

## Old School

The reaction of mainstream analysts to the events of the past two months was as amusing as it was predictable. As soon as commodity and metals prices weakened, they were out in droves, tut tutting and warning the great unwashed that we had seen the top of the cycle. They patiently explained to those too dim to understand their market insights (which included us, I suppose) that the “abnormal” commodity markets were coming to an end and the “bubble” had burst.

It is to laugh. These articles did not surprise us. Many of the best known market strategists and market generalists have not understood this cycle from day one. Anyone who makes even a cursory study of commodity markets could see that there was something very different about the current cycle. The opinion of many commentators and business journalists is that most commodities, but especially metals and energy have not been acting in a “predictable” fashion. Their definition of predictable is a short cycle that passes through phases of under production, shortage, price increases, production scale up, oversupply and price collapse. It was ever thus, according to these observers. Collapse of the commodity markets is always just around the corner.

Lest you think we are about to break into a chorus of “this time it’s different” backed by the CNBC Internet Analyst orchestra we’d better clarify a couple of things. This cycle is not different from all others; it’s just different from the garden variety economic boom and bust cycle. It actually looks pretty normal so far compared to past secular commodity bull markets. Those don’t come along very often. There have only been a couple of true secular commodity cycles in the past century prior to this one. So generalists can be forgiven for gloating about the demise of the “old economy sector”, even if its based on an ignorance of the data.

The generalist view was based solely on the strength and speed of the up move this spring. They believe that it had to be a bubble because things moved too fast. There is some truth to this view. We’ve talked about how much influence hedge funds in particular exercised in commodity and emerging markets lately. The momentum buying –and selling- they exhibited was scary. Scary enough in fact that we think it influenced the world’s major central banks. There were real concerns about inflation and the economies of both Europe and Japan were accelerating quicker than expected. We think central bankers were also worried about markets getting carried away by speculative money their loose monetary policies created. In response, central bankers sucked an enormous amount of liquidity out of the system in the second quarter. That led to a lot of trades, especially leveraged hedge fund trades, getting unwound. That is where most of the selling came from in commodities and emerging markets.

Keep in mind that in most commodity and futures markets the speculative money far outweighs the trades of “real” suppliers and buyers. It always has and it always will. That didn’t make the nose dives less real or painful. Nor does it mean that buyers won’t use the price cuts to advantage. It does mean the price drops were driven at least as much by trading considerations as by supply and demand. .They were trades. There have been no mountains of copper or nickel or lakes of crude oil appearing in front of NYMEX or the London Metal Exchange. Where inventories changed at all in the past two months is has been to the downside. The cycle is intact and supply still needs to catch up to demand in most metals. As long as synchronized growth in North America, Europe, Japan and BRIC (Brazil, Russia, India and China) continues, the balance between supply and demand will be tight. This did not change just because traders saw bearish chart signals. It’s worth noting that metals that do not have developed forward markets and that are not “traded” like tungsten, uranium and molybdenum did not see much of a down move in this period.

Some commodities may not exceed their May highs but most will. Oil already has thanks to political tensions and the start of hurricane season. Nickel already has thanks to tight supply and zinc probably will for the same reasons. Copper may not, but it will also not see prices anything like old cycle lows for a very long time, if ever. Silver, as we predicted, fell harder once an expected “ETF Lift-off” didn’t materialize but it has bounced and started climbing. Gold has too. Short covering probably helped all these markets and the moves may flatten out through August, though Q3 is traditionally strong for gold and silver in particular. We still have inflation concerns. We’re very concerned about just how much drag the US housing market creates. Remember though, that one of the lasting changes from this cycles is that the US will be less dominant in most markets. It actually already is, but it will take time for traders to accept that. If the US can hold to a slower growth track without over shooting rates, the rest of the world can take up the slack and keep this party going for a while. If the Fed really is done the Euro and Yen in particular will keep gaining. This will add to the upward pressure on metals prices – especially gold and silver.

**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 [www.hardrockanalyst.com](http://www.hardrockanalyst.com) for more information.**