

Momentum Mania

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Was this a pivotal week? For the first time since March 6, the Dow Jones Industrial Average closed lower for the week. I'm not a technical analyst, but I know people who do follow technicals attach a lot of weight to this sort of loss in momentum. And momentum has been a critical factor in driving the markets higher over the last couple of months.

This week we look at how investors have been "riding the wave" of rising stock and commodity prices recently. Much of the buying that drove these price increases was not based on fundamental analysis of the market. People simply felt good that the market was going up again and wanted to get in on the trend. This last month we've seen some interesting reports from OPEC and natural gas regulators in the U.S. on the effects this kind of speculation has had on energy markets. The results are startling. Speculators have been pushing prices hard. Making it tough for fundamental investors to understand what's really happening in these markets.

We'll also keep up our "deflation watch". I wrote last week about how deflation could grip the U.S. (and the world) despite the \$1 trillion in new money supply the government created over the last nine months. As expected, I took a lot of heat for these comments from the inflationist camp and believers in \$2,000 gold. I'm going to take more heat this week as we look at why base metals production costs are likely to deflate in China. And how record levels of domestic U.S. government bond purchases could spell trouble for the American economy.

As an aside, I did get a modicum of support from deflation sympathizers. Especially regarding my arguments about why the gold price is likely to stay even while gold stocks prosper. The following submitted quote was particularly apt, "Gold is not bought by poor people hoping to become rich, but by rich people hoping not to become poor." (Thanks to Jonathan Challis.)

Whether you're in the inflation or deflation camp (or undecided, as many of us are), the critical thing is to keep looking at the data. Anything is possible in this economic environment. We're seeing both money creation and wealth destruction on an unprecedented scale. As the old saying goes, something's gotta give. We need to keep an

open mind and keeping looking for leading indicators that tell us what that something is. This week's letter should help in that regard. Let's get to it.

Everyone's A Speculator

Is the current rally in stocks and commodities sustainable? I've had a lot of long talks about this with my associates lately. This week, one of my friends commented that he is avoiding the current markets because they have "lost touch" with fundamentals. As he put it, "Everyone is a speculator now."

The observation has merit. Investors buy things based on a careful appraisal of value. If a stock or a bar of gold or a Malibu vacation home are selling for a price below their intrinsic value, the investor buys. When the price rises significantly above that intrinsic value, the investor sells.

Speculators operate differently. The speculator has little or no regard for value. They buy when they believe there is a strong chance someone else will want to buy the stock, gold or vacation home at a higher price than the speculator is paying. Speculation is often based on momentum. When a stock rises in price (for fundamental or other reasons) the positive performance attracts further buying. Buyers assume the rising price is indicative of something good happening with the company in question. Or indicative of growing interest in the stock that will attract further buying. The momentum becomes a kind of "pyramid scheme". You make money as long as someone buys in after you. This kind of speculation can drive a stock well above its fundamental value. Remember the tech days when companies with no earnings had billion dollar capitalizations.

Today, we are witnessing widespread speculation. People are making investments based on their guesses about what "the other guy" is going to do. Not on fundamental analysis of economic and business conditions. This is worrisome.

The U.S. natural gas market is a perfect example. In the last three weeks, NYMEX front-month gas rose from \$3.25 to \$4.50. A 40% gain. Impressive performance. But what was the cause? During that period U.S. gas in storage increased by 200 billion cubic feet (a 10% rise). The amount of gas in storage is well above the five-year average for this time of year. In fact, it's one of the highest storage levels we've seen in the last five years.

At the same time, gas consumption is falling. At the end of April we learned that February gas consumption by industrial users fell 10% month-on-month to 520 Bcf. February's industrial use was the lowest in the last nine years. By far. Previously, the lowest February usage was 560 Bcf, in 2006. The average for the last eight years was 615 Bcf. This year we're 15% below average.

None of that is good news. And yet the gas price rallied 40%. This wasn't a seasonal effect. Typically the gas price is flat in April and May as the winter heating season winds down and the summer cooling season has yet to crank up. So why has the gas price been rising? Speculation. Technical analysts have been screaming for months that gas is

oversold after plunging from \$13 last June. People started thinking that other people would soon start buying. When the price did show a little bit of life, everyone jumped in. Driving gas up 40%. Regardless of the poor fundamentals.

This "do what everyone else is going to do" mentality drives markets. The Federal Energy Regulatory Commission recently found that speculation in natural gas futures was a major factor in driving gas prices to \$13 last June. As the Commission noted in its report, "None of the market fundamentals were extreme enough to explain why spot Henry Hub prices reached \$13.31/MMBtu by July 3." The real explanation was "large pools of capital [that] flowed into various financial instruments that essentially turn commodities like natural gas into investment vehicles."

