

Copper Bull Market?

Most analysts believe this deep global recession has abruptly ended the powerful secular commodities bull that was born at the turn of the 21st century. And it is certainly hard to argue this point considering the dismal panic-selling-induced performance of nearly all commodities.

The volatility and fear that took hold of the markets have given traders the mindset that all economic activity has ground to a screeching halt. And the markets have discounted the idea that global economic growth is over, thus warranting the aggressive selling of all assets.

Now these are indeed extraordinary times that most traders have never experienced in their lifetimes. And we've seen plenty of parallels to the Great Depression that a growing contingent of fearmongers continues to proselytize. But is the sky really falling as hard and fast as people think?

There is no denying that this recessionary slump has done a lot of damage to the global growth story that had captivated the markets in recent years. But I believe today's prices may not accurately reflect the commodities trade, even within this rapidly changing environment.

As an investor, and as a trader, there are a few commodities I look to in order to capture the essence of what I consider to be a still-alive commodities bull. Of course crude oil on the energy side, and then copper on the industrial metals side.

Copper's notoriety as the base metals' bellwether is apparent when you watch any business channel. Within a few minutes you are likely to see its price quoted on a headline ticker. As far as traders are concerned copper is the king of the base metals. As goes copper, so goes the balance of the base metals complex.

Copper's incredibly powerful bull market erupted from the foundation of spectacular fundamentals. A growing economic imbalance rooted from demand outpacing supply, mixed with a bit of speculative exuberance, saw copper forge a trough-to-peak gain of 574% to its recent July 2008 high.

Copper made many traders rich over the course of this powerful bull, but it also broke the bank for those traders that rode a fast and sharp crash off its high. Copper's plunge that was accelerated by the panic selloff saw it *crater by 69%* in just 124 trading days. And this incredibly swift decline was par for the course for the rest of the base metals. Aluminum, zinc, lead, and nickel saw respective declines of 62%, 77%, 78%, and 84% from their highs.

Many pundits believe this precipitous selling of the base metals has put an end to their bull markets. So let's take a closer look at copper to see if this is indeed the case. The first thing we can look at is a snapshot of copper's technical scene.



Copper's bull launched from its low of \$0.60 in late 2001 and initially progressed in orderly upward fashion with solid multi-year support. By 2004 it had more than doubled as fast-growing demand created a massive economic imbalance, which is characterized in the next chart.

In 2006 copper launched nearly vertical and climaxed in a wild parabolic rise that saw its price break through the \$4 mark, nearly doubling in just 60 trading days. After a reprieve from this high that saw it shed 41% leading into 2007, copper then entered into what turned out to be another multi-year uptrend.

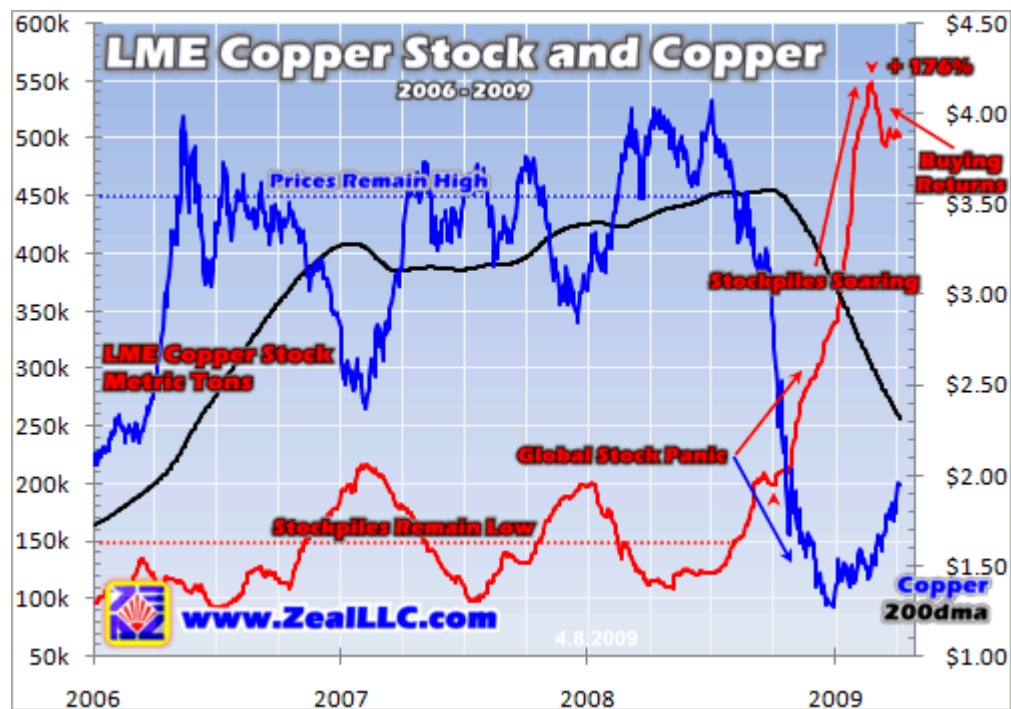
After achieving a new high in Q3 2008 copper then knifed through support and took a nosedive to its December low of \$1.27, a price not seen since 2004. Copper's rapid decline shattered the support of every technical model conceivable. And as you can see by the red shaded area it has spent the last 7+ months trading underneath its 200dma. With prices typically outpacing their 200dmAs in bull markets, this subpar ([relativity](#) lower than 1.0) season is certainly testing the integrity of copper's bull.

