Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Morning Bullet Points   April 19, 2004

At least one independent research firm (as well as a number of hedge funds) with a shorter time horizon are convinced the commodity-stock rally is over because the Fed likely is entering a rate-hiking cycle, gold is no longer climbing and China has begun to actively work to decelerate its economy. Part of their case is that the "carry trade" in commodities -- borrowing cheap and loading up on reflation beneficiaries -- is now unwinding. Thus, they argue, there will be no liquidity driver to keep the rally going even if company fundamentals continue to improve for a little while. Further, since the sky is no longer the limit on commodities, there is no point in bidding up the stocks since it's only a matter of time before things start to actively get *worse* for the commodity sectors. Finally, certain supposedly sensitive indicators such as the Baltic Freight Index have peaked, signaling weaker tidings for the entire physical-commodity universe. The sector, they contend, is no longer timely.

I continue to take the other side of this bet. Here is the logic:

<u>1) The Fed is likely to remain a friend to commodities for longer than is generally assumed.</u> Absurd as it may seem, the inflation-forecasting model used by the Fed's research staff does not incorporate any measure of the the dollar's value, instead relying on the hopelessly-flawed output gap model. The output gap model shows plenty of slack in the economy because employment and capacity utilization remain tepid. Hence, the Fed research staff still considers inflation risk to be low. As a result, the long end of the yield curve, which is more attuned to the *real* causes of inflation (i.e. dollar weakness), is likely to back up nearly as fast as the short end for the near-to-medium term. *The net effect may be a curve that remains almost as steep as it has been for the past two years.* Historically, a steeper-than-average yield curve tends to correlate with a rising gold price, though personally I remain neutral on gold. If the gold price just sits at $400/oz., that should be plenty good enough to allow nearly all commodity industries to continue to post improving earnings. If gold falls below, say, $365/oz., that would be negative for commodities.

<u>2) It's a myth that the Fed must be actively cutting interest rates for commodity industries to do well.</u> When the Fed began cutting interest rates in January 2001, the Dow Jones Steel Index was at 72. Two years later the fed funds rate was 525 bps lower (having been cut from 6.5% to 1.25%) but the *DJ Steel Index was down 34% to 47*. In the interim, the steel index twice rallied to 100 on false expectations that a rally in steel demand and pricing was right around the corner. What did steel bulls get wrong over these two years? They relied on a one-input model (the fed funds rate) and ignored the really important factors -- the gold price and changes in global grass-roots economic activity. A model geared to gold and the outlook for global grass-roots growth didn't generate a buy signal for steel until early 2003. Clearly, during 2001 and 2002, steel investors systematically failed to use the right leading macro indicators when gauging the outlook for this key basic industry. Thus, it doesn't make sense to use a Fed-only model when forecasting earnings for steel (or any other basic industry) for 2004 and 2005, either.

<u>3) Copper, aluminum and lumber rallied sharply last week despite a gold rout, bond rout and Chinese rate hikes -- all of which should have been negative for these commodities.</u> Copper rose more than a nickel on Friday to $1.35/lb. and remains close to its 52-week high. Aluminum has risen 10% over the past month and now stands at a 10-year high of $0.877/lb. Both lumber and oriented strand board (OSB) have recently broken out to new highs, with OSB piercing $500/mbf. NYMEX crude remains above $37/bbl.

Are these short-term blow-off tops, best ignored before the "reality" of slower growth and worsening supply/demand fundamentals kick in? My analysis suggests not. Gold at $403/oz. remains 61% above its 2001 low, offering tremendous monetary support to industrial commodity prices. Meanwhile, emerging market monetary and fiscal policies are *great* and the world has only recently emerged from a multi-year period of very-low capital investment in basic industries. Putting all these pieces together, it appears that the best way to interpret the recent strength in commodity prices is as a reflection of very real and pressing shortages of basic materials. Looking ahead, it seems most prudent to expect this imbalance to remain in place *until it demonstrably turns around* (i.e. until industrial commodities turn down in a sustained fashion and company managements start to warn that they see the end coming, neither of which is happening).

