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Copper: the bear is back

Talk about mixed signals. Last week, LME warehouse stocks sank to multi-year lows of 323,000 tonnes, a level not seen since mid-1998. Then, in the space of only three sessions, stocks jumped by some 60,000 tonnes, erasing many months' worth of falling inventories in one fell swoop (Chart 1).

The erosion of copper stocks had become something of a daily routine that traders would observe along with their morning coffee. However – as we've noted in previous discussions of copper – a drop in metal stocks is not as bullish as an increase is bearish. With a drop, we cannot be certain whether the metal has gone to bona fide industrial demand or whether it is simply being shuffled around as part of some investment-related arbitrage scheme. On the other hand, when stocks are rising, we know for certain that they exist. In this instance, given the unexpected appearance of large volumes at exchange warehouses in such a short time, it is quite clear that the copper in question was not used to manufacture pipes and wires.

Copper prices have tumbled about 15% since last summer, despite the fact that reported fundamentals seemed strong. The International Copper Study Group (ICSG) had been reporting global deficits each month throughout 2000. The only apparent reason for copper's weakness was the perception of economic weakness.

The bullish case came from both the supply and demand sides. China was a solid buyer for most of the year. High-cost producers were feeling the pinch of soaring energy costs and in some cases closed unprofitable operations. The markets in both London and New York flirted with backwardation several times. And of course, warehouse stocks did their vanishing act. There was little in the way of concrete evidence that the trend of a continuing tightening in the supply/demand balance had changed. Indeed, everything – but the price – was behaving as it should in a year of production/consumption deficit.

The most recent data from the ICSG support ideas that the tightness in the copper market over the past year and a half has eased. In its March report, ICSG estimates that supply outstripped demand in December by 149,000 tonnes. This was a rather hefty surplus for a one-month period. In fact it was the largest shift in the monthly supply/demand balance in quite some time. The market will still end 2000 with a formidable deficit. Slack demand during the holiday season and a slowdown in Chinese purchases, however, reduced the year-end deficit to 331,000 tonnes from 468,000 tonnes at the end of November. This new information allows us to make some sense of the sudden influx of stocks to LME warehouses.

Financial forecasters are divided on the issue of what's in store on the economic front. It is clear, however, that the period of rampant growth has ended. Even the most rosy forecasts call for moderate growth. Copper consumption grew by 7.5% in 2000 over 1999, to 15.2 million tonnes. The average rate of growth in the previous 5 years was 4.4%. It is difficult to visualize a scenario in which the growth rate of copper consumption could maintain the torrid pace it enjoyed in 2000.

One important area to be watched closely is Chilean production. Chile is considered a low-cost producer. As such, its output should not be affected much, because at current levels, prices are rich enough for its mines to remain quite profitable. In 2000, Chile produced 4.6 million tonnes of copper, 4.3% more than in 1999. The most recent Chilean statistics, how-

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ever, might be of some concern to bulls. Production in January was down 3.8% over December 2000, and – to quash the seasonality argument – it was also 0.9% lower than January 1999. Early estimates are for a 2% increase in output for 2001. Although national results for February have not yet been published, the world's largest copper mine, Escondida, reports that its February output was down 15% over February 1999. Apparently, maintenance work slowed down production. In any case, since we are busy developing a bearish case here, the Chilean issue must be monitored carefully.

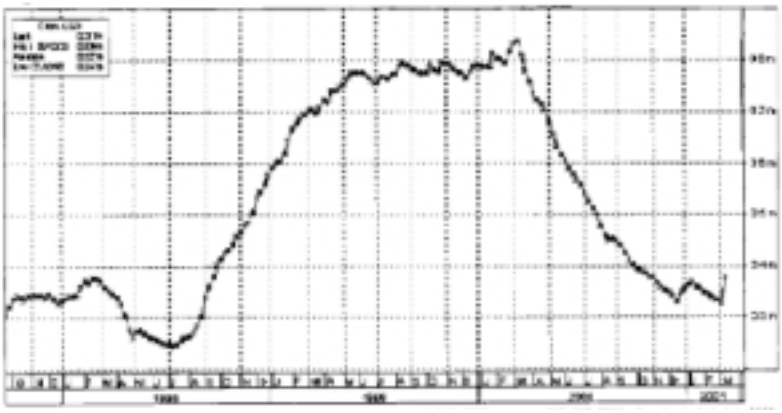
Commodity funds were heavily short this market. The recent sharp move off eight-month lows was almost certainly a short-covering rally and had little to do with changing fundamentals. The Commitment of Trader data show that funds moved from a net short position of 12,746 contracts to one of only 6,090 contracts in one week. In the meantime, small speculators who had a small net short position, moved to a 2,875 contract net long position.

