Impact of key economic data & news on metal markets

It is important for the participants in the metal value chain to take due cognizance of various economic and commodity-specific factors impacting the metal prices. And, based on this information, they should employ efficient price risk management instruments such as exchange-traded derivatives.



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Analysts expected 2008 to be yet another milestone in the multi-year bull run seen in most of the financial markets, especially commodities and metals, globally. But as the year is drawing to a close, it is becoming increasingly evident that not only has the tide been completely reversed, but these markets, as the analysts have started believing, could be headed for a prolonged bearish spell, thanks to the global meltdown that struck off guard. Plunging global economic output, constricting money markets, and rising unemployment amid a dip in almost all asset values are some facts that only go to vindicate the analysts' belief that this bearish spell could last much longer than expected earlier.

Amid the global downturn, heightened volatility in commodity prices had a trickledown effect on proper functioning of various industries, and the metals sector is no exception.

Highly fluctuating metal prices adversely impact metal-oriented industries. A significant level of volatility in metal prices tends to prompt those in the value addition chain to pass on the increased volatility to consumers by means of a risk premium. On the other hand, less incentive for new capacity expansions discourages metal producers from making investments in that. And this leads to a supply shortage when the existing capacities prove to be inadequate as demand starts picking up with the economy staging a recovery.

Thus, prices of metals, like those of several other commodities, exhibit a cyclic pattern exerting pressures on other sectors of the economy. It is therefore important for the immediate participants in the metal value chain to take due cognizance of various economic and commodity-specific factors impacting the metal prices. And, based on this information, they should employ efficient price risk management instruments such as exchange-traded derivatives. The price risk management through derivatives would not only help them protect themselves from the negative impact of an sudden, steep rise or fall in the prices but also soften the impact of volatility in the prices on other sectors of the economy. This would be a big boon to any economy during a crisis like the one we are currently in.

Let us now explore some major global economic data and news releases that throw important signals which help in formulating and fine-tuning risk management policies in the metals sector.

Signals that you ignore at your own peril

Prices of metals, like those of other commodities, are driven up or down by a myriad of factors, acting alone or in combination. Of them, from a broader perspective, supply and demand are two very basic factors. In fact, these are the functions of various other sub-factors that need to be identified and analyzed from various key data and news releases.

Now, to draw a comparison on the scale of importance of various data emanating from major economies, we observe that although China is fast emerging as a major force to reckon with in terms of both production and consumption of base metals, the US still remains the most reliable source for the timeliness, regularity and structure of its data releases on the price sentiments of base metals. We would therefore examine the intricacies of some major economic data releases from the US in the following heads.

Durable goods orders: This data reflects the new orders placed with domestic manufacturers for immediate and future delivery of factory hard goods.

Tracking data on durable goods orders makes participants in the metal chain aware of the economic backdrop with its impact on the current and future requirements of the markets. Orders show how busy factories would be in the coming months, as manufacturers work to fulfil the orders. The data provides insights into the demand for items such as refrigerators and cars, and also into investments in things like industrial machinery, electrical machinery, and computers. If companies commit themselves to spending more on equipment and other capital items, they are obviously experiencing sustainable growth in their business. Increased expenditures on investment goods pave the way for greater productive capacity and reduced inflation prospects in an economy.

Existing home sales: This gives the number of previously constructed homes, condominium and co-operatives in which a sale closed during the month. In fact, existing homes (also known as home re-sales) have a larger market share than new homes and, thus, indicate housing market trends. (National Association of Realtors)

Housing starts: The figure indicates the number of residential units (single-family and multi-family) at the initial construction stage on a monthly basis. Hence, a rising/falling trend in this data hints at an increase/decline in demand for furniture, home furnishings and appliances.

New home sales: This counts the number of newly constructed homes with a committed sale during a month. The number indicates the housing market/ demand trend and, hence, purchases of furniture and appliances showing overall economic momentum.

The housing data throws light on the demand position of various base metals, mainly copper. Higher figures, indirectly, indicate that construction jobs and incomes will be pumped back into the economy. Once a home is sold, it generates revenues for the builder and the realtor. And, on the other hand, the purchase in its trail brings a slew of consumption opportunities for the buyer in the form of refrigerators, washers, dryers, AC/cooler and furniture, among items galore. Obviously, the economic ripple effect can be substantial when a hundred thousand new households in a country are replicating the same activity month after month. The decision of buying a house reflects the level of comfort and confidence in one's financial position, which in turn mirrors the overall economic momentum of the country to which the buyer belongs.

Gross Domestic Product (GDP): This is the most broad-based measure of aggregate economic activity with all sectors of the economy coming under its ambit.

