Commodity Price Signals: The Good, The Bad, And The Ugly

The signers of the Declaration of Independence pledged their "lives, fortunes, and sacred honor" to the cause. We're all probably a little more aware of the value and fragility of life than we were just a few weeks ago, and most of us, alas, are now a little lighter in the fortune department.

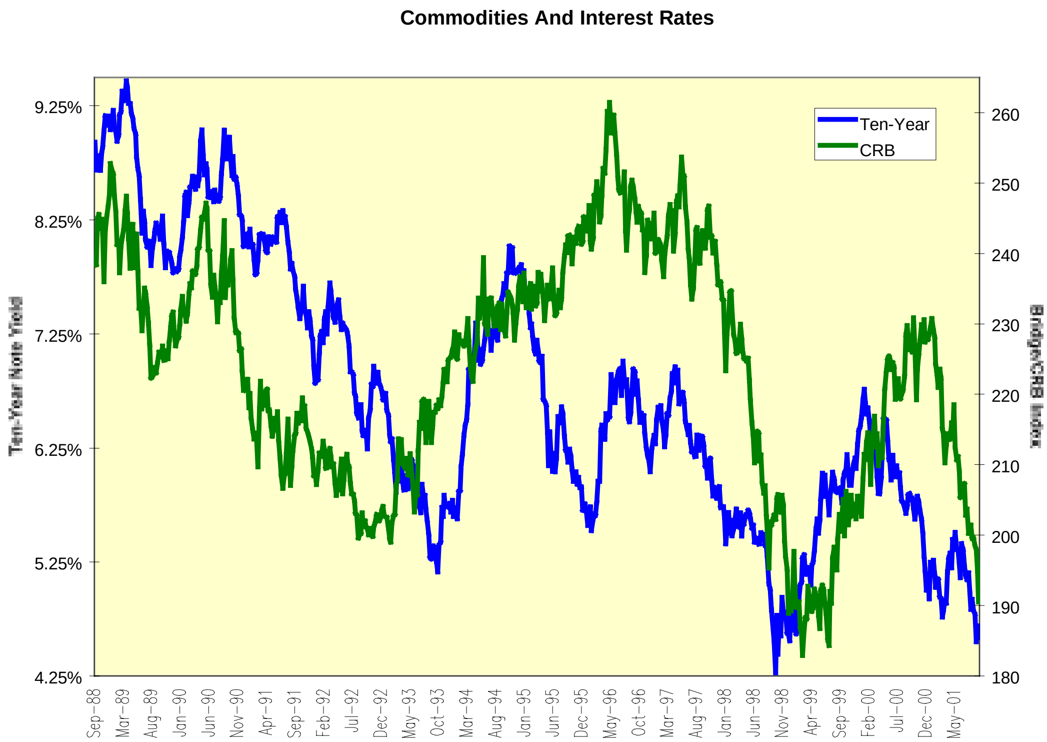
Sacred honor is not as irretrievable as life, but once lost is difficult to recover. This struck me while reviewing a piece I wrote for TheStreetPros.com last April (see "No Good Word From Metals") on the negative macroeconomic implications emanating from the base metal complex, which includes copper, aluminum, zinc, nickel, tin and lead. At the time, various members of the FOMC were traversing the countryside in defense of their lower-than-hoped-for rate cut of 50 basis points on March 20th. I commented:

> Credibility is the cornerstone of human relations on all levels: Most adults handle adversity reasonably well, but few of us tolerate a stream of lies and half-truths pointed in our direction. The recent spate of comments from various members of the Federal Reserve telling us things aren't all that bad in the face of a steady stream of evidence to the contrary risks a long-term loss of credibility for that suddenly-embattled institution.