But with copper's technicals showing the effects of what looks like an axe driving into it, there still might be light at the end of the tunnel. Not only was this December bottom still 111% higher than the 2001 low, thus showing that copper

has not even come close to giving up its secular ghost, an impressive rebound has materialized.

Once traders started to realize the irrationality of this selloff, copper has been quick to reverse off its deeply oversold panic lows. Bargain hunters have swooped in to buy copper at these multi-year lows and as you can see it has bounced up by 55% so far. And this buying is not solely trading-driven, as you can see in the next chart, consumption has resumed.

This chart merges technicals and fundamentals together thanks to the data made available by the London Metal Exchange, the flotilla leader of the global base metals trade. Not only does the LME host the premier futures and options marketplace, but it coordinates buying, selling, and storage on the physical front via its vast network of warehouses. And the stockpile data we get from these warehouses offers traders invaluable insights.



At Zeal we have long documented the inverse relationship between [LME stockpile levels](#) and the prices of the metals. Essentially when stockpiles are low it can be inferred that demand is outpacing supply. The metals are leaving the warehouses at a faster pace than they can be replenished. And this imbalance naturally causes prices to rise as more consumers are chasing after fewer goods.

Inversely if stockpiles are building it means supply is outpacing demand. Either consumers are demanding less metal, producers are supplying more metal, or most likely there is a combination of these two forces. This imbalance naturally

causes prices to rise as there are fewer consumers seeking an overabundance of goods.

The inverse correlation between copper and its stockpile levels is visually apparent across the 3+ years that we have daily LME stockpile data. And copper's price sensitivity to stockpile levels is especially prevalent at the low levels we've seen the last several years. The average global daily consumption of copper is about 50k metric tons, and with stockpile levels between 100k to 200k metric tons the LME had the equivalent of a mere 3 or so days of daily consumption.

Led by China's ravenous copper appetite, global stockpiles were pilfered to these alarmingly-low levels. And with the risk of running out of above-ground inventory, speculators took hold of copper's price and attached an enormous risk premium to it. When copper stockpiles retreated to about the 100k-metric-ton level, its price would soar to the \$3.50 to \$4.00 range.

With a strong copper price and ongoing demand growth, the copper miners worked hard to ramp up production. And from 2006 to 2009 mined copper production is expected to have risen by an impressive 16%. This is quite a feat considering the time and capital that goes into mine development. But the balance was to remain tight with demand growth expected to rise at a similar pace.

All seemed fine and dandy in copper's bull, until a fateful turn of events lopped the head off the global economy and drastically changed the game. The [Great Stock Panic of 2008](#) created so much uncertainty, so fast, that global commerce indeed seemed to grind to a temporary halt. This economic maelstrom sidelined consumers, thus wreaking havoc on goods and forcing a hasty revaluation of assets until some sense of normalcy returned.

And this state of panic is apparent in the sharp reversals seen in the chart above. With buyers nowhere to be found and the producers continuing to send copper to market, LME stockpiles soared. And of course the inverse relationship between stockpiles and prices held true. The speculative risk premium was quick to fade and copper's price embarked on a freefall.

From October 2008 LME copper stockpiles rose by a staggering 176% before finally leveling out in February. Other than a couple of flat interday moves, LME stockpiles grew *every day* for nearly 4 months. Nobody was taking delivery on the king of the base metals.

But amazingly, the price of copper did not fall to zero and buyers eventually returned to market. Shortly after copper's bottom, stockpile levels rounded the corner and have seen a net draw over the last month or so. Interestingly even though the stock markets plunged to new lows over this same period of time,

folks were realizing that it is not actually the end of the world and that there will still be demand for copper.

Now even though Armageddon hasn't bestowed itself upon the copper market much to the dismay of the doom-and-gloomers, these trying economic times are expected to significantly alter its landscape. Copper demand is indeed likely to fall and I suspect it will be quite some time before we see the torrid growth rates that supported the initial stage of its bull market.

But demand may not be as poor as people think and growth might resume in this sector faster than people are forecasting. And from my contrarian viewpoint it looks as though things are lining up for the copper market to regain momentum and continue in its secular bull.

From a macro perspective copper, and commodities as a whole, will be long-term beneficiaries of the staggering inflationary actions of the world's governments. Not only is there a massive pipeline of stimulus projects that will directly benefit the infrastructure build out, but rampant and [careless monetary policies](#) that have been set into motion will be a huge boon for commodities prices.

