

Crocodile Tears

What defines a commodity? Technically, a commodity is a good standardized to the extent that one producer's output cannot be distinguished from another's. When most people think of commodities they think of the usual things, like metals and agricultural products and indeed they are the best known of the class. When financial writers talk about any other good being "commoditized" they are referring to a market where there are many producers whose products are indistinguishable from each other. When an industry reaches this stage, the real selling point becomes price and price alone. Producers will fight for market share by slashing production costs and prices and selling at decreasing prices until the industry as a whole supplies no real "profit" to producers and producers no longer have "pricing power". The best known recent example of this process is the PC business, where price competition has been nothing short of brutal. This has led to an explosion in the sales of PCs but no explosion of profits for PC makers, with a very few notable exceptions.

This process is a boon to users and a something they come to consider as a "fact of life". Commodities always get cheaper in real terms, right? Well, what happens if something happens to change the basics of the market? For instance, if the price elasticity decreases to the point that price increases don't draw out the additional supply that's expected? Well, that's exactly what's happened to metals in the past few years. Thanks to insufficient investment, increasing constraints of development in many regions and decimation of the ranks of specialists required to find and develop new ore bodies it's suddenly gotten much tougher and more expensive to replace metals as they are used. In addition, costs have gone up nearly as fast as prices for many commodities.

The "conventional wisdom" hasn't changed. Market strategists continue to expect a tidal wave of new metal supplies to bring prices back to long term averages. Maybe, but don't count on it. In fact, the best analogy for the market to come may be the oil market, a commodity that has behaved very differently from most others for the past 30 years. Admittedly, there are some obvious differences. The oil market has much more "state control" and that control allowed a relatively small group to withhold production from the market and reverse the long term price downtrend. So are we talking about copper sheiks and iron ore emirs? Not really, but we are talking about an industrial sector where most of the survivors kept themselves and their companies going by driving down costs for decades through innovation and the pursuit of the lowest cost per unit deposits. The lesson these management groups learned was to expect (as market strategists do) that price peaks would be short lived and that companies that chased those peaks by opening marginal deposits and pushing production to the limit ended up being bought up at bankruptcy sales a couple of years later.

This might seem like an aside but it's a very important concept, central to how metals markets are likely to unfold in coming years that most people just aren't getting. Most producers are run by people who are NOT going to try and put deposits into production unless the cash cost is a third of today's prices or less. They don't intend to flood the market only to close half their operations a few quarters later. They have been through the wars and, in many cases, are more interested in bulking up their balance sheets and ensuring they pass on a strong company that won't be bouncing the pension cheques they will be cashing themselves before too long. Many of them would probably like to say (but won't) that no one was subsidizing them when countries were spending

hundreds of billions on agricultural and other subsidies to protect “important” sectors. Few if any on the demand side were troubled by the way low prices caused mines to close and people to leave the industry in droves. They merely congratulated themselves on the bigger margins those continuously dropping prices helped create and assumed it would go on forever. Well, the tables have turned. We don’t know where prices will top out for most metals, though we know it will be higher than today’s prices and that it will be a very, very long time before prices approach anything like the levels that prevailed a few years ago, if they ever do again.

There have been plenty of stories recently about buyers of one commodity after another screaming bloody murder about “unsustainable” high prices. There are negotiations going on right now in several sectors of the metals business where contract sales dominate, notably iron ore and coal. They are worth paying attention to; even if you don’t trade coal or iron ore stocks, just to get a measure of the bargaining power of the supply and demand side. Keep in mind however that coal and iron ore are probably the *easiest* commodities to increase supplies of. There will be plenty of CEOs from producer companies shrugging helplessly, apparently apologetic about the inability of their companies to boost supply quick enough to forestall price increases. Trust me, those are crocodile tears you’re seeing, and we’re firmly on the side of the producers on this one. Not an “important” sector? Try running the world without metals for a week. These CEO’s are probably thinking (but again, not saying) that the world learned to live with oil prices that increased 3000%. So maybe its time it learned to live with higher gold, silver, steel, copper zinc or (fill in your favorite metal) prices. Maybe they think that it’s simply their turn. We do.

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.