<u>4) Natural resource company earnings are going to be fantastic for Q1, and they should be just as good or better in Q2.</u> Several forest-product companies recently said they will beat Q1 estimates. On their conference calls, managements are likely to say that volume and pricing are improving across all business lines -- including paper. Shipping-company earnings will be stratospheric. Although headline shipping rates have fallen from their highs during the past month, managements are likely to be upbeat in their medium-term forecasts due to the ongoing shortages for shipping capacity and the looming phase-out of single-hull ships from European ports in 2005. Guidance from aluminum companies almost surely will be very upbeat given that a) managements were very optimistic about both volumes and pricing during their January/February conference calls, and b) the aluminum price has leapt to new highs recently. Coal concern CONSOL (CNX) pre-announced due to stronger-than expected volumes and coal pricing, although this firm's situation may be slightly unique within the coal sector due to a strong recent capex program which has left it with new, non-allocated coal to sell at high spot prices. (It should be very worthwhile to listen to the Massey Energy conference call because this management was the most informative of all the coals during its Q4 call on the subject of contract pricing.) Roughly 10 steel companies have announced or pre-announced excellent earnings, with the latest being Steel Technologies (STTX), which this morning reported Q1 earnings $0.05 above consensus. Oil companies should have great numbers. One sector where it will be difficult for managements to surprise on the upside will be copper. It's very easy to change copper company earnings models to reflect changes in the copper prices, so analysts and investors tend to ratchet up forecasts in step with copper price improvements.

<u>5) I'm wary of "second-derivative" analysis, which compels investors to dump themes when their rate of improvement slows.</u> This practice can easily mutate into intellectual overkill in which investors find themselves abandoning strong sectors out of fear they *may* implode overnight on *potential* publication of a weaker than expected *forecast*. As investor time horizons shorten due to reliance on market-timing, I find myself evolving toward an approach I'm beginning to think of as "*anti-timing*." As a general observation, I see a widening disconnect between the pace at which sectoral fundamentals evolve (in "geologic" time) and the often-frantic pace at which investor perceptions change (human time).

A good example of the mismatch can be seen in the long-running rally in the bank and homebuilding sectors. Homebuilder DR Horton (DHI) is up roughly 700% over the past four years, with the stock nearly tripling just in the past year. But homebuilders have been a "tired" call for quite a while. When they dipped last summer I thought about introducing coverage of the sector but decided against it because I thought clients would yawn at a report on such an obvious and long-running theme. In the past couple of months, some of my cutting-edge clients have begun yawning at the commodity call, telling me "The theme is over, dude ... I've moved on."

One benefit of supply-side investing is that it constantly forces one to benchmark decisions on 50-year and 100-year commodity charts, thereby countering the problems of theme boredom and premature selling.

<u>6) Commodities are not just contrarian -- they have become downright counter-cultural.</u> My macro model ranks technology, advertising, media and lodging just as high as commodities but I have

trouble getting excited about these mainstream sectors (in the U.S.) because analyst and investor coverage is so intense. When I look around for new investment themes, the only things that grab me are far-out emerging-market names in places like Serbia and the Ukraine. The commodity theme may be getting "old," but it's still the most contrarian investable theme out there because of the oddball nature of the drivers: the strong gold price and excellent fiscal and monetary policies in places like Russia, India and China. Hatred of commodities among mainstream investment professionals -- and investor fear of over-sticking with the theme -- is based on the fundamental weakness in commodity industry as a business enterprise: its total absence of branding power. It has now been 10 years since the last aluminum peak, 9 years since the last copper peak and 8 years since the last grains peak. Thus, for the last decade, investment-industry professionals have been coming to prominence with a built-in aversion to the entire commodity sector. It's interesting to note that most of the best big-picture thinking on commodity sectors is coming from old-timers like Marc Faber -- people who were around for the big commodity boom of the 1970s and who understand that a theme like this can run for quite a while.

The Classical Insights portfolio holds CNX and STTX.

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