In conclusion, consumption has nosedived, indicating that the sharp drop from 95¢ per pound was indeed warranted. As long as production continues to grow – at any rate – we expect prices to move significantly lower.

[March 15, 2001]

CURRENT STRATEGY: *Sell short May copper as per Flash Update of March 15. Place initial stops at 81.00, close only.*

Chart 1
LME Warehouse Stocks



CRUDE OIL

OPEC cutbacks: an exercise in futility

Petroleum prices enjoyed a spectacular bull market that lasted from January 1999 through last September. During this period, crude oil prices rallied to just below $38 per barrel from just above $10 per barrel. Since September, though, the market has given back almost half of those gains (Chart 2). Are we looking at a correction of a long-term bull, or has the bear returned to this market?

Consumption grew steadily throughout the 1990s, and – for the most part – production kept pace. When oil producers became wary of falling prices, they engineered a series of production cutbacks that coincided with a runaway boom in economic activity. Average consumption of crude oil products in 1999 was the equivalent of 75.09 million barrels per day (bpd). Production of only 73.64 million bpd left a shortfall of 1.45 million bpd. As a result, inventories suffered sharp drawdowns, and prices skyrocketed.

The world, however, has changed dramatically in the past few months. Economies around the globe have turned down and with them the prices of commodities, particularly those that are so sensitive to industrial activity. Even while the economy was having one last extraordinary burst of activity, the petroleum market was shifting back into balance, and inventories were being replenished. Output for all of 2000 averaged 76.03 million bpd, a 3.2% increase over 1999. Consumption averaged 75.66 million bpd, a mere 0.7% higher than 1999. The market was back into surplus territory.

We hear talk about the approaching driving season and the potential for increased consumption of unleaded gas. However, if the performance of heating oil prices this past winter is any indication, such talk fails to inspire us to any degree of bullishness.

According to American Petroleum Institute data, stocks of distillate fuels (used to manufacture heating oil) actually bottomed last spring (Chart 3). The tightness in the market began to disappear despite a bitterly cold Northern Hemisphere winter and stories of refining-capacity limits that often dominated energy news.

A similar situation is developing in the unleaded gas market because gas inventories already bottomed this past fall (Chart 4). Refineries were running at full capacity, but are now operating closer to 90% of capacity.

OPEC is fighting back with its second production cutback this year, but to little avail. In January, OPEC members agreed

to cut output by 1.5 million bpd. It worked for awhile, driving prices up by about $6 per barrel. The announcement of the current cutback of 1 million bpd that goes into effect on April 1 has thus far met no such luck. Prices have barely budged since the OPEC communiqué was issued on March 17.

We find little mystery in this. Besides the fact that falling equity prices are casting further gloom and depressing prices of anything even remotely connected to economic activity, OPEC compliance has not been exemplary. In February, OPEC members pumped as much as 560,000 bpd above quota limits. According to industry analysts, this brought compliance on the cutback portion to only 63%. OPEC Secretary General Ali Rodriguez told reporters earlier this week that he "expected 100% compliance" on this new agreement, even while conceding during the same session that compliance after the January cut was only slightly better than 85%.

OPEC's ability to control prices was obviously tied to the seemingly insatiable demand we saw these past few years. The vicious cycle that has made OPEC impotent to halt sliding prices in previous eras is in force once again.

As prices slide, member countries see their oil revenues slip and are tempted to produce more than their allotted share. It is clear that OPEC is running scared, because the ink was barely dry on the current agreement when it announced that another special meeting will be held in early June to decide if another cutback is necessary.

