

Changing Differences Between Stocks And Commodities

Some problems in market analysis have no definitive answers; however, this does not prevent people from fighting over them interminably. One of the oldest *casus belli* has been between fundamental and technical analysis, neither one of which should work given the efficient market hypothesis, itself at war with behavioral finance. For the record, the author's stands on these two issues, neither one of which rises to the stature of Armageddon, is:

- While markets tend to be highly efficient over the long-term, the short-term is dominated by the behavioral impulses of its participants; and
- While fundamental factors dominate over the long-term, technical factors dominate over the short-term.

Restated, long-term trading is a signal-oriented affair dominated by highly efficient assessments of fundamental information and the incorporation thereof into price. Short-term trading is a noise-oriented affair dominated by the traders reacting to each other and to themselves. Viewed in this light, the fight disappears, but where is the fun in that?

An ancillary battle is whether all markets can be analyzed with the same technical approach. The most doctrinaire technicians say everything is "just numbers," but that is unsatisfying in the extreme. We need to remember many markets have very different underlying distributions and therefore cannot be pooled together. For example, Eurodollar prices get compressed as interest rates decline toward zero, but Treasury bond and note prices expand as interest rates decline. Moreover, different markets have vastly different volatility structures and different asymmetries. For example, the volatility of stocks expands as prices fall, and while stock prices tend to have their biggest losses during bull markets, they also have their biggest one-day gains in bear markets.

Differences

As single-stock futures bridge the world of equities and futures, although not nearly as much as hoped for when the instruments began trading in the U.S. in November 2002, many prospective traders and analysts with their foot in one world wanted to know the differences and similarities. Some of the questions received were almost touching in their naïveté, including (seriously) "Why trade the future when you can trade the option?" and "How does the futures market predict the future?"

The real issues were, of course, the vastly different regulatory, margining and clearing differences between CFTC-regulated futures and SEC-regulated stocks, along with the grim reality no one on the stock side of the market had a back-office capable of handling the daily variation margining associated with futures. In fairness, the futures side of the equation was not well-equipped to handle corporate events such as mergers, bankruptcies, splits, special dividends and the like. An opportunity arose, or at least appeared to arise, to bridge the two worlds by compiling a list of their technical differences.

That was ten years ago. Are these differences valid today, or has the market and trading environment switched? The answer, amazingly enough given one of the tenets of technical analysis is the immutability of human nature, is a large number of the twelve differences cited had indeed changed.

Let's go down the list one-by one:

1. All futures contracts have a definite life and all bonds save perpetuities mature. This creates patterns of convergence toward a final value not present in stocks. A stock is born with the presumption it can live forever and therefore has no convergence and no defined upper limit. A long-term position in the futures market necessitates rolling between contracts. In addition, as futures enter delivery periods, many players exit the front-month contracts and change their price patterns as a result;
2. Stocks' price behavior is affected by dividend payouts and by corporate actions such as splits and rights offerings; these distort a stock's history in a way unseen in futures. Any analysis of stock prices should be done on a total return basis, yet few analysts actually make these price adjustments;
3. Stocks fulfill their economic mission of raising capital and distributing the risk of ownership at birth. Once this is achieved, the purpose of a stock shifts to a trading vehicle representing either a share of ownership if less than 50 percent and of control if greater than 50 percent. Control matters: If you do not believe this, ask why corporate acquirers are willing to pay a premium to achieve it.

The economic purposes of futures markets used to be price discovery, commerce facilitation and risk management. This changed with the widespread adoption of long-only commodity index funds; futures now exist to be held long, sold forward and rolled into a new long position. This not only affects price via a flood of long-side liquidity capable of overwhelming natural shorts, but it affects the forward curves of futures markets and their use as hedging and inventory-maintenance vehicles;

4. The mechanics of indexation and portfolio balancing affect stock prices for reasons wholly extrinsic to fundamental valuation. We now can say the same for futures markets. This is a major shift in the markets and has been manifested in increased correlation of returns between otherwise-unrelated commodity futures;
5. Stocks used to trade far more within a consistent set of national trading hours while many futures markets traded in a near-continuous 24-hour day that made the concept of opening and closing prices obsolete. Now the stock-trading day is nearly as unbounded as the currency and interest rate markets' day. This has lowered gap risk for stocks just as it has for other markets but at the cost of pushing what used to be pre- and post-trading day announcements into a zone of trade outside of the primary national market;
6. The underlying asset for futures contracts used to be constant; this is changing. For example, corn used to be driven by the demand for livestock and human food, but now we feed 40% of the crop to yeast to make ethanol. These sorts of changes will make the long-term comparison of futures markets as difficult as that of stock markets where the very nature of companies changes regularly. The old notion "Wheat is wheat, but John Deere is a very different company than it was fifty years ago" is not as cut and dried as it used to be;
7. Stock prices used to be far more volatile than those for storable commodities as they could be driven by nothing more than hope or rumor while process inputs had real industry economics behind their prices. Commodity index funds have overwhelmed these fundamentals with a wall of money. It is not unusual to see a "risk-on" or "risk-off" day drive futures markets higher or lower en masse for reasons wholly unrelated to those markets' economics;
8. Stocks used to be more amenable to a trend-following approach while commodities were best-traded via a mean-reverting approach. Stocks, after all, can go to zero or keep powering higher as the news and fundamentals dictate, while commodity markets have a natural mean-reversion tendency because both supply and demand respond to prices. However, the post-2002 period has seen stocks trade within a massive range and commodity prices rising under the aforementioned wall of money. Back to the drawing board as one more perfectly good theory goes up in smoke;
9. Despite the most fervent intentions of anti-traders within the regulatory agencies, stocks and futures have a vastly different relationship to information. The Sarbanes-Oxley law, SEC Regulation FD and various aspects of the Dodd-Frank law have restricted the free flow of information within the equity world in a way not seen for futures. The concept of insider trading and fair disclosure is not part of the commodities world;
10. Trade in futures markets is symmetric between buyer and seller. There is nothing like the short-selling restrictions or uptick rules for futures that we see in stocks. The regulatory attitude is quite different, too: The SEC never has been bashful in its desire to see higher stock prices; the CFTC has a number of markets, particularly in the energy space, where rising prices are not welcome;
11. Stocks have rule-based margins set by the Federal Reserve under Regulation T, at least for small players. Large players with access to joint back offices or who deal with prime brokerages often pay a fraction of the retail stock investor's 50 percent Regulation T margin. Stock margins are a down payment; futures margins are a performance bond and are set by the exchanges in response to market volatility. Exaggerated moves in futures tend to force players out of the market;
12. Finally, the taxation of stocks and futures is different. Stocks have favored treatment for long-term capital gains and qualified dividends; futures have favored treatment under Section 1256 (60% long-term and 40% short-term). Futures also have hedge accounting treatment under FAS 133. All of these considerations affect trading patterns, especially at year-end.

It seems six of the twelve differences noted between stocks and futures in 2002 have changed materially as the result of changes in market structure, money flow, tax treatment or some other cause. However, the net result is the two markets have a different set of differences; come back in another decade with more regulatory and legal change and greater evolution of market instruments and there will be yet another different set of differences. The conclusion the two markets should be approached differently stays the same.