Are The Miners Hitting Resistance?

In a world filled with changing business models, paradigm shifts, new normalities, old perplexities and the occasional conundrum, the mining industry is like comfort food: Dig the rock, move the rock, smelt the ore, come back for more just like our ancestors in days of yore.

While the business may be simple to understand, valuing it can be tough given the inelastic supply and demand curves (a small change in quantity leads to a large change in price) along with the vagaries of artificial demand from government stockpiling programs around the world, hedge fund demand and the industry's seemingly endless compulsion to consolidate. The corporate histories and plans of firms such as Freeport McMoRan, Rio Tinto and BHP Billiton would do a soap opera proud. Finally, as mines are among the most fixed of all fixed assets, the miners are subject to the depredations of host government tax and royalty policies if not to the risk of outright appropriation.

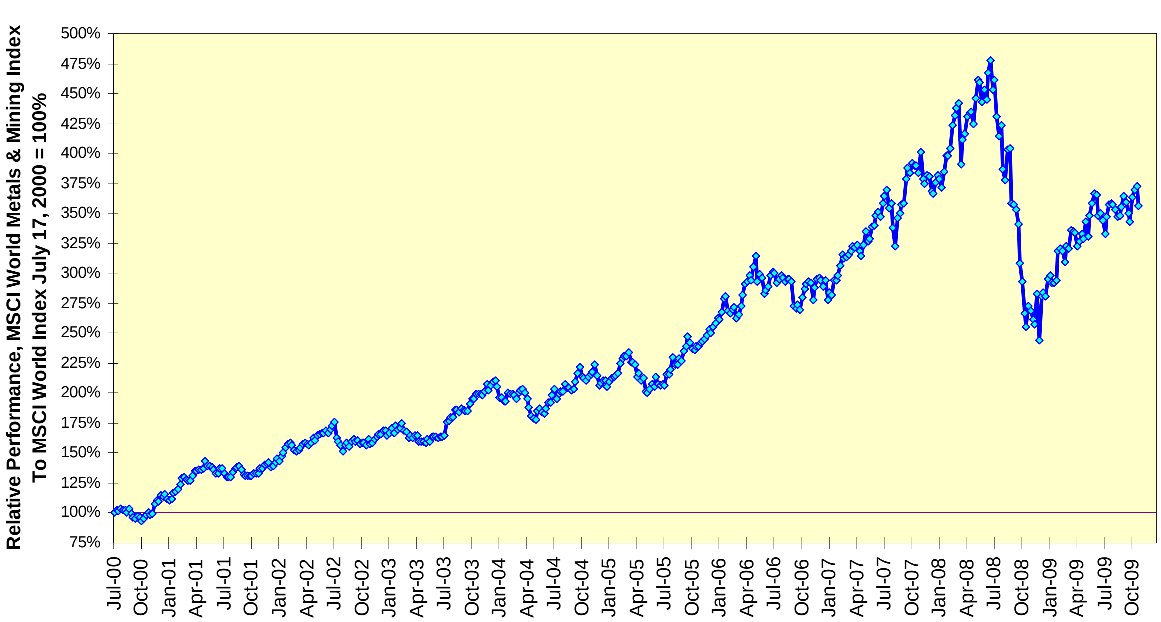
Relative Mining Stock Performance

A *RealMoney* reader brought the recent wobbles to my attention last week, which was all the prompting needed to update a column written during the very depth of the October 2008 financial panic. I concluded then:

> *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.*

The relative performance of the MSCI World Metals & Mining index to the MSCI All-Country World index had been plunging since the end of June 2008 and would keep on heading lower until the first week of December. In retrospect, this relative performance was a pretty good leading indicator both higher and lower; the end of June 2008 peak preceded the de facto nationalization of Fannie Mae and Freddie Mac, the peak in crude oil prices and the re-pegging of the Chinese yuan to the dollar by two weeks. The December trough preceded the move toward near-0% federal funds and the peak in corporate credit spreads by two weeks as well.