We also cannot forget where demand growth will come from in the future. Though this recession has slowed growth from the developing economies in Asia, these countries still have a long ways to go in their strategic development plans.

For example the Indian government says its recently completed fiscal year should see growth around 7%. And even with the current economic calamity it sees growth in the next year exceeding 5%. Moving to the northeast, according to one of China's largest banks this growing economic powerhouse should see 2009 GDP growth of around 8%.

Interestingly the China Geological Survey is actually worried about commodities production shortfalls in 2009. And this has been evident in 2009's activity so far at the Shanghai Futures Exchange. The SHFE saw record copper gains in Q1 as the metal has been trading at a premium to the LME in order to encourage producers to ship more copper to China.

Though China and India see growth at less than 10% in 2009, it is growth nonetheless and a lot of this will come in the form of infrastructure growth. China in particular has shouldered a larger portion of copper demand of recent, but when demand eventually picks back up in the rest of the world there will be fierce competition for what is likely to be a shrinking copper supply.

With copper near multi-year lows and demand growth slowing a bit, it is natural that the miners will eventually throttle back production. Production cutbacks are

usually lagging and reactionary events in response to shifts in demand. And this is why we are seeing global stockpiles on the rise.

But many of the world's top copper miners have already adjusted 2009 production forecasts to the downside. Some of these cutbacks are voluntary as a means to conserve copper for when prices and demand are higher. But some of these cutbacks are forced as a result of waning economics.

From mid-2005 to mid-2008 copper averaged over \$3, thus prompting aggressive industry-wide exploration and development programs. These high prices also allowed the producers to profitably mine lower-grade ore within the confines of existing operations as well as bring past-producing mines back to life.

But these lower-grade, thus higher cost, operations and development projects that were economically feasible at higher copper prices are now losers. Production cutbacks, mine closures, and the scrapping of now-uneconomical exploration and development projects will eventually translate into materially lower mine production. Supply will eventually shrink enough to balance demand, even if demand stays weak for an extended period of time.

Regardless of where this balance is met, I believe copper has seen its low. And investors and speculators have taken advantage of this wildly oversold environment to reap fantastic gains as the markets bounce back to reality. As mentioned the futures traders have seen the metal pop 50%+ since the beginning of the year. But stock traders have fared even better.

By the time the dust settled at the initial panic low in November, the copper miners had leveraged copper's losses to the downside in a big way. Even the world's largest copper stocks had sold off by 80% or so from their highs. As mentioned earlier investors had discounted an apocalyptic ending to the commodities trade and sold their shares with reckless abandon. But in hindsight this November stock-market low was the time to load up on commodities stocks, especially copper stocks.

After coming to the brilliant conclusion that the world wasn't coming to an end and we weren't entering into the next Great Depression, buyers returned to commodities stocks and took advantage of their wildly oversold levels.

Copper stocks in particular have been among the best performers in the entire markets in the last 4+ months. Many have already seen triple-digit gains from their bottoms in the midst of an S&P 500 grind that had seen new lows set just last month.

At Zeal we took the prudent course and bought when everyone else was afraid. We added a number of commodities stocks, including an elite copper miner, to our long-term investment holdings in the November edition of our [acclaimed](#)

[monthly newsletter](#). Through the end of March these stocks had *average gains of 54%*.

Ultimately even though we've experienced great initial success in this commodities bounce, uncertainty and fear still cloud copper's picture going forward. There are still a lot of headwinds on the global economic scene and it could be a choppy trading environment as a new supply and demand equilibrium unfolds. Traders should expect ongoing extreme volatility with both futures and stocks.

But if you can stomach the volatility there are still plenty of opportunities to be found in both the near term and long term. In fact in our hot-off-the-presses April Zeal Intelligence newsletter we recommended a buy in one of the world's premier junior copper producers that is still trading over 75% off its highs.

This miner continues to grow production and drive down its operating costs. And it should thrive in today's environment. For high-potential stock recommendations and cutting-edge market analysis, [subscribe to our newsletter today](#). New e-mail-edition subscribers will receive a complimentary copy of this April issue and will gain access to the subscriber charts section of our website that has a mix of frequently updated copper charts.

The bottom line is the sky is not falling as many folks are led to believe. While it is likely that slowing demand growth will rebalance the commodities trade to prices lower than those speculative risk premiums of yore, the commodities trade is not dead.

Commodities, as seen by copper's recent activity, have a number of forces working in their favor that should keep the secular nature of their bulls alive. This recession is likely to be a bump in the road to prosperity that the developing economies will champion for years to come. And investors have incredible opportunities to buy the highly oversold elite commodities stocks that should greatly outperform the general markets in the years to come.

Scott Wright

April 10, 2009

So how can you profit from this information? We publish an acclaimed monthly newsletter, [Zeal Intelligence](#), that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research as well as provides in-depth market analysis and commentary. Please consider joining us each month at ... www.zeallc.com/subscribe.htm

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