Miners Stop Getting The Lead Out

If you can ponder the imponderable, what can you do to the inscrutable? Here is a question for all of us to ponder: Does buying the low or selling the high, plus or minus a few ticks, define a good trader? I tend to think not. Amateurs are compulsive top- and bottom-pickers for the very ingrained reason they have a psychological need to be right rather than to listen to the flow of the market.

It is the duty of the analyst, however, to warn when the conditions for reversals are presenting themselves. Sometimes these calls are early, which frustrates timing. Sometimes they are after the peak or trough, in which case they can still be quite useful if they say something along the lines of, "This move is real and will last a long time." In retrospect, did it matter on what day and price you might have sold a Japanese fund in the early 1990s?

Mining Stocks One Year Later

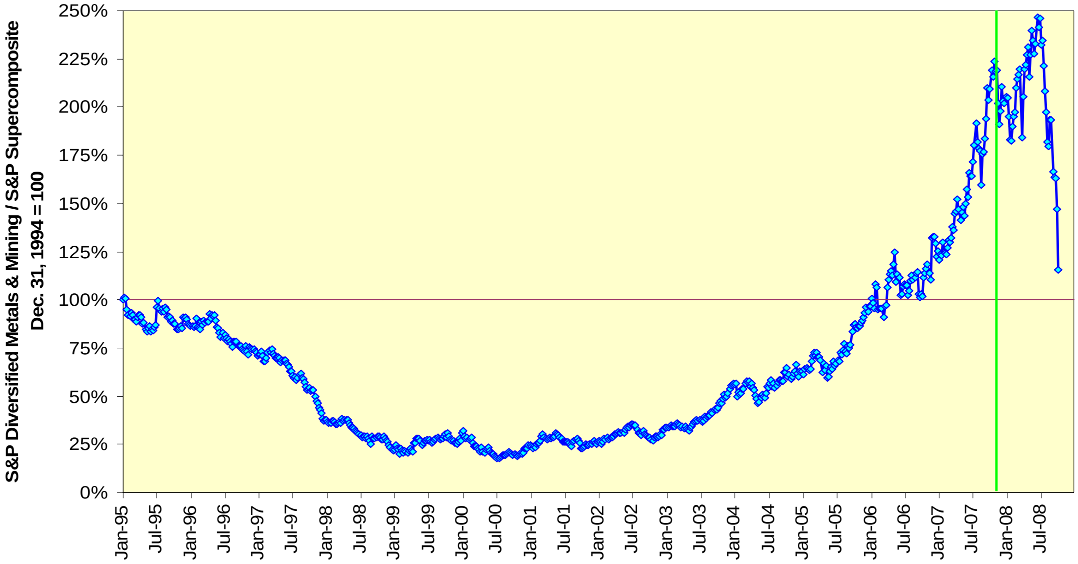
In light of last week's column on the deflationary forces signaled by the collapse in freight rates and ones from both last week and January highlighting the importance of changes in China's yuan policies, I thought it might be interesting to revisit a column from November 2007 calling for a top in mining shares.

That call was based on the inherently cyclical nature of all resource-based industries, on a forecast for a slowdown in macroeconomic activity and to rising costs of production. I wrote:

> *Either the metals & mining stocks are too optimistic about profitability and the ability of mining firm to engender both new supplies and reduced costs simultaneously, or the metals markets are about to go on a tear higher.*
>
> *The former defies microeconomic logic. Firms faced with huge capital spending requirements and rising costs of production after their prices have increased are more likely to face profit margin contraction than expansion. The latter is possible only if demand growth in the rest of the world offsets declining demand growth in the U.S. We have no experience in the last 150 years of the world growing in the face of a softer U.S. economy, so we are truly flying blind.*
>
> *Asking for the mining stocks to continue their outperformance in this environment looks like a losing bet.*

