Are Base Metals Topping?

Most writers would agree you have to begin a column on base metals by referring to the recent earnings news out of Chevron and ExxonMobil. These integrated oil giants came under pressure from declining refining margins. While none of this is likely to elicit much sympathy, along with similar bad news out of oil-service giant Schlumberger, it reminds oil industry veterans of how the whole picture started to come unglued in 1981.

With apologies to Martin Niemoller: First they came for the refiners and I did not care because I was not a refiner. Then they came for the service firms, and I did not care because I was not a service firm. Then they came for the producers, and I did not care because I was not a producer. Then they came for the economists and there was no one left to care about me.

All resource industries are cyclical by their very nature. The commodity price boom of recent years originated in the commodity price busts of the late 1980s and 1990s, which led to years of underinvestment in productive capacity. It got a kick from the demand side when the Federal Reserve's rate cuts of 2001-2003 stimulated consumption, as intended, but with the production being shifted outside of the U.S. to lower-cost Asian producers such as China who needed to build infrastructure. And while many persist in linking commodity prices to currencies, this connection is surprisingly weak, as I demonstrated in July and will return to below.

Metals And Mining Stocks

First, the last few years have been very rewarding for holders of metals and mining stocks. Not only have these issues risen on the back of higher commodity prices, the industry has undergone a wave of consolidation in response to the ever-higher capital costs of developing new sources of supply. And while it may seem these stocks, measured here by the S&P 1500's diversified metals & mining group, which includes AMCOL International, Brush Engineered Materials, Freeport-McMoRan, RTI International and Titanium Metals, have outperformed the broad market for a long time, the bulk of their outperformance has been a recent affair. They were underperformers for a long time, and have surged only in the past year even as base metal prices have failed to make new highs, also discussed below.

Nothing Has Been Finer Than To Be A Copper Miner…
For The Past Year, At Least

Regardless, the metals & mining stocks may be a highly unrepresentative measure of the state of the metals business. It used to be easy to measure copper against Phelps Dodge, but that company disappeared into Freeport-McMoRan last March. It used to be easy to measure copper against Inco, but that company disappeared into Cia Vale do Rio Doce last January. The global metals and mining business is being concentrated into a few giant players, including BHP Billiton, Rio Tinto and Norilsk.

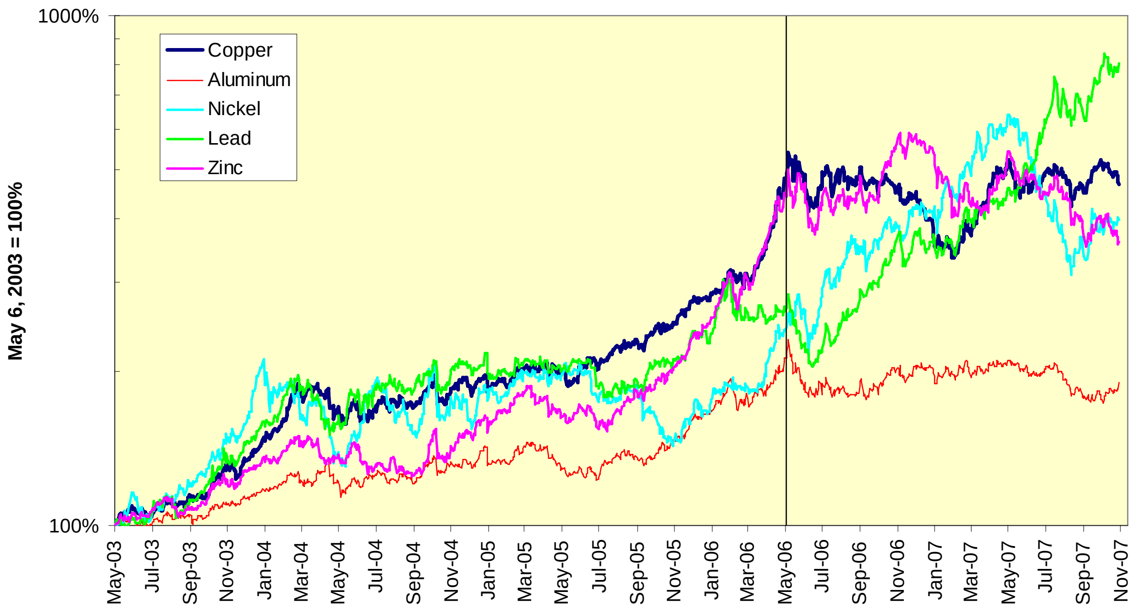
Kind of reminds me of the disappearance of oil giants such as Amoco, Arco, Sohio, Gulf, Phillips, Texaco and Mobil, or for that matter the massive consolidation seen in the banking industry in recent years. Bigger does not equate to better, but it does equate to greater concentration of risk and greater consequences in the event of error. If Chuck Prince calls, tell him we have his résumé and are giving it careful review.

