

Chinese Lead And Your Portfolio

Sir Isaac Newton was not the first person to observe an apple falling, and he might not have been the first to ask why it fell downwards, but he certainly was the first to construct a working theory of gravity. If you want answers, you have to ask questions.

I had this little insight while seeing the umpteenth Chinese-lead-found-in-toys story scroll across the screen during last Friday's 367-point drubbing. I was determined to be the first person to construct a working financial model of China, lead and the toy industry.

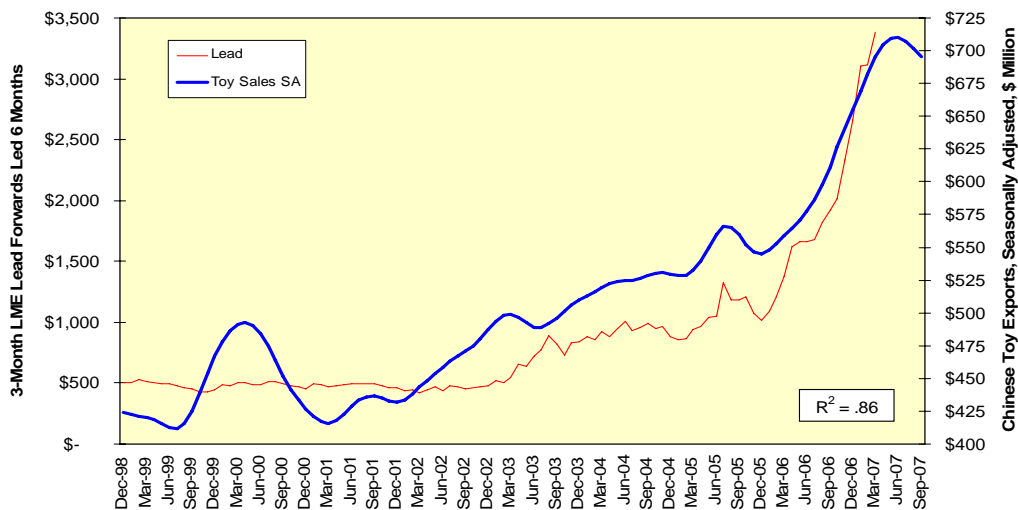
All the data and calculations below are real. However, as it was written tongue-in-cheek, you may wish to read it in a similar spirit.

A Bull Market In Lead

Lead is about as pedestrian a metal as you can get, and it seldom gets mentioned in the same breath as gold. Imagine the gold bugs' contrition upon hearing that while their favorite metal has resented a very respectable 139% over the past five years, lead has a truly spectacular 790%, or more than 5.5 times as much. But, like the late Rodney Dangerfield, it gets no respect.

Now let's map the price of three-month lead forwards traded on the London Metals Exchange against a seasonally adjusted history of Chinese toy exports. Not only do Chinese toy exports lead the price of lead by six months, the r-squared or percentage of variance explained by this simple model is 0.86.

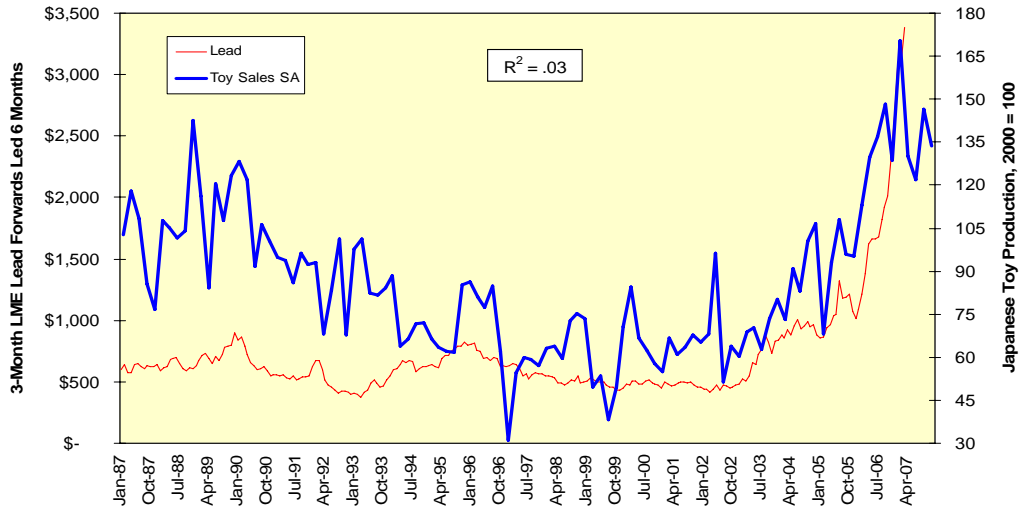
Chinese Toy Exports And Lead Prices



I am sure some commercial attaché or trade representative from the Peoples' Republic will protest this statistical demonstration. They will argue lead is used for purposes other than painting children's toys. Fine; we all have a job to do.

But the burden of proof is on them. Consider their neighbor and fellow export powerhouse, Japan. An index of Japanese toy production (the year 2000 = 100) has risen and fallen with no apparent connection to lead prices. Here the r-squared is an insignificant 0.03. A forensic economist could conclude the Japanese have learned to manufacture toys without the help of any toxic metals.