How big are these pools of capital? The Commission estimates that during the first 10 months of 2008, physical gas traded on the U.S. Intercontinental Exchange was about 1,200 Bcf per month. This gas was actually bought and delivered for use. The other part of the market is financial trading. Gas that is bought for solely for investment purposes and never actually delivered or used. "Financial gas" trading averaged about 40,000 Bcf per month. The financial market was 34 times the size of the physical market!

Here's the real evidence of the "speculation effect". Last October, the financial crisis hit. Investors no longer had cash on hand to play the gas market. By December, financial gas trading fell to 20,000 Bcf per month. A 50% decrease in two months! This shows just how much capital had flowed into natural gas when the sector was hot during the first nine months of 2008. These buyers were buying natural gas not because they felt it was undervalued. But simply because they saw it going up and wanted to ride the momentum. Speculation at its best.

This isn't just happening in natural gas. Any exchange-traded commodity can be used by investors as a funnel for pools of capital. OPEC said this month they believe large amounts of "hot money" have moved into the oil market recently. In the OPEC Monthly Oil Report, the group writes, "In the oil market, prices have remained above \$50/b *due more to market sentiment than fundamentals*. Considerable risks remain as oil market fundamentals are far from balanced due to the persistent contraction in demand and growing supply overhang" (emphasis mine).

The same thing is happening to oil today that happened to gas a year ago. Oil prices had a small rise, probably because of OPEC production cuts at the beginning of this year. Investors saw oil moving up and jumped in to ride the wave. They weren't buying because they believed \$40 or \$50 was a good price for oil. The price was irrelevant. They were buying the trend. And the trend was up. This "momentum buying" has taken oil close to \$60 over the last few weeks.

"One Night Stand" Pricing

I want to be clear here. I'm not claiming that speculators are a destructive force in the market. Or that speculation should be curbed (as some regulators have called for). The

great thing about free markets is that they are free. Free to be as irrational as buyers choose.

If someone wants to pay \$60 or \$80 or \$200 for a barrel of oil, that's their business. If you want to speculate, jump on the wave and ride it. But the danger for investors is confusing speculation with fundamentals. A number of analysts have recently pointed to the rising oil price as evidence that world industrial growth is recovering. But the oil price can only be used as an indicator of industrial growth if the oil price is based on fundamentals. That is, buying by people who are actually using oil. Or users who need to hedge their forward oil requirements to ensure a reasonable price. Buying by investors looking to ride a "trend in motion" tells us nothing about real oil demand or the world economy. The real meaning of the oil price gets smeared out by speculation.

As investors, we need to recognize when markets are sending us useful signals. And when we are getting "false positives" due to speculation. We can't just assume that the "market will get it right." We've seen too many examples recently where the market got it wrong.

Commodity producers too are realizing that market signals aren't as reliable as they used to be. And it's changing the way those producers do business.

The iron ore market is a perfect example. Iron producers are currently locked in their "negotiation season". Producers and sellers are coming together to set iron ore prices for the coming year. Traditionally, these prices are set on long-term contracts. This "benchmark" system locks in prices for the coming year. There's a small amount of flexibility for market conditions. But generally once the negotiations are done, the price is set for the year. Buyers and sellers forge a long-term relationship.

But this year will likely be different. Negotiations have stalled over the past few weeks. The biggest problem is that buyers are asking for a term price below the current spot price. Usually the spot price is taken as a general guide to the state of the market. Long-term prices are set more or less in line with spot. But buyers no longer trust the spot price. Spot prices have become increasingly volatile over the last few years due to factors like speculation. Buyers doubt that spot prices accurately reflect the state of the market. So they don't want to lock in a long-term price based on spot. They would rather have a flexible pricing system where price is continuously determined and re-determined based on what is actually going on with supply and demand. Long-term relationships are out. Buyers want "one night stand" pricing, the kind that changes quickly if conditions change.

Iron ore producers are mixed on the idea of flexible pricing. Groups like Rio Tinto still believe that spot prices are a good indicator for term pricing. As Rio said this week, "Some customers have suggested a benchmark price for this year below current spot levels, which is not acceptable to us." BHP Billiton is a little more progressive. The company's president of iron ore operations said at meetings this week that "the changed market dynamics... make obsolete a system whereby pricing is locked in for 12 months."

Brazil's Vale agrees, saying, "The market circumstances are determining that this [long-term pricing] is not the only system possible and we are prepared for alternatives if our clients should desire."

