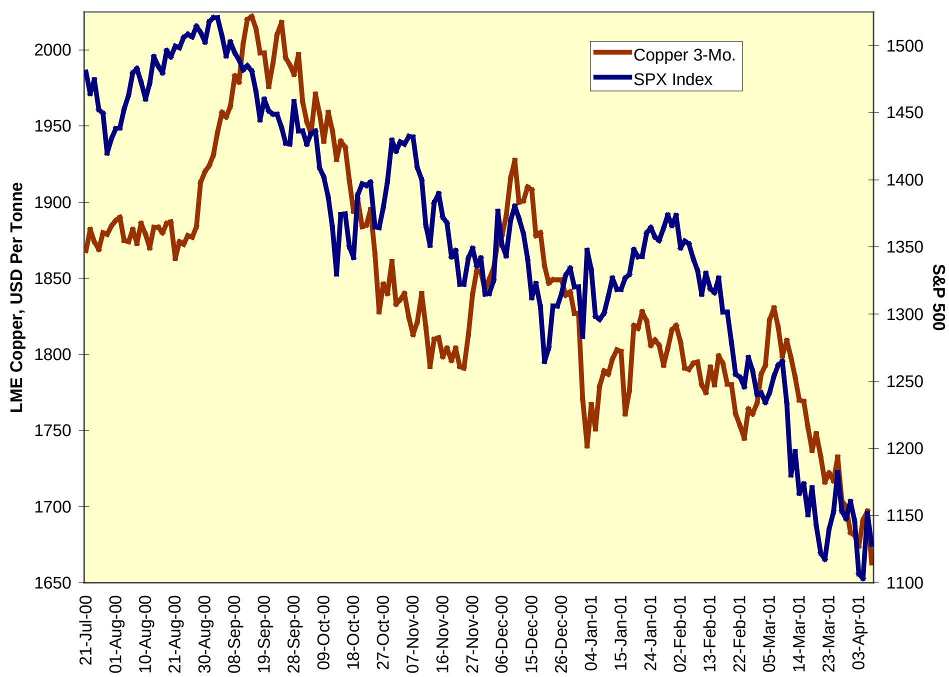
No Good Words From Metals

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.

Markets may get it wrong every now and then, but they are unflinchingly honest. The supply/demand balance for the base metals traded on the London Metals Exchange (LME) is an excellent barometer of manufacturing demand in what used to be called the Old Economy. Let's see what these markets are saying right now. And as long as we're on the subject of credibility, your loyal correspondent got this market wrong (see "Copper Potential Is No Miner Thing," July 25, 2000) last summer. Nothing then indicated the depth and severity of the present economic downturn. In self-defense, copper prices rose until the beginning of September 2000, and then entered a relentless bear market strikingly similar to that of the S&P 500.

Copper And S&P 500: Parallel Bear Markets



Looking For A Few Good Bottoms

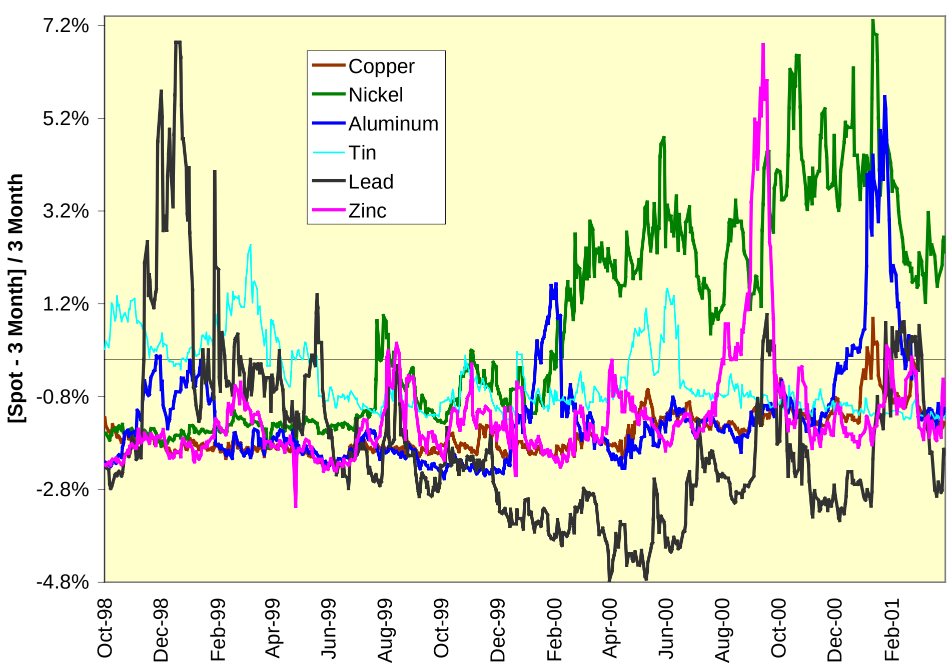
The find-the-bottom game in equities is getting boring; in fairness, the find-the-top game got pretty tedious on the way up as well. Bottoms in physical commodities are found in three general manners. The first, which makes the most sense from an economic standpoint but is the least effective in practice, is when prices fall below the marginal cost of production. The reason this is ineffective is many producers, especially state-run enterprises, stay in business to cover their fixed costs and drive prices down even further. This indicator will not be examined further.

