Copper at a crossroads

By Ben Turney — Friday 10 May 2013

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The recent decline in copper has just reached a crucial level of technical support.

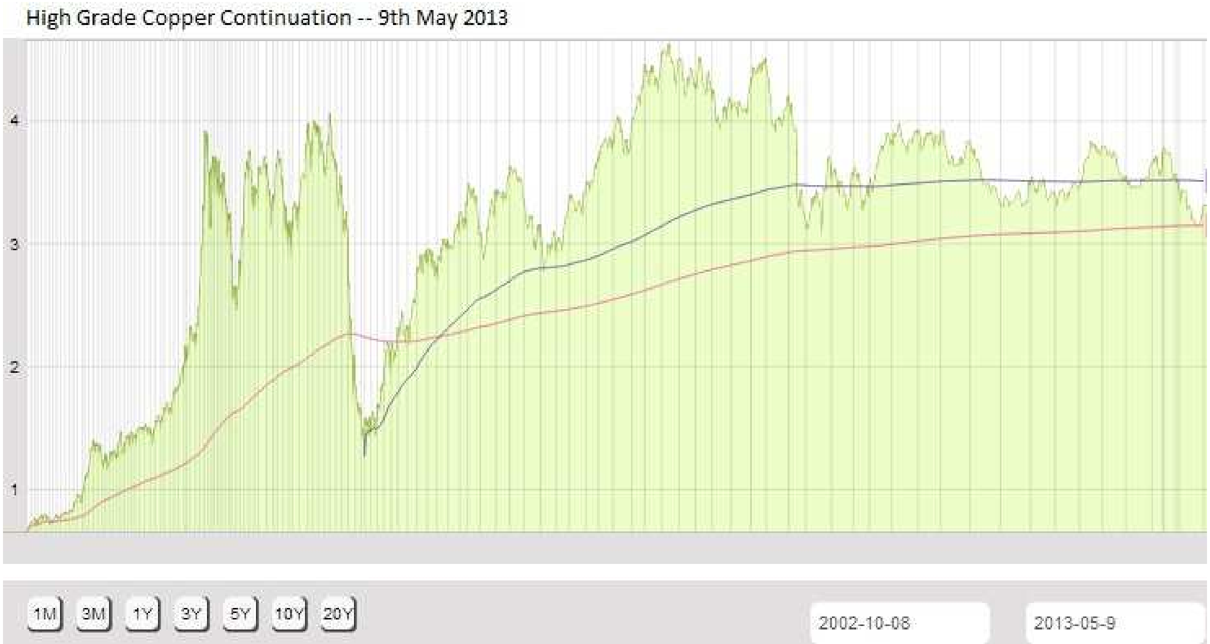
Thanks to its widespread application in industrial, manufacturing and construction processes, copper acts as a very useful indicator of economic activity. As I recently suggested in my piece on the Baltic Dry Index there are warning signs that the apparent "recovery" may not be as healthy as many would like us to believe. The fall in the price of copper is further confirmation of this.

Even so there is an argument for going long (but with caution).

The screenshot below is taken from the demo version of a proprietary trading system I am having built. Based on Paul Levine's MIDAS Method of technical analysis this charting package provides a unique view of looking at markets. Rather than plotting daily prices against time, daily prices are plotted against On Balance Volume ("OBV"). This is more useful than the traditional chart display as the width of each month is determined by the amount of volume present at that time in a given market. This gives an immediate view of how weak or strong a market is based on the amount of buying or selling (assuming buying occurs in a rising market and selling in a falling one).

The MIDAS Method itself is a fairly sophisticated calculation which allows the user to plot support and resistance levels in trending markets. It is most commonly used for individual stocks and indices but the principle can be applied to commodities as well.

Copper has been an excellent example with a high degree of conformance to the MIDAS method in the last ten years.



You'll note the primary support line (pink) starts on October 8th 2002. In the last 10½ years this line has only been breached once, in October 2008. This was at the climax of the Financial Crisis, in the immediate aftermath of Lehman's collapse. When the copper price broke through this level there was nothing to support it underneath and it went into freefall. Remember this was at a time of extreme economic stress and the future looked pretty bleak. Financial markets seized up, liquidity was next to zero and real world economic activity collapsed suddenly.

