There Is No Such Thing As Commodities

If wishing something were true only made it true I could at last reconcile some interesting thoughts with a more pedestrian reality. So could you. Let's make a hard-right turn and go into a pet peeve of mine, that there is a singular entity out there called "commodities." When professional investors use this term, they mean tangible physical goods traded on an exchange. Non-tangible futures, such as those on heating degree-days or emissions do not count, nor do tangible cash markets, such as industrial sand and gravel, that do not support futures markets. This is Red Queen logic: Things mean what you want them to mean.

I argue physical commodity futures represent a collection of unrelated markets we can, like Caesar's Gaul, divide into three parts:

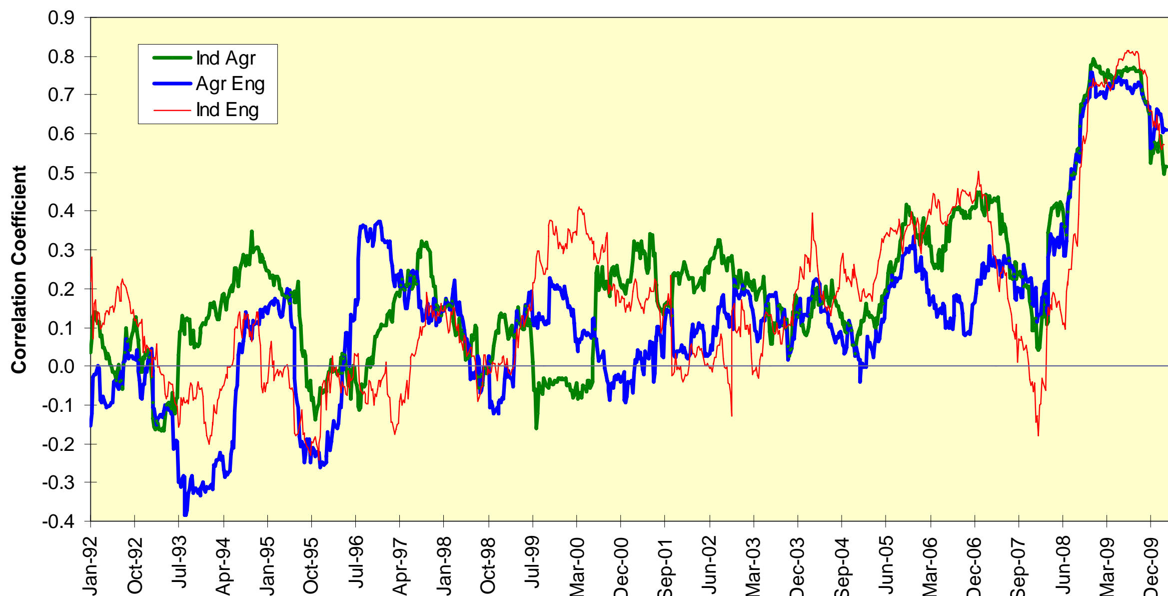
1. Resources consumed but regenerated where production is uncertain and substitution limited. This category includes grains, livestock and soft commodities such as sugar or cocoa;
2. Resources extracted but not recycled where demand is uncertain, substitution greater and producers face diminishing returns on investment. This category includes energy resources such as crude oil and natural gas; and
3. Resources extracted and recycled indefinitely; this category includes all of the precious and industrial metals.

Why anyone should think these markets should move together for any reason other than a wall of money forcing common behavior over a short period is not clear. Moreover, as we shall see in later discussions of this issue, the response of various commodities to various factors supposed to be primal to all of them, such as expected inflation or currency rates, is disparate.

