Coal Prices Report: What To Buy *Before* Coal Prices Climb

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For most of the past 50 years, since the birth of environmental awareness, coal has been the "black sheep" of the power-production family.

Now, thanks to more efficient furnaces, better exhaust-scrubbing systems and other technological advances, coal is regaining favor in the world's energy markets.

However, the biggest factor in coal's recent price surge is steadily increasing demand for the fossil fuel - in power generation and steel-making - aided by rising costs for other types of fuel, like oil and natural gas.

The question for investors, of course, is will this rising demand continue – and how can you profit if it does?

The answer to the first part of that question is almost certainly, "yes," but the second part is a little trickier.

Simple Supply and Demand

Coal has two major uses – fuel for the commercial generation of electricity and heat and conversion into coke, which is used as both a fuel and a reducing agent in steelmaking.

Roughly 92.8% (1,041.6 million short tons) of total U.S. coal consumption (1,121.7 million short tons) was used for electricity production at 22 major coal-fired power plants last year. Roughly 1.9% (22.07 million short tons) was used in coking, while the remainder was used for other industrial purposes and private and institutional (e.g., hospitals and universities) power and heating plants.

On the production side, U.S. coal output rose by 2.2% last year to a record 1,171.5 million short tons, helping fuel a sharp increase in coal exports.

The continued decline in the coking sector reflects the ongoing loss of U.S. steel production to overseas competitors, most notably China.

Indeed, according to all major industry sources - and the U.S. government's Energy Information Administration (EIA), China will be the driving force in the coal markets for at least the next two decades, accounting for more than half of the world's total consumption by 2025. Consumption will also be far stronger in other emerging-market countries than in developed nations.

The EIA projects growth in coal consumption in the U.S. and other nations of the Organization for Economic Cooperation and Development (OECD) will grow from 47.3 quadrillion British thermal units (Btu's) in 2010 to just 48.3 quadrillion Btu's in 2025, an increase of only 2.1%.

By contrast, coal consumption in China is projected rise from 62.7 quadrillion Btu's this year to 90.1 quadrillion Btu's in 2025 – a 43.7% increase.

Total non-OECD consumption, including China, is projected to rise by 36% from 93.3 quadrillion Btu's this year to 126.9 quadrillion Btu's in 2025. So in just 15 years, emerging nations will account for more than 72% of the world's annual coal use.

Worldwide demand for coal will rise to 175.2 quadrillion Btu's in 2025 from 140.6 quadrillion Btu's this year, an increase of 24.6%, the EIA said.

And much of that demand will be in developing countries, along with the major capital flow of the world's markets. Your broker may have told you the only safe way to profit from this movement is with ETFs and ADRs. That's simply not true. Global investors can find safe opportunities coming from these developing economies. Our latest special report has all the details.

Mining Is Falling Behind

Meanwhile, the mining industry has barely managed to keep up with rising global demand in recent years.

In 1990, total world demand was 89.2 quadrillion Btu's, while total world production was 91 quadrillion Btu's, a surplus of 1.8 quadrillion Btu's, or just over 2%.

By 2006, global demand had climbed to 127.5 quadrillion Btu's, while global output had risen to just 128.49 quadrillion Btu's – a surplus of just 0.99 quadrillion Btu's, or 0.77%.

Given the increased worldwide restrictions on mining operations and the shrinking likelihood of new coal discoveries, it's hard to see where another 47.7 quadrillion Btu's worth of coal are going to come from, especially since projections are already showing a potential production shortfall and depletion of existing stockpiles.

There's no anticipated improvement longer term. The World Coal Institute estimates there are only enough proven coal reserves to last 155 years - if the rate of consumption remains unchanged.

Investing in Coal

Unlike with many other popular commodities, individual investing in coal is generally not a simple matter of buying basic futures or forward contracts. That's because coal has extreme variances in quality.

In the United States, for example, there are five primary classes of coal, each with a different Btu rating.

Northern Appalachia coal, rated at 13,000 Btu per short ton, is the highest quality, while Powder River Basin coal (from Wyoming and other Rocky Mountain states) is the lowest quality, with a rating of just 8,800 Btu per short ton.

Because of those quality differences, the spot prices for Northern Appalachian coal and Powder River coal can be more than $50 apart on a given day.

The other classes of U.S. coal are Central Appalachia (12,500 Btu), Illinois Basin (11,800 Btu) and Uinta Basin (11,700 Btu).

While the NYMEX division of the CME Group does trade one major and two minor futures contracts - Central Appalachian, or CAPP (trading symbol: QL); Western Powder River Basin, or PRB (symbol: QP); and Eastern CSX Transportation (symbol: QX) - all are fairly thinly traded and used primarily by commercial interests for hedging and supply management. Inconsistencies with the spot prices can also be high - e.g., the nearby CAPP future closed at $52.30 compared to the spot price of $58.95 recently.

Coal prices also tend to move separately from coal fundamentals themselves. Coal prices track the changes of other energy commodities - primarily crude oil and natural gas - as well as certain hedging commodities such a gold. This was illustrated quite clearly in the last three years.

Coal prices skyrocketed along with oil in early 2008, peaking near $150, before plummeting back to just over $40 per ton in 2009. And now prices are climbing again.

Coal Investments to Make Now

So, assuming the demand will continue to grow – and oil prices will keep rising, dragging coal and natural gas along – how should you play the move?

Exchange-traded funds (ETFs) are among the best choices as there are at least four that take heavy positions in coal-related issues, including two that target coal specifically. All are up significantly in price since the March 2009 market bottom, but they should have ample room left to climb as the recovery gathers added steam.

They are:

Market Vectors Coal (NYSE: KOL): This fund aims to track the price and yield performance of the Stowe Coal Index. It normally invests at least 80% of total assets in equity securities, including American Depositary Receipts (ADRs), of U.S. and foreign companies engaged primarily in the coal industry.

PowerShares Global Coal (NYSE: PKOL): This fund attempts to mirror the NASDAQ OMX Global Coal Index. It normally invests at least 90% of assets in securities, ADRs and Global Depositary Receipts (GDRs) based on the securities in the underlying index, focusing 80% of assets on companies involved in the coal industry.

Market Vectors Steel (NYSE: SLX): Coal is a major cost factor for steel producers and consumers. And this fund invests in major steel players. Since steel is a major component in all sorts of infrastructure construction, the fund's holdings should benefit from new spending linked to developing country growth.

SPDR S&P Metals & Mining (NYSE: XME): A diversified fund that includes coal mining and processing companies among its portfolio holdings, many of which are international - meaning the fund can also benefit from currency fluctuations as well as changing prices for metals and other minerals.

For those who prefer picking individual stocks to riding along with fund managers, take a look at the Energy Advantage portfolio. It offers readers special stock picks in coal, oil, natural gas and "new energy" winners. Learn more right here.

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