Monetary Expectations, Grains And Energy

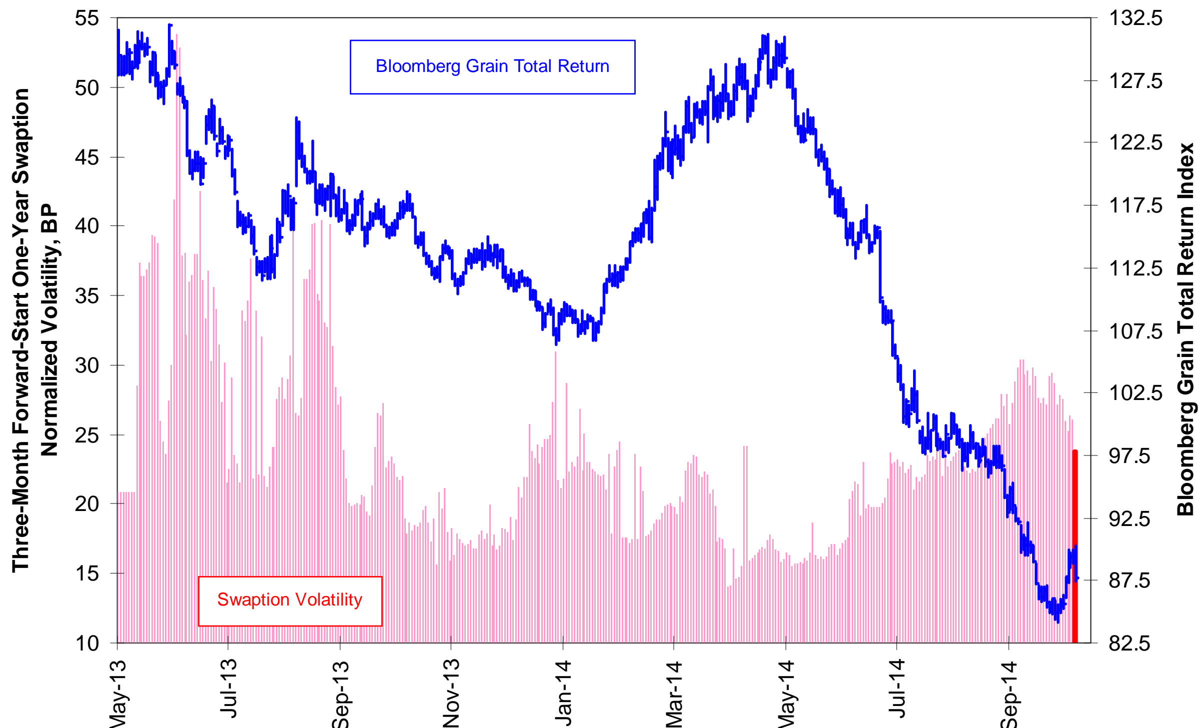
With insincere apologies to the late Albert King and all of those who covered the blues classic *Born Under A Bad Sign* after him, if it wasn't for pet peeves, I wouldn't have no pets at all. And what are some of these pet peeves, you ask? The notion physical commodity prices are a reflection of monetary excess and contraction would be a good place to start. While there have been periods where various physical commodity prices and monetary measures such as producer price inflation, the state of the dollar and monetary policy had periods of correlation, there really is no reason to confuse supply cycles, logistical factors and weather-driven production disruptions and demand surges with monetary policy.

