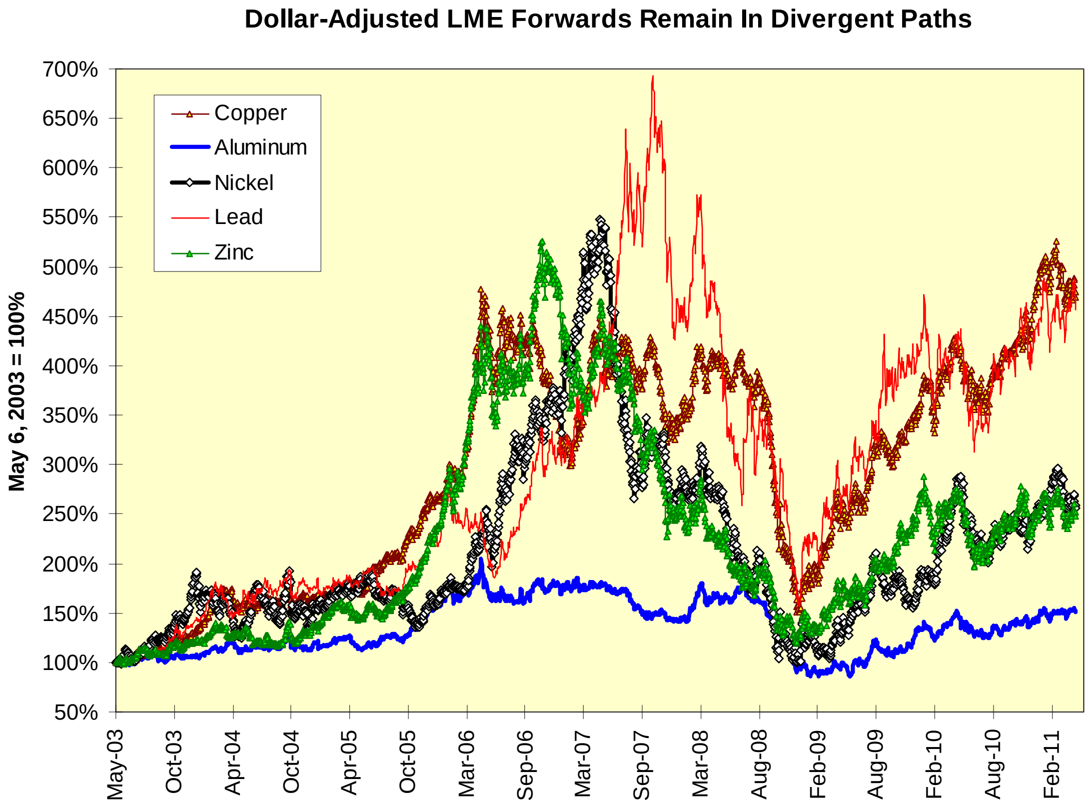
Base Metals And The Law Of Stuff

One of the points made yesterday about silver-mining equities was they were acting as if there was an embedded short call option on silver over $29 per ounce. These embedded call options are very common in the stocks of miners, crude oil exploration & production firms and indeed in the producers of all things "stuff." Markets are smart critters and they understand the Law of Stuff: Higher prices for Stuff destroy demand and induce new supply.

Politicians do not, as a rule, understand the Law of Stuff. They believe prices will rise forever and enslave us all, especially if the Stuff is gasoline, a commodity whose downturns go unremarked and whose upturns are accompanied by bellowing worthy of a bull seal on the beach. But, as usual, I digress.

Base Metals

The industrial metals that trade on the London Metals Exchange have been rising in price since early 2009; this is no surprise. What is a surprise is the groupings in their relative price paths. During the last long-running bull market in the metals, the one between 2003 and 2007, all but aluminum tended to rise and fall together, a phenomenon attributed widely to hedge funds getting a hunch and betting a bunch (Note: The chart below is messy enough, so I left tin out of it).