At present, OPEC's basket of crude oil prices is just below $23 per barrel. Under the OPEC price stability mechanism, it can cut production by 500,000 if that reference basket stays below $22 for 10 consecutive business days. So it will likely try again to save prices from falling further, but in vain, we suspect.

Most crude around the globe can be produced for below $10 per barrel. That is the real issue. Producers can extract handsome profits sometimes. At other times, however, when economies around the world are having every last excess sucked out of their systems, producers cannot get away with it. Look for lower prices.

[March 23, 2001]

STRATEGY: *We were stopped out of our first foray into the short side as per today's Flash Update. However, do stay tuned.*

Chart 3 – API Distillate Stocks

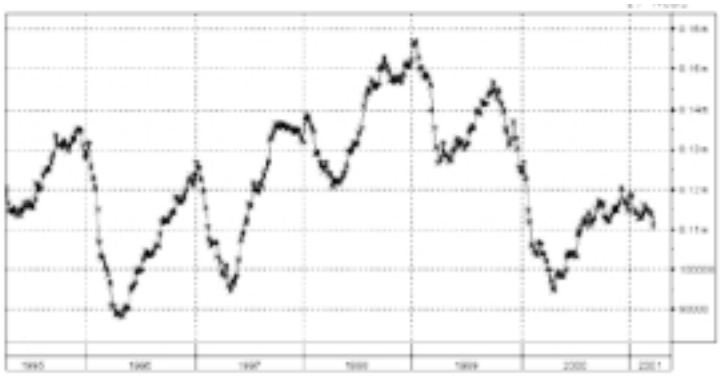


Chart courtesy of *Reuters*

Chart 2 – Weekly Spot Crude

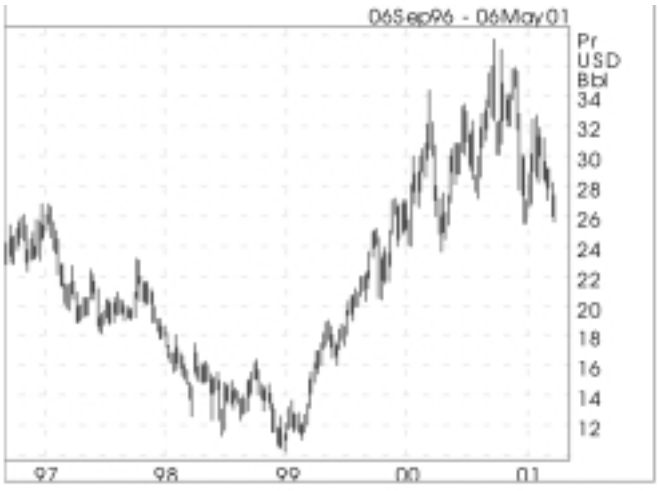


Chart courtesy of *Bloomberg*

Chart 4 – API Unleaded Gas Stocks

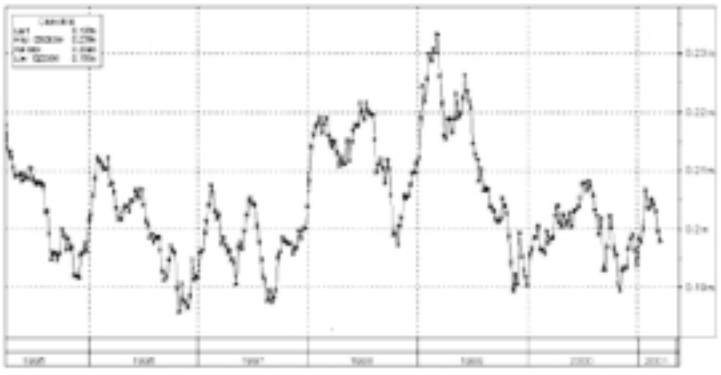


Chart courtesy of *Bloomberg*

ROUNDUP

Do commodities deserve the beating they're getting?

Recessionary fears have permeated the markets. Commodity prices have not escaped the axe and have taken a nasty beating. The CRB Index has fallen about 10% since it peaked last October (Chart 5). Of the 17 components of the index, a full 16 have tumbled anywhere between 5% and 40% from highs recorded in the past 6 months or so, or 18% on average.

