

**BME nickel market case study: using
mathematical models to sharpen thinking and
to de-personalise debate on metal prices**

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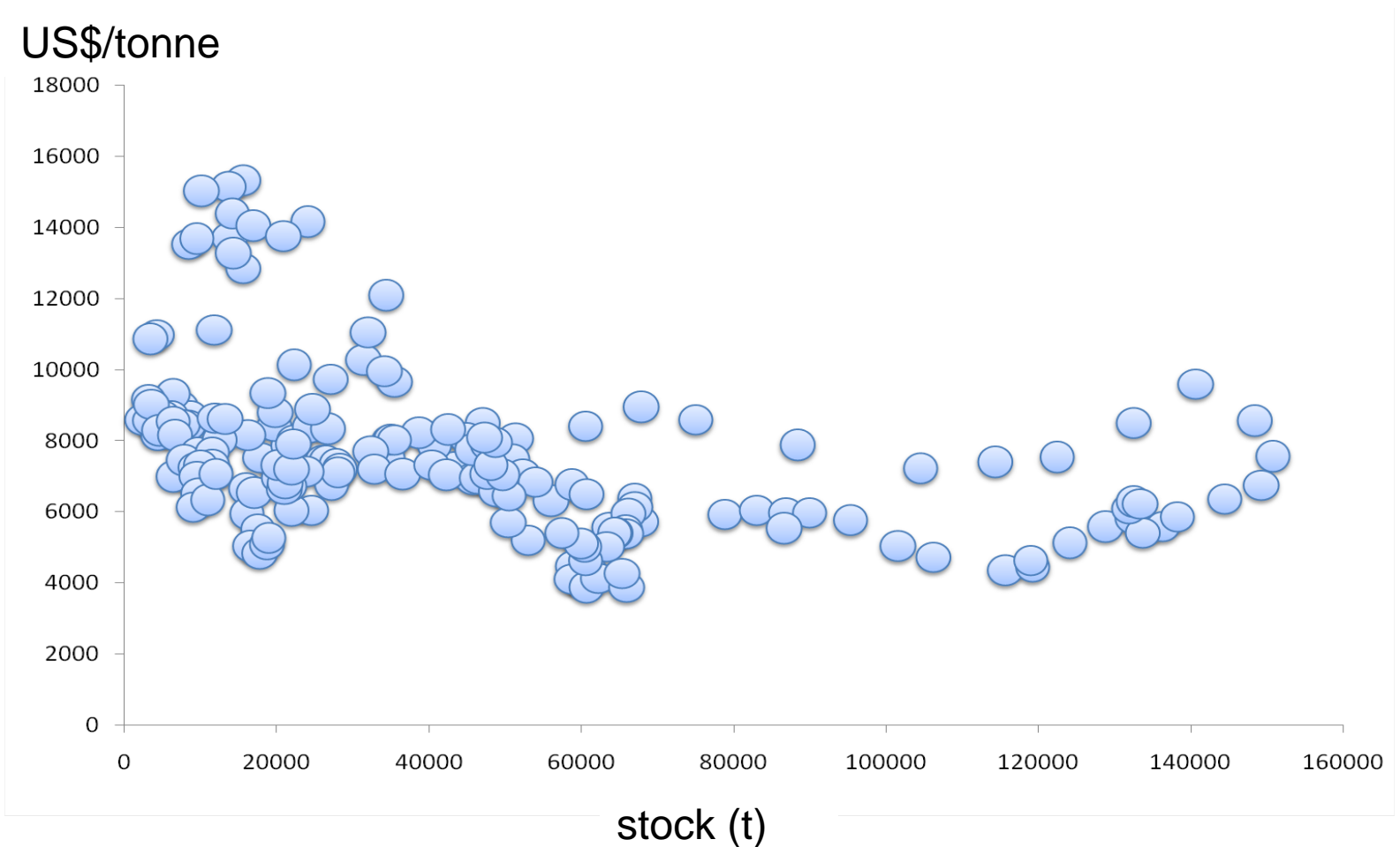
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Mathematical modelling was a very useful tool that got forgotten while prices “flat-lined” in the 1980s

- For those old enough to remember, there always used to be two strands to market analysis: (1) in depth knowledge of supply, demand and stocks and (2) mathematical modelling of prices.
- In the 1980s, prices were moribund for a decade, the mathematical modellers all moved to the Forex markets, and the supply-demand-stock experts felt no urge to understand prices: what was there to understand about a flat price?
- The surviving supply-demand-stock experts (including BME at first) dumbed down analysis just to a the price to stock curve.
- That over-simplification made prices much harder to understand once they stopped being just a flat line.

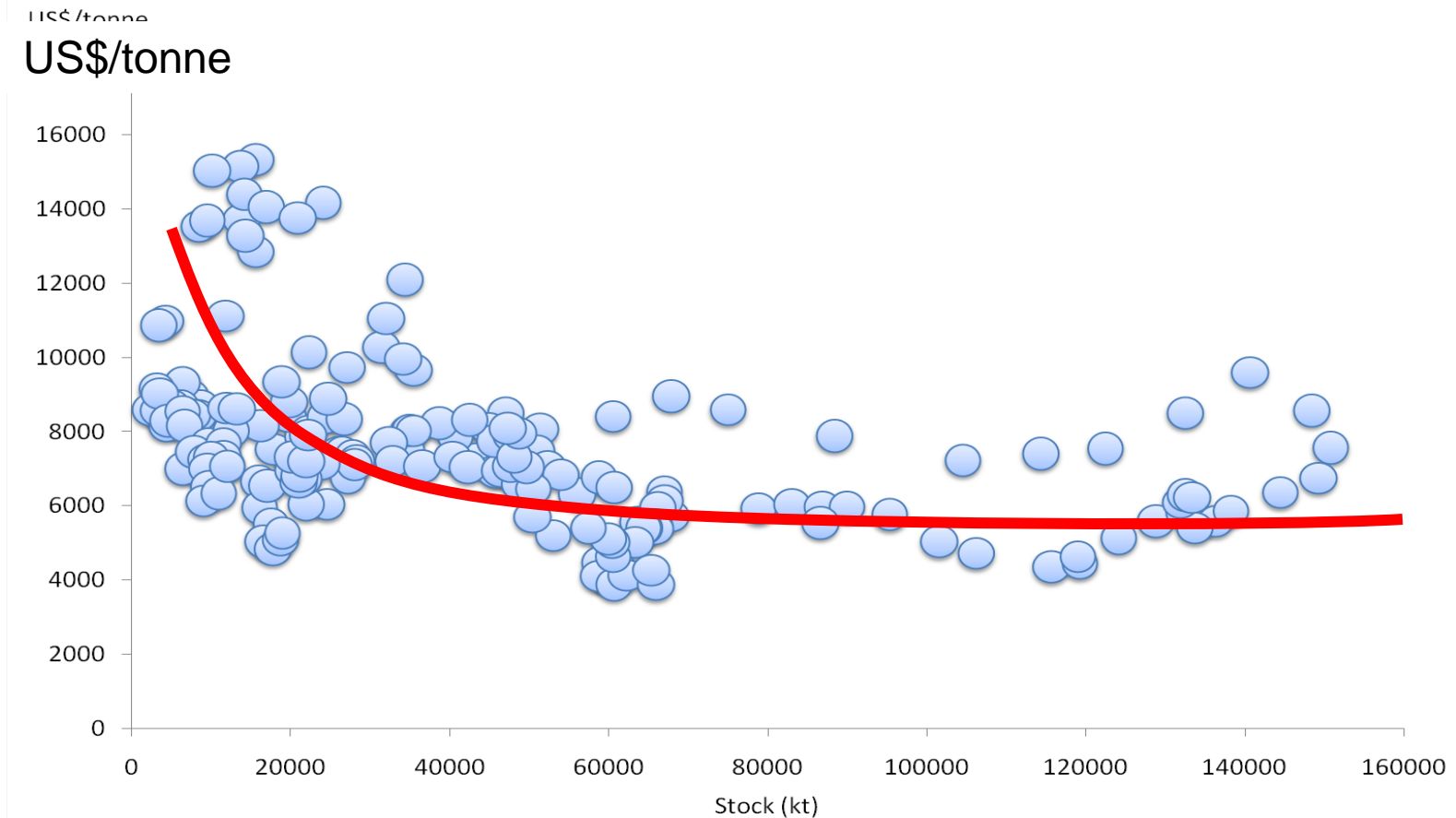
LME price to stock relationship, 1990-2004, using nickel as the example

This chart shows the former price to stock relationship. Note how poor the fit is. Prices of \$8000 have corresponded to stock levels from near zero to 150 kt. Conversely stocks of 20 kt have equated to prices from \$4k to \$16k.



