Lead Zeppelin Signals Economy On Wrong Stairway

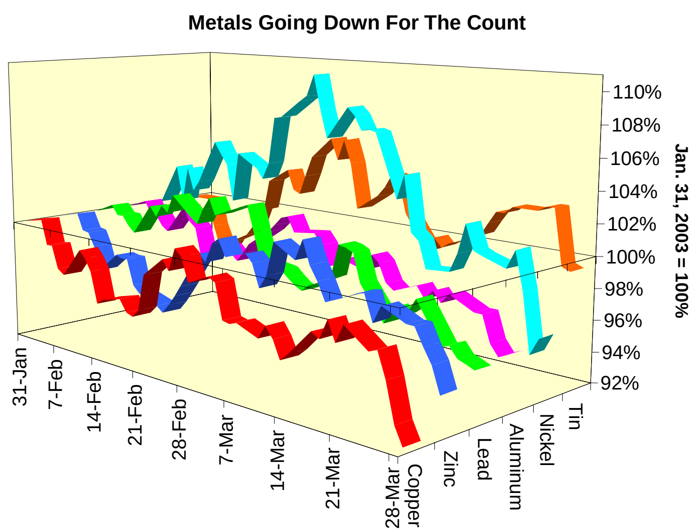
Yes, I know the band's name was "Led Zeppelin," so save the e-mail. We're talking real lead, the beloved *plumbum* of Rome from whence the elemental symbol Pb is derived. It is a fair bet that lots of lead is emerging at high velocities from rifles these days.

While we are at it, let's revisit the base metal complex because wars consume vast quantities of metals. Artillery casings are made with brass, an alloy of copper and zinc. The shaped charges of armor-piercing rounds have copper cores. Aircraft have aluminum skins. Steel is toughened and made more corrosion-resistant with nickel and zinc. So, pun intended completely, the metals business must be booming, no?

No.

Pointing Down

The last time I wrote on this subject, in December 2002, I concluded that the base metals markets were sending out very mixed signals on the economy. The good news is that ambiguity has dissipated. The bad news is metals prices are pointing lower. All six of the base metals traded on the London Metals Exchange have fallen in price since January 31. Only nickel, always the most volatile base metal, and tin even attempted a rally during the last two months.



