A Penny For Copper's Thoughts

Throw a rock down Wall Street and you will hit an economist with a bearish outlook which, come to think of it, might be a good use for a rock. The status and prospects for U.S. residential construction are keeping the practitioners of the Dismal Science in a dyspeptic state of mind.

This view is not shared in these precincts. Yes, there are some overextended homeowners whose spending habits will be curtailed if they have to stop using their house as a piggybank, but since when was that the intended purpose of a residence? Did our cave-dwelling progenitors take out second mortgages or home equity lines of credit? I rest my case.

And, of course, various lenders will discover what every thumb-breaking loan shark has known for years, and that is you should never issue a no-documentation loan. Our friends on the docks and in the pool halls must wonder what they teach at the nation's universities these days. The very word "credit" derives from the Latin word "belief," and even the most dimwitted thug understands inviting people to lie to you in order to obtain funds is not a belief-enhancing behavior. Nor is issuing option ARMs and other negative-amortization loans that can increase the riskiness of borrowers with the passage of time. If there is any justice in this world, these lenders will lose money on the account of their own stupidity.

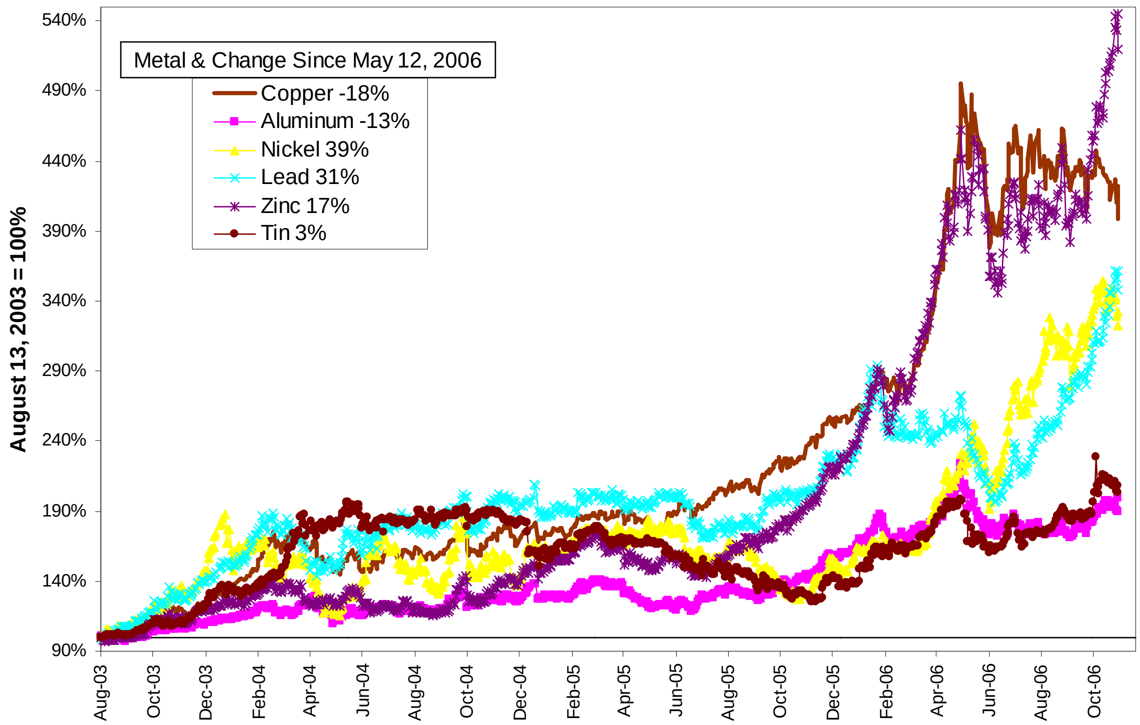
But will any of these necessarily plunge everyone else in the macroeconomic abyss? Methinks not. Too many homeowners have operated under the illusion their abode was an investment first and a consumed service second. They lost sight of some simple realities, such as holding costs such as property taxes increase with nominal price, that while land can acquire a scarcity value the structure itself must depreciate over time and, most importantly, that the replacement cost for one inflated house is another inflated house. Unless a homeowner downsizes or moves to a lower-cost region, housing price appreciation best is seen as the illusion of wealth, not the creation of wealth. As an aside, this illusion is what propelled Spanish conquistadors, French mercantilists and Japanese exporters alike to confuse acquisition of money with wealth. Putting a higher price tag on your house does nothing to expand your capacity to consume, the operant definition of wealth.

A slowdown of this housing merry-go-round will produce some frictional costs, to be sure, but is unlikely to throw everyone into the bread lines. After all, a natural source of demand exists: While not everyone has to own stocks, all those who do not choose homelessness as an option do have to live somewhere. Just as changes in interest rates operate as a wealth-transfer mechanism between debtors and creditors, changes in real estate prices will operate more as a wealth-transfer mechanism than as a wealth creation or destruction mechanism.

Copper: First Amongst Bases

The recent downturn in copper prices has been seized upon, selectively, as prima facie evidence of a slowing economy. Copper has been an excellent coincident economic indicator for years by virtue of its role in construction and in various aspects of the electric utility industry. It peaked on May 12, 2006, just after I called the market for base metals a lead balloon, and has since declined 18% in price.