Non-modellers adapted the price to stock curve to appear to be useful by drawing a trend line (nickel 1990-2004 used as the example again).

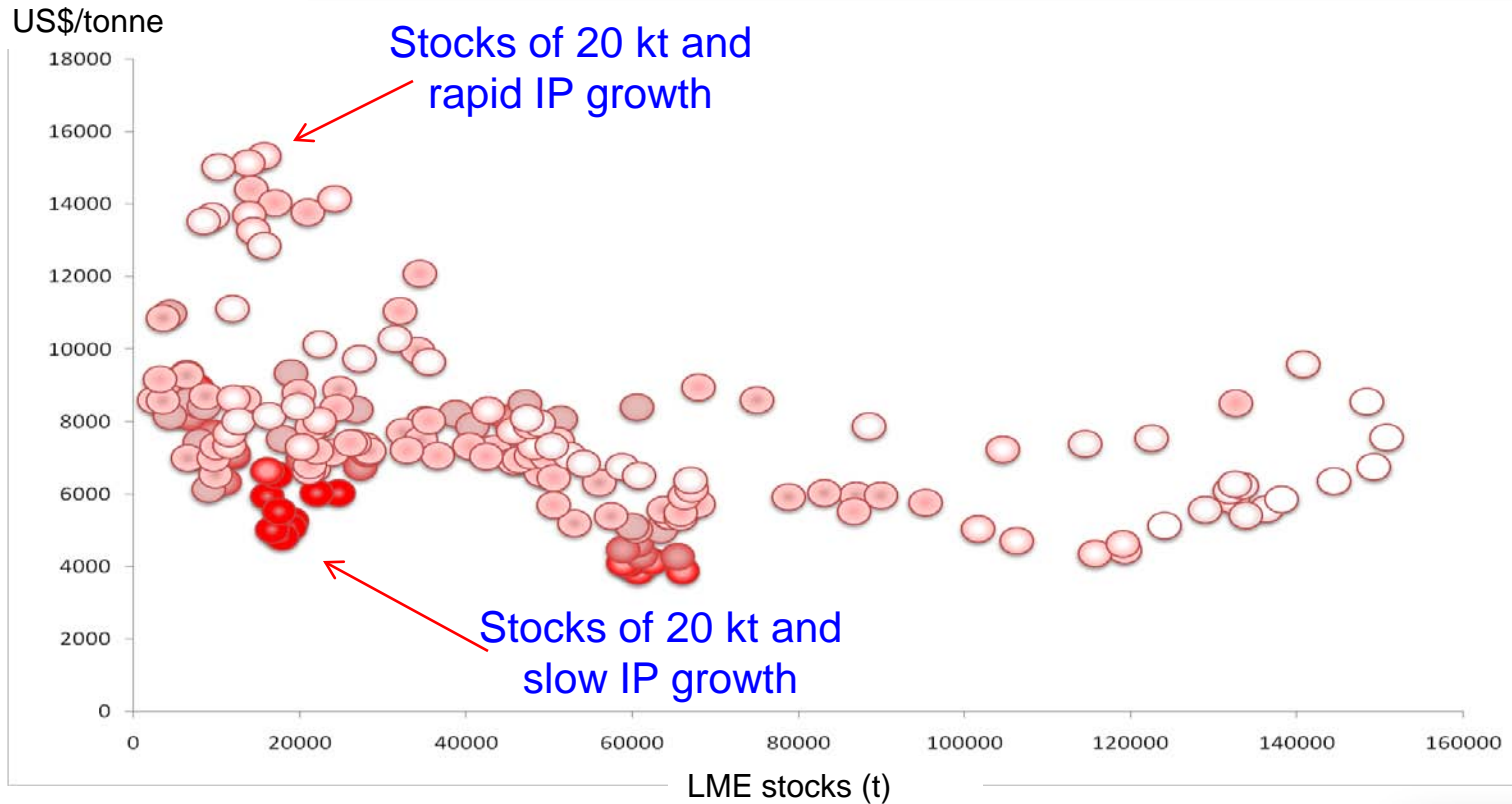
Unfortunately, that only makes any sense if variation around trend is random, which it very definitely wasn't. See next two slides for proof...).



stock (t)

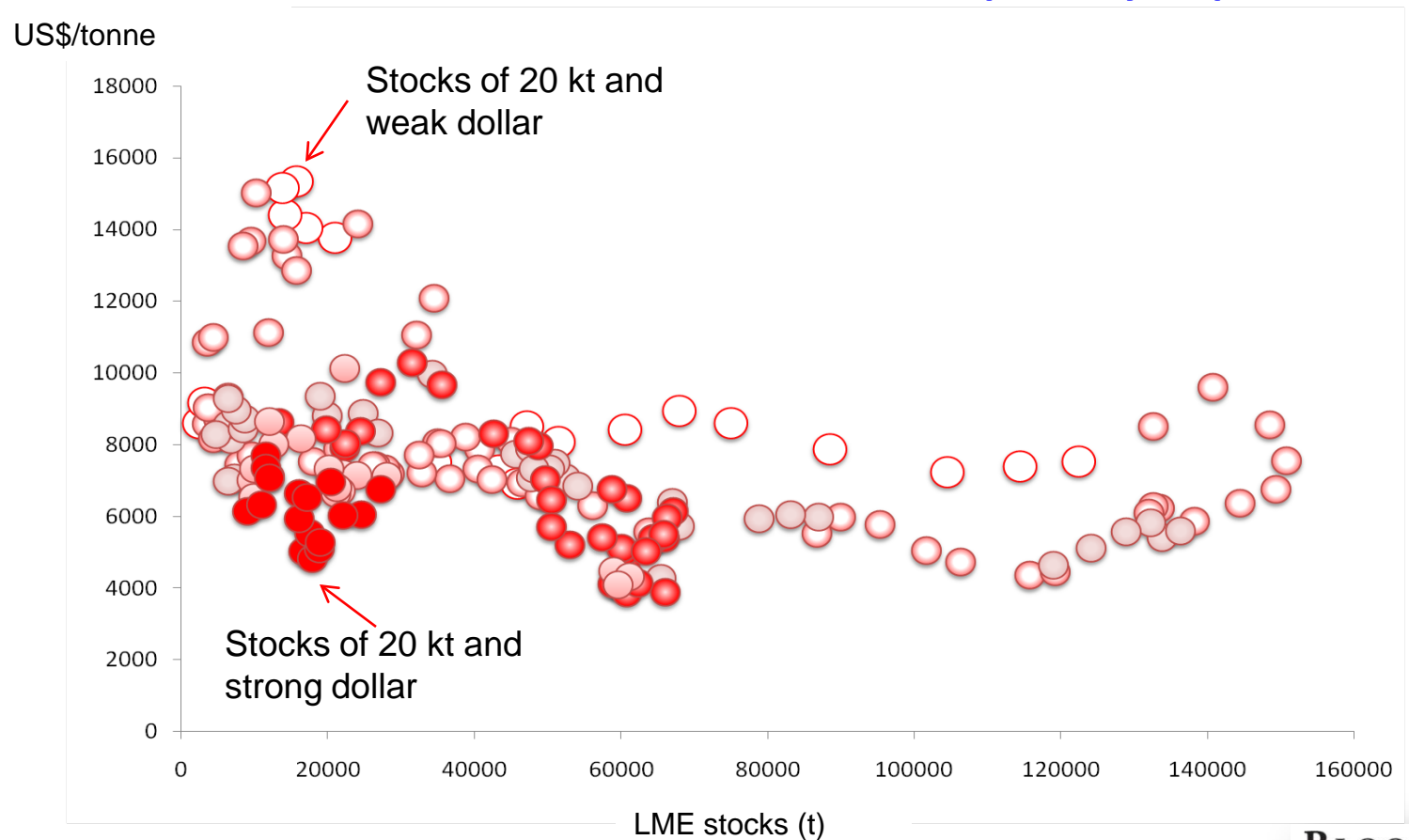
Variation around the price to stock trend was systematic

The the rate of demand growth (or industrial production growth, a useful proxy) was one systematic cause of variation around the trend. Note that shifting attention away from the variation eliminated most of the useful information.