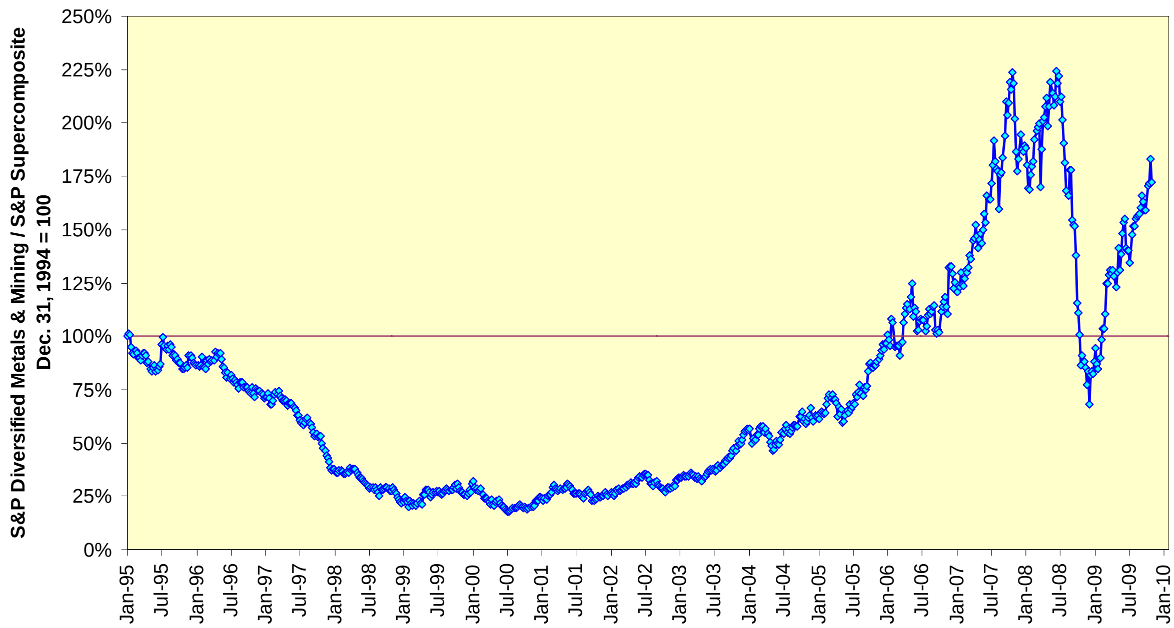
Global Miners Have Retraced Half Their Break



This is probably nothing more than a coincidence, but it is hard to ignore nevertheless. The stall in relative performance on the week ending October 23, 2009 may be just as much of a short-term phenomenon as the previous peak on June 12, 2009, but as the ACWI itself is turning lower, we should pay attention.

A similar relative performance measure for the S&P 1500 Diversified Metals & Mining index to the S&P 1500 itself shows a far greater degree of volatility. While the global measure is stalling at about 50% of its 2008 break, the U.S. measure has pushed into the bubblicious zone first hit back in the glory days of July 2007. Yes, the FCXdominated index can outperform the S&P 1500 on the basis of world demand, but if the global markets and economy weaken any further, this will be a bad bet.