The GDP report is a mammoth repertoire of information, which in its entirety provides a large picture of the overall economy while simultaneously taking the market participants through all the key micro trends within the big picture. Components of GDP such as consumer spending, business and residential investment, and

Metal futures ñ A beacon of hope

In matter of 1.5 years metal prices saw historic highs and lows having different impact on the producers and consumers.† While the price levels may be low but the uncertainty of volatility continues.

To achieve the advantage of fixing long term prices in order to plan business better, corporates can now hedge on MCX in local time and local currency which otherwise they could do only in global market.† MCX also offers the price efficiency of LME. †Metal futures can effectively help firms lock costs for fairly longer time period thereby deliver value to the consumer and minimize the impact of such crises on their books.† We strongly believe that innovation and productivity shall remain two major drivers of the growth, but for only those who adapt faster.†The current major products of MCX, namely, copper, aluminium, zinc, lead, tine, nickel, gold and silver have been found very useful by the industry as they witness trading interest of over Rs.12000 crore a day within the total trading volume of Rs.17000 crore witnessed by MCX daily.†We are happy to see the entire supply chain of metal industry use MCX for reducing their risk.

Mr. Joseph Massey, MD & CEO, MCX

price/inflation indexes bring to the foreground the economy's undertones, which in turn indicate investment opportunities and also provide leads on managing a portfolio. Besides, the rate of growth in GDP indicates future demand prospects for the industrial metals.

ISM Manufacturing Index: This is a composite diffusion index of national manufacturing conditions whose measure is based on a survey by the Institute for Supply Management of nearly 400 manufacturing companies on employment, production, new orders, supplier deliveries, and inventories. A reading of the ISM Mfg Index above/below 50 percent indicates an expanding/contracting factory sector. Export orders, import orders, backlog orders and prices paid for raw and unfinished materials are also measured, but these are not included in the overall index.

The ISM manufacturing data gives an insightful view of the manufacturing sector, giving out the details indicating how busy the sector is and what are the latest positions of the various sector-related activities. This report influences the pricing of metals in a big way as the manufacturing sector is a major source of cyclical variability in the economy. More than one ISM sub-indexes provide insights into commodity prices and clues with regard to the potential for inflation build-up. The Federal Reserve keeps a close watch on the ISM report as the inflation signals flashing in this data help the US central bank in deciding on the course that the interest rates should take.

Employment report: This release provides a set of labour market indicators. The unemployment rate calculates the number of unemployed as a percentage of the total labour force. Non-farm payroll employment counts the number of paid employees working part-time or full-time in the US's business and government establishments.

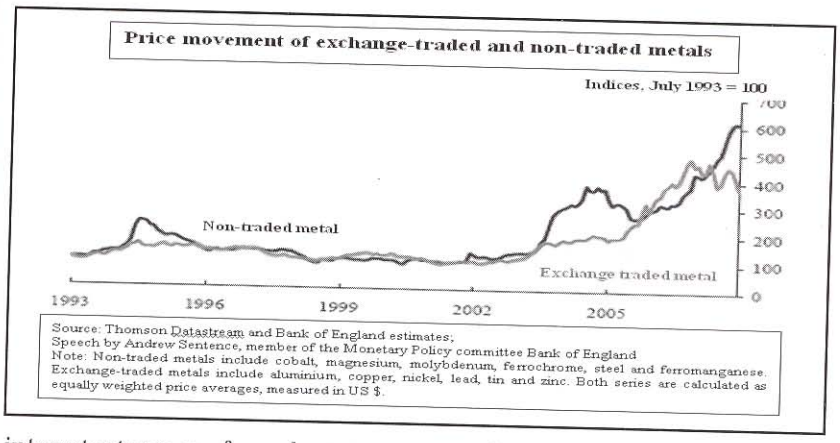
This is the most comprehensive report on all possible employment details such as how many people are looking for jobs, how many of them are employed, how much they are being paid and how many man-hours they are putting in. No doubt, these numbers are the best option to form a clear idea about the current state as well as the future direction of the economy. Obviously, this indicates, albeit indirectly, the future tightness or absorption capacity of the metal industry. The employment statistics also throw light on the wage trends for the Federal Reserve, which sees wage inflation as one of its strongest enemies for ensuring that the economy sails through or, at the worst, trudges along. By tracking the jobs data, market participants can sense the degree of tightness in the job market. If wage inflation threatens, it is a good bet that interest rates will rise. In contrast, when job growth is slow or negative, then interest rates are likely to decline. Interest rate movements alter the sentiments of industrial activity and, hence, the same towards metals.

Inflation: This is an indicator of general increases in prices of goods and services. The most preferred data releases as indicators of inflation in the US are Consumer Price Index (CPI) and Producer Price Index (PPI). Inflation (along with default risk and opportunity cost) basically explains how interest rates are set on everything from mortgage and auto loans to treasury bills, notes, and bonds. As the inflation rate and inflation expectations change, all markets, including the industrial sector, adjust interest rates accordingly. And the effect spreads across sectors, including metals, in an abrupt way.

