Copper Seizes Brass Ring

Here's a little wager you can offer your friends: Which commodity had a higher percentage gain in 2004, crude oil or copper? The answer is copper, whose futures gained 43.34% on the year, far outpacing the 30.62% gain for heating oil and the 29.52% gain for crude oil.

That's nice you say, of interest to the *commodititstas* once again walking the earth and celebrating the first ascent of the CRB index over the 300 level in nominal terms since 1981, but of no value to me, an adroit stock trader. Well adroit is not just a city in Michigan: For all the ink spilled on the macroeconomic impact of higher energy prices, it turns out that copper prices, acting by themselves and as a proxy for of other base metals such as aluminum and nickel, have a broader and more diverse impact on the stock market groups than do higher energy prices.

Intermarket Relationships

The skills required for successful intermarket analysis are similar to those required for three-dimensional chess and catching fish out of a stream with your bare hands. The relationships are slippery and change frequently, not so much in the direction of their impact on a given market's performance, but in the relative strength of these impacts. Think of them as primary colors in a paint mix. The dash of yellow can be overwhelmed easily by the blue or the red in a given mix, but it still contributes a yellow tint. All else held equal, lower interest rates are always a positive *partial* contributor to higher stock valuations, but their effect can be overwhelmed by negative earnings expectations.

As mentioned in a recent Columnist Conversation posting, all of these effects have to be weighed together on a system-wide basis, one wherein the various relationships are weighed together to see which are in fashion at the moment. Let's take a look at the latest relative contributions within this model of copper and crude oil to the performances of the nine economic sector ETFs in the S&P 500 (there are ten sectors, but the Telecommunication sector does not have an associated ETF).

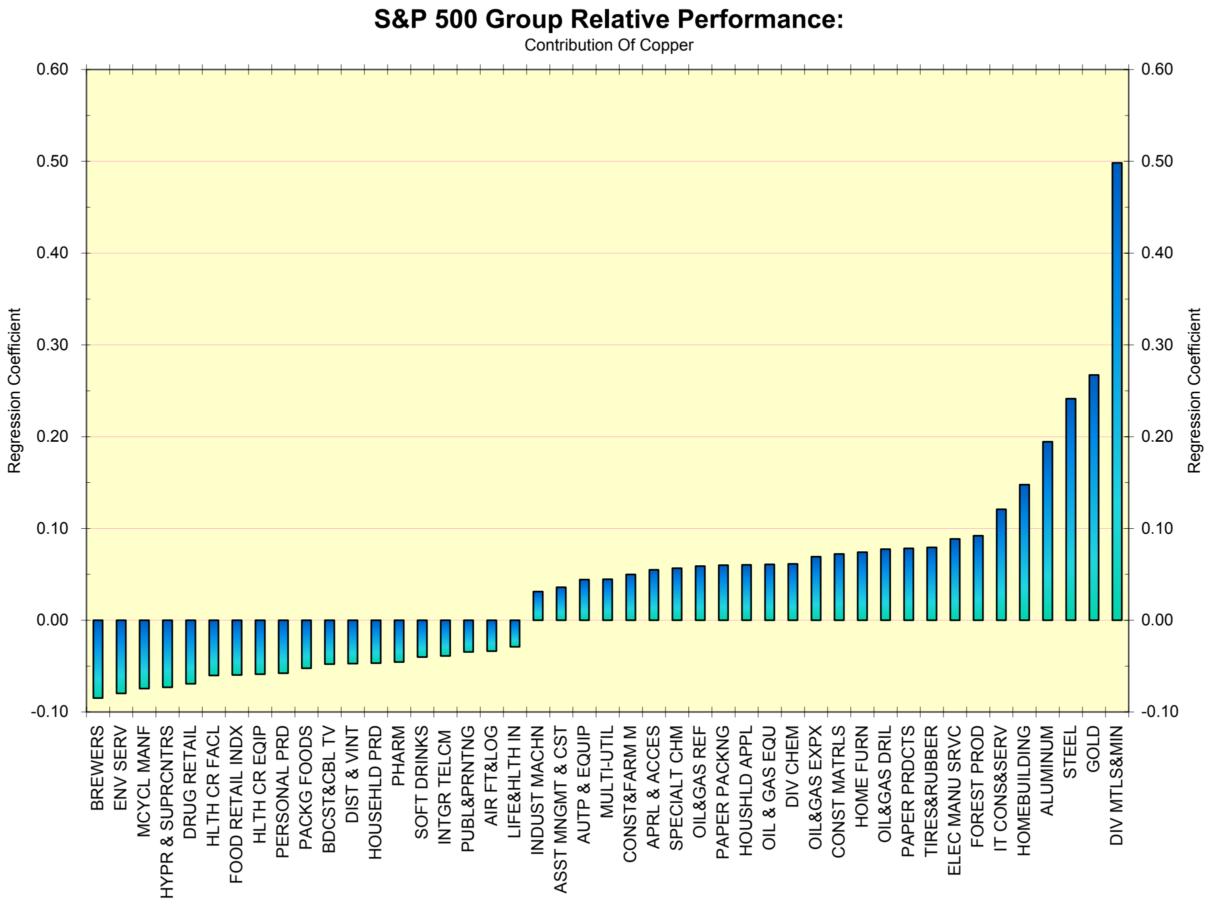
Sector SPDR		Positive Contribution	Negative Contribution
XLB (Materials)		**Copper**	
XLE (Energy)		**Crude Oil**	
XLF (Financial)		**Copper**	**Crude Oil**
XLI (Industrials)		**Copper**	**Crude Oil**
XLK (Technology)			
XLP (Cons. Staples)			
XLU (Utilities)		**Copper**	
XLV (Health Care)			
XLY (Consumer Discretionary)		**Copper**	**Crude Oil**

