Copper prices: a story of extremes

Below, John E. Gross, a veteran copper analyst, presents his observations on the volatile copper markets and answers a few questions from WJI.

If one believes that history has a way of repeating itself, then the stunning year in terms of the price for copper may not be so surprising. But industry consumers of the red metal would have to be truly stoic in nature not to be numbed by what has happened in such a short time.

It was just a little more than a half year ago, July 2, 2008 to be exact, that the price of copper on Comex closed at a record high $4.08 per pound. Today, copper is trading at the $1.35 range, down $2.73, or two thirds of that historic peak, and it may well fall further.

How and why did the market rise this way? What caused the precipitous fall? To better understand what is happening now it helps to look back at events and facts that read more like fiction than reality.

One can say the roots of this bull market have their origin in 2002, following the dot.com bubble burst that dropped equity prices sharply lower. Coupled with the horrific 9/11 attack that sent the global economy into a downward spiral, the copper market was in a near depression. Global copper consumption in 2002 declined by almost 200,000 metric tons (MT), or 1.3%, the first such loss in a decade. Copper prices slumped to the 60¢ range, a near 15-year low and a blow to cable companies with large inventories.

The ensuing weak demand, depressed prices and excess inventories that rose to a record high 1.27 million MT in Comex and London Metal Exchange warehouses, producers slashed output in 2002 and 2003 as losses mounted. As actions were being taken to restore market balance, an "x" factor began to have an effect: China. Consumption there continued to rise, and in 2002, China topped the U.S., then the world's largest producer and consumer of refined copper, in both production and consumption. That change in the world order of supply and demand was a key element for the events that would follow.

Typically, bull markets don't begin with a bang. Rather, the early stages tend to be long drawn-out affairs, with periods of doubt that the markets will ever fully recover again. But recover they did. By the fourth quarter of 2003, inventories held in exchange warehouses had fallen some 575,000 MT, or 45% from the peak, with the price closing above the $1 level for the first time since 1997.

As 2004 got underway, it became increasingly apparent that a rising trend was developing, one that attracted the attention of the speculative community, including major hedge funds. One by one, they climbed on board, and with vast sums of money, multiplied many times over with the use of leverage, bought massive quantities of copper. That collective push was enough to further the price curve from a gradually rising slope to a far more vertical path that was fed by increasingly higher prices.

Aside from a few periods, copper pricing by and large over the last 40-50 years has been docile in nature. Many companies would buy inventory for months out without concerns of major price swings, but during the first half of 2006, it wasn't unusual to see the price climb 10¢ in a single session, with more than a few days seeing a 20¢ advance.

This was not your grandfather's copper market, and another factor, an outside influence, was about to come to play that would make the market even harder for industry veterans to fathom. Two major speculators, with opposing views of the market, fought for supremacy in a test of nerves that could only one could win. By May 2006, the copper market was in a full panic mode. By the time the battle was over, copper had soared 44¢ in a single day, closing at $4.08 on May 23. The market slid to $3.10 a few weeks later, and by February 2007, it stood at $2.40, off 40% from the high.

From this point, it appeared the bull market had run its course, with expectations of lower prices ahead. Once again, what seemed to make sense was not what happened. Throughout 2007, the concept of a long-term bull market in commodities – a 'Super Cycle' was gaining credibility. The thought was that a new world order was emerging, one where the developing BRIC (Brazil, Russia, India and China) economies, among others, would have an insatiable appetite for commodities for many years to come. Once again, the copper market reacted. Prices moved higher across the board, and not just for copper. Crude oil hit a record high $145 per barrel and copper soared back to its previous high of $4.08.

High times continued in 2008 until yet another factor came in to play, one that did not fit in with the upward trends: the global economy, suddenly and stunningly, was in turmoil. The first flames erupting in the U.S. domestic housing market ultimately turned into a full-fledged global conflagration. Major financial institutions throughout the world suffered massive losses. Almost overnight, markets that had embraced and indeed marketed the wonders of easy credit became risk adverse. Commodity prices

began to collapse. In just one month, October 2008, copper fell more than $1 a pound, causing an unprecedented loss in value for inventories.

Today, the global economy and markets face significant problems, some that are deeply complex. The current thinking is that copper prices will fall until the excesses of the past several years are eliminated from the financial system. If history is our guide, however, once this phase of contraction is completed, a new cycle of growth will commence for the economy and for copper. And then, maybe, we will find ourselves asking the same questions a decade or so from now.

WJI: Is there a lesson to be learned from what happened or is it that as long as the current financial tools exist for hedging exists, this same cycle can and will be repeated?

Gross: We have seen in the past ten years where a greater level of oversight (not greater regulation) by the CFTC, Comex and London Metal Exchange is necessary to prevent unusual and destructive market behavior. Cycles in the copper market reflect, in large part, global economic cycles, interwoven with production and consumption of copper itself, as well as inherent speculative influences that are a necessary and integral component of a properly functioning market. Thus, we will see reoccurring cycles in the market. However with a greater level of oversight, we would not have an excessive level of volatility.

WJI:Was the damage caused by wild price fluctuations avoidable?

Gross: A lot of companies dependent upon copper ran into problems as the price of copper rose to record highs and then fell precipitously. This hits a company in terms of cash requirements, the cost of financing, inventory valuations and price risk exposure. Now, nobody has control over the market price of a commodity, but there are ways to offset the downturns.

The key is to have a proactive strategy to offset price risk to the extent possible. For example, a company that sells a product for future delivery should insist if at all possible that the metal price be locked in at the time of order. It then offsets the risk of that sale with a corresponding purchase of metal in the futures market. Conversely if a company holding inventories was concerned about a decline in prices, it could offset that risk by selling in the futures market. Thus, if the market price fell, reducing the value of inventories, the futures market transaction would be rising in value, negating the physical inventory loss. While this may seem complex, it is really quite simple and straight forward when one becomes familiar with the mechanics of the market.

WJI: If you were the copper czar of the world, is there any one action you would suggest be implemented?

Gross: Contrary to the view that a bubble cannot be identified until well after the fact, enough evidence exists that the early stages of a "potential" bubble can be identified. Thus, the appropriate actions, be it through regulation, oversight, trading/position limits, financial requirements and or tax levies, can and should be brought to bear to prevent a massive speculative bubble from forming.

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