



27th June 2017

Up, Up and Away – Yellen the Copper Kicker?

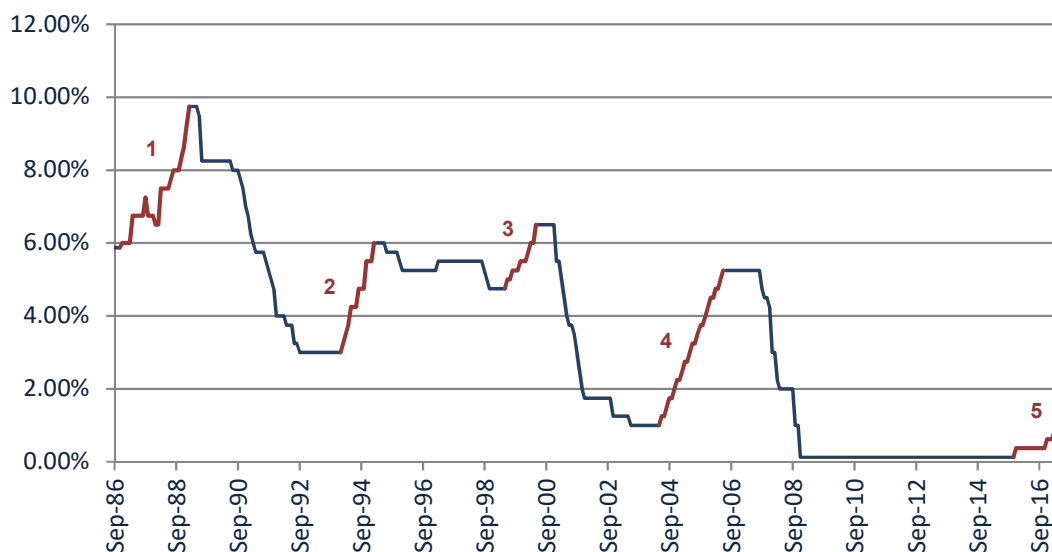
It may come as a surprise to those of us of a certain vintage to realise that the 30 year-old graduates now manning trading desks around the world have never seen a bear market (at least not in developed stock markets). Assuming graduation at 23, these bright young things started their careers in financial markets in 2010 when the S&P 500 was approximately 1100. Today it stands at 2435.

“The most aggravating thing about the younger generation is that I no longer belong to it”
Albert Einstein, 1879-1955

More importantly for the purposes of this note, they have only ever seen the US Federal Reserve adjust interest rates upwards (albeit on just four occasions). And that thought prompted me to revisit a subject we first raised in a research piece back in 2014 – what happens to our markets when the Fed raises rates? Our strategies trade in the metal and energy sectors on US and UK commodity exchanges. With a focus on market liquidity, our key markets are copper, gold and oil. We demonstrated back in 2014 that there is no meaningful correlation between gold and US rates so I have focused this note on copper and oil.

“If we knew what it was we were doing, it would not be called research, would it?”
Albert Einstein, 1879-1955

I started trading in commodity markets just over 30 years ago (just as the aforementioned graduates were being born then). My start date of September 1986 conveniently falls just before a significant tightening cycle that began in December 1986 so I thought that that would be a good place to start. Graph.1 below shows the level of the Fed Funds rate since that time;



Graph.1 – US Fed Funds Rate Sep'86 to Jun'17 (where rate is range, graph shows mid-point).

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You can see from Graph.1 above that there have been 4 previous cycles before the current one. The table below shows the salient details of each;

	First Raise	Last Raise	Summary
#1	Dec'86 from 5.875% to 6.00%	Feb'89 from 9.25% to 9.75%	Rates raised 10 times in 27mths
#2	Feb'94 from 3.00% to 3.25%	Feb'95 from 5.50% to 6.00%	Rates raised 7 times in 13mths
#3	Jun'99 from 4.75% to 5.00%	May'00 from 6.00% to 6.50%	Rates raised 6 times in 12mths
#4	Jun'04 from 1.00% to 1.25%	Jun'06 from 5.00% to 5.25%	Rates raised 17 times in 25mths

*"The only reason for time is so that everything doesn't happen at once."
Albert Einstein, 1879-1955*

The table below shows what happened to the prices of copper and oil in each of those 4 cycles;

Market Performance

- #1 Copper rallied 220% from \$1348 at end Nov'86 to \$2965 at end Feb'89
Oil rallied 21% from \$15.00 at end Nov'86 to \$18.15 at end Feb'89
- #2 Copper rallied 50% from \$1882 at end Jan'94 to \$2826 at end Feb'95
Oil rallied 22% from \$15.20 at end Jan'94 to \$18.50 at end Feb'95
- #3 Copper rallied 26% from \$1408 at end May'99 to \$1776 at end May'00
Oil rallied 72% from \$16.85 at end May'99 to \$29.00 at end May'00
- #4 Copper rallied 265% from \$2776 at end May'04 to \$7345 at end Jun'06
Oil rallied 85% from \$39.85 at end May'04 to \$74.00 at end Jun'06

Clearly both markets are positively correlated with US rates in tightening cycles. This shouldn't be a surprise since both are crucial industrial inputs and should therefore be reflective of underlying economic strength (or lack of). Although the sample size is small at just 4, the consistency of the gains is compelling – especially for copper. Interestingly the number and length of rate rises seems to correspond well to the magnitude of the return.

The current cycle (#5) technically started in December 2015 – but that seemed to be something of a false start. The Fed then went on hold and after a 1 year hiatus (which incidentally never happened in any other cycle) it raised them again in December 2016. For this analysis, I have ignored the December 2015 rise and instead I have treated the December 2016 rise as the first of the current cycle. That being said, where does that leave us today;

Market Performance

- #5 Copper fell 0.5% from \$5825 at end Nov'16 to \$5800 at end 23rd Jun'17
Oil fell 13% from \$49.45 at end Nov'16 to \$43.00 at end 23rd Jun'17

So after 3 rate rises in 7 months, copper hasn't moved and oil is actually lower – I will leave you to draw your own conclusions.

*"I have no special talents. I am only passionately curious."
Albert Einstein, 1879-1955*

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