The partial contribution of copper is higher for the Materials, Financials, Industrials, Utilities and Consumer Discretionary sectors. For three of these sectors, the Financial, Industrials and Consumer Discretionary Sectors, the partial contribution of crude oil prices is a negative. Higher crude oil prices are a boost, unsurprisingly, for the Energy sector.

This set of largely offsetting relationships helps explain how and why higher crude oil prices have not been the drag on the stock market they were in all previous episodes: The global economy, as evidenced by the high and rising prices for copper, is strong enough to absorb the higher energy costs.

Group Performance

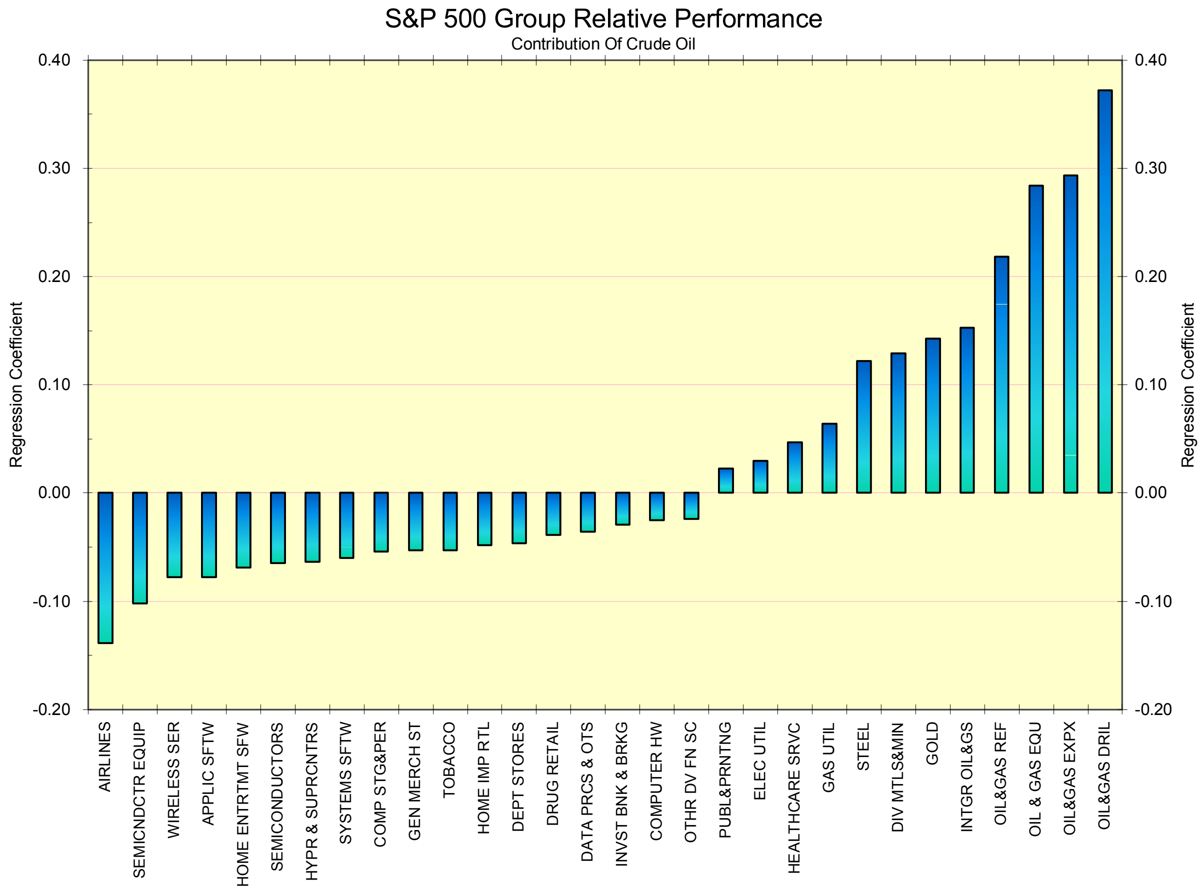
Now let's return to an analysis first demonstrated here in early February for the impact of the euro on various S&P industry groups. As before, the performance of each of the S&P 500's 113 industry groups relative to the index as a whole was regressed against copper and crude oil, each separately. Forty-five of the groups had a statistically significant beta against copper, while only 30 of the groups had a statistically significant contribution beta against crude oil.