Although the outbreak of hoof-and-mouth disease has kept hog prices strong – up about 30% from last fall's low – they too are vulnerable. Traders are operating under the assumption that the destruction of herds is more bullish to the supply side than the potential damper on consumption is bearish to the demand side. If that sentiment were to shift, the lone holdout would quickly fall prey to the bears.

We believe that while the prices of some commodities are justifiably weak, others are not. In many cases, the fundamentals of these markets, at least as determined by available information, are not necessarily commensurate with the steepness of their declines. With their bearishness, however, traders – most notably large commodity funds – are forecasting that supply/demand balances will soon vindicate their pessimism.

A good example of a market that we feel is deserving of the thrashing it is receiving is **copper**. According to Bloomsbury Mineral Economics, the market ended 2000 with a production/consumption deficit of 400,000 tonnes. It forecasts that 2001 will end with a deficit of similar size.

In the March 15 issue of *Focus on Futures*, we presented a case that is forward-looking and takes into account the probability of a contraction in demand. Given the current economic environment, it is certainly difficult to make a case in which the supply/demand balance will shift so little as to leave the market with a deficit that is no smaller than that of 2000.

After a short-covering rally, which saw the market rise over 5¢ per pound, the commodity fund shorts were back in full force. Chart 6 graphs the commodity fund section of the open interest and shows that the funds turned from a net long position of 28,836 contracts back in the fall to a net short position of 13,187 contracts at present. The peak of the net long position coincides almost to the day with the 93¢-per-pound peak in prices. One could very well argue that the pressure from speculative sources has – in a sense – determined the direction of this market and at present is exaggerating the price weakness. However, we feel comfortable with our bearish read of the fundamentals. The market will make counter-trend adjustments from time to time to shake out weak hands, but should maintain the major trend.

Since the economy began to slacken, it has been quite common to associate the movement of copper prices with the direction of the stock market action. While the stock market rally that began last week seems to have brought counter-trend moves to some of the other "stock-market-play markets," the copper market has not really participated. The long awaited output cuts by Phelps Dodge were finally announced but were smaller than expected. After a brief inter-day rally, the market settled lower. News that Chilean copper production in February was down 2.5% year-over-year pushed the market 0.75¢ per pound higher, but that gain was quickly erased in the next session, with the market setting new lows for the move.

On the other hand, there are markets in which the activity of commodity funds is almost identical to that of copper, and yet we feel that the downward pressure on prices has been exaggerated by speculative activity.

Wheat prices tried to rally a couple of times this year, but those attempts ended, as all rallies in wheat have in recent history, with new contract lows. In a nutshell, the bullish argument – espoused by grain analysts for ever so long and discussed many times in this publication – has been that world ending stocks of wheat have been shrinking for years. This bear market has been so persistent and so inconsistent with wheat's fundamentals that it has dumbfounded analysts. So much so that Bill Gary – editor of *Price Perceptions*, an excellent newsletter that has covered the agricultural markets for 33 years with fundamental analysis and has correctly identified some of the major turns in the grain markets – has thrown up his arms.

He believes that the strength of the dollar has distorted the realities of tight grain markets. In the current issue he declares, "Fundamental factors do not support the recent free fall in wheat futures. However, the strong dollar has made US prices prohibitively expensive for many importing nations. Therefore, as long as the dollar remains strong...US exports will remain slow. We advise utilizing technical tools as the primary indicator of price direction."

The bearish arguments for commodities as a whole are plentiful and often accurate. A strong dollar keeps foreign buyers away from the US. Consumers' increasing comfort with just-in-time inventory systems means ending stocks in exporting countries will remain stubbornly high. Overly generous farm subsidies have killed the natural order of cyclical commodity markets, because farmers can keep producing even when market prices of their goods are near or even below their cost of production.

We, however, continue to believe that each commodity, security, etc. should be judged on its own merits. If anybody needs a reminder about the hazards of trading markets in concert with a crowd and following a very general, macro template without being aware of the underlying health of balance sheets and supply/demand balances, we would ask them to look at a chart of the NASDAQ. The "tech-wreck" that decimated many stocks with unrealistic values attached to them could happen in the inverse to dramatically undervalued commodities.