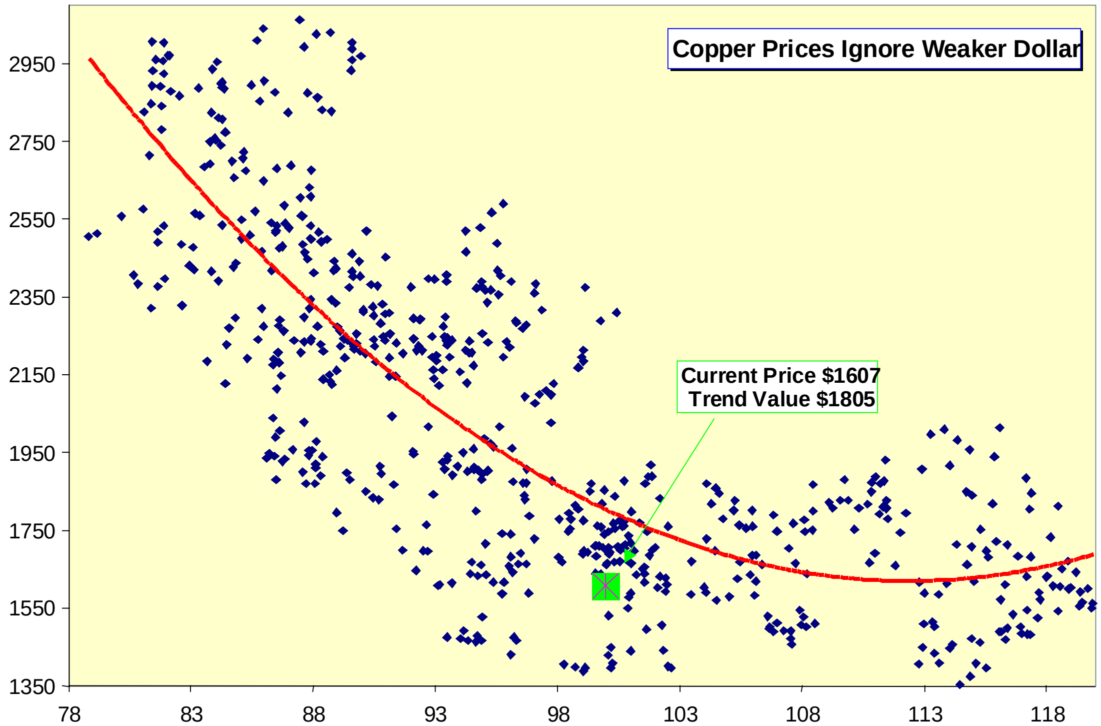
The Greenback Connection

The LME metals are quoted in U.S. dollars, and like all tangible assets tend to have an inverse relationship therewith. If each dollar is worth less, then each metric ton of copper or aluminum should rise in dollar price. Moreover, a weaker dollar has tended to stimulate U.S. manufacturing as exports rise.

This relationship is failing at the moment. The dollar has weakened under the Fed's shock and awe campaign of monetary creation and lower interest rates and under the weight of lower expected returns on U.S. assets. A weaker dollar lowers the effective cost of metals for non-dollar buyers, and that should stimulate demand in Europe, Asia and elsewhere.

That, alas, is not happening. Let's take the particular case of copper, a good barometer for overall manufacturing and construction activity. It is unexpectedly weak relative to the dollar at the moment; if it were on trend for its 1991-2003 relationship, it would be at $1805 per metric ton right now instead of its present $1607.

The weaker than expected price of copper bodes poorly for manufacturing demand in the near-term, regardless of the duration of the war. It is an unmistakable sign of weak capital spending and construction plans, both globally and in the United States.



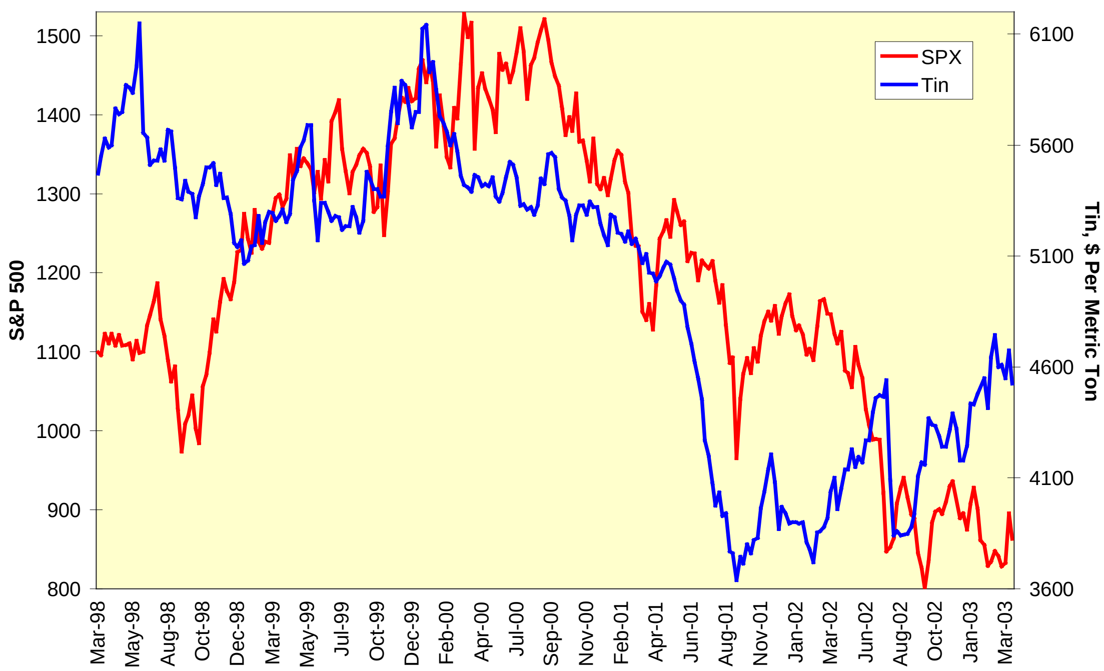
A Tin Ear

The topics of military logistics have been very much in the news, as they should be. Quartermasters are the unsung heroes of every war: No less of an authority than Napoleon said "an army travels on its stomach." The tin can was invented in France in the 1790s, and despite an entire epoch of human history being designated the Bronze Age in honor of the copper-tin alloy, tin and cans have been linked ever since.