Exchange rates were the other key cause of variation around the trend.

With a price to stock trend and two main systematic causes of variation around the trend, a model is the simple way to proceed.



What people understood until 1980s, when mathematical modellers left metal analysis for the Forex markets

That the relationship with stocks was close only for copper and that the rate of economic growth, currency factors and stocks (the latter as a proxy for physical market conditions) jointly moved price. Degrees of fit (R^2) 1990-2004 in fact were:

	LME stocks	Y-O-Y IP Growth	US\$ Index	The three combined in a BME model
Nickel	0.21	0.12	0.21	0.84
Copper	0.62	0.11	0.59	0.82
Aluminium	0.13	0.14	0.09	0.69



The purposes and benefits of fundamentals-based price models

- Constructing a model forces the modeller to think rigorously about mechanisms in the market.
- A model allows the effects of many forces to be combined; more than can be handled in 2-D charts.
- A model allows you to quantify links between market circumstances and price.
- A model tells you quickly when relationships have changed. Models can be at their most useful when they go wrong - you know a new force has arrived - especially if five models go wrong simultaneously.
- A model facilitates rigorous scenario analysis.

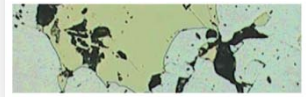
Limitations and risks of fundamentals-based price models

- They are only relevant over the medium- and long-term periods when fundamentals drive prices (for the short-term use BME technical analysis expert systems).
- They do not involve a mechanism for wholly new forces to be anticipated before they happen (e.g. sudden requirement for nickel pig iron).
- When quantitative relationships first change, a model user may be over-confident that this is a temporary deviation, and may trade the wrong way.
- Over-emphasis on modelling can cause non-quantitative price drivers to be neglected.



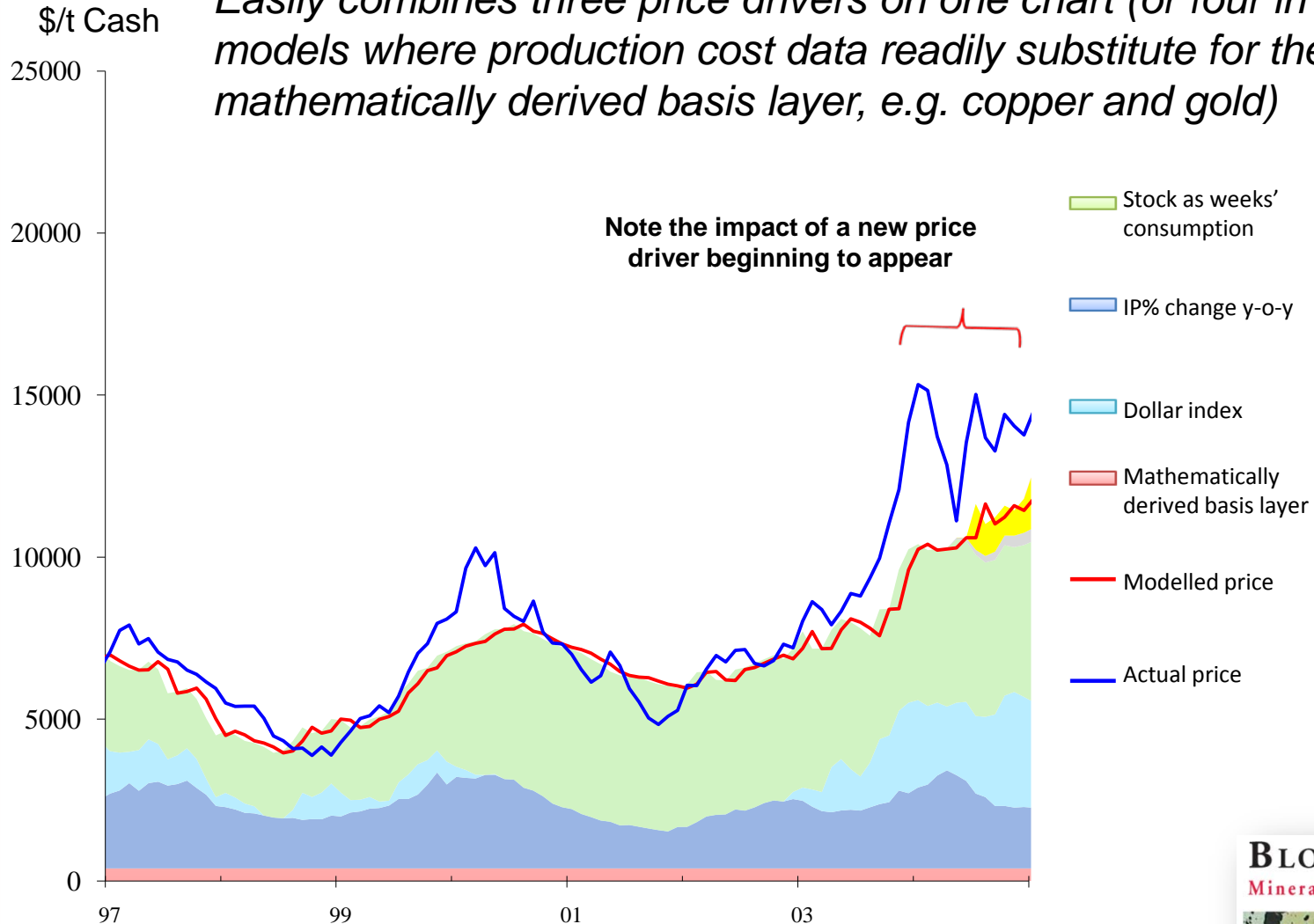
How BME constructs a price model

- Commonly used methods to forecast time series are based on multivariate linear regression.
- BME uses a refinement: **multivariate regression splines**.
- This method estimates different linear slopes for different ranges of the independent variables.
- This type of regression is useful in our case where we have change of relationships between prices and drivers at crucial thresholds, “floors” or “ceilings”.
- For example, we can detect “pinch-points” in stock levels associated with a sharp change in price behaviour.



