



THE COPPER CONUNDRUM – FEBRUARY 2014

Those of you who read our monthly performance report for January 2014 will have seen our slightly tongue-in-cheek analysis of the Chinese Zodiac in regard to predicting copper prices. For those that may have missed it, we simply pointed out that in the last four “Snake” years the copper price closed the year lower – in some cases substantially. Conversely in the last three “Horse” years the copper price closed the year higher. The average loss was 13.8% while the average gain was 11.7%. Figures 1 and 2 below show the yearly returns;

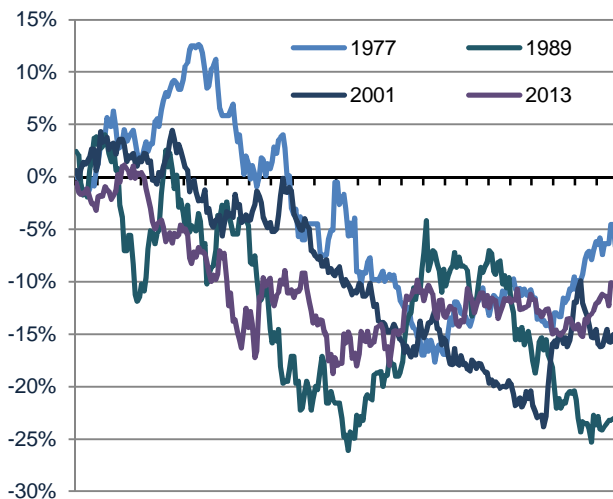


Fig.1 – Years of the Snake

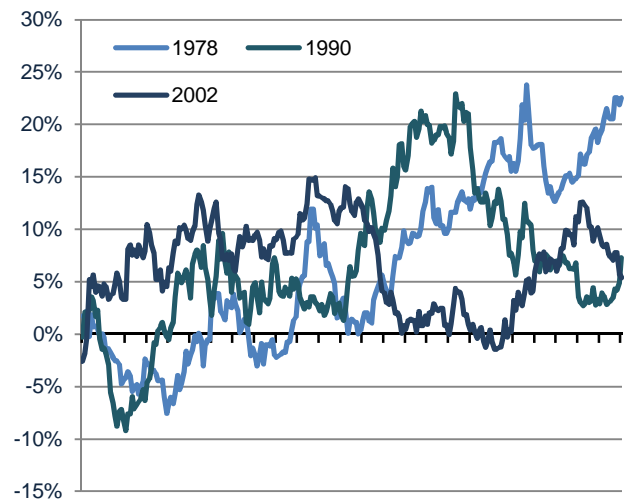


Fig.2 – Years of the Horse

The consistency of direction (if not magnitude) is striking, but from a statistical standpoint the sample size is so small that any conclusions should be accompanied by large buckets of salt. But it got me thinking about where the copper price is really headed in 2014. Will we close higher this year and extend the astrological coincidence?

“The chapter of knowledge is very short, but the chapter of accidents is a very long one”.

Earl of Chesterfield, 1584-1656

The copper price has historically been closely correlated with a number of financial instruments, including US equities, the dollar, and of course other industrial metals. We have written about these correlations and their implications in previous reports – which are available to download on our website. In another report we highlighted how the close correlation between the copper price and the US Fed Funds rate had collapsed (as a result of the zero interest rate policy in the US) and how instead the copper price was more finely aligned to the Chinese Reserve Requirement Ratio.

But of course the copper price is most closely aligned (over time) to the underlying fundamentals of the copper market – or at least it should be – and so this is where our analysis started.

"I am an optimist. It doesn't seem too much use being anything else".
Winston Churchill, 1874-1965

It is always difficult, if not impossible, to assess how much physical material is stocked at any one time and so the best (or rather the most consistent) benchmark we can use is the level of stocks that are freely available in exchange registered warehouses. Figs.3–5 below show freely available stocks in LME and COMEX (CME) warehouses (all in metric tonnes);