Sub-Indices For The Short Run

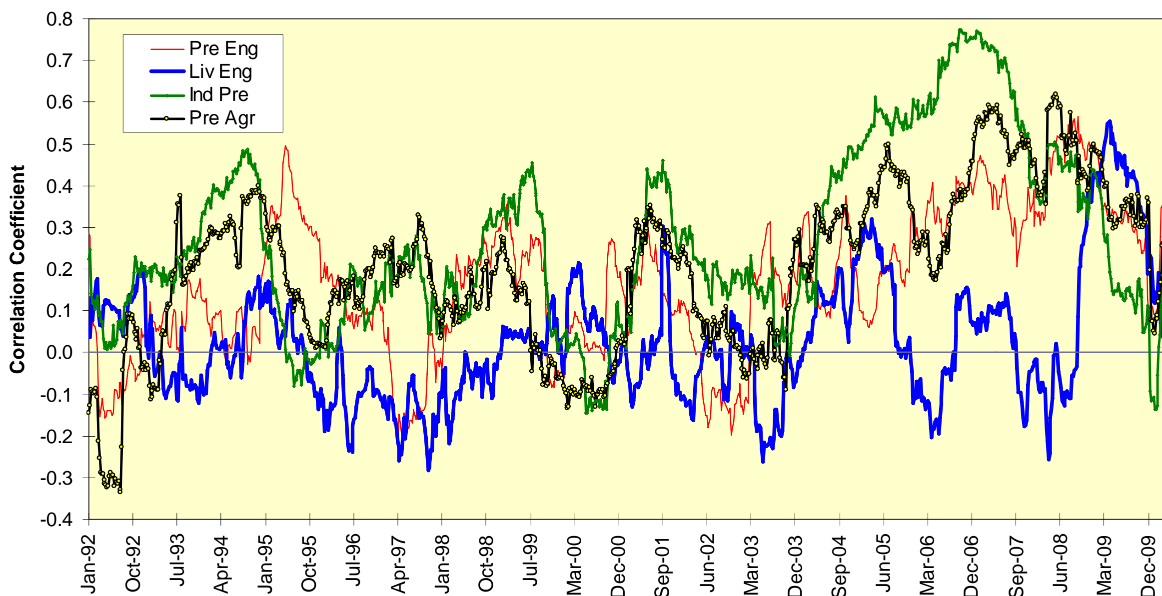
The biggest argument of all, however, is we can demonstrate how the returns of various commodity sub-indices as constructed by Dow Jones-UBS (not to be confused with its former parent, Dow Jones-AIG) exhibit highly unstable and often negative one-year rolling correlations of returns with each other. Negative correlation implies you are trading against yourself when you own both assets. Unstable and oscillating correlation means you own a random mess. Why would you want to do that?

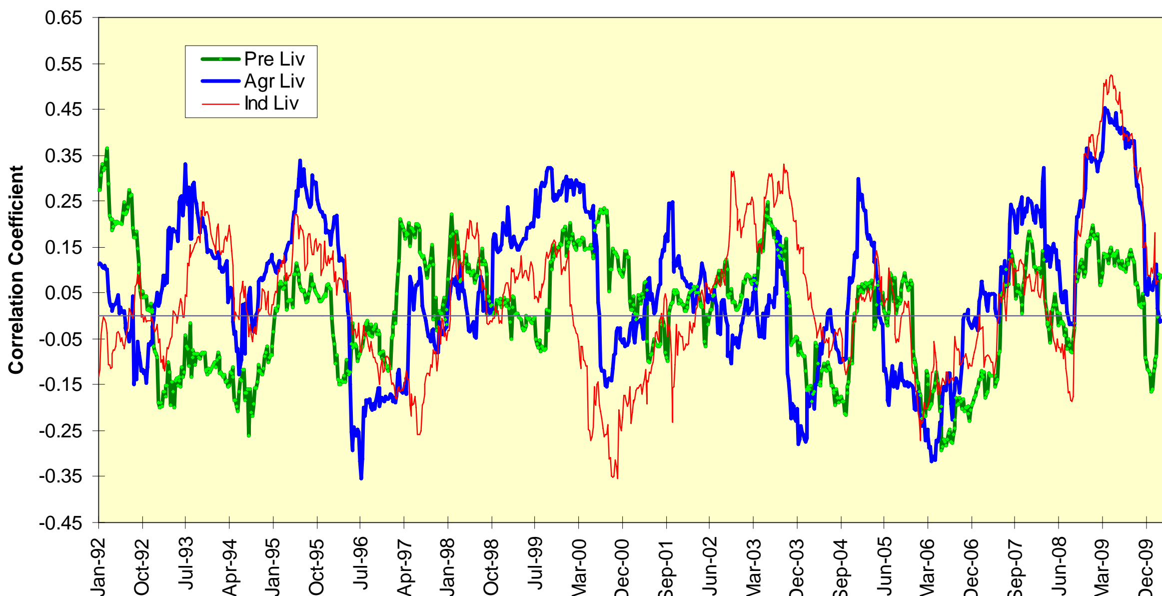
But let's be generous and take the three crosswise pairs with the highest positive correlation of returns at present, energy versus industrial metals, energy versus agriculture and industrial metals versus agriculture.



Note the large jump in late 2008 and early 2009; that was not convergence during a bull market in commodities, that was the period when all commodities along with all stocks, all real estate, all corporate bonds and a handful of markets none of us knew could roll over and die all rolled over and died together in the financial market musical tribute to mass cyanide poisoning, *Jonestown Is Your Town*.

Prior to that episode, the one-year rolling correlation of returns for these indices had never exceeded 0.51 and had in fact been negative. We are in the process now of moving back toward randomness. The chart above is the strongest argument for commodities as a single entity; the other pairs involving precious metals (PRE) and livestock (LIV) look much, much worse.





Will this dissuade anyone from lumping these markets together? If past performance predicts future results, which I am pretty sure it does, the answer is a resounding, "No."