

FROM THE CAPITAL

Copper penny is yet to drop

ICSG stats point to a looming dramatic shift in copper-sector outlook

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Copper market demand and supply statistics offer a more ebullient vision of market conditions than recent price action. The statistics, if they can be believed, say markets could be as little as a few months away from a cyclical recovery with only minor changes to the balance of demand and supply.

Last year appears to have been the fifth consecutive year of increasing copper usage, according to the latest statistics produced by the International Copper Study Group (ICSG). The ICSG data suggest 2014 growth in usage will be the most tonnes ever in a single year. Looked at in isolation, the usage figures could easily be taken to mean the market has never been in better shape.

According to the ICSG, usage in the first 11 months of 2014 was higher by 1.9Mt, or 9.8%, than the corresponding period in 2013. Adding the final month of the year to this tally will not materially impact the growth outcome.

Such a growth rate would normally accompany a full-blown acceleration in global output growth. In 2010, for example, when global GDP growth was 5.4 percentage points higher than in 2009, zinc, nickel and aluminium experienced usage gains of 16-18%.

The copper consumption increase was a more modest 7% in 2010 and surprisingly tame by historical standards – just as the 2014 outcome appears unusually, even suspiciously, strong. The results might have something to do with prices that were pushing toward US\$4/lb in the first period but dropping over the past year. Rising prices may have deterred or delayed copper consumption in 2010, while recently falling prices may have added demand.

Of course, this explanation may yet prove too sophisticated economically. China's 45% share of industrial use and willingness to allow vast but unknown amounts of copper as security for loans have made measurement of physical use more difficult.

Uncertainties on this front also hint at the possibility that reported 2015 usage rates a year from now could show a sharp slowing in the rate of growth, even a decline in volumes, once the inflating effect of collateralised loans has been eliminated.

How accurately Chinese usage rates can be measured is an important consideration in understanding the market condition. Clearly,



methodological issues persist. The ICSG has had to put in place a less than satisfactory work-around to help measure stock movements that are an input into its calculation of apparent consumption.

As things stand, refined copper output is reported to have increased by 1.55Mt during January to November 2014, while metal use is supposed to have risen by 1.91Mt. Despite the resulting 362,000t shortfall, the estimate of stocks on hand has dropped by only 127,000t.

This pushes price forecasters into a nightmarish predicament. Not only are the numbers more rubbery than usual, but even relatively modest variations in anticipated economic growth rates could have a dramatic impact on inferences about price outcomes.

Historically large increases in the tonnages of metal being used are going to become more common. Growth in copper consumption in line with its long-term growth rate of 3.4%/y now implies the need for an extra 800,000t/y of refined metal. That is a challenge for the mining industry. Numbers that had once been cyclical records for the industry are becoming the required norm.

On the mining supply side, around 1.2Mt seems a feasible expansion rate in 2015 and 2016, suggesting enough coverage for average growth conditions in the near term. If, on the other hand, growth in demand is better than average, the challenge and market impact will quickly escalate.

Historically, a one percentage point acceleration in global GDP growth would have produced an average 4.5% increase in copper usage or the equivalent today of a highly meaningful 1Mt – enough to alter expectations of future prices.

In 2002, at the beginning of the last major cyclical uplift, inventory holdings were equivalent to approximately six weeks of consumption. That was near the point of take-off. Today, the inventory level is close to three weeks of current consumption.

In this sense, today's industry is poised in an even better position than in 2002. What would an investor do with the chance to return to 2002 knowing what came shortly after? And, yet, there appears little excitement at the prospect.

Forward price spreads also tell a tale. A move toward backwardation would normally be an early sign of a change in the direction of spot prices and a signal for equity investors. For a period of alleged cyclical weakness, the spreads in the copper market have remained surprisingly tight.

Perhaps copper is being dragged down by its peers. Iron-ore and oil prices have raised anxieties about global output growth prospects despite adjustments in those markets, however dramatic, reflecting structural characteristics that do not apply to copper. A rising US dollar will also be having a detrimental effect on US dollar denominated copper prices.

The data on copper output and usage, looked at on their own, imply a market closer to a turning point than the spot price of recent months has been suggesting. With a historically thin inventory cushion, an acceleration in global output growth could precipitate an explosive price response.

In a future assessment of the next cycle, 2014 might well be seen as a critical year. If the numbers now being advanced stand the test of time, the foundation could have been laid for a cycle every bit as dramatic as the one starting up a dozen years ago. ▼

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