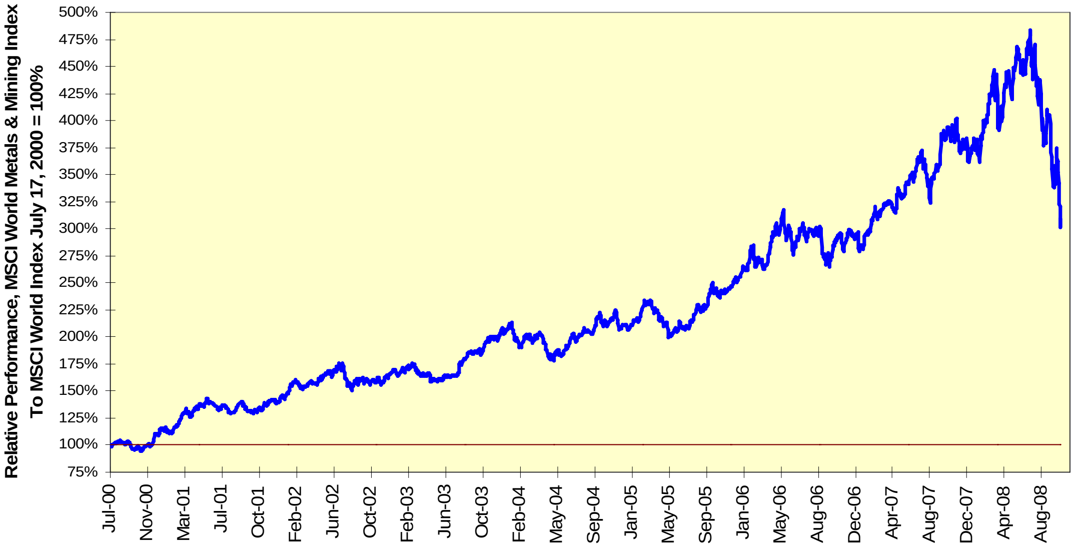
The timing of that call was pretty good for two and one-half months. The relative performance of the S&P 1500's diversified metals and mining group to the S&P 1500 Supercomposite itself declined into the January 2008 Société Générale panic low, rebounded until a new collapse into the March 2008 Bear Stearns panic low and then accelerated into the very peak of the commodities bull market at the end of June. Look at what it has done since then; the green vertical line marks last November's market call. And remember, this is miners' performance relative to the S&P 1500, which itself has declined 13.8% since the June peak in commodity prices.

Hard Times For Hard Assets



The metals & mining index is dominated by Freeport-MoMoRan Copper & Gold, with an 89.5% weight. The other members of the index are Titanium Metals, AMCOL International, RTI International Metals and Brush Engineered Materials. Given this lopsided weighting and the dominance of firms such as BHP Billiton, Rio Tinto and Vale do Rio Doce located outside of the U.S., we should ask whether this is a global phenomenon. It is.