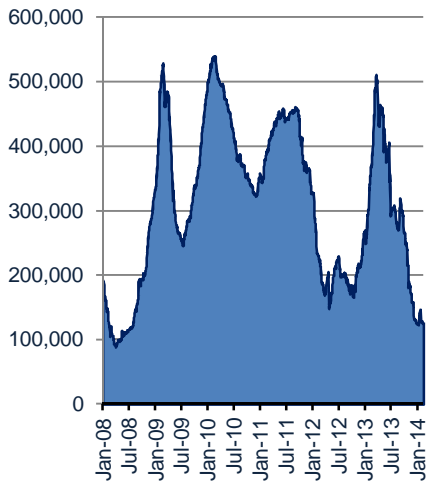


Fig.3 – LME warehouse stocks

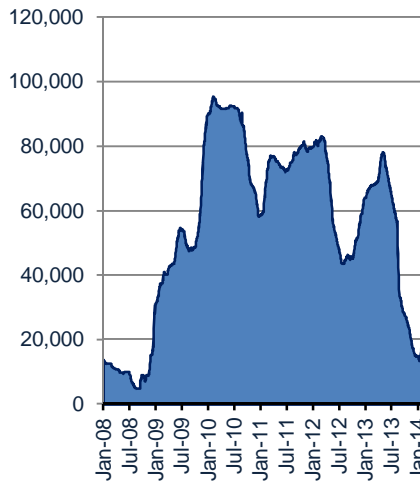


Fig.4 – CME warehouse stocks

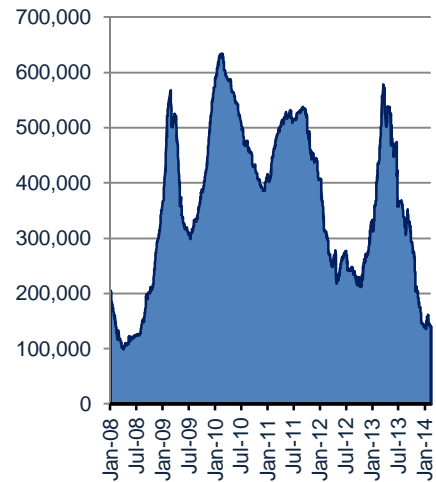


Fig.5 – Combined warehouse stocks

Clearly inventories have been drawn down substantially in the last six months or so. More interestingly, the last time that either LME or CME warehouse stocks were at this level was back in July 2008 – when the price was at \$8000/mt. Perhaps unsurprisingly, this has led to tightness along the nearby forward curve, as in Fig.6 below;

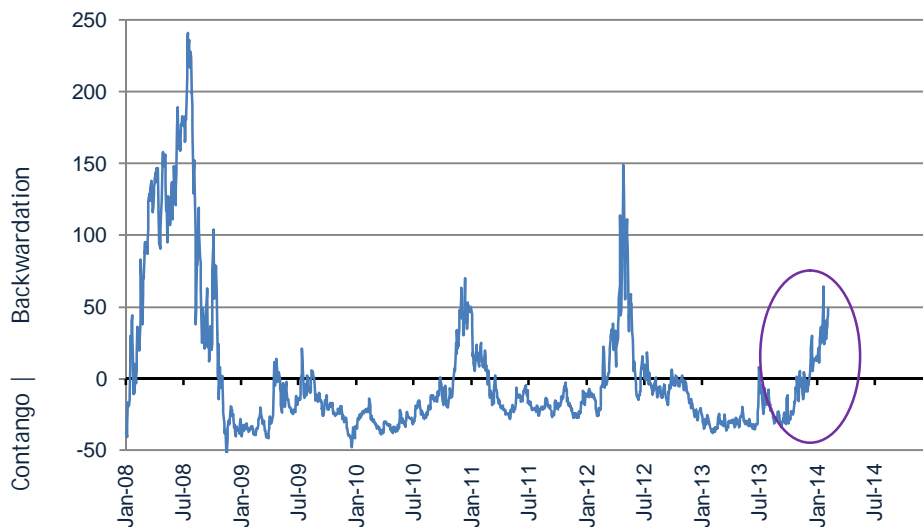


Fig.6 – LME cash-3m spread (\$/mt)

So far, so good – the basic fundamental indicators are positive and pointing to higher copper prices...just as we might expect in the Year of the Horse!

"If it was so, it might be; and if it were so, it would be; but as it isn't, it ain't".
Lewis Carroll, Through the Looking-Glass, 1872

If we look at some other (historically reliable) indicators however, we see less convincing patterns; From early 2008 to late 2012, the S&P 500 and LME copper moved lock-step – albeit with copper being slightly more volatile.