More important than the quantity of the groups affected by copper is their distribution across industries. The groups with the strongest beta to copper include Information Technology Consulting, Homebuilding, Aluminum, Steel, Gold and Diversified Metals & Mining. Only a few groups have a strongly negative beta. The most negative slot is occupied by Brewers; Distillers & Vintners also have a negative relationship. Someone is taking copper prices a little too seriously.

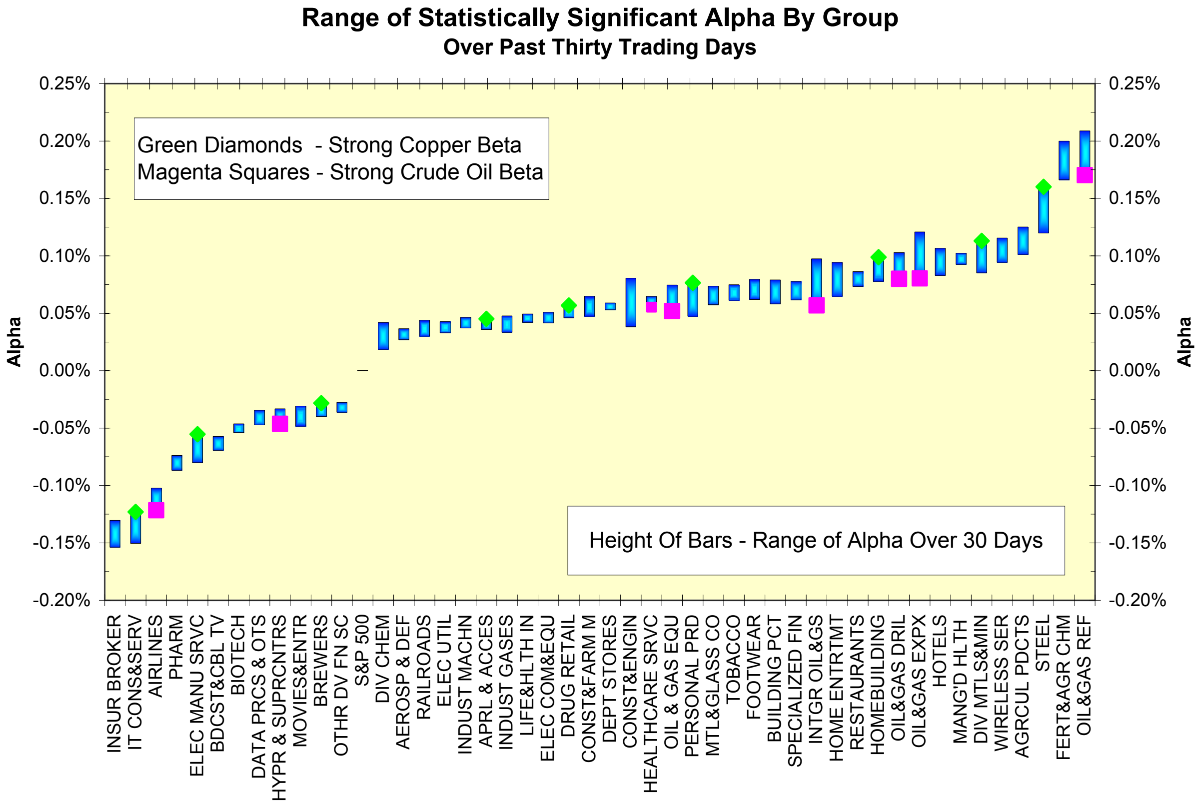
The groups with positive betas against crude oil are all oil-related. These include Integrated Oils, Refiners, Oil & Gas Equipment, Exploration and Drilling. The groups with negative betas include, unsurprisingly, Airlines. But the list also is weighted heavily to high-tech groups such as Semiconductor Equipment, Wireless Services, Application Software and Semiconductors.

Higher oil prices are still a drag on the economy. This primary color is being masked by strength elsewhere; should those other colors fade, the black tint of crude oil will become visible in all but sectors dependent on it.



Searching For Alpha

One final way of looking at the contributions of these two commodities is to map the sectors with statistically significant alpha, or expected over- or underperformance relative to the S&P 500. Here we find the market's leadership has been concentrated in a few oil-related sectors. A much larger number of sectors with positive alpha have a strong beta relationship to copper than to crude oil.



The conclusion we can reach from all this is the stock market can continue to absorb the drag of higher energy prices so long as this is offset by stronger economic growth. If you see copper wobble and crude oil continue to move higher, watch out.