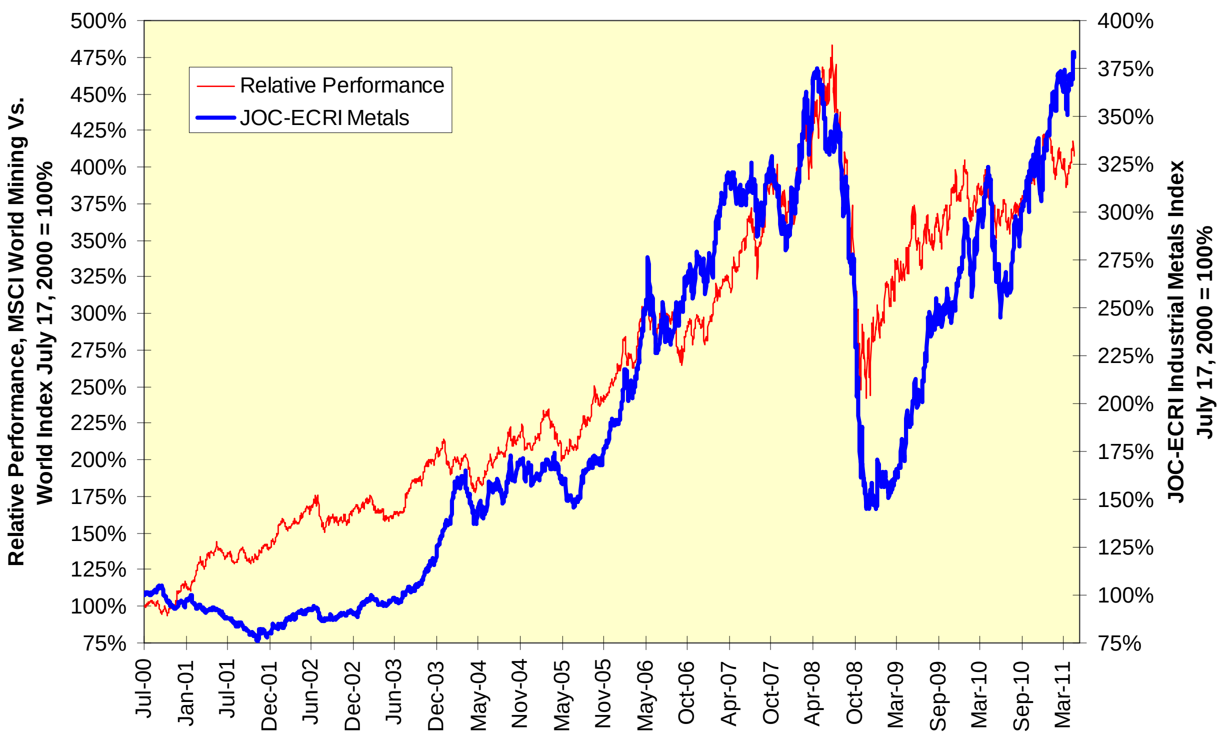


Now we have a couple of odd couples. Nickel and zinc, two metals unrelated in production or use, are moving together in parallel as a copper and lead, two more unrelated metals. What is especially strange here is copper and aluminum can substitute for each other in certain applications and lead and zinc are often produced out of the same ore bodies. Yet these are not the observed clusters; no explanation is offered.

The Short Call

What is clear is these metals have put in a pretty good run and will encounter the Law of Stuff soon. We should expect, therefore, to see a diminishing return on the relative performance of the MSCI-Barra World Mining index against the MSCI World Free index as a function of the Journal of Commerce-ECRI industrial metals index (We live in wondrous times; all I have to do is think of an index and it appears out of the mists). This indeed appears to be the case so far in 2011.

Miners' Relative Performance Now Lagging Metals Index



Once again, this is the embedded short call option in operation: You will make money in the mining stocks as metals prices rise, but your gain incremental to that of simply buying the broad market will get smaller.

All of this makes perfect sense from an economics point of view. As the prices of metals or other resources rise, the costs of production rise as governments, landowners, labor and equipment suppliers all try to capture part of the economic rent. Moreover, while rising prices for stocks often attract buyers, rising prices for commodities eventually attract sellers and discourage buyers. The conclusion reached in early March, that the relative gains of commodity-linked equities are bound to slow, is affirmed.