We needed, then as always, to hear the bad news. President Bush has benefited from our sense he's leveling with us on how difficult the war on terrorism will be. Pollyannaish Treasury Secretary Paul O'Neill and those brokerage house analysts and strategists, many of who still are predicting unlikely massive rallies between now and the end of the year need to take note. You can't promise your audience you will be right, but you can and must promise them you will be honest. I, for one, am tired of writing downbeat assessments and yearn to bear good news, but I cannot let this impulse color my analysis.

The Good

The conclusion reached both in the piece above and on one written immediately prior to the March low (see "Some Cheer From Commodities") was that the deflation in commodity prices produced by the slowing economy would have some benefits. Lower commodity prices generally precede a drop in long-term interest rates; this leading relationship was distorted over the past three years by the artificial price supports in energy from OPEC and from last winter's natural gas price surge.



The recent drop in energy prices will act as a massive tax cut for the economy. Since we import nearly 12.5 million barrels per day of crude oil and refined products, the recent plunge of nearly $4.00 per barrel is equivalent to an annual tax cut of $18 billion. The even larger drop in natural gas prices since last winter represents a domestic wealth transfer to consumers from producers of approximately another $16 billion. (Stray thought: Are consumers gouging producers?)

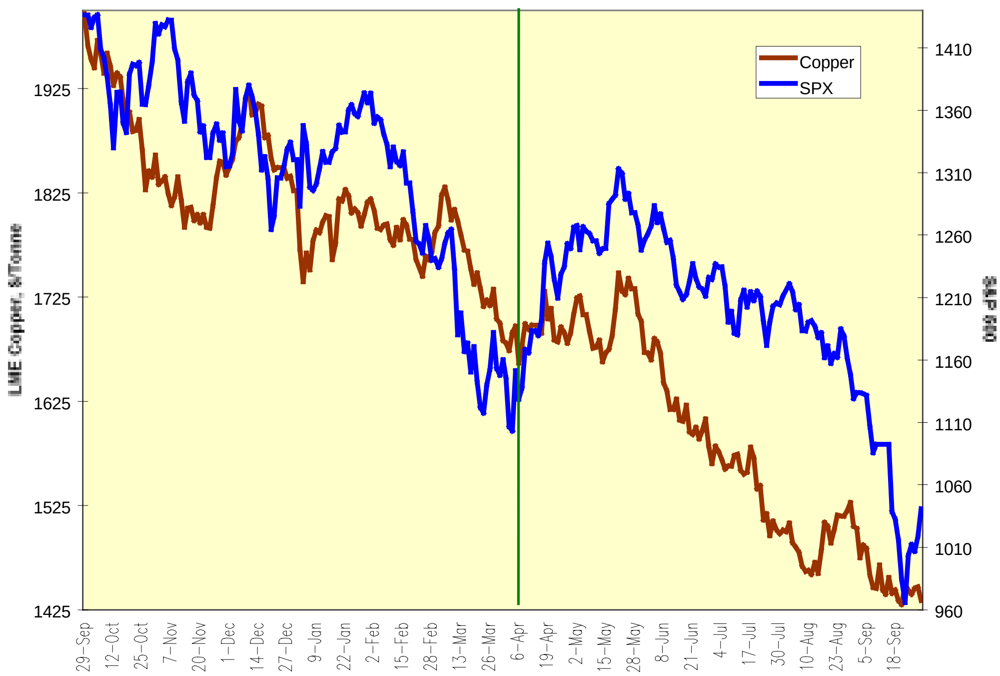
On both the expected interest rate and energy counts, therefore, the average consumer and non-commodity producing businesses should benefit.

The Bad

As stated so often in this space, real commodity prices should trend lower over time to reflect increased production efficiencies. A striking, but hardly unique, example of this is the 85% drop in real wheat prices since 1946, a period in which the world's population grew from 2.5 to 6.1 billion people. Commodity price spikes, such as the recent one in energy, are self-correcting as they stimulate both demand conservation and new production.