This is an important change in mentality. One that could spill over into other commodities markets that use term pricing. Coal, for example. Buyers and sellers are both realizing that commodity price volatility is a fact of life. And spot prices may get distorted by non-fundamental factors. They are trusting the market less and less. Investors would be wise to do the same.

China Compacts its Cost Structure

China has become "ground zero" for the base metals markets over the last few months. Record Chinese imports of copper and zinc have been one of the only bright spots for these metals recently. It appears that China has been nearly single-handedly responsible for driving base metals prices higher in 2009.

As we've discussed in the past, some of this demand was due to stockpiling. This is "apparent demand". Stockpiled metal might sit in storage for some time before its used to make industrial or consumer goods. Stockpiling is therefore a temporary source of demand. Sooner or later, stockpiles grow to desired levels. Then the owners stop buying.

But there are encouraging signs of "real demand" for base metals in China. Chinese production of automobiles was up 17.6% year-on-year in April. The Chinese government is offering rebates on new automobile purchases to stimulate demand. This appears to be working. Auto sales were up 25% year-on-year in April. Sales were over one million units in both March and April. China's first two-month, "plus-one million" period ever. China is also trying to stimulate demand for new appliances in rural communities, although this campaign doesn't appear to have had much effect on demand yet.

The pick-up in Chinese domestic demand is positive for base metal demand. Chinese domestic base metal prices have been running 10 to 20% above London Metal Exchange prices. Sellers around the world have been sending metal to China to capture these higher prices. Which has helped lift global prices for most of the base metals.

Why are Chinese prices running at premium to the rest of the world? As mentioned above, stockpiling of base metals by the Chinese government has helped drive up prices. The government is attempting to support its domestic metals producers. And the Chinese base metals industry needs higher prices than the current global average to survive.

That's because many Chinese base metals producers haven't yet modernized their operations. They're using old technology and production techniques. So their production costs are higher than in other parts of the world. Take zinc, for example. The average cost to produce a pound of zinc in China is \$0.75. The current London Metals Exchange zinc price is \$0.65 per pound. At this "global" price, the Chinese zinc industry as a whole would be losing money. Some producers would be forced out of business. The Chinese

government wants to avoid producers going under (for the moment, anyway). So the government needs to push the domestic zinc price above \$0.75 to keep everyone in business. In January, the Chinese zinc price was around \$0.65 per pound. Government buying over the last few months has pushed prices above \$0.85. A comfortable level for domestic industry. And a very attractive price for zinc producers throughout the rest of the world.

But China's elevated metals prices are having unintended consequences. Imports of copper, zinc and aluminum have jumped to record levels. Some of this is due to speculators buying metal in London at lower prices and bringing it to China in the hopes of selling at local prices and making a tidy margin. This is creating a massive flow of metal into China, probably more than the nation needs. As one of my colleagues put it, "The Chinese government wanted to support its domestic producers, not buy the entire world's supply of copper."

Unfortunately, the world's base metal supply will keep flowing to China as long as domestic prices exceed world prices. And domestic prices will have to stay high until Chinese base metals producers lower their costs.

The government realizes this. And this week they announced plans to do something about it. Authorities plan to spend \$3 billion upgrading base metals production facilities throughout the country. This will modernize old factories and should reduce production costs. Some outdated facilities will be closed all together. The government will also attempt to reduce production costs by consolidating base metals sectors. By 2011, the government wants China's top 10 copper producers to control 90% of production. The top 10 aluminum producers will control 70%. Lead and zinc targets are 60%.

By putting more production in the hands of bigger and better operators, the government should be able to cut both operating and overhead costs. Bringing down overall production costs closer to global levels. This should eliminate the need for elevated prices in China. Chinese industry will now be able to compete at the same prices as everyone else.

This is another example of cost-driven deflation. Around the world, industries are responding to the economic downturn by tightening their belts and cutting production costs. And as production costs fall, sale prices can fall without causing a large number of producers to go out of business. The market can get the supply it needs at a lower price.

This is going to be a "headwind" for metals prices. Anyone betting on a large jump in base metals should consider the changing industry cost structure. It is going to be a major driver of prices going forward.

Terror in the Bond Market

The global economy found a rhythm over the last ten years. America bought goods, largely from Asia. And the American government and U.S. consumers ran up large debts

as a result. The U.S. current account deficit rose from \$125 billion in 1996 to over \$800 billion by 2006. A massive increase in debt.