Japanese Toy Production And Lead Prices

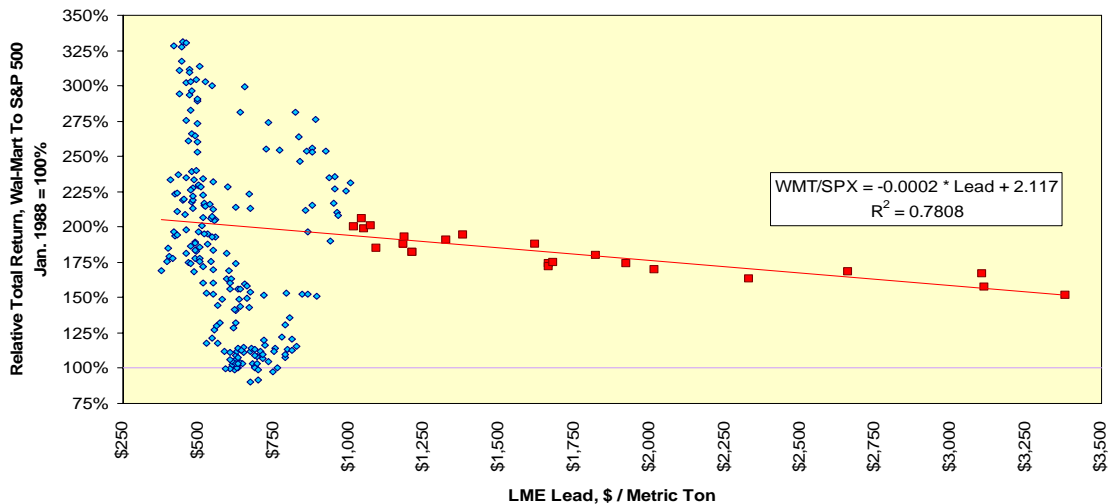


The Big Importer

It is impossible to talk about either China or toy sales without mentioning Wal-Mart; the firm imported close to \$27 billion of goods from China last year. Anyone who has held Wal-Mart in recent years surely has noticed its poor performance. Its average annual return since October 2002, the low of the bear market, has been a -3.2%. And since lead began its breathtaking breakout in November 2005, the stock's average annual return has been a -2.3%.

But did anyone ever ask the Newtonian question, "Does lead have anything to do with this?" Apparently it does: If we map the total return of Wal-Mart relative to that of the S&P 500 since January 1988 against the price of lead, we find two distinct periods. The first, denoted with blue markers in the chart below, through November 2005 shows no distinct relationship. The second, denoted with red markers, shows a very distinct relationship.

Wal-Mart Underperformed As Lead Price Surged



As the price of lead surged, Wal-Mart's relative performance declined in a linear fashion with an r-squared of .78. While we would be remiss in ascribing this poor performance to the higher price of goods containing lead, it does provide food for thought, does it not?

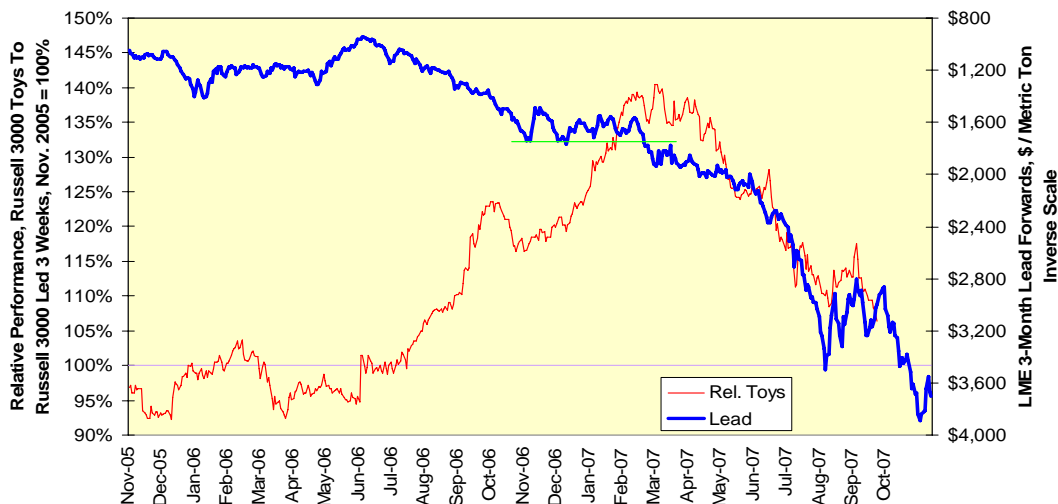
Toys Are Us

Now let's compare the performance of the Russell 3000 Toys index, consisting of Hasbro, Jakks Pacific, Leapfrog Enterprise, Marvel Entertainment and Mattel, to the Russell 3000 Industry Group Index.

These American toy firms' relative performance led three weeks did very well between April 2006 and the end of the year even as lead prices, plotted on an inverted scale, edged higher. But there is a reason we are taught the

parable of the straw that broke the camel's back. Once lead broke resistance, marked here with a green line, the relative performance of the toy firms collapsed and has been collapsing ever since.

American Toy Industry Suffered As Lead Prices Surged



A Grain Of Salt

Suspicious? A coincidence, you say? Ignore facts at your own peril. We have seen how Chinese toy exports lead the price of lead, how Japanese toy production is unrelated to lead, how Wal-Mart's relative performance has been an inverse function of lead prices for close to two years, and how an index of American toy firms' relative performance has collapsed during lead's price surge.

There is, of course, a second lesson to be had here, one that derives from the disclaimer above that all data and calculations contained herein are objective: You can have an absolutely fact-based argument supported by statistics and still reach a preposterous conclusion.

That is why once the price of lead falls on the LME, buy Wal-Mart, Mattel and Hasbro like they are going out of style.