No Bear Market In Base Metals



But what about the prices for other base metals? Are they in a similar bearish trend – and that chart for copper can be used in a technical analysis primer as an example of a pennant top if it continues lower – or have they diverged from a simplistic bloc correlation with copper? Only aluminum has declined in price since May, while tin has remained virtually flat. Even after substantial downturns last Friday, we see six-month gains for nickel, lead and zinc of 39%, 31% and 17%, respectively. If the course of the global economy involves a handbasket, it is not apparent from the other base metals.

Copper And Stocks

Now let's return to an analysis first introduced in February 2005 and ask the question which industries are exposed to copper prices and in what amount. This time let's add a little twist. Instead of just measuring the relative performance of S&P 500 industry groups at a 90% confidence level to the index as a whole as a function of copper prices, the 'HG Beta' columns in the table below, let's multiply these betas by the groups' weights in the S&P 500 to get a weighted beta.

Copper Beta-Weighted Impact On S&P 500							
Group	SPX Weight	HG Beta	Weighted Beta	Group	SPX Weight	HG Beta	Weighted Beta
Pharmaceuticals	6.32%	0.032	-0.20%	Integrated Oil & Gas	6.38%	0.092	0.59%
Systems Software	2.95%	0.035	-0.10%	Oil & Gas Equipment	1.40%	0.157	0.22%
Computer Hardware	3.24%	0.030	-0.10%	Oil & Gas Exploration	0.97%	0.148	0.14%
Integrated Telecommunications	2.77%	0.033	-0.09%	Diversified Metals & Mining	0.25%	0.534	0.13%
Multiline Insurers	1.93%	0.040	-0.08%	Investment Banking & Brokerage	2.61%	0.037	0.10%
Household Products	2.22%	0.033	-0.07%	Steel	0.27%	0.270	0.07%
Home Improvement Retailers	1.02%	0.051	-0.05%	Oil & Gas Drilling	0.38%	0.170	0.07%
Healthcare Equipment	1.53%	0.031	-0.05%	Construction & Farm Machinery	0.67%	0.088	0.06%
Soft Drinks	1.67%	0.021	-0.04%	Gold	0.17%	0.311	0.05%
Drug Retailers	0.54%	0.064	-0.03%	Oil & Gas Refining	0.33%	0.133	0.04%
Life & Health Insurers	1.22%	0.027	-0.03%	Railroads	0.73%	0.056	0.04%
Restaurants	0.86%	0.039	-0.03%	Diversified Chemicals	0.84%	0.044	0.04%
Property & Casualty Insurers	1.44%	0.022	-0.03%	Aluminum	0.20%	0.159	0.03%
Hypercenters & Superstores	1.12%	0.027	-0.03%	Industrial Machinery	0.75%	0.039	0.03%
Data Processing & Outsourcing	1.02%	0.028	-0.03%	Electrical Components & Equipment	0.48%	0.038	0.02%
Packaged Foods	0.92%	0.023	-0.02%	Homebuilding	0.23%	0.081	0.02%
Brewers	0.32%	0.065	-0.02%	Fertilizers & Agricultural Chemicals	0.20%	0.060	0.01%
Healthcare Facilities	0.27%	0.059	-0.02%	Industrial Gases	0.28%	0.039	0.01%
Publishing & Printing	0.41%	0.037	-0.02%	Forest Products	0.13%	0.068	0.01%
Food Retailers	0.35%	0.033	-0.01%	Paper Products	0.16%	0.047	0.01%
Computers & Electronics Retailers	0.22%	0.048	-0.01%	Construction & Engineering	0.06%	0.114	0.01%
Home Entertainment Software	0.14%	0.073	-0.01%	Paper Packaging	0.10%	0.052	0.01%
Internet Retailers	0.10%	0.083	-0.01%	Employment Services	0.09%	0.052	0.00%
Motorcycle Manufacturers	0.15%	0.046	-0.01%	Household Appliances	0.16%	0.028	0.00%
Food Distributors	0.17%	0.040	-0.01%	Construction Materials	0.07%	0.056	0.00%
Environmental Services	0.19%	0.033	-0.01%	Tires & Rubber	0.03%	0.065	0.00%
Leisure Products	0.13%	0.036	0.00%				
Diversified Commercial Services	0.09%	0.053	0.00%	Subtotal	17.92%		1.71%
Subtotal:	33.31%		-1.11%	**Total:**	**51.22%**		**0.60%**

The results are telling. The groups with a statistically significant positive relationship to the S&P 500 are almost wholly those in the energy and basic materials sectors. Combined, they account for 17.92% of the index and have a weighted beta of 1.71% to the S&P as a function of copper prices. The groups with a statistically significant negative relationship are concentrated in the health care and consumer staples sectors along with property & casualty-related insurance firms. They account for 33.31% of the index and have a weighted beta of -1.11% to the S&P 500 as a function of copper prices. On a net basis, industry groups with a statistically significant relationship to copper prices account for 51.22% of the S&P 500 and have a net weighted beta of 0.60%.

If we multiply this beta by copper's price decline since May, the net impact is -0.11%. As the S&P 500 has had a total return of 7.93% since May 12, we can classify the partial contribution of copper to the S&P 500 as trivial. Will it stop anyone from proclaiming great insight into the course of human events based on copper prices? Not a chance.