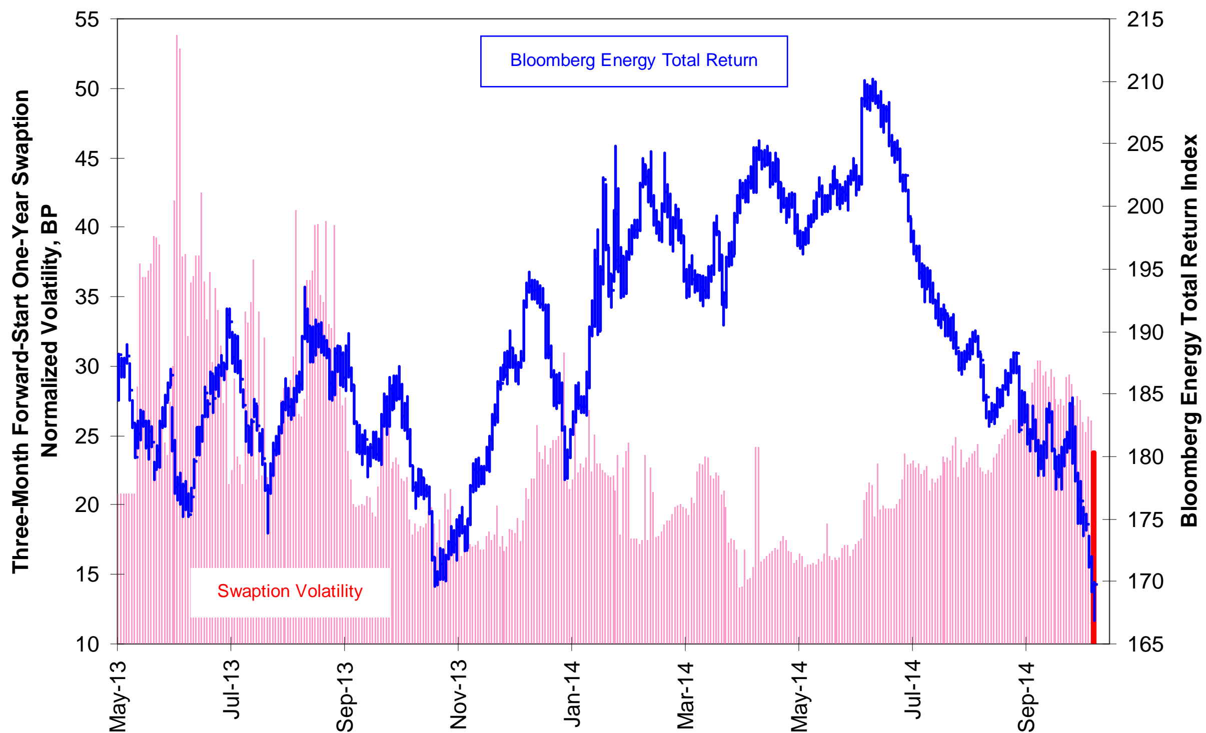
If I may continue to make hay with a straw dog, one of the worst recent manifestations of this blame-the-Federal Reserve for everything thought process occurred in early 2011 when the so-called Arab Spring's food riots were blamed on QE2 instead of the previous summer's drought in the former Soviet Union. That error then was repeated in 2012 with higher corn and soybean prices in the U.S. following our own drought. Will some blame the recent downturns in both grains and petroleum on the tapering of QE and the unconvincing tease interest rates will rise sometime in 2015?

Grains, Petroleum And The Great Taper Caper

We can get a good sense of the market's expectations for short-term interest rates from three-month forward-start one-year swaption volatility. This is what a floating-rate borrower is willing to pay for the right but not the obligation to fix interest rate payments for one year starting three months from now. If grain and petroleum prices were being driven by monetary expectations instead of things like 2014's near-perfect growing season or Saudi Arabia's policy of defending market share via lower prices, we should see an inverse relationship of higher swaption volatility leading to lower returns and vice-versa. Do we?

If we map the relationship from the May 2013 start of speculation when the Federal Reserve would start tapering QE3, the answer is a decided, "No." Actually, it has been a non-relationship for a much longer period as well, but it is visually simpler to isolate this particular market regime.





There are some physical commodities where monetary expectations matter, most notably gold, but even there the income elasticity of demand has outweighed factors such as net inflation expectations over the past decade. If wealth levels in major gold-buying regions such as India and the Persian Gulf states rise, the demand for gold as a store of value will increase. This has held true over several phases of inflation expectations and changes in U.S. monetary policy.

If we look at other physical markets, though, the argument that physical commodity prices rise during periods of monetary accommodation and fall during times of monetary restraint starts to break down rapidly. In any case, nothing the Federal Reserve or any of its sister central banks has done over the past year caused the downward moves observed in both grain and energy returns.