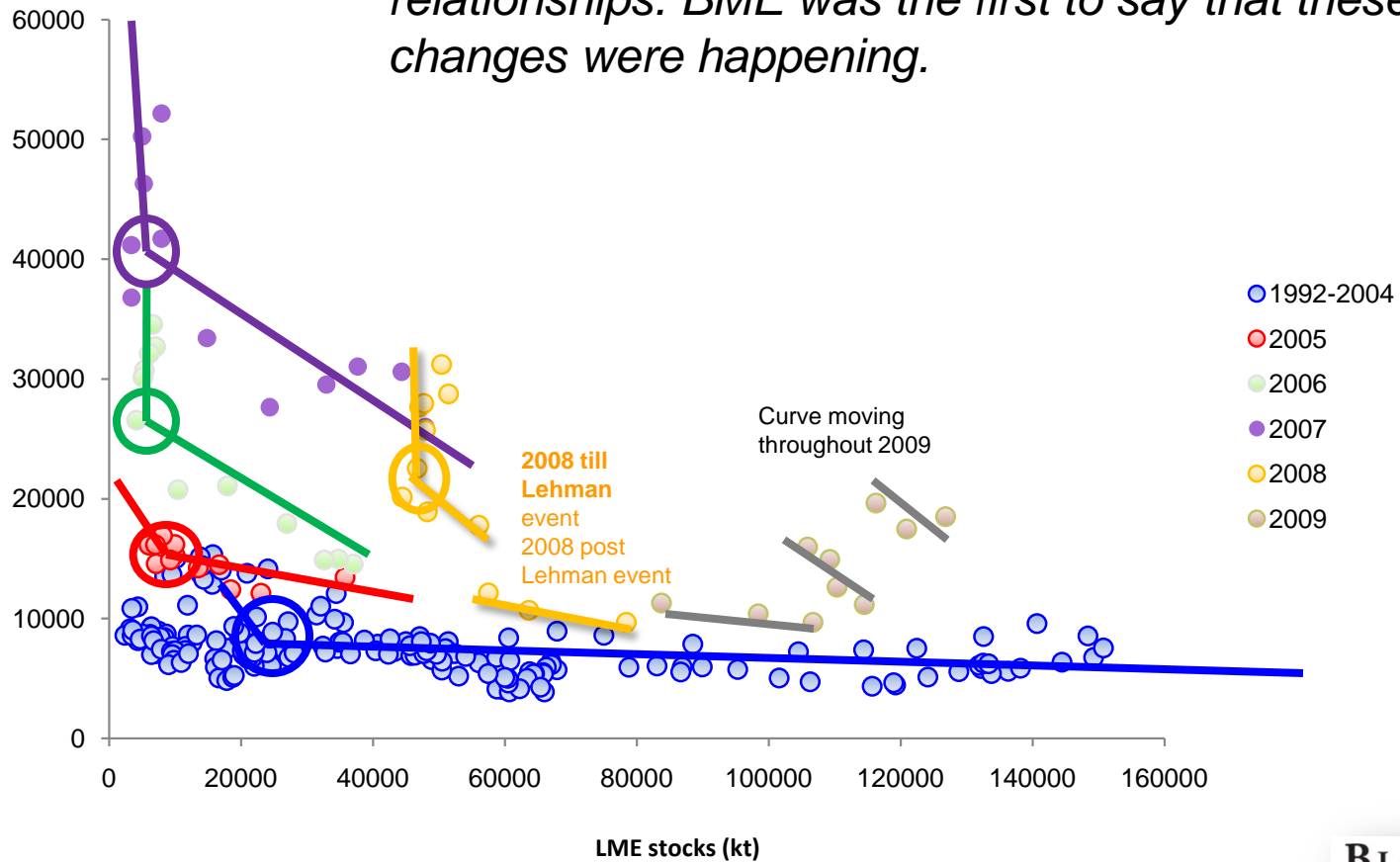
BME price model for nickel in the period 1997-2004

Easily combines three price drivers on one chart (or four in those models where production cost data readily substitute for the mathematically derived basis layer, e.g. copper and gold)

