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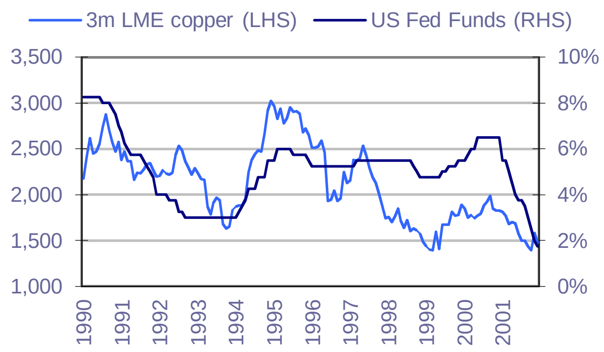
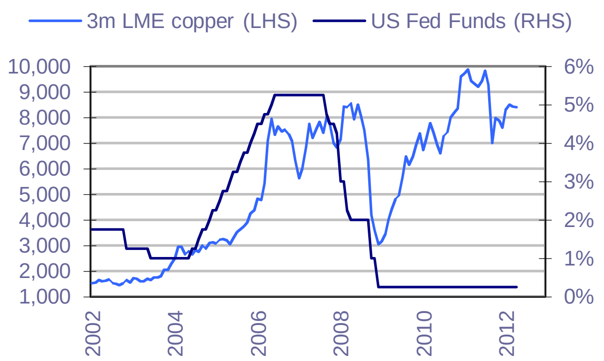
COPPER – EVER THE BELLWETHER – MAY 2012

"They spend their time mostly looking forward to the past"
John Osborne, Look Back In Anger, 1956

It has long been accepted that the copper market has been a leading indicator of global economic activity. For many years this was most visible perhaps through the high correlation between the copper price and US interest rates – specifically the Fed Funds rate (see chart below left);

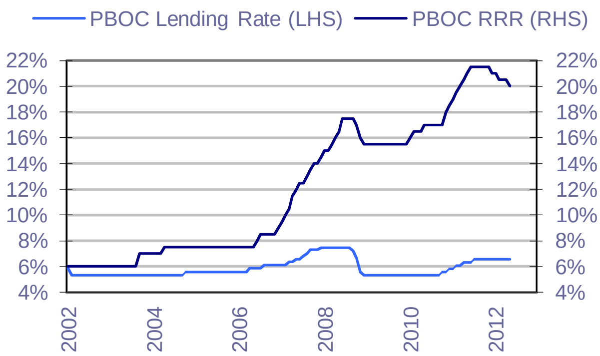


Throughout most of the 1990s, the copper price led the Fed Funds rate by approximately 3-4 months. The new century brought significant market events however, notably the dot-com implosion and the 9-11 attacks. As a result the Fed became much more proactive and as the chart below shows, the copper price began to lag the Fed Funds rate instead of lead it;

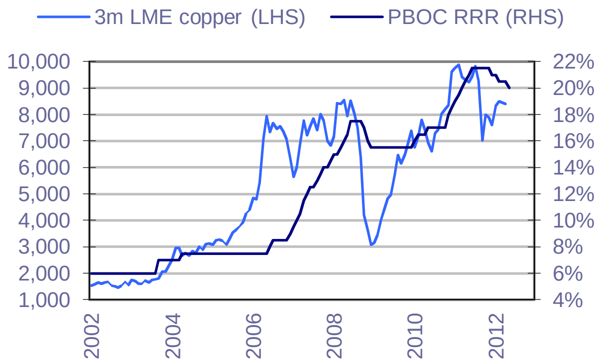


As in the chart, with US interest rates flat-lining at historical lows the relationship has clearly broken down completely; from the end of 2008 there has been no correlation with the copper price.

Does this mean that the copper market is no longer relevant? Absolutely not. As with most things in the 21st century, the mantle has been taken up by China. The Chinese monetary authorities prefer to adjust policy by altering their Reserve Requirement Ratio rather than interest rates or open market operations – see the chart below left;



The chart above right shows how the copper price and the Reserve Requirement Ratio have correlated.



The chart shows that the copper price leads the RRR just as it did the Fed Funds rate in the 1990s. But there is no pattern as to how far ahead it leads – it can be anywhere from 3months to 12months. And it doesn't really help us predict where the price is going next. However of more interest is what happens at the end of each tightening/easing cycle. Unsurprisingly perhaps, once the market concludes that the PBOC has finished a cycle then the copper market reverses sharply;

Jun08 – Tightening cycle stops and copper drops sharply;
Dec08 – Easing cycle stops and copper rallies sharply;
Jun11 – Tightening cycle stops and copper drops sharply

CONCLUSION

If we can identify when tightening/easing cycles are stopping we can attempt to predict copper price action. Happily the PBOC cycles tend to be regular events – the current easing cycle occurs every 80 days or so, with the next due on 4th August 2012. If no such easing occurs on/by that date then we would view copper as a significant buy...