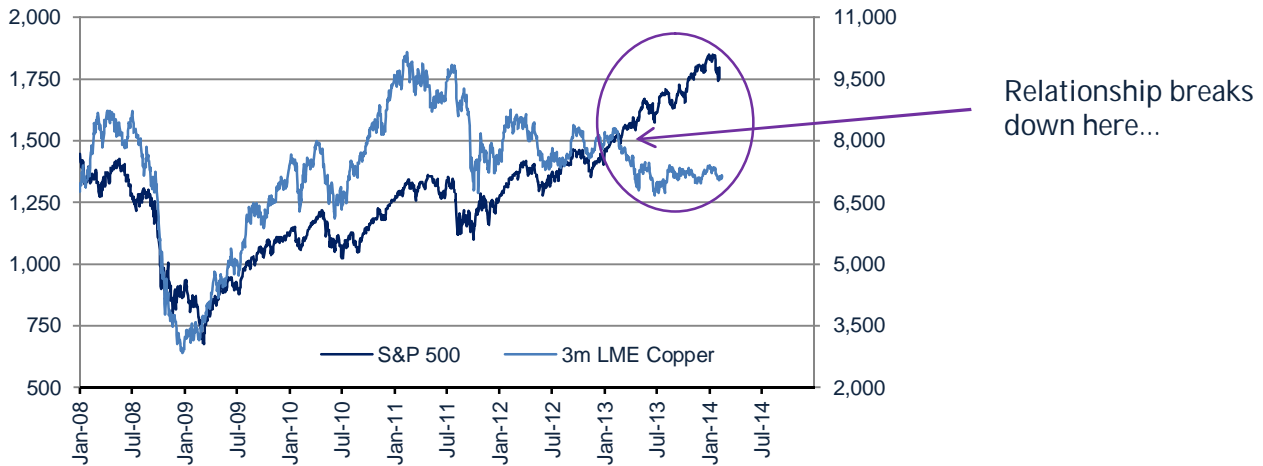


Fig.7 – S&P 500 vs. 3m LME Copper

Since late 2012 however the relationship has broken down with the S&P scaling new highs and the copper price going sideways. The question of course is whether the S&P reverses course or whether copper plays catch-up?

Similarly the relationship between the EUR/USD exchange rate and the copper price was fairly tight until the middle of 2012. At that time, it looked like the EUR was headed for parity vs. the USD but Draghis now famous “whatever it takes” speech put a floor in at 1.20. Since then the EUR has recovered to 1.38, a gain of some 15% but the copper price has fallen from around \$7600 to \$7150, a loss of around 6%.

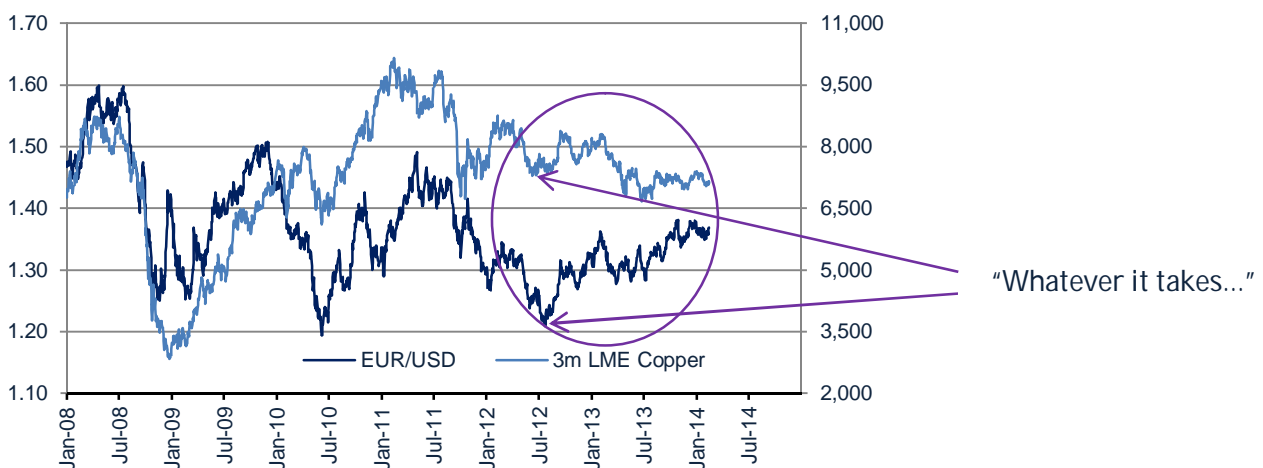


Fig.8 – EUR/USD vs. 3m LME Copper

So as with the S&P, does the EUR/USD reverse or does copper catch up?