To fund this shortfall, America sold government bonds. Also known as Treasuries. Between 1998 and 2008, foreigners bought \$4 trillion in U.S. Treasuries. Americans purchased an additional \$5 trillion during this period. All told, \$9 trillion dollars in net sales flowed into U.S. government coffers as a result of bond sales during this decade. These revenues easily made up for the \$6 trillion in total current account deficit that the U.S. ran during this period. All told, the government was actually up \$3 trillion.

So the game went. The U.S. spent money and the world financed American spending by buying U.S. Treasuries. Thus the global economy expanded. All was well.

Then came the financial crisis. It's now apparent that the U.S. economy is hurting badly. American consumers are no longer spending the way they used to. U.S. consumer credit fell \$11.1 billion in March. The largest monthly drop since World War II. Americans just don't have the buying power they used to.

Countries around the world recognize this. And it's making them think twice about buying U.S. government bonds. Nations like Japan and China were happy to buy Treasuries back when times were good. They were essentially funding U.S. consumers to buy more Japanese and Chinese goods. No problem. But now the U.S. consumer is a lame duck. So why pour much-needed money into more U.S. bonds?

This is the "bond flight" that many American analysts have been fearing. Foreign buyers stop investing in Treasuries as the U.S. sinks deeper into recession. At a time when buying is badly needed. The U.S. government has stated it plans to run trillion dollar deficits for the next several years. This shortfall has to be made up by bond sales. And lots of them. A seemingly difficult task if foreign buyers put away their wallets.

These fears came to a head last Friday when an auction of 30-year Treasuries had a difficult time attracting aggressive buying. The sale got done, but the government was forced to offer a 4.29% yield to get buyers to buy. The previous 30-year auction, on March 12, was completed at a yield of 3.64%. That's a large jump in yield in just two months. The rise made observers worry that U.S. bonds are losing their appeal. Not good for funding the U.S. current account deficit going forward.

Analysts are right to worry about U.S. bond sales. At least when it comes to foreign buying. Since October 2008, foreign investors have cashed out a net \$70 billion in U.S. Treasuries and Agencies (Agencies are a different type of U.S. government bond). The four months from October to January each saw net decreases in the amount of bonds held by foreigners. That's the first consecutive four-month drop ever recorded. And by far the largest consecutive fall in value. (The previous record was \$25 billion in Q4 1998.) \$70 billion is not a huge amount in the overall picture. Foreigners still own \$5 trillion in U.S. government bonds. But the trend is concerning. Especially at a time when the U.S. needs lots of new buying to fund its upcoming deficits.

But foreign bond purchases are only part of the picture. Americans themselves also buy their government's bonds. And domestic bond demand appears very strong. In the last nine months alone, Americans have purchased \$1.1 trillion (!) in Treasuries and Agencies. American purchases alone covered the U.S. current account deficit in 2008 (\$675 billion). And then some. Domestic purchases of Treasuries so far in 2009 are on pace to cover the \$1.8 trillion deficit expected by the Obama government this year. Without any contribution from foreigners.

And there are some signs that foreign bond buyers are returning to the market. In February (the last month for which the U.S. has reported data on foreign bond purchases), at least one nation came back to the market in force. Japan. Japanese buyers picked up \$24 billion in new bonds in February. Their largest net purchase since August 2004. This buying made up for weak demand from China and Europe. Overall, the U.S. took in a net \$23 billion from foreign bond sales in the month. A respectable amount.

The Dark Side of Domestic Bond Buying

As foreign buying of U.S. government bonds recedes, Americans are stepping in to pick up the slack. This is good for funding the U.S. deficit. But it has a darker side. It drains money out of the U.S. economy, acting as a brake on economic stimulus.

Much has been made of recent growth in the U.S. monetary base. Money supply has ballooned by \$1 trillion since last September. Raising fears of massive inflation as all this new money "roams the streets", driving up asset prices. But as we saw above, Americans have put \$1.1 trillion into government bonds since last October. In effect, all of the money created recently (and then some) has turned around and gone right back to the government. The net amount of cash available to buy assets has actually decreased. Not an inflationary scenario.

Americans are buying Treasuries as a "safe haven" to store their money. Because they're afraid to spend it. With U.S. household wealth having fallen \$11 trillion last year, fewer people are in the mood to buy new cars, televisions or vacation homes. They're putting money away in case they need it later. This is taking money out of the economy. Away from businesses and ultimately out of the pockets of workers. None of this bodes well for a quick economic recovery in America. Or a return to asset inflation anytime soon.