But even in this age of plastic-wrapped MREs, tin remains an outstanding economic indicator. Over the past five years, a period chosen to avoid the immediate aftermath of the Asian financial crisis on Malaysia, a leading tin producer, tin prices have led several major moves in U.S. equities. They peaked shortly before the bear market began in March 2000, and then entered a precipitous waterfall decline in 2001 once the $4,920 level was broken.

This key support level has been rejected on the approach several times so far this year, with prices never exceeding $4,820. During the war relief rally two weeks ago, tin gapped lower. Such a move is hardly consistent with expectations of increased demand.

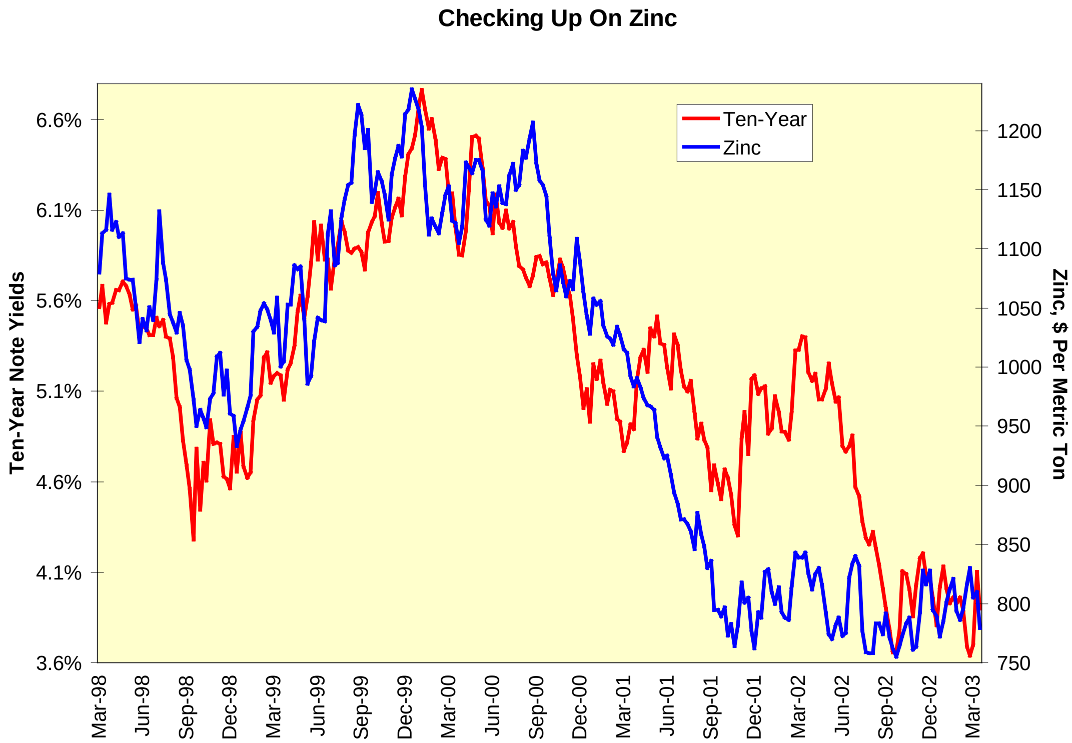
Tin Can Rally... But Not Now



Interest In Zinc

The close relationship between zinc prices and ten-year note yields was noted here last December. The conclusion was that interest rates would rise along with credit demands, which in turn would rise with increased activity in manufacturing. Zinc, used to galvanize steel and make brass, reflects manufacturing demand closely, and has the benefit of having almost no speculative content whatsoever.

One of my mental checklist questions when I see an extreme price move is to ask "is the market accepting or rejecting this price?" Zinc's price peaked along with the stock market in early 2000 and spent the entirety of 2001 falling to levels from which it has yet to recover. The conclusion is that if the market has not rejected the lower price - even the smallest rally attempts have fizzled - then there is no recovery in demand on the horizon.



A Dreary Conclusion

Whatever happened to the New Economy wherein we would all be conducting frictional electronic commerce and living happily ever after? Maybe we will live to see it; if I remember correctly, it all looked neat in the ads. For now, however, we still have to get by on making and moving things that cannot be transformed into bytes.

Until this reality is repealed, financial markets are unlikely to disconnect from the real economy while memories of the previous experience are still fresh. That means we are going to have to wait for an upturn in manufacturing, and if this little tour through the base metals complex is any indication, we are just going to have to wait.