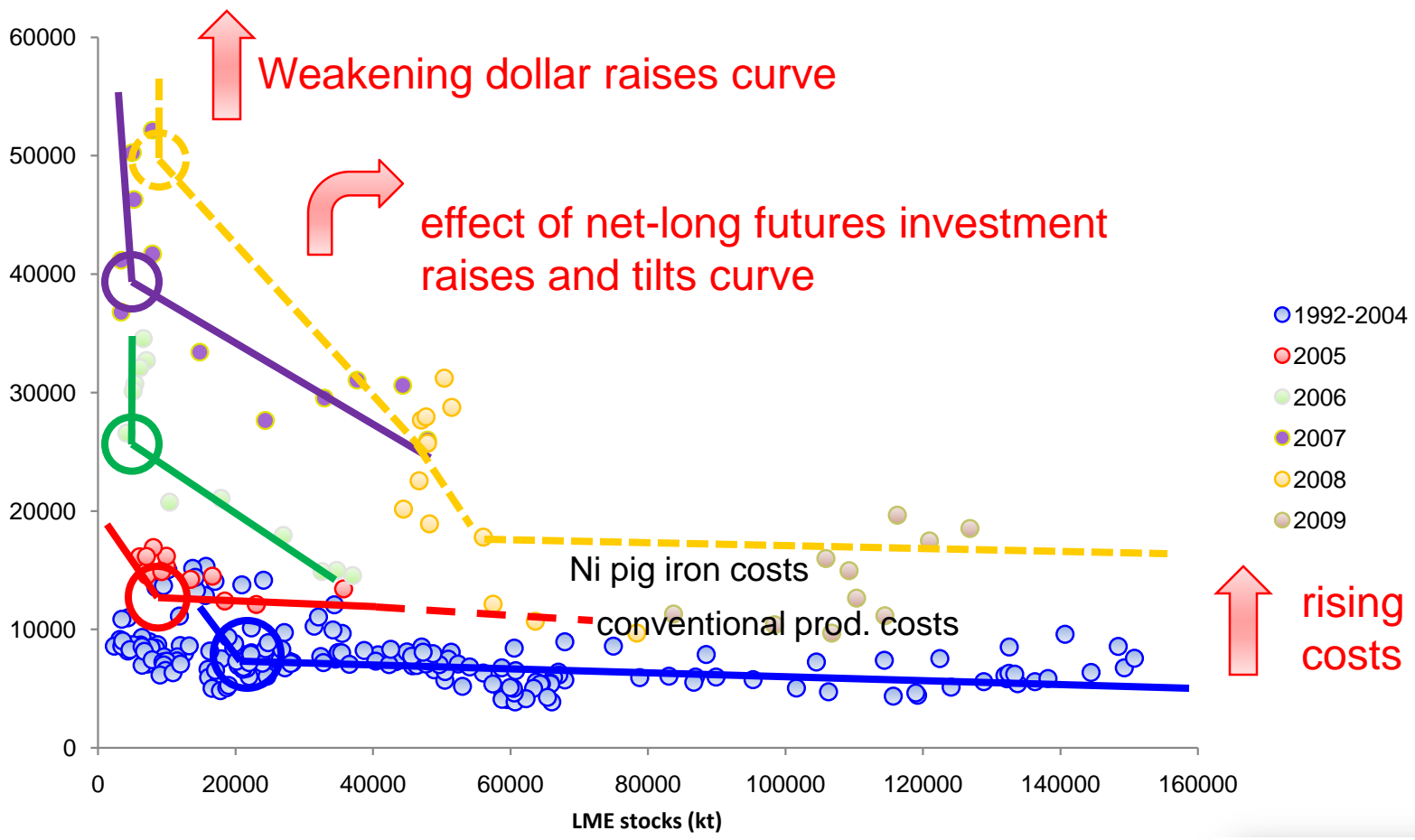


How LME nickel price to stock relationships changed after 2004

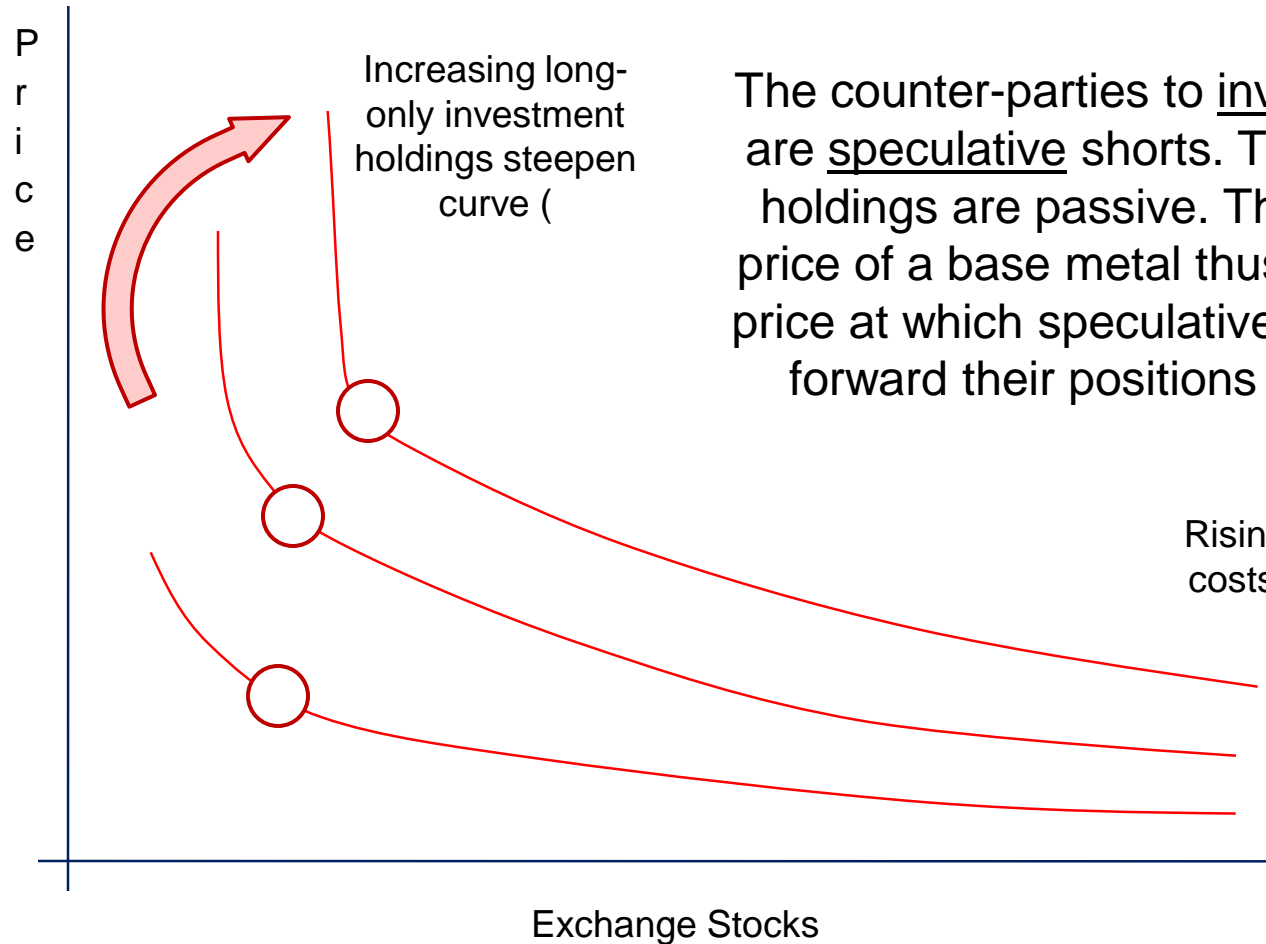
A price modeller is alert to changes in quantitative relationships. BME was the first to say that these changes were happening.



LME nickel price to stock relationships through time: a modeller seeks causes (in red below)



The BME hypothesis on what has been happening to price to stock relationships over 2005-2009



The counter-parties to investment longs are speculative shorts. The investment holdings are passive. The equilibrium price of a base metal thus becomes the price at which speculative shorts will roll forward their positions each month

