

# Classical Insights

Global Investment Analysis Based on the Classical Economic Model

## Classical Insights Morning Bullet Points February 25, 2005

**The ongoing commodity-stock rally creates an intense analytical challenge.** Monetary models suggest commodities are “expensive” relative to historical norms, but the factor at the margin is now *scarcity* – and it probably will be for some time to come. How to rectify these opposing forces? I am gravitating toward what I’m coming to think of as a “zen” approach: don’t fight the flow, feel one’s way through the fog, examine each new data point with a tranquil and receptive mind. Here are 10 points on the matter:

1) With the exception of corn, every raw commodity I watch closely is above its monetary equilibrium point (defined by the historical relationship to the gold price, which is used as a proxy for the value of the dollar). In the classical economic model, this is an important cautionary signal for holders of commodities or commodity stocks.

### Monetary equilibrium prices for selected commodities

	current price	Equilibrium (w/gold at \$431.40)	upside to monetary EQ
Crude oil (NYMEX)	51.39	32.36	-37%
Copper *	1.48	1.27	-14%
Aluminum	0.923	0.889	-4%
Coal (eastern blend)	51.62	46.48	-10%
Nat gas	6.304	5.38	-15%
Corn	2.06	3.17	54%
Lumber	439	428	-2%
Oriented strand board	398	284	-29%

\* This is the 1990s EQ for copper. The pre-1971 EQ for copper was much higher.

However, the classical model also holds that deflationary downturns (such as we had in 1997-2001) that are resolved via reflationary monetary policies (such as occurred from 2001 to 2004) lead to booms – booms that feature *above-equilibrium* commodity prices. The dynamic goes like this: Minimal capex is done during the deflationary downturn, so whoever is left standing in the upturn is besieged with customers willing to pay a scarcity premium to get access to the raw materials they need. This, of course, is precisely what’s happening now. Scarcity premia are now being commanded by producers of metallurgical coal, oil-tanker space, polyethylene, oil, gas and oriented strand board.

2) A crucial question, then, is this: How long will scarcity premia last and how big will they get? This is a difficult question, because there’s just no reliable model to use to quantify scarcity premia. Monetary equilibrium prices can be quantified, but scarcity premia cannot. (Who could have forecast VLCC rates at \$200,000/day, or metallurgical coal at \$120/ton?) Part of the reason scarcity premia are so tricky to forecast is that commodity buyers frequently don’t care what they pay – they are much more interested in just getting their hands on the material. A builder of a house doesn’t really care if he pays \$6,000 for boards vs. \$3,000. Either way, it’s a small portion of the overall house price and he can probably pass it through to the buyer anyway. The same holds for buyers of metallurgical coal, polyethylene and oil-tanker space. The result: it’s fairly easy to generate a reasonable idea of where a commodity should *eventually* trade, but it’s almost impossible to say how long it will take to get there, or how high the commodity will climb at its peak.

3) Without a reliable way to quantify scarcity premia, an analyst is forced to work in a thick fog. Even in a fog, though, there are good ways to navigate and bad ways. Let’s start with the bad

ways. One bad way is to stop, find a rock, sit down, cross your arms and say, "I'm not going any further because I can't see." I've done this many times in this commodity boom. When commodity prices were first breaking through their monetary equilibrium points early last year, I was concerned that, since there was no way to quantify how long any premium might last, no one would ever pay it. Thus, I sold out of several sectors way too early. I maintain a table on the reflation stocks sold from the Classical Insights portfolio and how they've done since the sale date. In most cases, I've recycled the proceeds into other reflation names, but the table still makes for some hurl-inducing reading:

### Reflation stocks: What they did after I sold them from the portfolio

			Sold	24-Feb		
	Sector	Date sold	price	close	% change	
Chiquita Brands	CQB	Bananas	12/6/2004	20.33	22.11	<b>9%</b>
Lubrizol	LZ	Chemicals	11/10/2004	33.38	42.40	<b>27%</b>
Fording	FDG	Coal	10/26/2004	62.79	87.30	<b>39%</b>
Phelps Dodge	PD	Copper	7/28/2004	74.71	100.37	<b>34%</b>
Occidental Petroleum	OXY	E&P	4/29/2004	47.96	69.93	<b>46%</b>
Plains Exploration	PXP	E&P	4/29/2004	19.89	33.42	<b>68%</b>
Pogo Producing	PPP	E&P	4/29/2004	50.44	47.90	<b>-5%</b>
Terra Nitrogen	TNH	Fertilizer	10/6/2004	22.35	26.00	<b>16%</b>
Frontline	FRO	Oil shipping	5/17/2004	30.25	52.92	<b>75%</b>
General Maritime	GMR	Oil shipping	5/17/2004	21.23	50.18	<b>136%</b>
OMI Corp	OMM	Oil shipping	5/17/2004	10.36	19.89	<b>92%</b>
Steel Dynamics	STLD	Steel	11/10/2004	37.80	43.80	<b>16%</b>

average change 46.1%  
S&P since 4/29/04 7.7%

4) Another bad way to navigate through a fog is to start running, with no concern for what's ahead (cliffs, brick walls, ravines). This was the general approach both in the internet boom of 1999/2001 and toward the end of the commodities boom of the 1970s, when conventional wisdom held that oil was headed for \$100/barrel, gold for \$1,500/oz. and silver for \$100/oz. The current commodity rally, by contrast, is noteworthy by the general *dearth* of forecasts calling for super-high commodity prices. There are some oil bulls out there, but the only analyst I can think of who maintains an eye-popping number on a grain or metal is John Tumazos at Prudential, who is calling for \$1.75/lb. copper in 2007. Why the restraint? Some of the reasons are regulatory (the legal liability to brokerage houses if they are bullish and wrong), intellectual (lack of appreciation for the power of global tax cuts & global reflation), and general post-internet-boom caution (no one wants to be the next Henry Blodgett or Mary Meeker).

