Industrial Metals' Decline Not A Negative Indicator

I always have had the greatest respect for prosaic markets, those quiet little workhorses with little speculative content. However, one of the consequences of modern finance is some trader's tentacles get stuck in every gearbox and manage to turn non-financial assets into financial ones. Just try and find tentacle-remover at Home Depot (HD). It used to be possible to analyze copper in terms of physical supply and demand, but now you have to contend with Chinese firms who used it as collateral for a loan and managed to turn the red metal into red ink in the process.

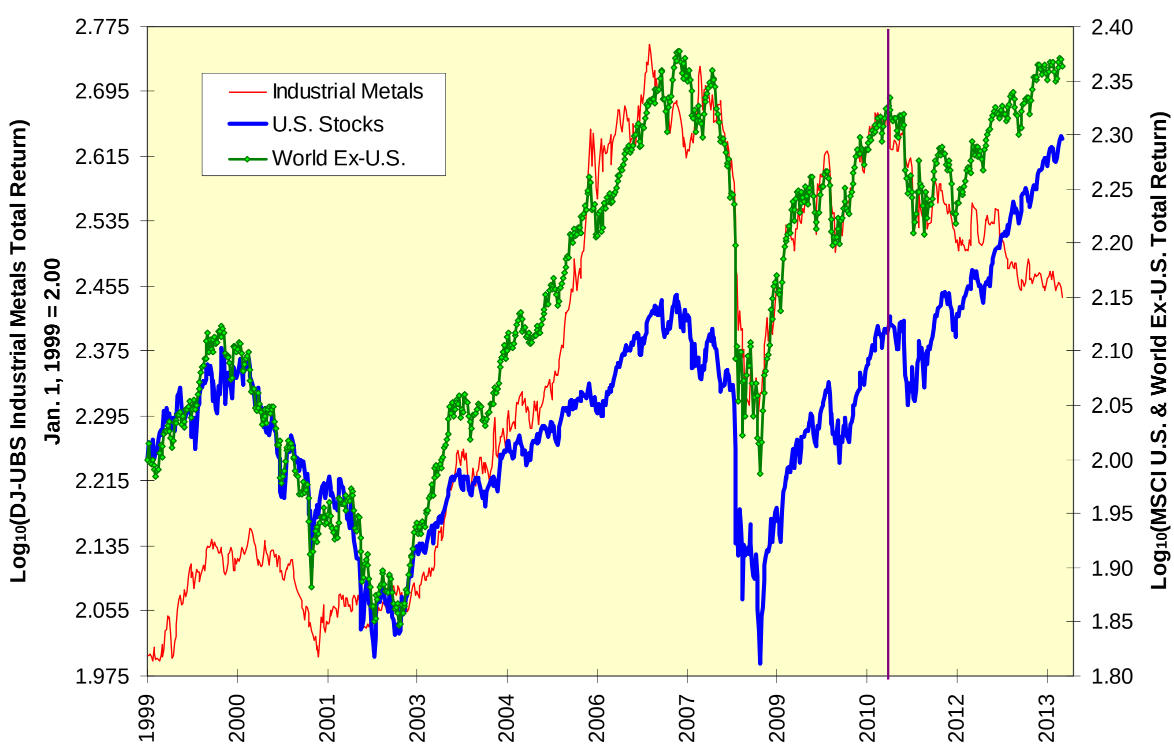
Should you panic about the decline in the Dow Jones-UBS industrial metals index, which consists of copper, aluminum, nickel and zinc? On one level, only if you wish to amuse whoever is looking at you by taking a few selfies and posting them all over Facebook (FB) or other social media sites unfamiliar to your aged correspondent. On a more serious level, the only times declining industrial metals have been a coincident, and not even a leading, indicator of equity returns have been recessions. If the global economy is weak and metals demand declines, both stocks and industrial metals decline.

Three Years Of Divergence

Let's map the total returns for the DJ-UBS industrial metals index against the MSCI-Barra total return indices for the U.S. and the World Ex-U.S. on a common logarithmic scale. Two things should be apparent immediately. First, the World Ex-U.S. and the industrial metals indices tracked each other very closely between the Federal Reserve's first declaration of war on deflation in May 2003 and January 2012; the r-squared or percentage of variance explained, was 0.932.

Second, industrial metals started to turn lower at the end of April 2011, almost three years ago. Their total return since then has been -41.2%. Total returns for the U.S. and the World Ex-U.S. have been 50.2 and 9.48%, respectively. Oh, and while I am tossing negative news for industrial metals around like the Acme anvil of cartoon fame, the Producer Price index has advanced 4.46% since then. Anyone who thinks something called "commodities" is an automatic hedge against inflation has some homework to do.

Equities Have Diverged From Industrial Metals Since April 2011



The message from the past three years could not be clearer: Equities have no problem rising while industrial metals are falling. The betas, or relative variances, of U.S. and World Ex-U.S. equities to industrial metals since April 2011 have been -0.888 and -0.282, respectively. To say, "stocks up, metals down" is not some Pollyannaish permabull nonsense; to say otherwise is simply unstudied prattle. The declines in the industrial metals have been a logical consequence of large-scale mining investments made during the previous decade intersecting with the inevitable slowdown in China's construction boom. If, however, China implodes and we have a world recession or worse, all bets are off.