The bearish Baltic Dry Index

By Ben Turney — Wednesday 01 May 2013

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The bad news just seems to keep on coming for small cap miners and explorers. Share prices are in the dumps, funding is hard to come by and some companies are starting to exhibit signs of severe stress.

The contrarian in me would like to view this environment as the perfect buying opportunity, but unfortunately there are indicators that suggest things are going to get worse before they get better. Much worse.

One of the clearest warning signals comes from the Baltic Dry Index ("BDI"). The BDI is at the top of my list of closely watched leading indicators. Issued daily it tracks traffic on 23 of the most popular shipping routes around the world. It directly charts shipping demand against shipping supply. The OECD estimates that 90% of world trade by volume is carried by sea. In other words the BDI is justifiably regarded as one of the purest measures of true economic activity.

Shipping supply is largely highly inelastic (not subject to quick change). When you consider the costs and time required building a ship, not to mention the expense of taking a ship out of service, it is clear why the supply side of the BDI calculation is a reliable constant.

Shipping demand however varies greatly and correlates directly to the large scale movement of goods. It is really quite simple. The more demand there is for shipping materials, products and food stuffs the higher the BDI ticks.

The index can be prone to sharp movements as demand rises and falls. As a general rule investors in miners and exploration companies want to see metal and mineral prices appreciating in harmony with a rising BDI moving average (to smooth out the peaks and troughs). Such conditions are strongly suggestive of a healthy pricing environment supported by genuine underlying demand.

Regrettably, as the chart below shows, this has not been the case for the last two and a half years.

So what does this tell us?

The first conclusion is the most obvious. Although it is about 50% off its 25 year lows, set in February 2012, the BDI paints a far from healthy picture of the global economy. Shipping demand is back to levels last seen in 2001 and 2002 and there is little sign of an imminent recovery.

The next conclusion concerns China. For resource investors the state of the Chinese economy is vitally important. China imports a vast amount of raw materials both for its manufacturing sector and construction industry. Chinese demand will no doubt return at some point, but at the moment the BDI suggests that the Chinese appetite for raw materials has waned substantially.

The final conclusion concerns the comparison between the states of the mining and exploration sectors in 2008/09 and the current malaise in those stocks.

The calamitous plunge of the BDI in late 2008 proved to be the perfect harbinger for the crisis about to afflict world trade. As much as central bankers and politicians have tried to persuade us that QE fuelled “growth” is the answer to all our troubles, the BDI has continued to point to stifled economic activity.

It is true that there was a sizeable rally in the BDI from March 2009 to mid/late 2010, but this was a specific global response to the Federal Reserve’s first QE programme (the Troubled Asset Relief Programme). The combined effect of the first tranche of QE and increased demand helped put wind in the sails of small cap mining and exploration stocks. The consequent boom in share prices left many people extremely wealthy.

Fast forward to today and eye-watering doses of monthly QE from the Federal Reserve and Bank of Japan have done nothing to lift fraught small cap mining and exploration stocks from their lows, while other sectors and the main market have powered to record highs.

Conspiracy theories abound on most individual bulletin boards about why share prices are so low. Shorters, de-rampers and even automated bots are the most common evils blamed for the woes of various stocks, but the most casual glance over the BDI chart should tell us all we need to know about why things are the way they are.

There is just not enough demand for raw materials.

The BDI has been in a catatonic state for nearly 18 months. What is happening now looks and feels decidedly different to what happened in 2008/09. At the previous bottom for mining and exploration stocks the BDI was at similar levels to those today only for about 3 months. This time the share price lows are being set and reset against a backdrop of extremely weak demand.

Until the BDI recovers to and holds the 1600 level (at a minimum) we can expect more pain for long-suffering shareholders.