"What we anticipate seldom occurs; what we least expect generally happens".

Benjamin Disraeli, 1804-1881

Given these uncertain relationships, perhaps the copper price is fairly valued at current levels. Certainly the analyst community seems to think so. Most copper analysts are neutral to mildly negative on price. Fig.9 (below) illustrates the 2014 forecasts (\$/mt) by a handful of major copper houses;

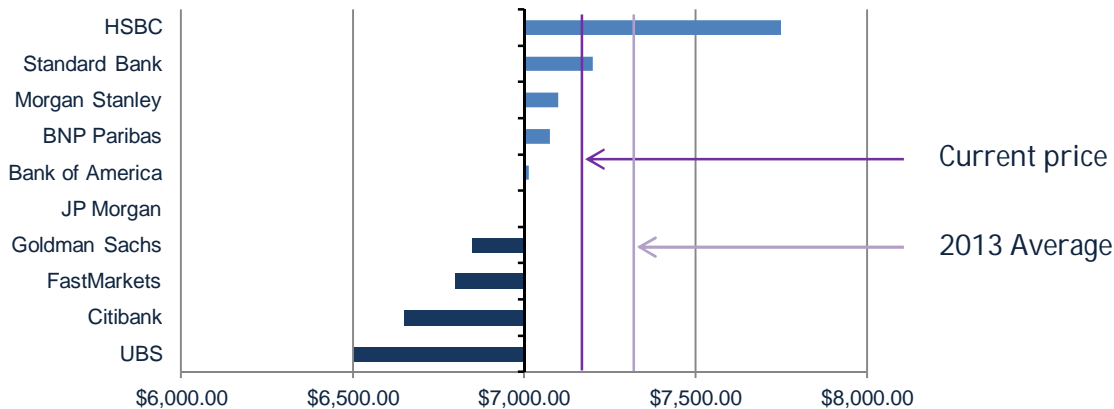


Fig.9 – Latest 2014 forecasts for LME 3mths Copper (\$/mt)

Their average forecast for 2014 is approximately \$7000/mt vs. a current price of \$7150/mt. The 2013 average was \$7320. With the exception of HSBC, all are looking for the copper price to fall year-on-year. This neutral to mildly negative stance is confirmed by a cursory glance at the CFTC Commitment of Traders Reports (see Fig.10 below) which show the market running mildly short;

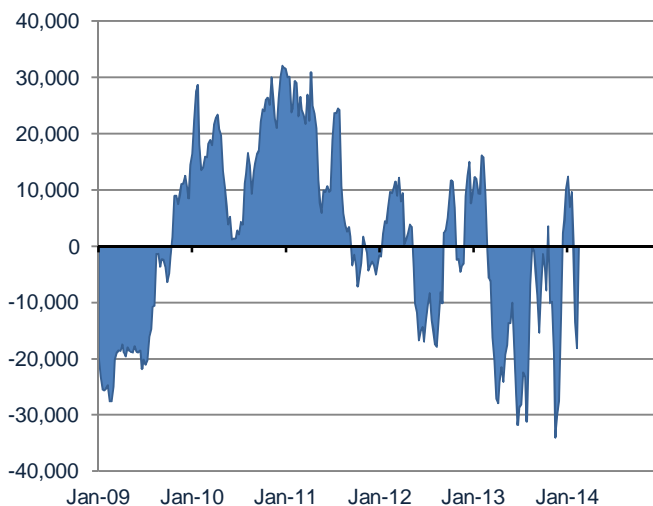


Fig.10 – CFTC COTR, Non-Commercial at 14th February 2014

Estimated Systematic Commitment				
	Overall Position		Max Cap. (lots)	Change
Copper	-7%	Short	60k	unch
Aluminium	-65%	Short	115k	5%
Zinc	-5%	Short	50k	3%
Nickel	-20%	Short	22k	5%
Lead	-30%	Short	30k	unch
Tin	-10%	Short	4k	7%

Fig.11 – RBC Systematic Estimate 14th February 2014

Continuing the theme, the daily estimate of LME positions by RBC shows the market as also marginally short.

