Winners And Losers From Commodity Decline

Had Isaac Newton been an economist rather than a natural philosopher, he might have stated his Third Law of Motion as, “every market action has an equal and opposite reaction.” Fortunately for his reputation, he was not an economist and no such law exists, for had it been stated as such, it would have been wrong.

We like to think there is an equal balance between winners and losers in markets, but the net result generally are anything but neutral. For those of you around during the August 1982 takeoff point of what turned out to be the greatest bull market in history, please recall how the sudden and unexpected decline in long-term interest rates propelled nearly everything higher and for a sustained period of time. A similar unbalanced ascent occurred with the start of the first Persian Gulf War in 1991, with the end of interest rate hikes in early 1995 and with the March 2003 start of the current Iraq War.

There are unbalanced negatives, too. Consider the downward spirals of October 1987, August 1998, or May-July 2002.

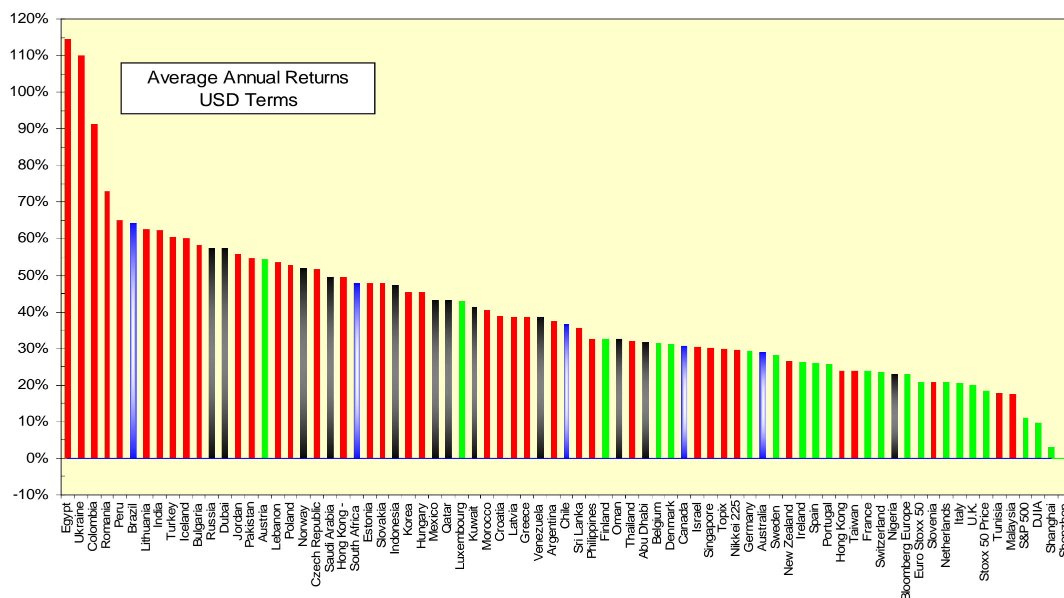
If markets and economies are confronted with events such as the ongoing drop in commodity prices, resources must get reallocated. These produce what economists term frictional costs, or the deadweight losses created by investments now rendered uneconomic. As we learned a quarter-century ago, and as I wrote in March 2005, commodity investments can turn sour in a hurry once the supply/demand balance starts to shift.

If we are at a major turning point in the commodity price cycle – and that is still an uncertain proposition – the firms who will lose will lose massively. The economy as a whole will benefit, and non-commodity sectors of the market will gain more than the commodity sectors will lose.

The 2003-2006 Global Experience

First, who were the global winners during the commodity boom, which we can bound with the Federal Reserve’s May 6, 2003 declaration of war on deflation and the Bank of Japan’s May 12, 2006 end of quantitative easing. If we rank the average annual returns of global equity markets in U.S. dollar terms, distinct patterns emerge. The markets of crude oil exporters (black columns) and commodity exporters (blue columns) were not at the top of the return heap as we might have expected. The best-performing of these markets was Brazil, followed by Russia and Dubai.

