Slow Motion Across The Ocean

One of the consequences of everyone waiting for a plan to emerge from Washington, D.C., is traders and investors are locked in a waiting game. As of the Saturday time of this writing, (I feel as if I have to timestamp everything I write so that if it is horribly obsolete you will know why) no plan has emerged, and if and when one does, we really cannot be sure of its reception in the markets.

As the various equity derivative markets have been handicapped by the ban on short-selling, as the interbank lending markets have been handicapped by seemingly unbreakable credit stresses, as currency markets are handicapped by the inability to borrow and lend at reasonable spreads and as corporate bond and swap markets, our subject last week, are trading at or near record-wide spreads, it is getting increasingly difficult to find economic "signal" amidst all the noise.

One powerful signal is making some noise, however, and that is the precipitous decline in our old friend, the Baltic Dry Freight index (BDI), a topic I last visited in January right after the Société Générale debacle. As an aside, that crisis and panic low seems like something from the *Ancien Régime*, and it was only eight months ago. Time flies when you are having fun.

I concluded that January column:

> *If China continues to use a rising yuan as a policy tool while the rest of the world is slowing down, with the various effects noted above as evidence, the results are going to remain ugly. Our focus as investors really has to remain, "how should I protect my capital" far more than "what should I buy?"*

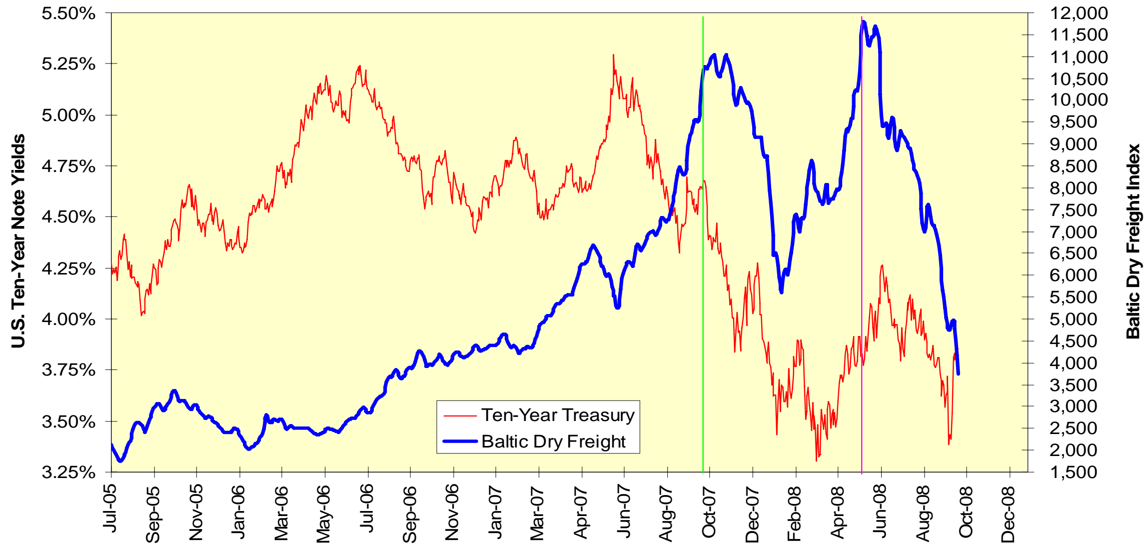
That conclusion was reinforced in a recent column positing a connection between the July backstopping of Fannie Mae and Freddie Mac and the end of the yuan's appreciation. That "deal," if it in fact existed, was the first of Hank Paulson's recent blunders, a list that includes wiping of the preferred shareholders of the mortgage giants, thinking a Lehman Brothers bankruptcy would not have the consequences it did for the money markets and scaring the stuffing out of the credit default swap market anchored by AIG. We should fork over $700 billion, no questions allowed, to such a genius? Why, no price would be too high for this level of public service!

Bye-Bye, Baltic Dry

But Hammering Hank's acumen extends to currencies, too. The BDI hit a peak in October 2007, and started to fall within days of the Chinese acquiescence in a stronger yuan. Ten-year note yields have mirrored the BDI's movements since that time. Each time the BDI rose, signaling increased Chinese demand for raw materials to manufacture goods for export to the U.S. and elsewhere, Treasury yields rose, and vice-versa.