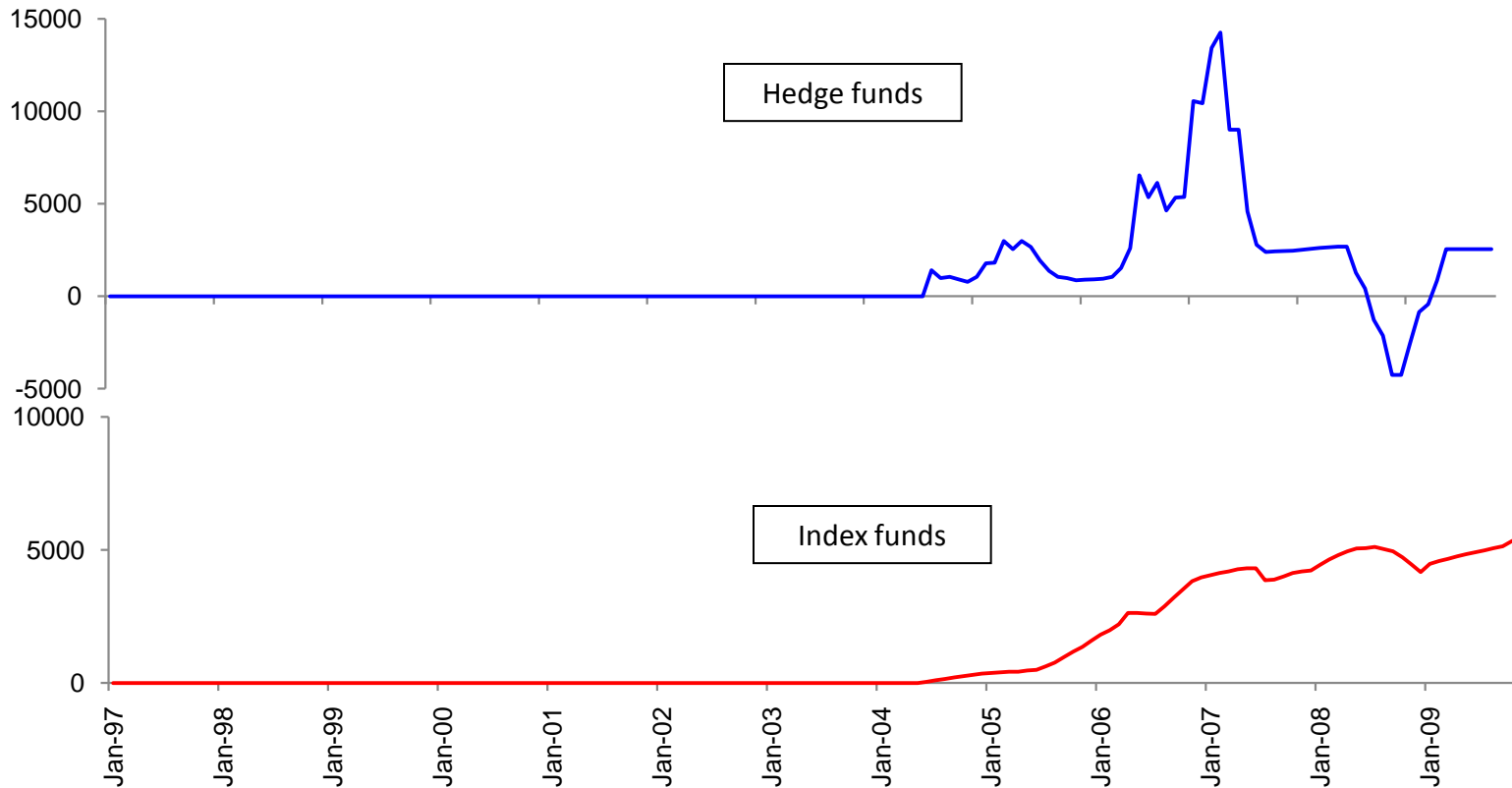
Rising production costs raise curve



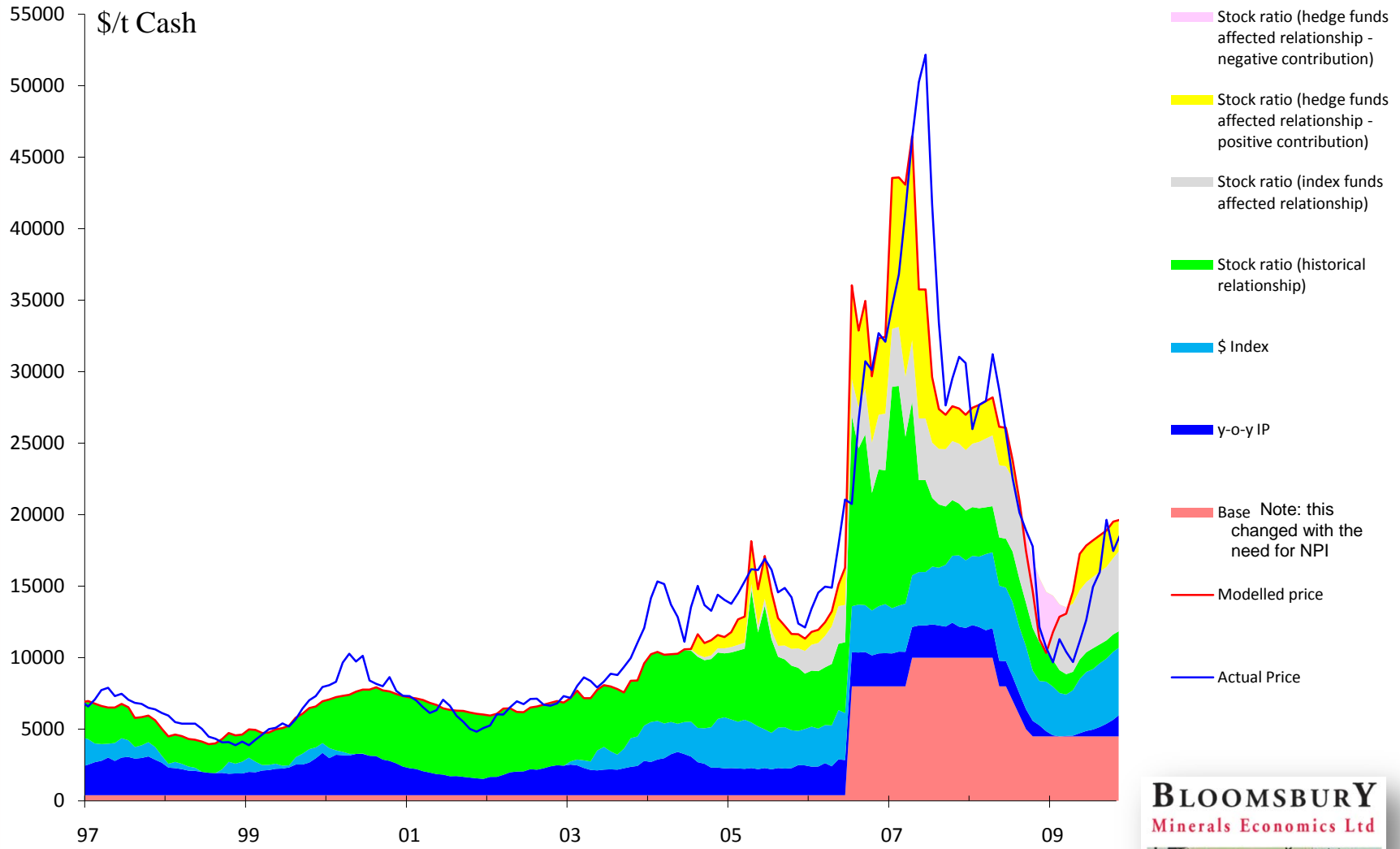
Splitting the *traditional* physical market price drivers from the *new* net-long-investment price driver



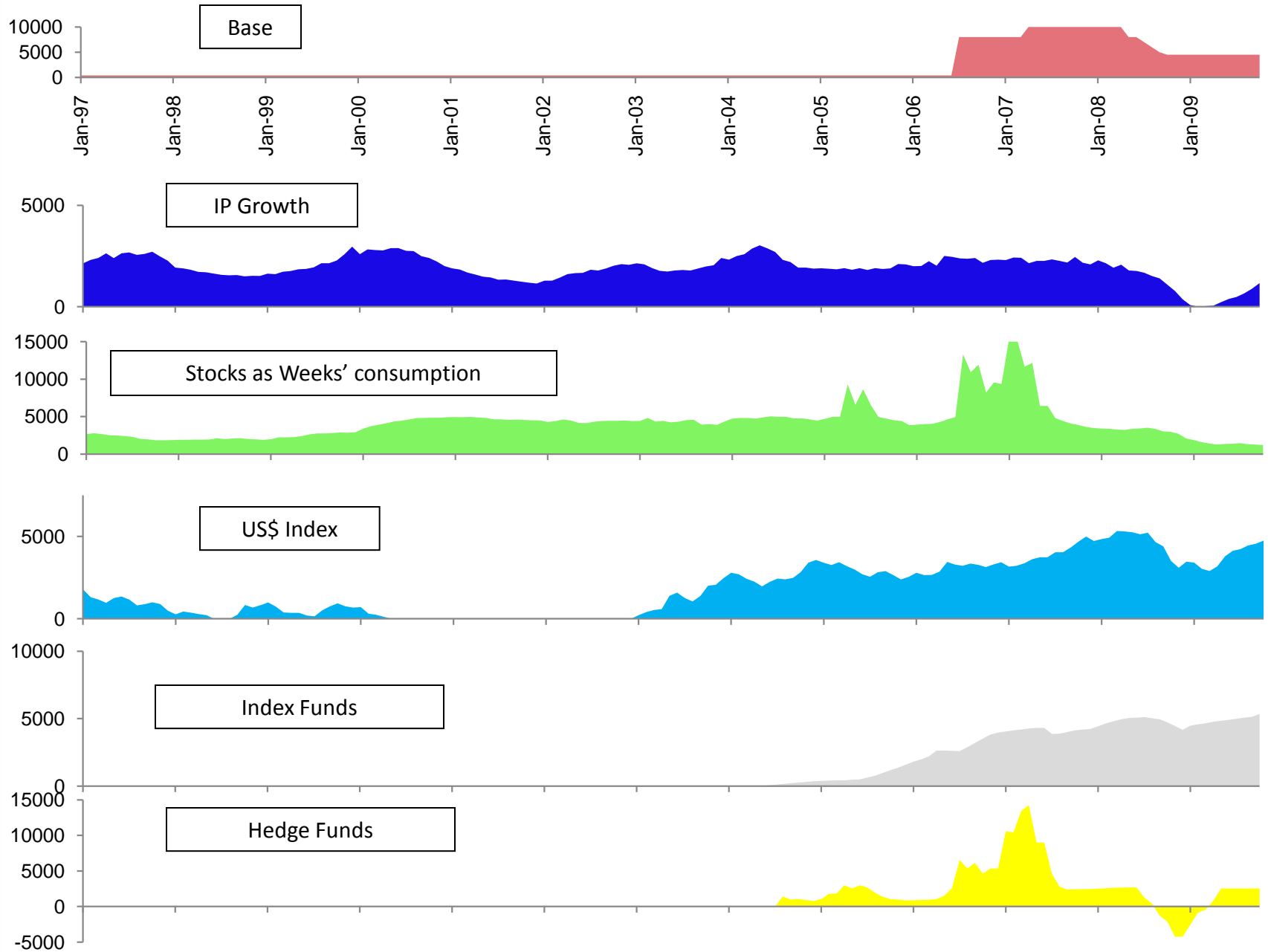
Splitting net-long-investment price driver into quite smoothly growing positive only index funds and much more volatile long/short hedge funds