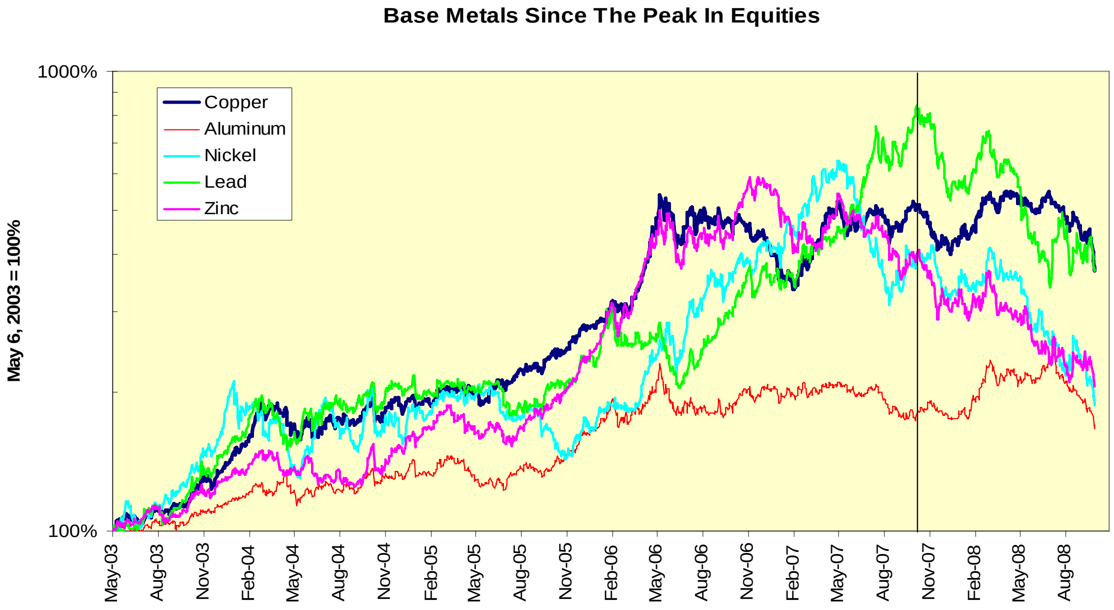
Miners' Difficulties Are Global



Metals Prices

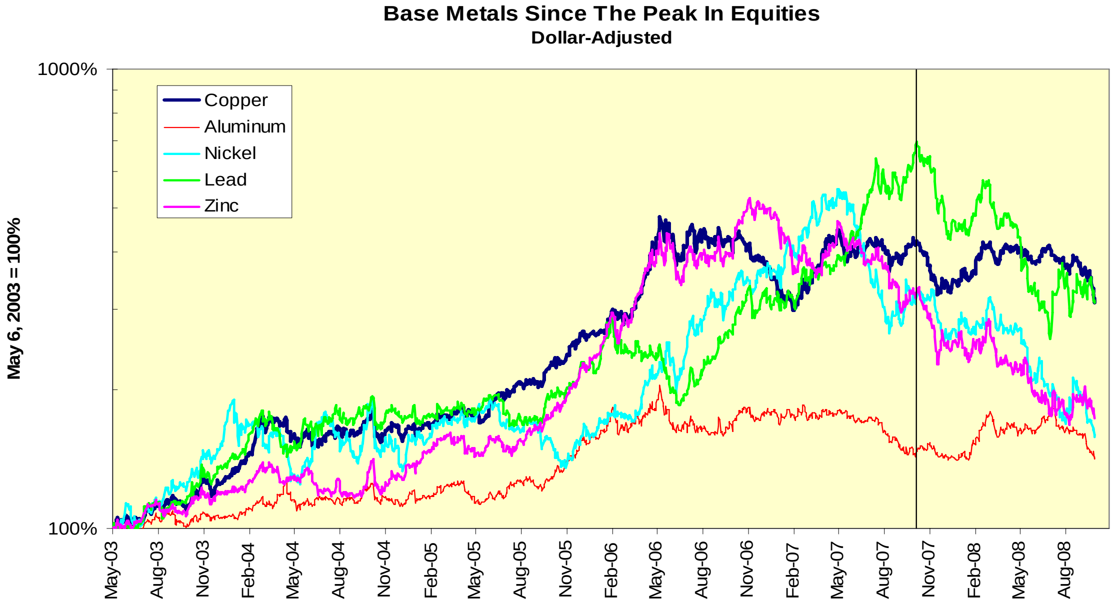
Let's put coal to one side with a small but shocking mention: The total return of the S&P 1500 coal group since June 30, 2008 has been -64.7% and focus exclusively on the base metals whose forwards are traded on the London Metals Exchange.

Please remember I never embraced the notion the September 2007 – June 2008 commodity moonshot reflected monetary largesse and a weak dollar so much as it did continued strong primary commodity demand out of East Asia in general and China in particular. The following two charts support that view. The first depicts the dollar prices of these forwards before and after the October 2007 peak in equities and accelerated revaluation of the yuan; the second adjusts these prices for changes in the dollar index.



While copper and aluminum stayed bid between October 2007 and July 2008, none of the other metals rose in price. Nickel and zinc remained in ongoing downtrends, and lead broke from an all-time high into a new downtrend. A casual observer looking at these charts would conclude the bull market in metals was really a two-year affair between October 2005 and October 2007. The effects of monetary policy on these markets are not noticeable, which should tell us something about the efficacy of monetary policy in stimulating real growth.

An additional lesson is observable in the currency-adjusted chart. Here the dollar's recent rally does not contribute to a major downward acceleration of metals prices, contrary to what those who believe commodity prices are dollar-driven.



The overall conclusion is metals prices are growth-driven more than money- and currency-driven. Until we see some stabilization or reversal in the negative global growth outlook, we should not expect these stocks to outperform. A foray into them is an exercise in bottom-picking, nothing more.