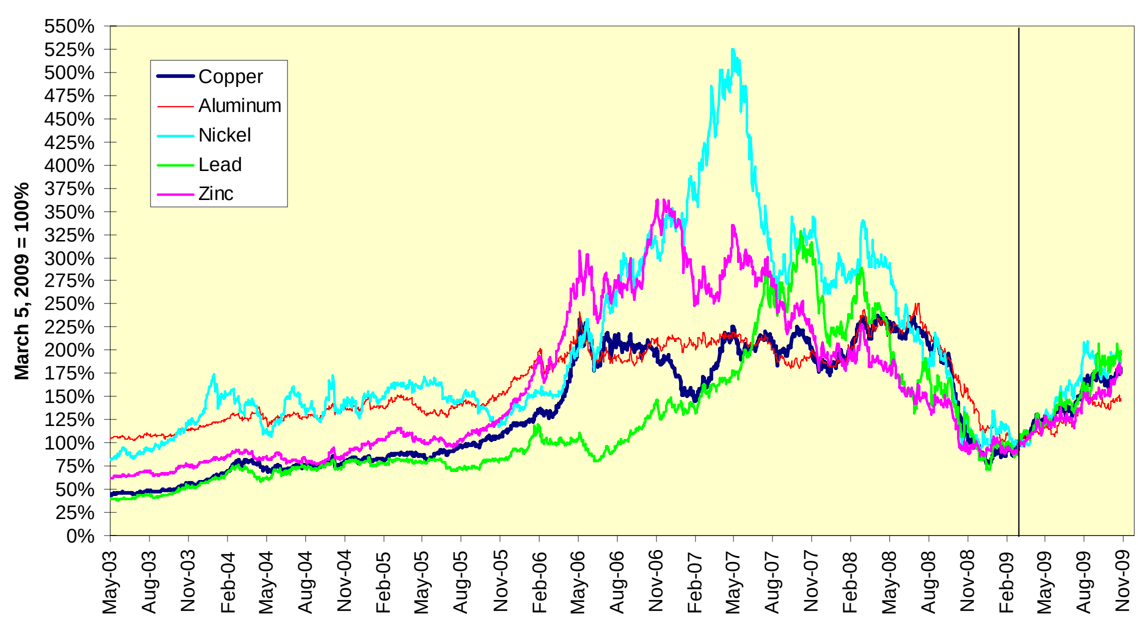
U.S. Miners Moving Back To Resistance

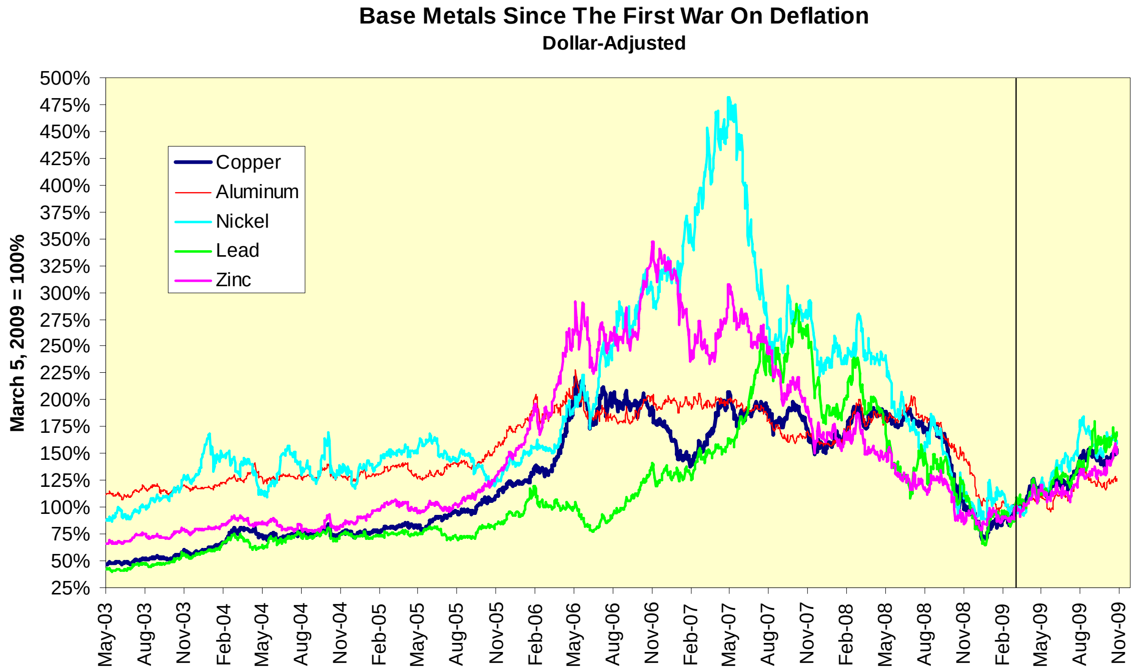


Base Metals

A common theme in this space has been commodities and commodity-linked equities are poor substitutes for one another and will remain so despite financial product designers' most fervent efforts. As a case in point, the 37.8% increase in the relative performance of global miners since the March 5, 2009, local maximum in the dollar index may be impressive, but only if you ignore just how much these stocks underperformed base metals prices. If we re-index three-month forwards of six different base metals traded on the London Metals Exchange to March 5, 2009, we find aluminum is the weakest performer with a 144% increase before currency adjustment and 124% thereafter.

Base Metals Since The First War On Deflation





The miners have not been able to capture the gains in metals prices. This statement would have passed for normal in the days before we felt it necessary to distinguish between the new normal and any predecessors, and would have been interpreted as mining stocks containing an embedded short call option on metals prices. Conceptually, this is equivalent to saying investors fully expected someone else, be it suppliers, governments, landowners or even customers able to reduce the metal content of their products to capture the gains of higher metals prices.

Price Convergence

A second feature of the charts above should not pass without comment. Please notice how divergent metals prices used to be prior to 2007; while the timescale there begins with the Federal Reserve's first declaration of war on deflation in May 2003, the divergence of price extends backwards for as far as we can measure. Now notice how convergent the prices have become after the March peak in the dollar or, for that matter after the December 2008 cyclical low in prices.

Convergence can be forced by an external agent; here the likely suspect is China and its stockpiling program, but also the world's suddenly resurgent hedge funds. This convergence should make you leery; these metals derive from different sources and have vastly different uses (try making an airplane out of lead). They should not have a high degree of cross-correlation to one another. If prices and demand both have increased as a function of a Chinese state decision to buy and store metals or from a gaggle of hedge funds with a surfeit of other peoples' money, watch out below if either is reversed.

The miners have had a good run. If you have been long, cash in and let someone else dig themselves a hole.