Central Banking Goes Horribly Wrong

Speaking of Japan and bonds, there was some unbelievable news from the Bank of Japan last week. The Japanese banking system is not one of the most transparent. The relationship between Japanese commercial banks and the central bank is much more cozy than in the U.S. and many other OECD nations. But to the credit of Japan's central bankers, they do make available a decent amount of data on their activities. And they release minutes from the Bank of Japan's monetary policy meetings so we can get some "insider view" of what the Bank is thinking month to month.

Last week, the bank released the minutes from its April meeting. Most of the discussion was unremarkable. However, one passing remark from a board member screams for comment.

Like everywhere else around the world, Japan's commercial credit markets have suffered badly of late. Japanese companies have had a tough time issuing corporate paper and corporate bonds to fund their short-term cash requirements. To help, the Bank of Japan recently began purchasing corporate paper directly from companies. This is a drastic measure for a central bank. Basically, it allows corporations to bypass the commercial banking system completely and borrow money directly from the government.

The problem is, how much interest does the government charge in return for this lending? Private lenders like commercial banks do detailed analysis on a corporation before deciding what interest rate they need to cover their default risk in lending to that company (at least, banks are supposed to do such analysis). In Japan currently, the commercial banks have looked at companies and decided that the risk is too high. They are not lending. So what can the government do? Charge an incredibly high interest rate to cover the risk? This will saddle companies with immense interest payments. Not a great idea when you're trying to stimulate your business sector.

Instead, the Japanese government has taken the "ostrich" approach. They are putting their head in the sand and ignoring the risk. They've decided to lend to companies at very low interest rates. And therefore very low yields. Too low. During the Bank of Japan's above-mentioned policy meeting, one of the members reported that government buying of commercial paper has pushed commercial paper yields down significantly. To the point where some corporate paper is now yielding less than Japanese government bonds! This is the height of lunacy. Japan's government bonds are notionally one of the safest investments on the planet. They should have a low yield because there is little risk of default. Corporations on the other hand, always have some default risk. Certainly more risk than the government of the world's second-largest economy. So why then is commercial paper from these companies paying less of a "risk premium" than bonds from the government? Something has gone horribly wrong.

The problem is the government has become the major buyer of corporate paper. And the government has motives other than profit. So it is not pricing its purchases properly, from a risk perspective. This is incredibly damaging to the system. The government cannot keep buying corporate debt indefinitely. At some point, they need the private sector to step in and start lending. But no private investor is going to buy into a market so obviously mispriced. They'll simply put their money into higher-yielding, lower-risk government bonds. The Bank of Japan has destroyed any incentive for the private sector to lend to corporations.

This does not bode well for the public-private partnership that the U.S. government has proposed in order to buy assets from troubled banks. The private sector is (usually) good at evaluating risk and pricing it appropriately. Governments have motives other than

making money, and this tends to distort their view on pricing. Hopefully, officials involved in the U.S. partnership will allow their private counterparts to do the bulk of the analysis and bid preparation. If not, we could see price distortions of the kind that are emerging in Japan.

Panama, Colombia and Vancouver

It's been great to have a few weeks to rest around home. Especially with so much going on in the markets. Sometimes a lot can happen in a few hours when you're traveling away from your computer! And being home has given me a chance to catch up on some important family rituals like my daughter Erika's dance recital. I have to be at that one no matter what is going on in the markets!

But my home time is soon to end. I'll be back on the road at the end of the month. First in Panama for a couple of days for a reconnaissance trip on the demand for natural resource investments amongst individuals and funds who call Panama City home. Then onto Colombia for a week. There I will get to wear both my mining and petroleum geology hats as we meet with a number of oil producers as well as mineral exploration teams. Colombia is blessed with fantastic potential for both. We'll see what kind of opportunities we can uncover.

I get one night back home before heading off to Vancouver for the World Resource Investment Conference. This is the "crown jewel" of Cambridge House's excellent slate of resource conferences. It's always well attended and this year my friends Joe Martin, Howard Fitch and their team have lined up an A-team of speakers. I'll be sharing the stage with Rick Rule, Doug Casey, Paul van Eeden and Brent Cook along with a host of other excellent analysts. There should be some lively discussion and some great advice handed out. I'll be sitting on a panel talk about the junior mining sector at 1:00 PM on June 8, and then hosting a workshop later that afternoon at 3:30. Look forward to seeing some of you there.

It's great to be ramping up for these events again. Especially with so much to think about after all we've been through over the last several weeks. Where will be in another few months? I can't wait to see. Enjoy your weekend! May you all be having as much fun in your work as I am!

Here's to the current rally (R.I.P.?) and the ones to come,

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