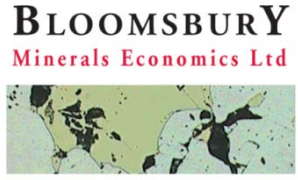
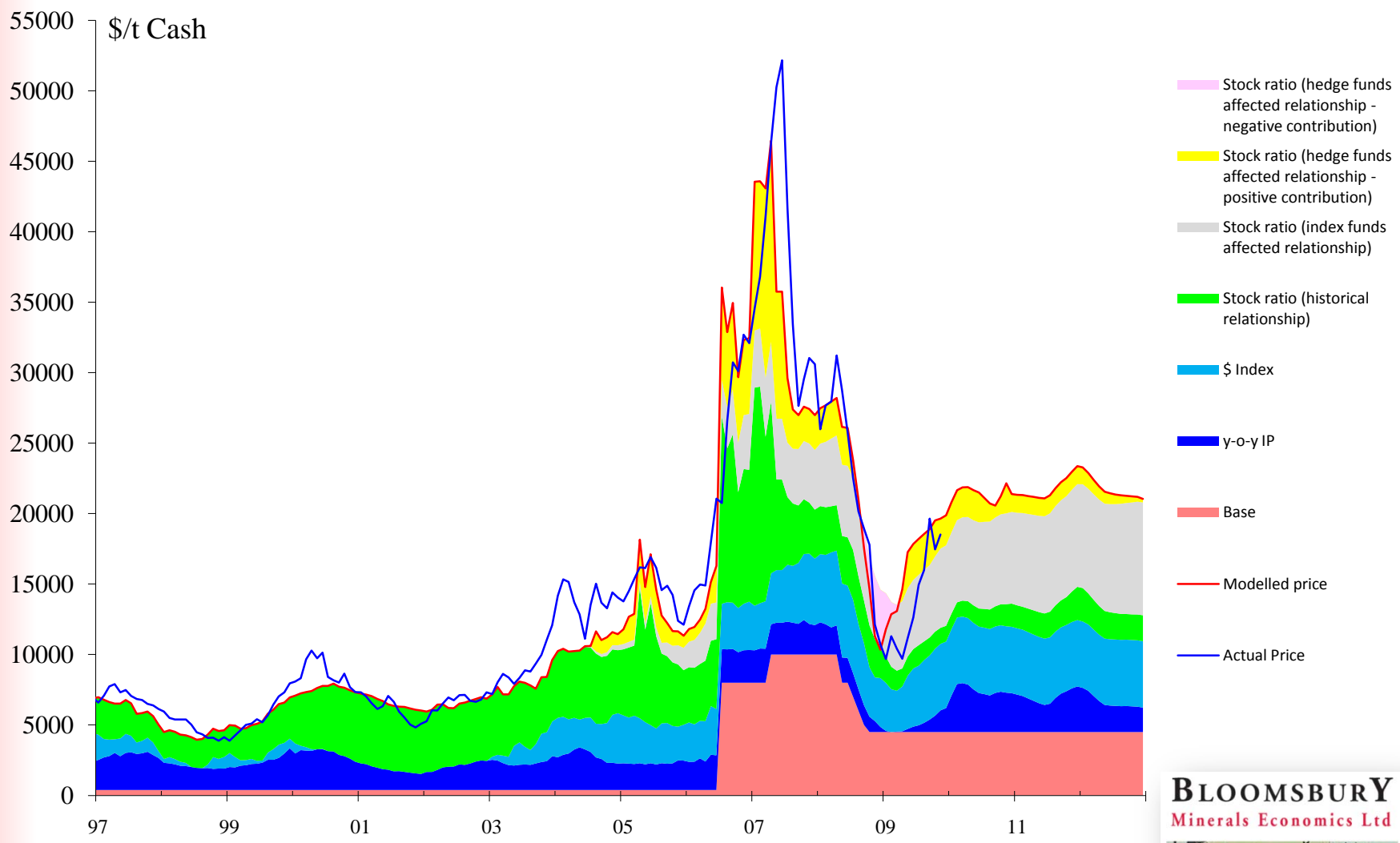
BME nickel price model output as a layer diagram (1997-October 2009) – historical



Contributions to price



BME nickel model



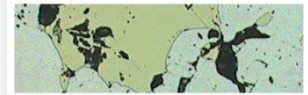
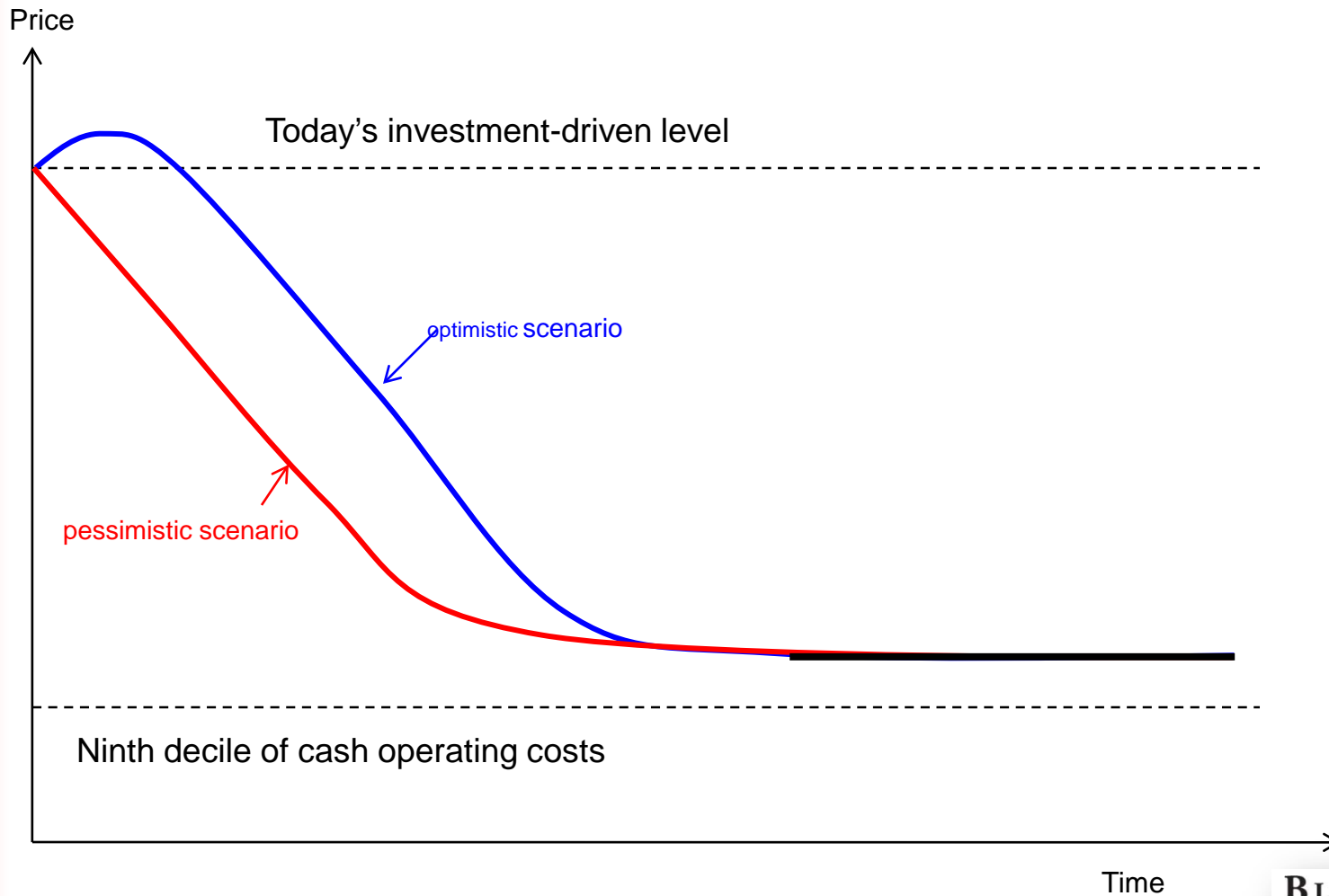
How do our existing users take advantage of the nickel price model?

- They use it to convince their colleagues and bosses that the nickel price is (mostly!) understandable and not just the plaything of one or two major players.
- They use it to de-personalize discussions on price.
- They use it to explore different future scenarios.
- If they do feel obliged to forecast (to rank competing investments, to value assets or projects for instance), the model allows them at least to explore rigorously their assumptions on all of the main price drivers. But, it is not magic. Forecasting remains a difficult business that one does (as best one can) only if one must.