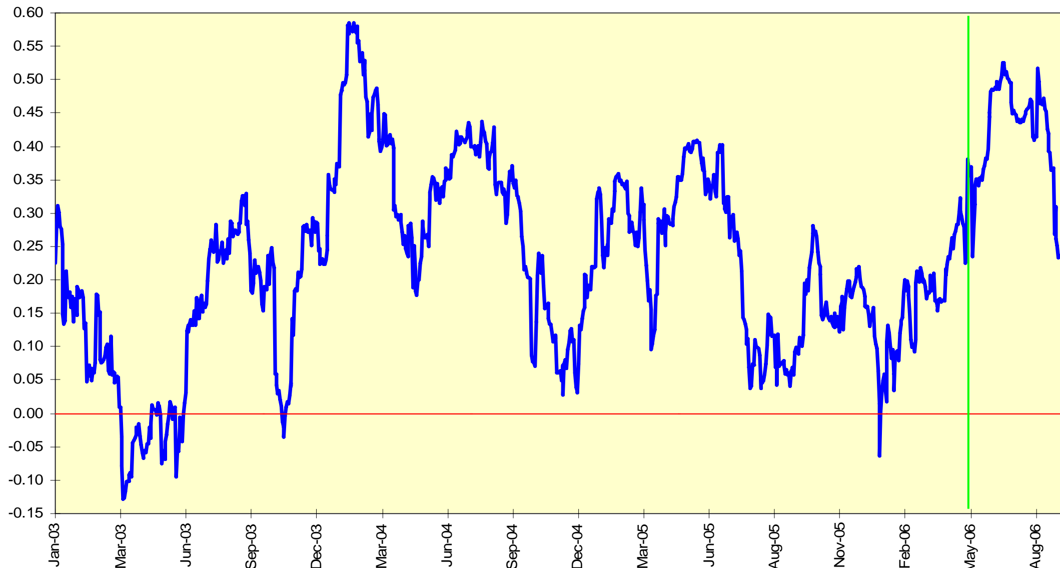
Global Equity Returns During Three-Year Commodity Boom



Who was at the bottom of the pile? The markets of major commodity importers, such as China, the U.S. and nations in Western Europe, all colored in green. For all of the China-growth stories we all have read, it was not a good place for financial investments.

And at the top of the heap was who? Markets on the periphery of commodity exporters, such as Egypt, Ukraine and Colombia; these nations enjoyed all of the benefits of selling to their prospering neighbors with fewer macroeconomic distortions. In a gold rush, sell shovels.

It was easy to classify much of the rally in emerging markets as a commodity story over the past three years, but the data indicate otherwise. If we map the rolling three-month correlation of returns of the MSCI Emerging Markets Free index against those of the Reuters/Jefferies CRB index, we see how the correlation has diminished sharply in recent weeks. Restated, as commodity prices have fallen, the returns on emerging markets have continued to move in a positive direction, thereby accounting for the quickly shrinking positive correlation. The most prolonged and growing period of positive correlation between these two markets occurred between March 2003 and February 2004.



Domestic Winners And Losers

Let's return to an analysis first introduced in February 2005 and revisited several times since. The tables below present the relative performance of industry groups within the S&P 500 to the S&P 500 itself as a function of various factors at a 90% confidence level. The first tables below depict those groups who benefited the most since May 2003 from higher crude oil and natural gas prices. In addition to the obvious candidates in the oil industry itself, we see a surprisingly strong link from the utilities, construction & engineering and steel. The utilities were able to pass on their higher fuel costs, and the oil industry is a major user of both steel and construction services.

Crude Oil		Natural Gas	
Group	Beta	Group	Beta
Electric Utilities	0.033	Forest Products	0.021
Multiline Utilities	0.050	Construction & Engineering	0.031
Gas Utilities	0.060	Steel	0.076
Agricultural Products	0.074	Gold	0.090
Aluminum	0.076	Integrated Oil & Gas	0.097
Construction & Engineering	0.097	Diversified Metals & Mining	0.116
Steel	0.150	Oil & Gas Equipment	0.171
Gold	0.235	Oil & Gas Refining	0.187
Diversified Metals & Mining	0.237	Oil & Gas Drilling	0.191
Integrated Oil & Gas	0.268	Oil & Gas Exploration	0.195
Oil & Gas Refining	0.404		
Oil & Gas Equipment	0.409		
Oil & Gas Exploration	0.430		
Oil & Gas Drilling	0.466		

The next set of tables depicts the vastly larger set of industries hurt by higher energy prices over the past three years. The list is dominated by firms in the consumer sectors, retailers especially, and by firms in the technology and automobile-related sectors. If we are headed back toward an era of lower energy prices – a statement, not a forecast – the list of beneficiaries is found below.

