Miners Underperforming In Money Gusher

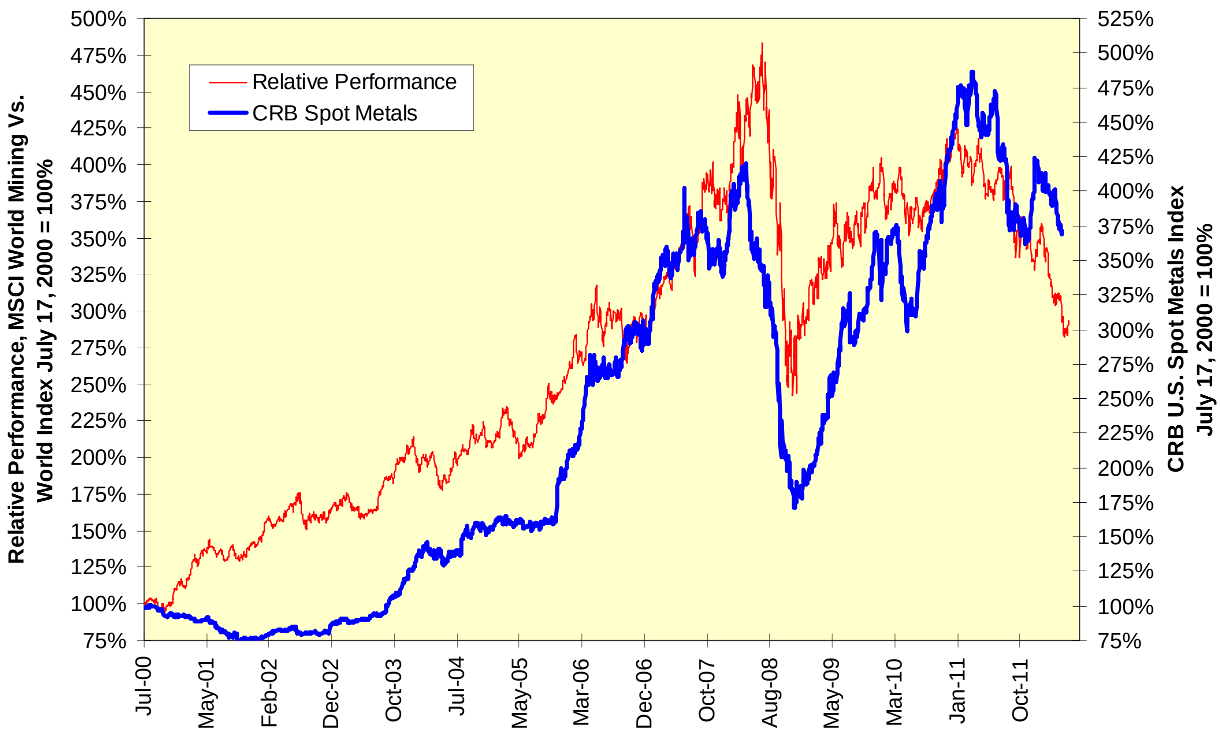
All Cyclical Industries Manage To Over-Expand

While Charles Barkley may have claimed he was misquoted in his autobiography, that fate will not befall me so long as I can search databases and cite articles such as April 2011's Base Metals and the Law of Stuff wherein I uncorked this beauty: "Markets are smart critters and they understand the Law of Stuff: Higher prices for stuff destroy demand and induce new supply."

The Law of Stuff is silent on what happens when the magic-money machine is left running unattended. The intuitive response, on held near-and-dear by many as an article of faith, is more money supports commodity prices, which in turn support commodity-linked equities such as global mining stocks. It is a great theory, one that someone must have spent the better part of a coffee break concocting, but it does not described reality.