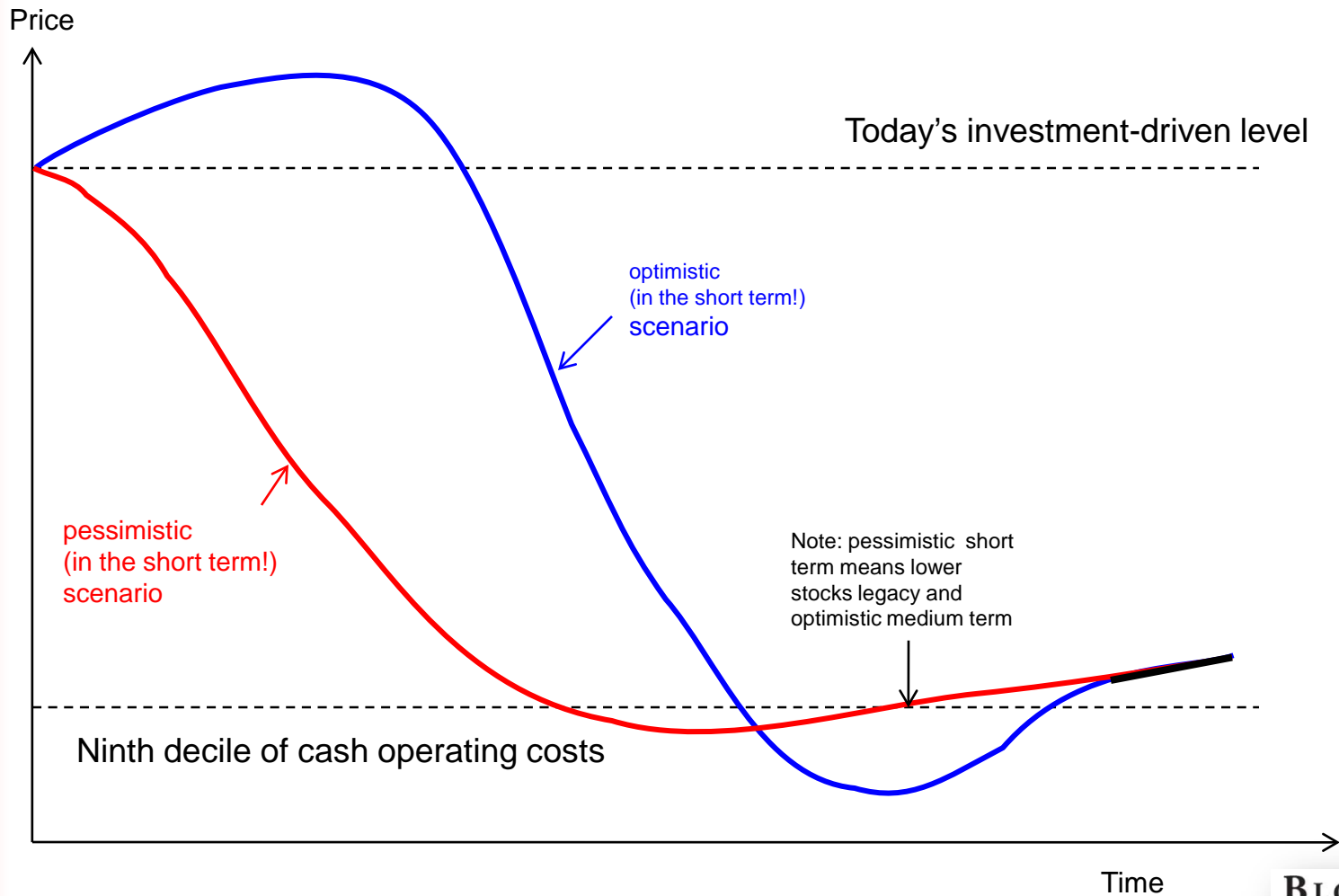
A brief comment on long-term price prospects and modelling as BME extends its models to 2030

- Most companies which need to work with long-term prices assume a simple, smooth reversion from today's very high investment/speculation boosted prices to much lower production cost related prices.
- Mathematical modellers on the contrary would analyse the anticipated legacy of excess stocks and structural over-capacity that will result from any continuation of excess (investment/speculation driven) prices.
- Modellers would then attempt to assess when and for how long prices would be below assumed cost-related levels, before reverting to presumed long-term equilibrium.
- The two views of assets' capital values can be very different.

A typical long-term price scenario analysis of a non-mathematical price modeller



A possible mathematical price modeller's rather different long-term price scenario analysis



Understanding commodities prices: a moving target

- **Analysis of simple industrial raw material markets**

BME was the 'thought leader' since 2002

- Stock ratios
- Rate of demand growth
- Strength / weakness of the dollar

- **Analysis of hybrid raw material / investment vehicle market**

BME the first to incorporate investment effects from late 2005

- Add effect of commodity index fund longs
- Add / subtract effect of hedge fund longs / shorts

- **Next stage is to model better the level of investments in commodities**

BME leading the way in 2010 (work with us to customize your models).

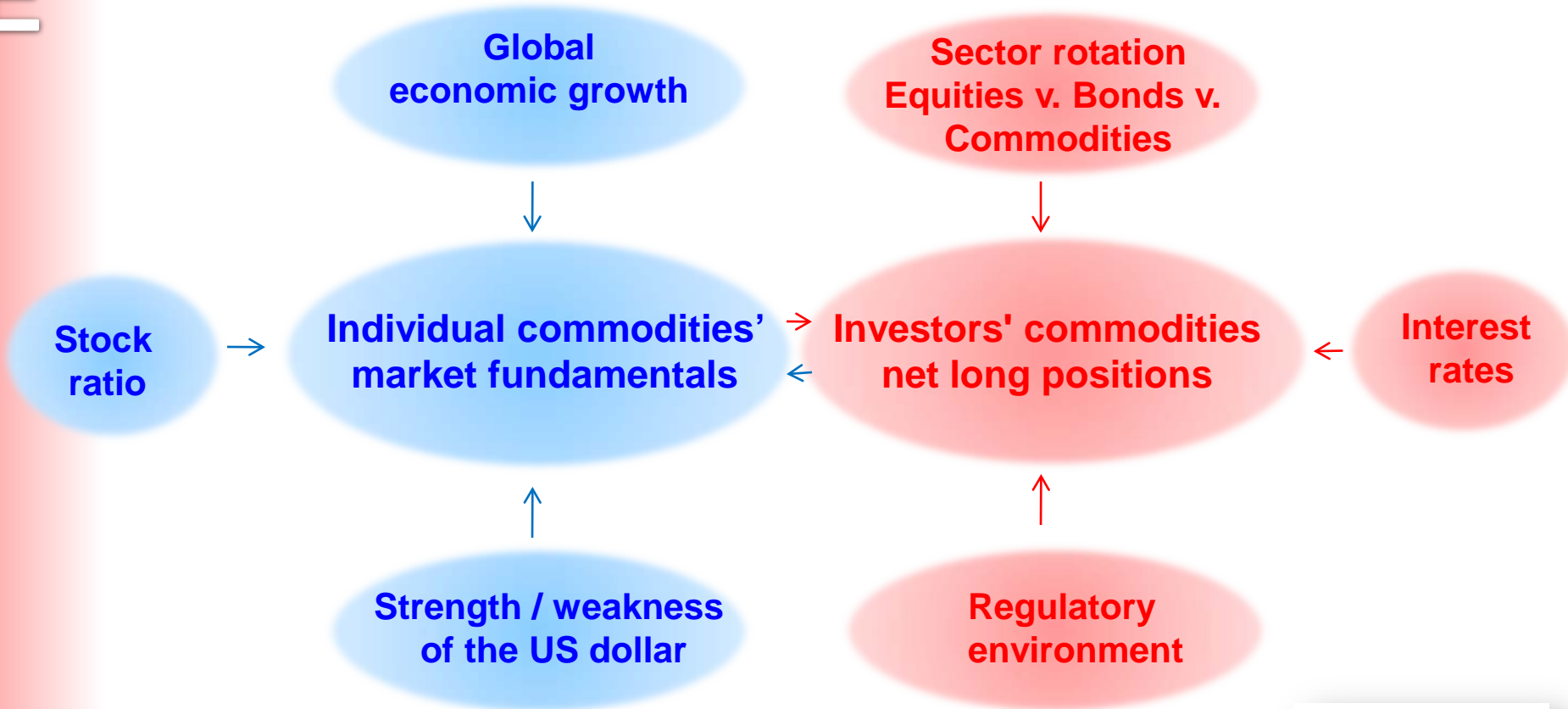
- Feedback loop from investor driven prices to market balance
- Investor sector rotation: equities, bonds, commodities

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Understanding commodities prices: a moving target

The old world shown in **blue**; the new world of commodities added in **red**



The next step: gaining access to standard or customised BME models

- BME's current models run with monthly data through 2012; they are updated and circulated to clients monthly.
- The models are being extended to 2030 to allow users to explore in full future legacies of excess stock; eventual disinvestment; short-, medium- and long-term price prospects.
- There are five standard models: nickel, aluminium, copper, zinc and lead. Annual licenses cost £10,000 for one metal, £16,000 for two, £20,000 for three, £23,000 for four, £25,000 for five.
- BME can work with clients to customise
- these models or create new ones.

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