In our wheat example, the recent weakness can be attributed to some developments that are indeed bearish. In February, the USDA attaché in China added 11 million tonnes to Chinese stocks. Surprisingly, the USDA did not make the

appropriate adjustment in its March supply/demand situation report. If it did, world ending stocks as a percentage of consumption would jump from a very bullish 18% to a very ho-hum 20%. In addition, Algeria and Egypt made some large purchases from Europe and Australia, which might have otherwise gone to US exporters.

While traders will view the lost US business as a negative for the US market, we would interpret it a bit differently. Certainly, in the short run it is bearish for prices. With ending stocks at 34% of consumption, the US can ill afford to lose business from traditional customers. However, if inventories in exporting countries – Australia, for example, which is not saddled with plentiful inventories (16% of consumption) – are depleted, then it doesn't really matter where the wheat is purchased. Eventually, the buyers will have to come back to the US.

As far as Chinese stocks are concerned, it will be interesting to see what the USDA does with its attaché report in its April report. Eleven million tonnes added to the balance sheet seems to be an overwhelming amount. But we have to remember that the crux of the bullish case in wheat has come from the supply side. Demand has been steady the past few years, but production, has declined consistently.

Based on what we know at this point, we will have yet another year of declining production. EU wheat acreage is expected to be smaller than last year. Subsoil moisture in the Canadian prairies is said to be poor. And above all, US farmers planted the smallest winter wheat crop in 30 years last fall.

Although it is too early to make any accurate predictions, it is clear that even if the USDA would acknowledge its Chinese attaché's revised stock estimate, much of it would be offset by lower production.

Even in the US, we don't believe that the situation is as bleak as current prices would make it seem. As of this past week, export commitments are still running slightly ahead of last year at this juncture of the season. Shipments have slipped behind last year's pace, but just by a hair. We believe that wheat prices have discounted all the bearish news and made no provisions for poor crops and increased demand.

Another example of a commodity that may be undervalued is **sugar**. Here, too, the market is being pressured by a negative attitude towards commodity markets. Again, the net position of large commodity funds is heavily weighted to the short side. Consider that funds are net short 15,070 contracts. As recently as the end of January, they were net long.

Just yesterday, the International Sugar Organization (ISO) revised its estimate of the world sugar balance for 2000-01 upwards to 3.3 million tonnes from its previous estimate in November of 2.3 million tonnes. The market yawned. The ISO took pains to remind us in the same report that the deficit should not be taken too seriously, because it comes after five years of surpluses. Duly noted.

We feel that it is significant news, because it is the first upwards revision in the deficit after a series of many downward revisions. It was precisely this type of pattern – indifference to bullish news – that allowed us to buy sugar at 5.5¢ per pound last year and ride it to 10.5¢.

There are two hot issues that this market is looking at for direction. One is the upcoming Brazilian crop, and the other is Chinese purchases.

As we illustrated in our last article on sugar (February 20), Brazil is the key player on the production side, because of its status as the world's largest exporter. As we approach the harvest season, it is still not clear to what degree output will bounce back from last year's inclement-weather-ravaged crop. When the crop was first planted, analysts talked about a 15% recovery. Now we're hearing estimates that are in the neighborhood of a 5% to 8% recovery. January and February were unseasonably dry in the center-south region, where 80% of the crop is grown. The daily precipitation reports we see indicate that the region has been getting some rain in March, but not quite enough to compensate for the dryness earlier in the season and that yields will definitely suffer.

For all we know, the crop will look better once it is harvested, but with the market trading at multi-month lows, traders have left little slack for disappointment.

Also, the Brazilian government is comfortable enough with the prospects of a decent-sized crop and has moved the alcohol/gasoline ratio back up to 24% from the 20% conservation level. This will remove about 1 million tonnes of sugar from potential exports.

China will have a production/consumption deficit of 500,000 tonnes this year, according to Chinese officials. Independent analysts say the deficit could be as high 1.5 million tonnes. Either way China will need to buy sugar at some point. Chinese officials have played down the country's import needs, telling reporters that it has a prearranged deal with Cuba for 400,000 tonnes and that after that sugar is secured, its needs will be insignificant. So how's Cuba's output this year? At last check, it was running 300,000 tonnes behind the already paltry target of 3.7 million tonnes.

