Copper — the challenge continues

By John E. Gross

The market is bullish, and why not?

Over the past two years, following the financial meltdown of 2008, copper has not only recovered all lost ground, but has also risen to record highs in a record amount of time. Virtually everywhere you look, forecasts call for continued global economic growth that will require more copper with expectations that production will not keep up with demand, thereby drawing down already low inventories. Further, if industrial demand is expected to keep prices aloft, it is thought the introduction of Exchange Traded Funds to meet investor demand will have markets soaring. Thus, almost to a person, the outlook remains positive, with many if not most calling for higher prices throughout 2011.

There is little point in trying to outguess the market; it can't be done consistently.

On the numbers, it is hard to disagree with conventional wisdom. After copper hit a low of $1.25 in 2008, the market climbed $2.08, or 166% to close 2009 at $3.3275. 2010 saw more of the same with the Spot price on Comex closing out the year at a record high $4.4395, with the full year also averaging a record high $3.4251, up 45% from the $2.3542 average in 2009. Correspondingly, inventories of copper held in Comex and London Metal Exchange warehouses fell 156,000 metric tonnes, or 26% during 2010 to close out the year at 436,166 mt. (See chart on opposite page.)

In large part, the decline of inventories reflects a market in deficit that is expected to continue supporting prices going forward. Based on recent statistics from the International Copper Study Group, the global copper market generated a 436,000 mt deficit through September as compared to a 56,000 mt shortfall during the first nine months of 2009.

Although production of refined copper rose 707,000 mt, or 5.2% through September to 14.24 million mt, it was not enough to keep up with consumption that climbed 1.09 million mt, or 8% from the year ago period to 14.68 million mt.

Looking ahead, it is anticipated that consumption will outpace production again in 2011, with the market being in deficit by another 440,000 mt and paving the way toward higher prices. Indeed, a consensus of opinion among analysts predicts that copper will average $3.75 in 2011, up almost 10% from 2010.

Expectations of continued economic growth in major industrial economies as well as emerging markets also support the positive outlook. Gross Domestic Product is forecast to grow 2.6% in the United States during 2011; Germany +2.2%; Japan +1.3%; China + 8.9%; India +8.6%; Russia +4.0% and South Korea up 3.9%. Collectively, these countries account for approximately 70% of global consumption.

There is another side to the story, however, one that is considerably more sobering. The bullish argument is certainly a logical one based on current fundamentals prospects, but in the world of commodities logic is often in short supply and expectations can change in an instant.

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On July 2, 2008, the copper spot price on Comex traded at a high of $4.0775, and the outlook was for further gains. But as we now know, the economic crisis changed the equation entirely as commodity prices crashed, with copper falling a mind-numbing $2.83, or 70% to $1.25 just six months later.

To state the obvious, just as we can't predict changing winds, neither can we know what will cause the markets to shift course, or when it will occur. To this point, China, the world's largest consumer of copper is working to transform its economy from being export dependent to one based more on domestic consumption, and is also now attempting to limit rising inflation. Thus, for the second time in three months, interest rates were increased, with further tightening anticipated. If these changes result in a slower consumption rate, the world will see more metal moving into inventory. Also, while no statistics are available, some analysts believe that China is already holding significant quantities of unreported stocks.

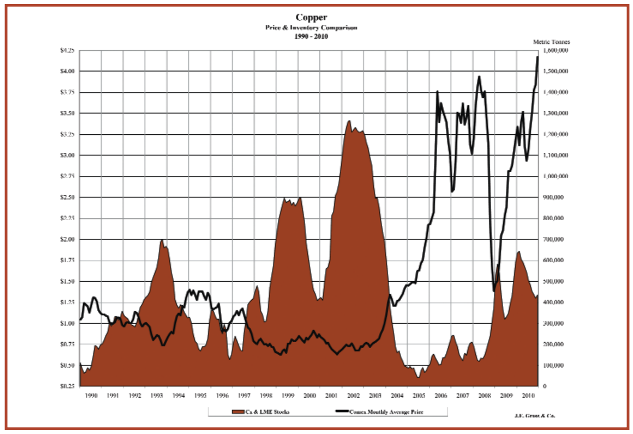
On the European side, we saw the impact of the sovereign debt crisis during the second quarter when Greece had to be rescued causing markets to shudder throughout the world, with copper falling 85¢ before recovering. Since then, Ireland also had to be bailed out, and it is thought that Portugal, or possibly Spain will be facing a similar fate. As we've already seen, any crisis of confidence, regardless of the source can have a swift and severe impact.

Within the United States, fears of a double-dip recession seem to have receded, but our economy has yet to see any meaningful recovery in the building and construction sector that represents almost 50% of domestic demand. Construction spending overall is running at an $815 billion annualized rate through November, down 30% from $1.167 trillion posted in 2006, while housing starts which came in at an annualized 555,000 in November are off almost 75% from the peak of 2.068 million during 2005.

From a different point of view entirely, and completely unrelated to the fundamentals, one proprietary technical indicator with more than fifty years of history and a record of 78% accuracy indicates prices will fall this year rather than reach a new high annual average.

Thus, with copper currently trading at record highs and some analysts eyeing the $5.00 level, we would be remiss to ignore the potential pitfalls. Further, if nothing else, the past five years have clearly demonstrated an unprecedented level of volatility that poses an unprecedented level of risk for any organization dependent upon copper and other metals.

It necessarily follows, therefore, that your organization must have a plan in place that can be implemented when necessary, to mitigate price risk exposure. There is little point in trying to outguess the market, it can't be done consistently. What can be done, however, is to properly manage purchases and sales, and protect inventory valuations.



Copper supply inventory and demand are not in synch.

This is the key to maintaining profitability, regardless of whether the market rises or falls.

John Gross, the publisher of The Copper Journal, *is a metals industry consultant with a focus on price risk management. For more information on his company's services, go to www.copperjournal.com.*

ANALYSIS