Metals Prices

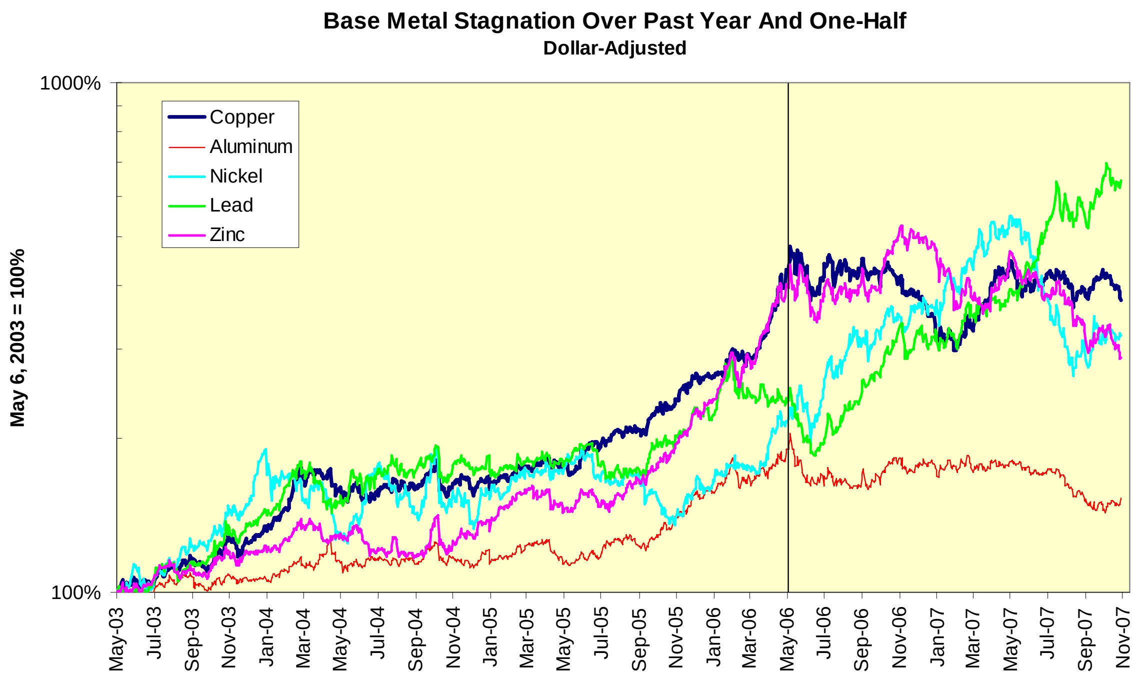
Given all the discussion surrounding the price surges in gold and crude oil and all of the concerns expressed over the sliding dollar and the Federal Reserve's apparent willingness to risk inflation through monetary creation, it must seem a given that base metals prices have been headed skyward.

Too bad the facts do not bear this out. I called the base metals markets a bubble in May 2006, marked with a vertical line in the chart below. Let's see how the prices of three-month forwards traded on the London Metals Exchange have fared over the past year and one-half.

Base Metal Stagnation Over Past Year



Would the chart above look materially different if we adjusted the prices by the dollar index? Yes, it would look worse from the point of view of those who believe metals prices rise as a function of dollar weakness. Quite simply, the metals' increases have not kept up with the dollar's decline.



Only lead and nickel prices are higher today than in May 2006; I discussed some of the extenuating circumstances surrounding lead two weeks ago. The larger and more important markets such as copper, aluminum, and zinc all are lower in nominal price terms. Moreover, the LME copper forward curve just shifted into contango, indicating a surplus of available copper. Viewed in this light, something has got to give. Either the metals & mining stocks are too optimistic about profitability and the ability of mining firm to engender both new supplies and reduced costs simultaneously, or the metals markets are about to go on a tear higher.

The former defies microeconomic logic. Firms faced with huge capital spending requirements and rising costs of production after their prices have increased are more likely to face profit margin contraction than expansion. The latter is possible only if demand growth in the rest of the world offsets declining demand growth in the U.S. We have no experience in the last 150 years of the world growing in the face of a softer U.S. economy, so we are truly flying blind.

Asking for the mining stocks to continue their outperformance in this environment looks like a losing bet.