I love Ya, Tomorrow

We recently talked to our *Dispatch* subscribers about the (relatively) sudden deluge of fund buying in the commodity markets. We pointed out then, and it seems to get truer every day, that it's important to realize the way many funds are buying into the commodity run. There are fundamental impacts on how the markets are moving and what may happen when profit taking starts so we wanted our Kitco readers to think on it as well.

We've talked a few times in the past six months about the conundrum of the forward charts on most base metals. Though many metals are tracing charts that can only be described as parabolic, there has been little or no widening of the gap between spot and forward prices for these metals, as one would expect. In many cases, the long end of the curve has been coming up faster than spot, closing the gap between current prices and 27 month forward prices.

There are several ways to read this situation. One, which we think fits the situation best, is that funds increasingly view the commodity uptrend as something secular that can be traded long term. That being the case, the most leveraged way to get exposure to it is the forward market. Forward prices are clearly moving with spot, so they don't lose out much on the shorter term fluctuations. It also has the major advantage of being an "all paper" transaction. Mutual fund managers don't have to take delivery of a few thousand tonnes of copper or zinc and store it in the lunchroom. They can buy the long end of the forward curve and simply keep rolling over contracts (selling near term contract maturities and buying longer term ones to replace them) as long as they want to hold the position. Another factor that surely appeals to the hedge fund part of the sector is that forward contracts allow buying and selling on miniscule margins. We all know how hedge funds love to leverage their bets and few markets let you do it to a greater extent than commodity exchanges.

More than one market observer has noted that it takes mutual funds five years to decide to join a trend and at least five years more for them to leave it. They are not famous for being ahead of the curve, whatever their advertising copy might maintain. That too is good news if they are true to form. We hasten to add, though, that another advantage of trading the long end of the curve for funds is that they can move out of positions just as quickly as they move into them.

We think things have gotten to the point where the forward market is pushing the spot market around. The physical markets remain very tight and no one is willing to take the short side. Until someone is, in force, prices are likely to move higher. More supply will start to arrive at some point but traders will need to see inventories expanding again before they cover positions. That leads to a final important point about playing the forward curve. All the trading the funds do at the long end of the futures curve will have no impact on warehouse inventories, at least not for the foreseeable future. That's why we watch both inventories and the spread between spot and forward prices to gauge trader's intentions.

For the time being, everything looks strong. China put out a Q1 growth estimate of 10.2%, acceleration from the Q4 2005 rate, rather than the slowing that was expected. Add to that inflation concerns thanks to oil above $70 again coupled with narrowing rate spreads and the recipe for strong metals, and especially strong precious metals, is in place.

There have been plenty of winners in this market and there will be many more before it's over. HRA readers have had more than their share of them. Even so, the types of metal price moves we've seen lately all but beg for correction and continued trimming of high flying positions should be part of everyone's planning . We are entering the phase of the market that requires us to find relative, not just absolute value. That is a taller order, though not an impossible one – we've done it before. Part of seeking better values is trading some of your shares that have seen big price runs without commensurate changes in assets or results to back them up for those that hopefully still have their big runs ahead of them. That continues to be a sensible strategy.

David Coffin and Eric Coffin are the editors of the HRA Journal, HRA Dispatch and HRA Special Delivery; publications focused on metals exploration, development and production stocks. They were among the first to draw attention to the current commodities super cycle and have generated one of the best track records in the business thanks to decades of experience and contacts throughout the industry that help them get the story to their readers first. Please visit their website at hardrockanalyst.com for more information.