

Resource Stock Rally: Will Treasuries Spoil the Party?

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We have to give the March tug of war to the bulls based on market levels and economic news. Those of a more ursine persuasion can still rightly point out that the rally really is getting very long in the tooth.

As this is being written the resource exploration sector seems to be in for its traditional spring rally. We are being cautious about that. The TSX Venture Index, our exploration stock proxy, has been slower to regain the January high than senior indices. It just barely reached that mark on April 4. Three months peak to peak with a 10%+ drop in between at least qualifies as a respectable correction. That breather may have set the market up for another up-leg through Q2, but some further gain is required to confirm the correction is over.

Also meaningful for the exploration sector is a relatively mild and snow free winter in most of Canada. Several areas that will be very active this summer can get an earlier start this year than they normally would. That means news will start arriving sooner and will continue longer. That may help to strengthen or extend the spring bounce exploration stocks tend to get.

Senior markets, by contrast, have had three periods of consolidation in the past 12 months, though none of these were large enough to be a "correction". That is as much a concern as anything. Even the more bearish might be willing to dip their toe in on the long side if there was a correction large enough to feel like a real shake out.

It has been improving economic stats and continued low interest rates that have kept markets buoyant. We're not sure that combination can last much longer. Will falling bonds take the equity markets down with them?

That will depend on why they are falling. The chart below displays yields on the 10 year US Treasury for the past two years. Note that the latest print is just barely below 4%. Looking back you'll also see that that last two times the 10 year yield reached this level a correction, or at least pullback, began in the larger markets.

The current bond move has not stalled out stock markets because there has been good news to go with it. March was finally the first month with a significantly positive jobs number in the US. While the figure was slightly below consensus the report included upward revisions to the last three months. That took the total "gain" to about 225,000 jobs. Equally important was news that hiring for the US Census was only 50,000 of those jobs, not the 100,000 that had been assumed.



Yes, we can do the math. At that rate, it would take something like seven years (!) to regain all the jobs lost to the recession. No pretence from us that it was a "good" number. It was merely a "better one". As important was the news that consumer confidence and the ISM numbers, particularly for the larger service sector, were much better than expected. Again, not fabulous numbers but better than we have seen for over two years.

These figures account for some of the strengthening in bond yields. As long as yields continue to trend upwards due to good news on the economic front the markets will be able to shrug them off.

Cause for concern is the extent to which rates are rising due to the oversupply of debt. This may also have been part of the problem last month. Bond traders have been getting worried about declining bid-to-cover ratios for several weeks. There is also evidence that foreign central banks, particularly Asian ones, have been backing away from the market.

It's next to impossible to confirm this directly. The US Treasury has redefined the different classifications of bidder in the bond market. Only the terminally naive believe this is anything other than completely intentional. We'll have to wait for flow of funds statistics to divine things.

We doubt it's a coincidence that light bidding in bonds coincided with US politicians and a couple of Nobel economists taking Beijing to task over the Dollar/Yuan exchange rate. There has been talk of forcing the issue by imposing across the board tariffs on Chinese imports.

This would be a move we could only view as profoundly stupid. There is no good reason to think that would do anything but raise US prices. Consumers would either look for cheaper goods from elsewhere (elsewhere not including the US itself), or simply have to pay higher prices.

We're not saying we think China is right to hold down its currency. It's time for China to let the Yuan rise for everyone's sake; Chinese consumers as well as US exporters. However, trying to carry a big stick to threaten the people you are simultaneously borrowing money from is simply ridiculous. A number of commentators have pulled out the "when you owe the bank a billion they are in trouble" line. Try taking the bids from China and a couple of other creditor nations out of the Treasury market and see what happens to yields. Yes, Beijing would lose money on its Treasuries, but the US would be driven into a new recession as rates exploded. Creditors would win that round. They usually do.

It now looks like Washington is holding back a report that was expected to brand China a currency manipulator. This was a relief and we hope that Beijing will let the Yuan start rising again to ensure the report just gets buried. On balance, the rise in yields has been driven by good news, but this market has to be watched. If there is a major correction in Q2 it will probably start in the bond market.

Anecdotal evidence points to improved demand in the US for a few months. That plus good export earnings should lead to growing profit numbers for the Fortune 500, which will support share prices. Rate increases in areas of better growth like Australia, India and Canada will help temper Dollar gains. This should be enough for the markets to keep levitating for a couple of months more.

Good economic stats leave room for some further gains in base metals. We continue to be surprised by the disconnect between inventories and prices. Some of this is speculative and some of it is arbitrage trades, but it's happening across the board. Hoarding copper we could see, but hoarding iron ore and coal seems rather less probable.

It may simply be that the current relationship between metal prices and inventories is the "new normal". We are not willing to assume that is the case just yet, nor does it seem to be the market. Base metal miners have not seen much share price increase even though more should be putting up very strong earnings numbers.

As we've noted before a quarter or two of better earnings will usually drive some money down the food chain. We are watching closely for that and will add base metals explorers if it happens. For now we'll continue to focus on precious metals. They have their ups and downs but have also held their own in the face of the uncertainty that will be with us for some time yet.

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To view Eric Coffin's latest video interview on **Industry Watch** with Al Korelin, please go to: http://www.youtube.com/watch?v=DXQI4DYK_Tg [April 12, 2010]

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