Crude Oil

Group	Beta
Airlines	(0.207)
General Merchandise Retailers	(0.100)
Healthcare Distributors	(0.094)
Semiconductor Equipment	(0.072)
Drug Retailers	(0.066)
Tobacco	(0.064)
Computers & Electronics Retailers	(0.064)
Hypercenters & Superstores	(0.064)
Environmental Services	(0.063)
Automobile Manufacturers	(0.061)
Home Improvement Retailers	(0.060)
Data Processing & Outsourcing	(0.059)
Application Software	(0.058)
Air Freight & Logistics	(0.056)
Apparel Retailers	(0.053)
Systems Software	(0.053)
Photo Products	(0.053)
Department Stores	(0.052)
Communications Equipment	(0.049)
Multiline Insurers	(0.049)
Computer Storage & Peripherals	(0.048)
Wireless Services	(0.047)
Auto Parts & Equipment	(0.046)
Integrated Telecommunications	(0.045)
Semiconductors	(0.045)
Leisure Products	(0.045)
Casinos & Gaming	(0.044)
Food Retailers	(0.043)
Household Appliances	(0.042)
Thrifts & Mortgages	(0.042)
Consumer Finance	(0.042)
Specialty Stores	(0.041)
Household Products	(0.041)
Distributors	(0.040)
Regional Banks	(0.040)
Computer Hardware	(0.040)
Pharmaceuticals	(0.038)
Personal Products	(0.038)
Diversified Banks	(0.036)
Hotels	(0.036)
Industrial Conglomerates	(0.035)
Biotech	(0.034)
Property & Casualty Insurers	(0.032)
Diversified Commercial Services	(0.032)
Other Diversified Financial Services	(0.030)
Asset Management & Custodial Banks	(0.029)
Healthcare Equipment	(0.027)
Specialty Chemicals	(0.026)
Diversified Chemicals	(0.025)
Movies & Entertainment	(0.022)
Aerospace & Defense	(0.022)
Office Services & Supplies	(0.019)

Natural Gas

Group	Beta
Internet Retailers	(0.052)
General Merchandise Retailers	(0.047)
Automobile Manufacturers	(0.045)
Thrifts & Mortgages	(0.041)
Distributors	(0.038)
Airlines	(0.038)
Healthcare Suppliers	(0.038)
Auto Parts & Equipment	(0.037)
Photo Products	(0.032)
Drug Retailers	(0.031)
Environmental Services	(0.031)
Hotels	(0.031)
Diversified Commercial Services	(0.030)
Diversified Banks	(0.030)
Department Stores	(0.028)
Broadcast & Cable TV	(0.028)
Personal Products	(0.028)
Data Processing & Outsourcing	(0.027)
Industrial Conglomerates	(0.026)
Hypercenters & Superstores	(0.026)
Home Improvement Retailers	(0.026)
Tobacco	(0.025)
Air Freight & Logistics	(0.025)
Commercial Printers	(0.025)
Regional Banks	(0.024)
Integrated Telecommunications	(0.023)
Packaged Foods	(0.022)
Leisure Products	(0.021)
Consumer Finance	(0.021)
Household Appliances	(0.019)
Multiline Insurers	(0.019)
Household Products	(0.019)
Property & Casualty Insurers	(0.017)
Soft Drinks	(0.017)
Pharmaceuticals	(0.016)
Publishing & Printing	(0.013)
Office Services & Supplies	(0.012)
Other Diversified Financial Services	(0.011)

We see a confirmation of this relationship at the economic sector level via the sector-specific credit default swap (CDS) costs as a function of both crude oil and natural gas prices; this subject was last addressed in June. As crude oil prices rose, levels of credit stress rose in the consumer discretionary and consumers staples sectors, in technology and, interestingly enough, in the energy sector itself. As natural gas prices rose, CDS costs rose in the basic materials, consumer staples, energy, healthcare and industrial sectors.

Economic Sector	Crude Oil	Natural Gas
Basic Materials	(0.028)	0.019
Consumer Discretionary	0.019	(0.007)
Consumer Staples	0.064	0.006
Energy	0.032	0.013
Financial	(0.032)	(0.036)
Healthcare	(0.009)	0.031
Industrial	(0.008)	0.020
Technology	0.039	(0.023)
Telecommunications	(0.003)	(0.027)
Utilities	(0.023)	(0.015)

Briefly, CDS costs rising in a healthy industry is not as strange as it may seem. The rapid expansion of these firms, their rising investment and risk levels and their various corporate actions designed to reward shareholders at the expense of bondholders all serve to increase the risk of these corporate bonds.

Where do we go from here? If you believe, as I do, the present downturn in the energy sector still must be considered a correction within a long-term bull market rather than the restoration of a non-trending or even bear market, now is the time to rebuild holdings in the energy, steel and construction & engineering sectors. If you are bearish on energy, the gains for the consumer sector will outweigh, and by a large margin, the losses in the energy sector.

But whatever you do, stay away from Newton's First Law, often called the Law of Inertia: Matter in motion tends to stay in motion, and matter at rest tends to stay at rest. That behavior, seen most often in drawing a line through the last two points on a chart, may land you a cushy job as a financial pundit but it will do you no good as an active trader.