However we all know what happened next. Central banks stepped in, Quantitative Easing was launched and everything resource related went on a wild run.

When the snapback recovery for copper kicked in, the OCT2002 Support Line very briefly acted as resistance in April/May 2009. Broken support lines can often act as resistance once a recovering price returns to them, so this was to be expected. Shortly after copper staged a breakout from this support level in June 2009. This was confirmation a new bullish trend had begun (it was also a gilt-edged trading opportunity).

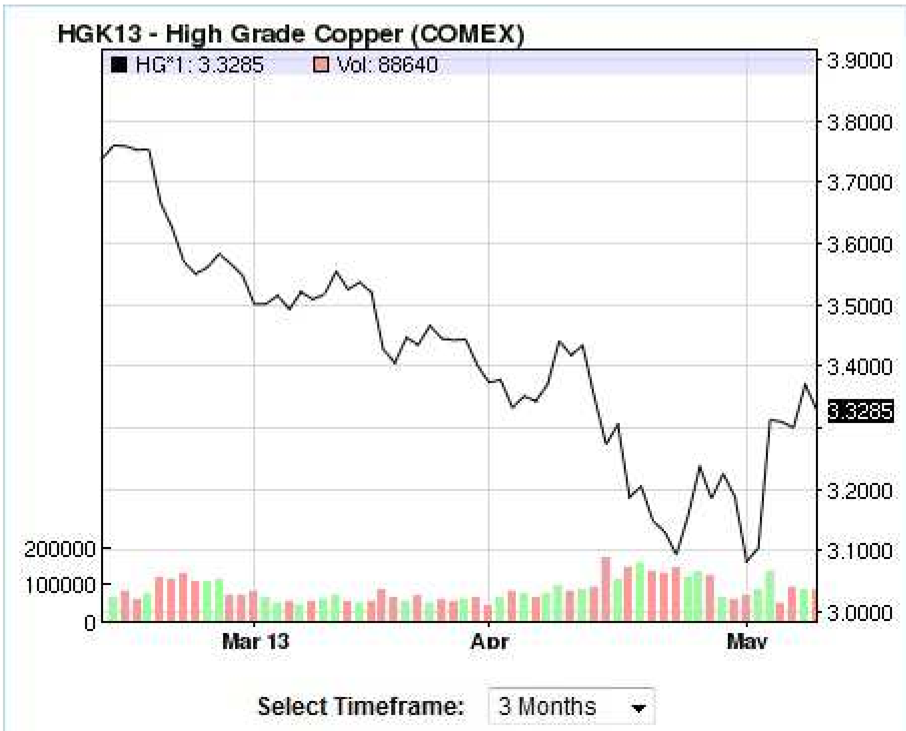
The new bullish trend was support by the JAN2009 Support Line (blue). When this secondary support line was broken in September 2011 it was a signal that copper's latest bull market was over. There have been tradeable opportunities in the intervening period since, but copper has not made a serious attempt at regaining its 2010/11 highs.

Instead the price has foundered and now finds itself at the decade old support line it has not tested in nearly 5 years.

So the question is what to do?

The OCT2002 Support Line is currently $3.15/lb.

The chart below is a conventional 3 month view of High Grade Copper.



A quick glance at this chart suggests that $3.1/lb could be a supportive price for copper. Given that this coincides with the MIDAS support line there is a case for buying.

The significance of a decade old support line is high. This is the long-term line of support and should in theory provide a sturdy floor. When this support line was breached, it was at a time of widespread and acute financial stress. Although I am bearish on the economic outlook, the situation today is nowhere near as extreme.

Right now it is hard to see what might cause another catastrophic drop in price in the near future, but it is equally hard to see what might act as the catalyst for the next bull market. As the Baltic Dry Index is clearly telling us global demand is weak.

The possible more likely current outcome would be a less pronounced rally from this point followed by more weakness as the range-bound price drifts lower.

$3.7/lb appears achievable as a near-term trading target, but if there is a more sustained drop below $3.15/lb this could act as further confirmation of more trouble for the beleaguered resource sector.

Copper is indeed at a crossroads, watch it closely.

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