However, commodity price deflation caused by macroeconomic recession reflects an unwelcome set of circumstances. Let's update a chart from last April, one comparing London Metals Exchange prices for 3-month forward copper and the S&P 500; the date of the previous comment that metals prices were still headed lower is marked on the chart. While copper is used as an example, the same story would be told by aluminum, nickel, and zinc – but not by lead or tin – prices.

Parallel Bear Markets



Copper prices never "took the bait" like stock prices did last spring; after all, we can express hope and confidence for the future with our equity investments, but copper buyers have no room for such sentimentality. The demand is either there or it is not. During last week's relief rally in stocks, nickel prices hit a new low for the year and both copper and aluminum approached theirs. If there is a global recovery in manufacturing demand, it's news to metals buyers.

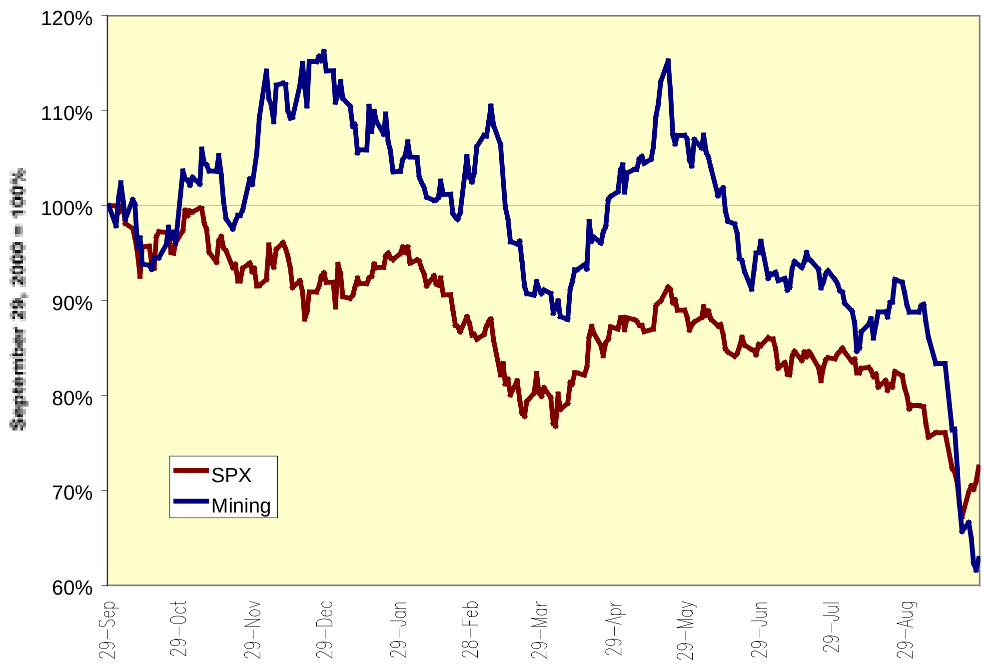
The Ugly

The previous article on metals prices offered three ways to tell whether commodity prices have bottomed:

1. Have prices fallen below the marginal cost of production?
2. Has the forward curve of futures prices moved toward a deep carry, wherein the prices of distant futures are well above near-month futures?
3. Are the stocks of primary producers rising faster than the market as a whole?

Of these, the third method is the most reliable. Let's take a look at the six-member Bloomberg U.S. mining index in comparison to the S&P 500. The pack of six includes Apex Silver (SIL), Brush Engineered Materials (BW), Kaiser Aluminum (KLU), Phelps Dodge (PD), RTI International (RTI), and Titanium Metals (TIE).

Relative Performance: Mining Index Vs. S&P 500



The picture is discouraging, to say the least. The mining index took the bait even more than did the S&P 500 in the spring rally on hopes of a macroeconomic recovery, but its recent descent has been far sharper and deeper than the broad market's. If metals prices are sensitive leading indicators of economic growth, and if the equity market is doing its job of discounting future earnings properly, we've still got a rough road ahead.

Well, that's the good, the bad, and the ugly. Not a good way to make a fistful of dollars and a few dollars more.