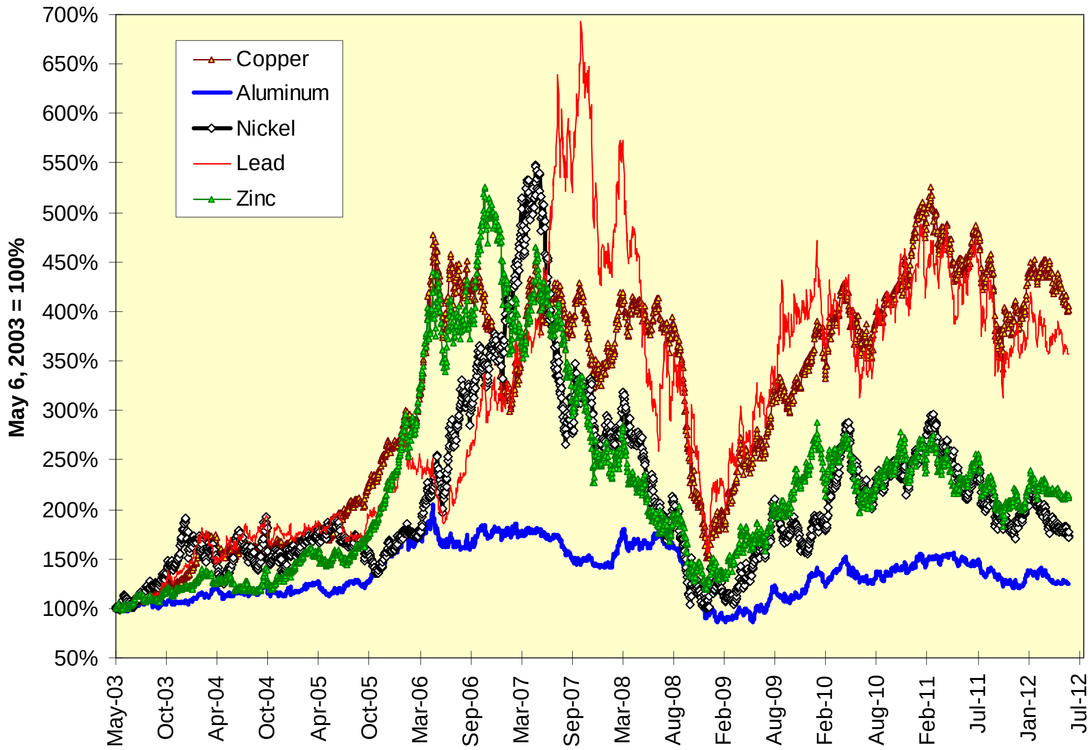
First, let's update the relative performance of the MSCI Metals & Mining index to the MSCI-Barra World index and map it against the ThomReuters/Jefferies CRB Spot Metals index. Relative performance began declining in February 2011, before the end of QE2 and before Operation Twist, LTRO I, the expansion of currency swap lines, an implied promise to keep U.S. rates near zero into 2014, LTRO II and, depending upon whom you wish to listen to, either QE3 or Operation Twist II. The relative performance of the miners accelerated downward as each monetary infusion was made. So much for the theory commodities and commodity-linked equities are a defense against central bankers on a mission from wad.

Miners' Relative Performance Signaling Lower Prices Ahead



The dollar-adjusted prices of LME forwards for industrial metals have been declining along a similar path. The weakest metals since LTRO II in February have been copper, lead and nickel. These are coincident with a downturn in Chinese demand. Those who believe China's latest rate cut is going to stimulate demand via the construction of more empty cities and office buildings will be disappointed. Worse, such a misallocation of capital will reduce global growth and lead to a downturn in metals demand everywhere.

Dollar-Adjusted LME Forwards In Sixteen-Month Decline



Mining is a cyclical business; always has been and always will be. Everyone in the industry sees the same signals at the same time, expands at a diminishing return on investment and then watches the new supply hit the market just in time for demand to slow down as a result of the higher prices. Once the mines are developed, the miners will operate below their marginal cost of production in an attempt to cover their enormous fixed costs.

A second escape route, consolidation, has been taken already; firms such as Freeport McMoRan (FCX), BHP Billiton (BHP) and Vale do Rio Doce (VALE) have absorbed many of their erstwhile competitors both to gain efficiencies of scale and to diversify their output portfolio across as many commodities and markets as possible. As the integrated oils such as ExxonMobil (XOM) and Chevron (CVX) have discovered to their dismay, once you get too big, there is almost nothing you can do to expand meaningfully.

The outlook for miners and base metals prices, both of which prospered during the China boom, is going to remain weak until overcapacity is absorbed. That will take years; this is, after all, a cyclical business.