5) In recent weeks, I've decided that the best approach for navigating through the fog of scarcity is something analogous to zen: Stop fighting the fog. Become one with the fog. Move slowly through the fog, hands extended, feeling one's way. Explore each new leaf, branch and rock outcropping to see what clues each might hold about the terrain one is entering. When iron miner CVRD signs an agreement with Japanese steel mills stipulating a 71% price hike on iron ore for 2005, that is a very interesting tree branch. When the yield curve flattens but gold doesn't fall, that is an interesting rock outcropping. When the CEO of Arcelor forecasts that the global steel industry will consolidate into a handful of giants over the next 5-10 years, that is an interesting leaf.

6) The zen approach would be riskier if we knew, based on topographic maps, that the landscape were inherently dangerous – riddled with steep cliffs, for instance. However, the aerial view provided by a supply-side macro analysis of the world suggests the terrain is fairly smooth – smoother, in fact, than it has been since the 1960s. The positive tailwind created by monetary reflation is more powerful than probably anyone really understands. Not only did it raise the monetary equilibrium point of all commodities by 65% (which is the percentage the gold price

rose as it climbed from \$260/oz. to \$430/oz.), but it also made life immeasurably easier for emerging market central bankers seeking to keep their currencies stable against the dollar, finance ministers seeking to balance budgets, prime ministers seeking to push through “responsible” tax cuts and CEOs seeking financing at reasonable rates. The sum total of all these good things is that the *whole world is booming*, with the exception of a few spots in Western Europe. In that kind of situation, supply/demand ratios for basic materials are likely to continue to be tilted in producers’ favor.

7) The macro backdrop for basic industries is further improved by the fact that the positives in the world are not as visible to those who don’t subscribe to the classical/supply-side worldview. Since this group includes most CEOs, it is fair to assume that the macro assumptions undergirding most corporate strategy decisions (i.e. capex) are too bearish. Hence, conceptually, it’s possible that corporate capex will be insufficient to meet demand for a number of years yet. That said, it’s likely that 2005 will bring more announcements of new mines and plants, and some of these announcements will hurt share prices of companies in the affected spaces (such as happened to Georgia Gulf recently). To a large extent, though, these capacity additions will be *necessary* to prevent materials prices from going to the moon.

8) This brings us to the question of the P/E ratios one should use for price targets. Currently, I use very conservative multiples, on the assumption that investors will always view basic industries with skepticism. This is actually a weak assumption on its face – especially in a supply-side framework -- and certain stocks are already testing the limits of its functionality. One in particular is U.S. Steel. I maintain a \$51.32/share target for the stock, but still hold it in the portfolio even though it trades at \$62. My target makes two assumptions with which I’m decreasingly comfortable: 1) earnings fall to \$4.89/share in 2006 from \$8.50/share in 2005, and 2) the historical bias against steel stocks continues to hold, leading investors to put only a 10.5x multiple on 2006 earnings. In bidding X shares up to \$62, investors are pushing against these biases right now. Intellectually, this makes sense. After all, U.S. Steel’s cash flow is just as green as any other company’s, and so, if U.S. Steel’s earnings are conceptually sustainable at \$4.89/share (and I believe they are), why shouldn’t X merit a 15x multiple instead of 10.5x, generating a \$73.35/share target price? While the market isn’t ready to go that far yet (and I guess I’m not either), it has also decreed that my target of \$51.32 is simply *wrong*. The zen approach suggests nodding to the will of the market. What that means in terms of setting a new target ... well ... I’m not sure yet.

9) To some extent, this problem can be finessed by moving out on the obscurity curve. In 2005, it should once again be possible to boost relative return within the basic-industry universe by exploiting the valuation arbitrage between big, well-known companies and the small, obscure ones. I have a couple of very-nimble hedge fund clients who have been knocking the ball out of the park on a daily basis this month because they are both a) heavily ensconced in the basic-materials theme and b) pushing out on the obscurity curve faster than the vast bulk of investors (including me). As more and more interest is generated in the commodity theme, ever-more-bizarre vehicles are gaining attention and rising in price. Capitalizing on this theme may (and probably will) mean going to Calgary, Kinshasa, Warsaw, Bucharest, Seoul and Jakarta, but it seems destined to work. Importantly, it won’t just be materials that will work in emerging markets. Banks, real estate, media and even consumer products all become *de facto* reflation plays when located in countries that are top reflation beneficiaries.

10) Risks to the commodity story are several: 1) A sharp decline in the gold price (say to below \$380/oz.) would pull down the monetary equilibrium point for all commodities to where it would start to outweigh the positive impact of strong demand and shortages. The recent flattening of the yield curve probably implies an increase in this risk, though as of yet nothing has happened (i.e. gold is still over \$430/oz.); 2) The U.S. Federal Reserve open market committee could err in its interest-rate policy decisions, slowing growth via too-high interest rates, or perhaps creating other sorts of problems via too-low interest rates; 3) U.S. CPI readings could blow out on the high side in the wake of the recent gold rally; 4) Bad policy moves by important foreign governments or unexpected negative geopolitical events could serve to weaken global growth; 5) Oil may climb to

the \$75-plus range due to much-worse-than-expected scarcity (i.e. the Hubberts Peak scenario). All of these risks deserve careful monitoring.

The Classical Insights portfolio holds U.S. Steel and Georgia Gulf.

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