The second method, and one that works fairly well in crude oil, is when the forward curve shifts into contango. This is a powerful signal the market's present supply glut is expected to end, and it generally does within six to nine months. Base metals seldom trade in contango; the natural state long has been backwardation, or a premium of the spot month price to the three-month forward. The reason for this is simple: The cheapest place to store metal is in the ground. The producer is stuck holding the metal and must sell it forward to hedge, which drives the price of the three-month forward lower.

The third method is when producers' shares start to outperform the general market. As we've seen several times in this series, commodity-linked equities have a call option-like relationship to the underlying commodity's price. Since it's a fairly low-risk trade to get in early, we find stocks to be a good forward-looking indicator of commodity prices.

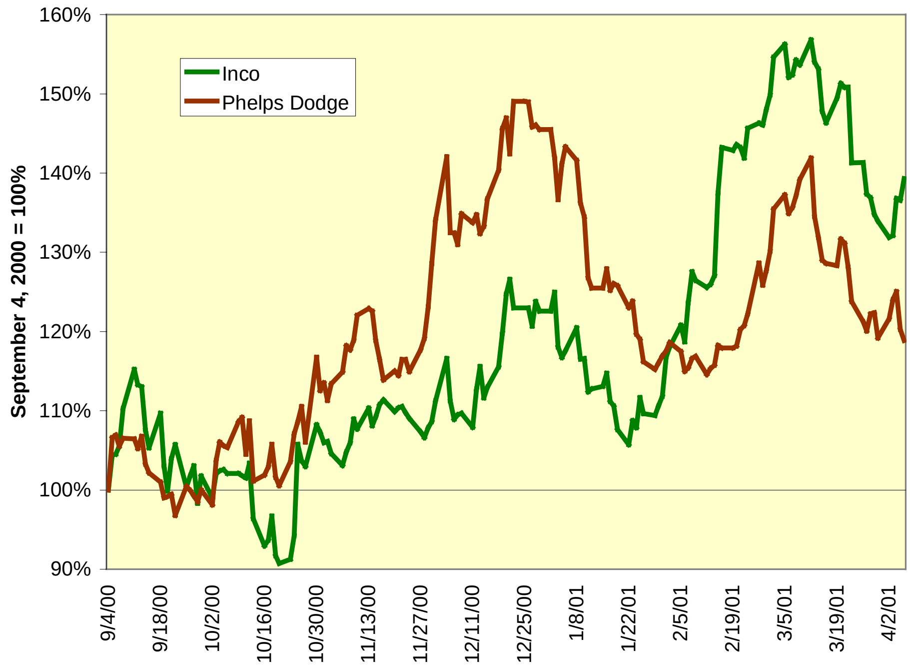
Is either of these two methods signaling an incipient economic upturn? The forward curves of the six principal metals traded on the LME are not flashing any buy signals right now. In fact, the most recent contango signal was in lead during the spring of 2000; by September, spot lead rose from $400 to $520 per tonne. Aluminum, copper, tin, and zinc all continue to drive lower without any discounts developing in the forward curve. Only nickel, which is subject to the vagaries of Russian exports, has any stability in price, but its backwardation signals a discomfort with the present $6,220 per tonne as too high. The conclusion from the metals is drearily familiar: The economy should remain weak.

Forward Curves Of LME Metals



This leaves us with the equity indicator. Let's take two mining firms examined here recently, Phelps Dodge in copper and Inco in nickel (see "Base Metals, Exotic Spreads," December 3, 2000, wherein we recommended a successful long Inco / short Phelps Dodge spread). Has either of these stocks outperformed the S&P 500 or Toronto Stock Exchange since the present leg of the bear market began?

Relative Performance Of Phelps Dodge And Inco



Here again the picture is unhelpful. Both miners have outperformed their respective indices, but do we need to recount what's happened to the technology sectors of both the U.S. and Canadian markets? Even worse, their relative performances peaked in late February, the time at which the downturns in both markets accelerated. As the questions regarding the length and severity of the recession grew, the miners started to underperform.

The metals markets are unblinking coincident-to-leading economic indicators. They're going down apace with the equity markets. Their forward curves are flashing yellow lights at best. Miners' stocks are starting to underperform. We shouldn't require more information to remain cautious in our investment stance, and our central bankers and elected officials shouldn't require more information to make decisions on monetary and fiscal policy. After all, their credibility is at stake.