

Base Metals To Remain Flat

Go back to your distant childhood and recall tales of the Bronze Age. You probably had no immediate idea what bronze was or, if you did, you struggled to distinguish this alloy of copper and tin from brass, an alloy of copper and zinc, and darn if you really knew what zinc was. You sort of got by knowing the Bronze Age came between various Stone Ages and your own beloved Iron Age, and if you were of a spiritual bent you cast your eyes heavenwards in thanks no one was foolish enough to consider the metals themselves, as opposed to the firms that produced or added value to them, to be investments.

Then came hedge funds and purveyors of alternative investment products, a fancy name for chump-bait, with their arguments the metals themselves are investment products. These arguments received a great deal of traction last decade with the China-growth story and a general price boom in all industrial materials. What was left unsaid was how small many of these markets are. Let's take nickel, an essential ingredient in stainless steel. According to the International Nickel Study Group (do these 'study groups' pull all-nighters? Just asking) global nickel production in 2011 was 1.589 million metric tons. At an average spot price of \$22,843 per MT, this comes out to an annual total of \$36.3 billion. This is about the same as Oracle's (ORCL) annual revenue; Oracle ranks 50th in the S&P 100 in terms of revenue.

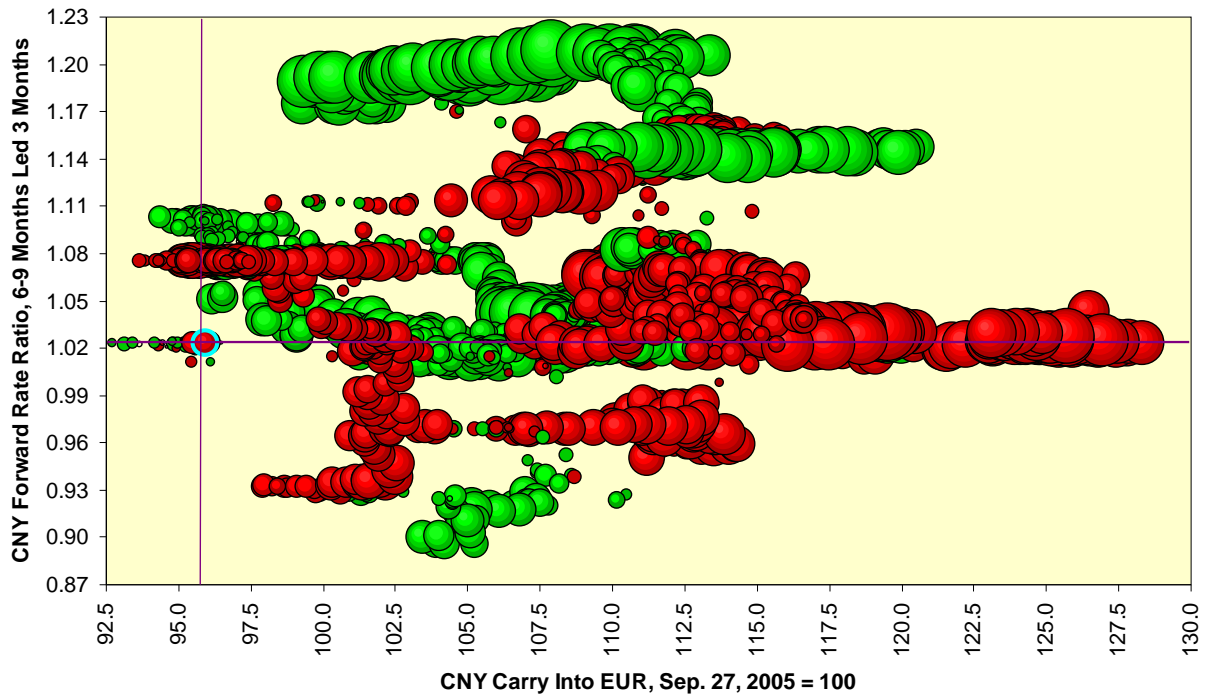
Your Nickel's Worth

The China story works both ways. The necessary slowdown in its construction activity has slowed demand growth for all of the base metals, iron ore included along with the lead, tin, nickel, zinc, copper and aluminum traded, sometimes on the up-and-up, on global markets. Supply has increased as well as miners responded in what they thought was a rational manner by adding capacity when all of their competitors did. Lemmings have nothing on cyclical industries' management teams; at least the latter have mastered paying themselves bonuses.

As all of the exchange-traded base metals' patterns have been similar, let's focus on the aforementioned nickel and map its prospective three-month returns as a function of two Chinese monetary variables. The first is the excess carry return of the yuan into the euro. The second is the shape of the Chinese interbank money-market yield curve as measured by the forward rate ratio between six and nine months. This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is.

Green bubbles in the chart below depict positive prospective returns, negative prospective returns are in red; the diameter of the bubbles corresponds to the absolute size of the return. The current environment is marked with a bombsight and the last datum used is highlighted with a turquoise ring.

Three-Month Ahead Nickel Price Changes As Function Of Chinese Monetary Variables



The chart here is stunningly simple to interpret and is duplicated for the other metals. We will not see positive returns unless the Chinese yield curve steepens and we will not see negative returns unless the euro strengthens relative to the yuan. Both developments would defy current central bank policies and therefore are unlikely to happen given the firepower imbalance between central banks and other investors at present.

If you have any alternative investments depending on base metals, the next three months are going to be dreary.