Given that inventory levels are low and falling, given that the dollar is relatively weak, given that Western economies are recovering well (at least as measured by equity indices and GDP), and given that the market is turning reasonably short, one could reasonably expect the copper price to start moving higher – especially since we are now in the Year of the Horse! So why isn't it? Have the analysts really got it right this time – is the price really going to track sideways to slightly lower over the next year? Is the market right to assume that there will not be any copper strength any time soon.

Maybe this is not such a big surprise. It seems to me that the consensus view at the end of 2013 was that the US would be just fine, Europe remained at risk of deflation but had Draghi (and his “do whatever it takes” bazooka) on standby, and that the rest of the world was ticking over if not ticking higher. China remained the question mark as always.

Six weeks into 2014 and the consensus view has changed dramatically. The US is waking up to the end of QE and trying to figure out what it really means. Europe may have Draghi on standby but markets are increasingly tiring of his incessant jawboning and concerned that his bazooka may not have any ammunition. Emerging markets have stumbled badly, raising fears of contagion and systemic risk once more. And China remains a question mark.

So let's look at China.

The RRR is of no help whatsoever since they stopped adjusting it in May 2012. But a look at Chinese GDP tells an interesting story (Fig.12 below);

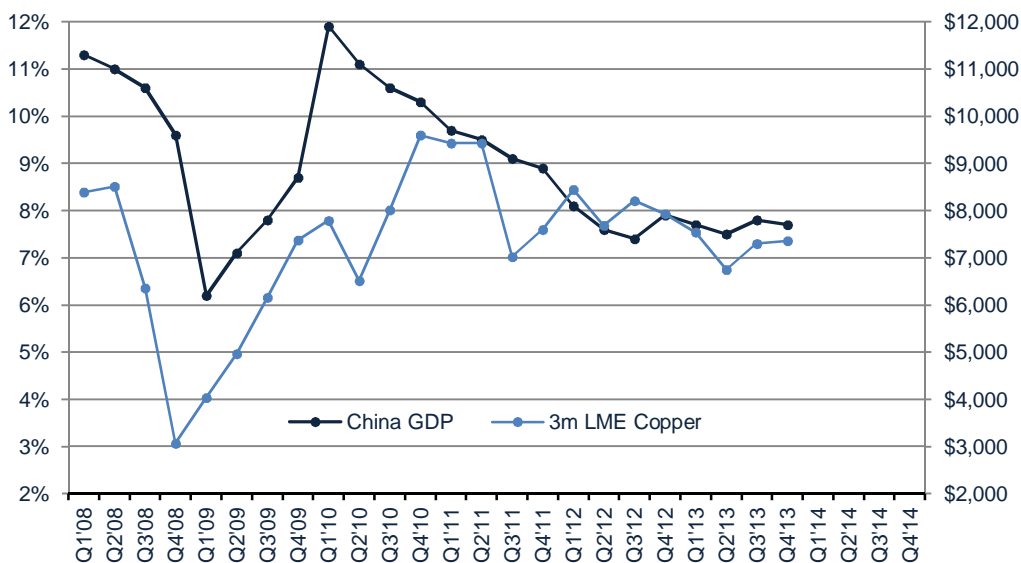


Fig.12 – China GDP, YoY vs LME 3mths Copper (\$/mt)

The correlation is clear and would indicate that regardless of Western economies, the copper price is absolutely driven by the Chinese economy alone. Consequently it would seem to indicate that the copper price isn't going to move higher until Chinese GDP starts to tick higher again.

With continuing and significant fears of a range of issues (from a real estate bubble, to lack of drinking water, to the shadow banking sector) it is perhaps difficult to see how growth can once again achieve and maintain the dizzy heights of 10%. Similarly it seems that the Chinese administration do not want GDP falling much under 7% - because the resulting increase in unemployment and falling living standards would cause too much social unrest (as it did in late 2008, early 2009). Their aim, if not stated, is to maintain GDP in the 7-8% range.

CONCLUSION

If we agree that the outright copper price is perhaps fairly valued at current levels there seems little opportunity for returns. However with such low inventory levels there are opportunities in calendar spreads, exchange arbitrage and inter-commodity spreads. Happily, these are ***precisely the very opportunities that our new ULTRO CAPITAL Strategy aims to exploit.***