagion from General Motors spread quickly through financial markets; it should have taught us all just how many linkages and transmission mechanisms we now have in markets. We have illustrated another. If the Federal Reserve's tightening of credit moves through the two-year note and the euro into commodity prices and affects both Chinese demand and the overall health of U.S. equities, it can damage commodity-linked equities such as Alcoa and Phelps Dodge on a leveraged basis by increasing their CDS costs.

Or, as our friends at the FOMC might lament, "every day we find it harder and harder to live up to our statements of bias."