FOMC rate decision: In order to determine the near-term direction of monetary policy Federal Open Market Committee (FOMC) meets eight times every year. The changes in monetary policy are announced immediately after meetings.

FOMC consists of seven governors of the Federal Reserve Board and five Federal Reserve Bank presidents. For weeks in advance, market participants keep on guessing about the possibility of an interest rate change or an alteration in the framing of the post-FOMC announcement suggesting a shift in policy. If the outcome is different from expectations, the impact on the markets can be striking and also far-reaching. The interest rate set by the Fed, or the federal funds rate, acts as a benchmark for all other rates. A change in this rate, the lending rate banks charge each other for the use of overnight funds, translates directly through to all other interest rates from Treasury bonds to mortgage loans. The interest rates or rather their levels impact the economy. While higher interest rates tend to slow economic activity, lower rates stimulate it. And, either way, interest rates influence the sales/consumption sentiment. Higher

Economic Indicator	Significance	Indicator Up/Down	Rating (A-F) & Bullishness in Base Metals
Durable Goods Orders	Leading indicator of manufacturing activity	↑	B
Housing Starts	New Construction	↑	B-
New home Sales	Demand Side Parameter	↑	C+
Existing Home Sales	Demand Side Parameter	↑	C+
GDP	Broadest Measure	↑	B
ISM Manufacturing Index	Manufacturing Growth & Expansion	↑	B+
Employment report	Unemployment/Wages	↓	A
CPI & PPI	Inflation	↓	B+
FOMC Rate Decision	Interest Rate	↓	A



interest rates mean fewer homes or cars will be purchased. Apart from this, interest rate costs are a crucial factor to be taken into account by businesses, particularly by companies with high debt loads or which have to finance high inventory levels.

More data and news releases

Besides the aforesaid data, there are some other US data releases that demand attention and regular monitoring. The data include Industrial Production Index, Consumer Sentiment Index, Consumer Credit, Wholesales Sale Inventories, among others. And moving away from the US, the stakeholders in the metal sector may also keep a close watch on releases of data by various ministries in China on exports and imports, besides data on production of different metals, rate fluctuations, etc. And apart from government data, the market participants may also train their sights on research and publication works of various individual metal-specific organisations and institutions. Loads of data on global production and consumption trends, centres of major activity, etc, periodically published by institutions such as International Copper Study Group (ICSG), International Lead and Zinc Study Group (ILZSG), International Nickel Study Group (INSG), International Aluminium Institute (IAI) may be of immense importance to the players in the metal value chain.

While all major data releases build expectations as their periodicity is known, the uncertainty element that adds twist to the pricing of metals stems from various reliable news releases. For example, news of a strike or possibility of a strike at a major mine anywhere in the world perks up the price of the metal in question - and that too immediately. Similarly, news of geopolitical tensions, natural catastrophe such as an earthquake in metal producing/consuming countries, development of new technology, and new discoveries can either strengthen or reverse a given movement in the prices of metals.

Misplaced notion of financial hand in price movements

Like many other commodities, metals too are traded on exchanges worldwide. The exchanges are considered to be the centre stage of a lot of investment activity. In the unusual and abrupt way the multi-year bull run which actually intensified in 2008 and suffered a free fall (more than 50 percent from their 2008 highs for most metals) in the latter part of the year sparked off a widespread suspicion over the heightened investment activity on these exchanges with doubts being cast that huge monetary funds might have been diverted from other sectors. However, the fact remains that though investments in commodities have indeed increased in recent times, this factor alone cannot act and has not acted as the prime force behind the surge and the subsequent unprecedented fall in metal prices. Various studies, such as the ones carried out by the International Monetary Fund (IMF) and the Bureau of International Settlements (BIS), have, reportedly, contended that a financial flow follows commodity price movements rather than drives them. What really vindicates the argument that heightened investment activity at commodity exchanges does not necessarily lead to an illogical spike in commodity prices is that exchange-traded metals, as a matter of fact, demonstrated a lower rise in the prices than those not traded on exchanges in the past almost 15 years (see graph).

Conclusion

While we know of the markets, it is essential that we are aware of the market moving factors as well. Following the above cited economic data releases and information would not only help in participating in the markets but also enable companies to effectively manage inventories, and take efficient pricing and sales decisions. An analysis of the prices of exchange-traded and non-traded metals, as above, clearly indicates that the benefits of such information flow into the markets where volatility and the directional move of the markets remained contained. All these suggest that there should be collective public-private efforts in aggregation and dissemination of similar economic data and research to prove the impact of these data on the markets in order to make the Indian market participants also follow the domestic fundamentals while pricing their value-added materials.

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