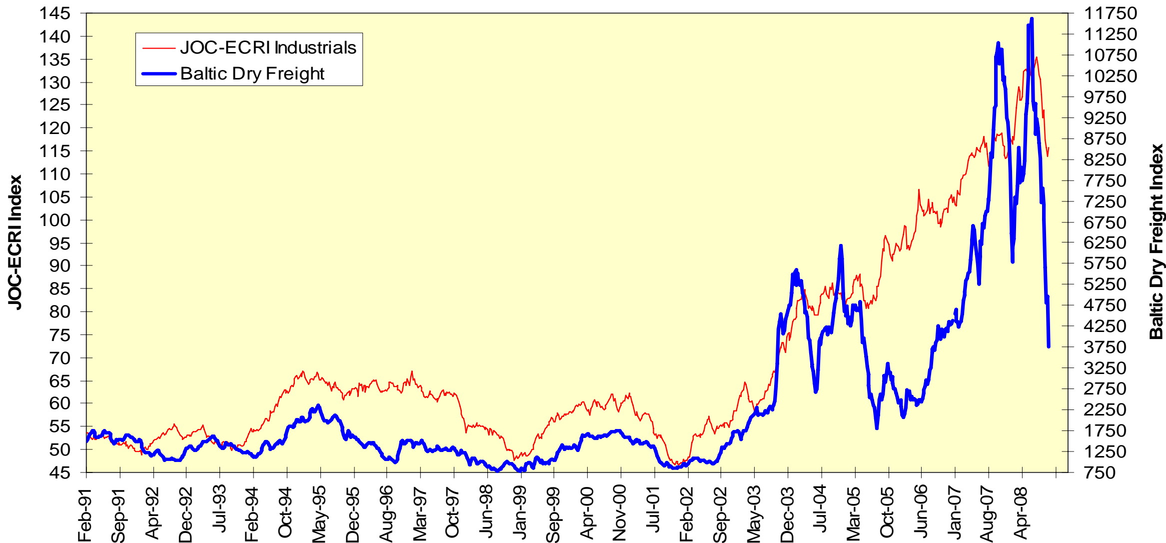
The BDI peaked on May 20, 2008, right at the peak of the U.S. stock market's reaction high after the March Bear Stearns panic. And for you Fibonacci fans, of which I am one, the BDI has lost 68.2% in the four months since.

Interestingly and ominously, Treasury yields jumped after the Fannie and Freddie nationalization and the huge expansion of the Federal Reserve's balance sheet following the loan to AIG. Even though the BDI continues to collapse, Treasury yields have moved higher as the U.S.' credit standing has started to erode. If anyone out there thinks the combination of slower global economic activity as evidence by the plunge in the BDI and higher long-term U.S. Treasury and corporate borrowing rates is bullish, stand and be counted for the unbelievable idiot you are.

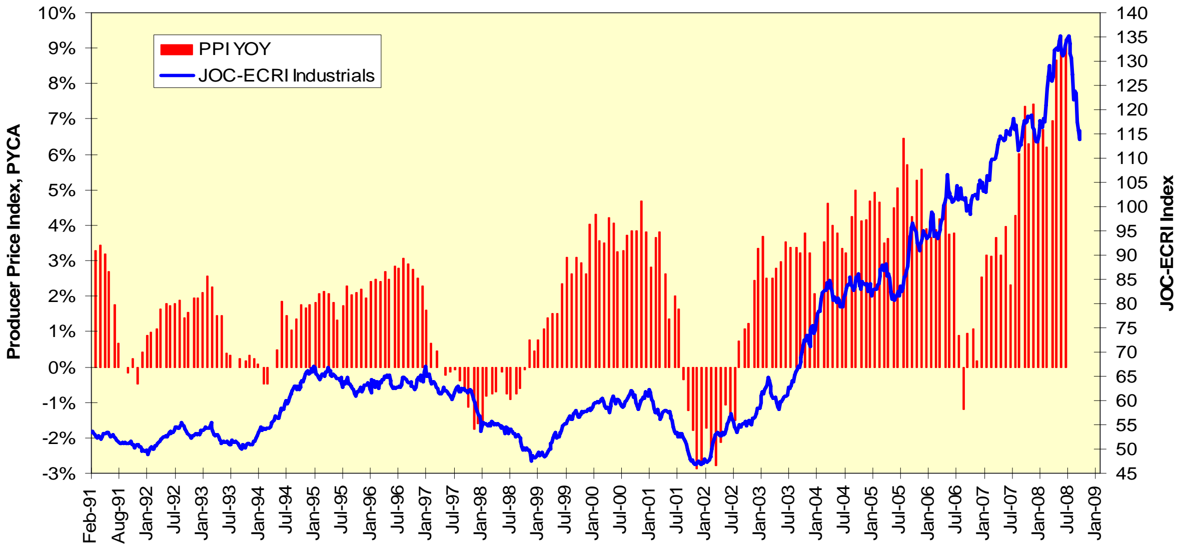


U.S. Industrial Demand

Can we confirm a relationship between the BDI and the Journal of Commerce-Economic Cycle Research Institute's industrial materials index? We should expect this relationship to be a direct one, and it is. The relationship was distorted between late 2005 and late 2006 by the speculative surge in various exchange-traded commodities in the JOC-ECRI index and by additions to the shipping fleet, but the two series are back in synch once again.