If either or both the Brazilian supply side and the Chinese demand side are more bullish than currently reflected in the depressed prices we're seeing, we will see higher prices.

In conclusion, demand for some commodities, like copper, are more inherently connected to even small changes in GDP. Although the market has at times stretched this relationship by allowing copper prices to trade in lock-step with each tick in NASDAQ futures, a strong relationship does exist. Commodity funds have taken this connection to a higher and unwarranted plane by pounding everything in sight.

In much the same way (but not quite as extreme) that it was suicidal to short NASDAQ technology stocks until there was some indication that the madness had ended, the commodities we've discussed – and there are others – are probably very oversold and should be watched carefully. Look for a change both in broad sentiment, by watching commodity fund activity and, of course – because we still watch the fundamentals – in the supply and demand issues described above. *[March 29, 2001].*

CURRENT STRATEGY: *Remain short May copper as per Flash Update of March 15. Lower stops to 81.00, close only. Sell short July platinum per Flash Update of March 30, placing initial stop at 581, close only. Stay tuned for recommendations on sugar and wheat.*

Chart 5
CRB Index



Chart courtesy of *Reuters*

Chart 6 – Net Open Interest in Copper for Commodity Funds

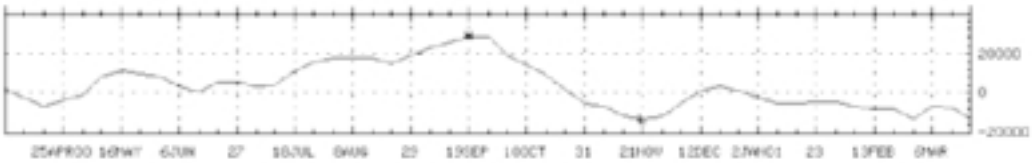


Chart courtesy of *Bloomberg*

HOTLINE UPDATE

***Flash Update* – Tuesday, March 6, 2001:**
Good morning for Tuesday, March 6, 1:30 pm. This is a Flash Update. We have liquidated our long March cocoa position at 10.90.

***Flash Update* – Friday, March 9, 2001:**
Good morning for Friday, March 9, 10:00 am. This is a Flash Update. We have covered our short April gold position at 283.30.

Friday, March 9, 2001:
Good afternoon for Friday, March 9, 5:05 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long May cocoa, with our stop at 1020; long June T-bonds, with our stop revised to 103-28; and long May sugar, with our stop at 8.62. All stops are close only.

***Flash Update* – Thursday, March 15, 2001:**
Good morning for Thursday, March 15, 9:30 am. This is a Flash Update. We hare two new recommendations: We have liquidated our long May cocoa at 1020, and we have sold short May copper at 81.30, placing our initial stop at 85.50, close only.

Friday, March 16, 2001:
Good afternoon for Friday, March 16, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long June T-bonds, with our stop at 103-28; long May sugar, with our stop at 8.62; and short May copper, with our initial stop at 85.50. All stops are close only.

***Flash Update* – Tuesday, March 20, 2001:**
Good morning for Tuesday, March 20, 10:15 am. This is a Flash Update. We have two new recommendations: We have liquidated our long May sugar position at 8.60, and we have sold short June crude oil at 26.70, placing our initial stop at 28.20, close only.

***Flash Update* – Friday, March 23, 2001:**
Good afternoon for Friday, March 23, 2:35 pm. This is a Flash Update. We have covered our short June crude oil position at 27.50.

Friday, March 23, 2001:
Good afternoon for Friday, March 23, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long June T-bonds, with our stop revised to 104-16, and we are short June copper, with our stop revised to 82.50. All stops are close only.

***Flash Update* – Tuesday, March 27, 2001:**
Good afternoon for Tuesday, March 27, 11:30 am. This is a Flash Update. We have liquidated our long June T-bond position at 104-16.

***Flash Update* – Friday, March 30, 2001:**
Good morning for Friday, March 30, 11:10 am. This is a Flash Update. We have sold short July platinum at 551, placing our initial stop at 581, close only.

Friday, March 30, 2001:
Good afternoon for Friday, March 30, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short June copper with our stop revised to 81.00, and we are short July platinum, with our initial stop at 581. All stops are close only.

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