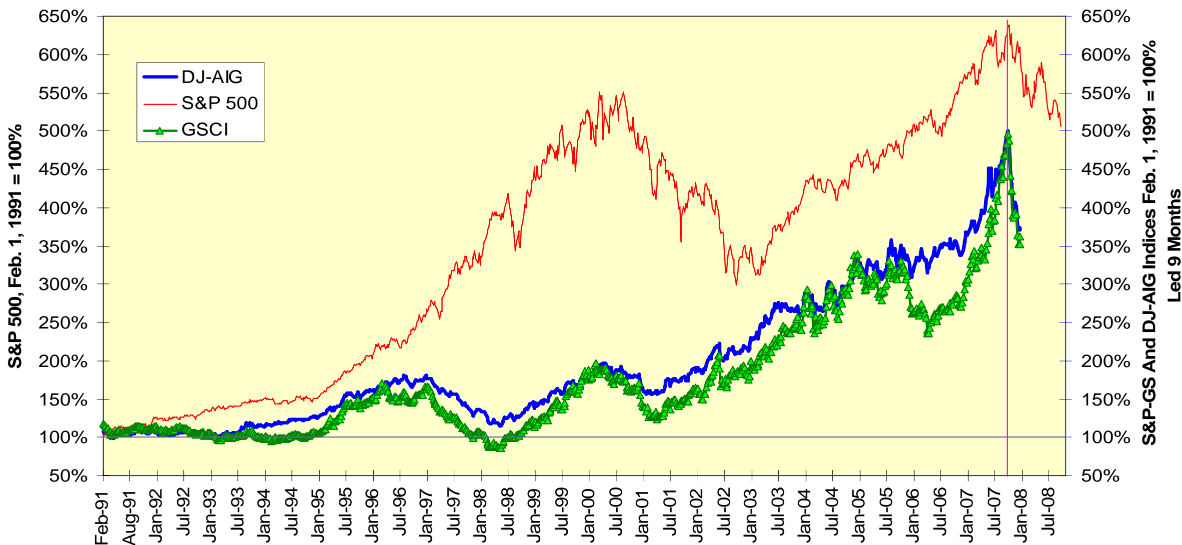
As the JOC-ECRI is designed to mirror the year-over-year changes in the Producer Price Index, its decline should push the PPI lower in the month's to come, all else held equal. All else will not be held equal: We are at very serious risk of deflation if the credit markets continue to deteriorate and if assets continue to be sold to raise cash. If by some miracle an all-clear whistle blows in the credit markets, we will have to make some quick decisions what to do with all that cash injected into the system; if its withdrawal is handled poorly, then inflation becomes a risk. This is true pick-your-poison stuff.



Commodities And Stocks

The hot commodities crowd sold long-only investments by whatever argument worked on a given day. They went from promising roll yield to promising diversification to promising price return. Let's take a look at the diversification argument very briefly. I love diversification as an academic construct; in practice, however, it mostly has allowed me to both make and lose money in many markets simultaneously.

Let's compare the total return on the S&P 500 index to those for both the Dow Jones-AIG and S&P-Goldman Sachs commodity indices led nine months. Once the S&P hit its all-time high in October 2007, the commodity indices kept on gaining into July 2008. Then the nine-month lead time took effect and reality bit. If the relationship holds, we can conclude the golden age of rapacious commodity speculation is in the rearview mirror.



The list of worst-performing sectors since May 20, 2008 is peppered with commodity-linked equities. The list of groups whose return is less than the -13.17% recorded by the S&P 1500 Supercomposite is presented below with commodity-linked groups highlighted in boldface:

Below-Average Groups' Total Return Since May 20, 2008

Group	Return
Trucking	-13.7%
Computers & Electronics Retailers	-13.9%
Diversified Chemicals	**-15.2%**
Housewares & Specialty Stores	-15.2%
Managed Health	-15.9%
Movies & Entertainment	-16.0%
Office Electronics	-16.3%
Consumer Electronics	-16.4%
Integrated Oil & Gas	**-16.6%**
Advertising	-17.1%
Gold	**-17.4%**
Fertilizers & Agricultural Chemicals	**-17.5%**
Industrial Conglomerates	-18.2%
Integrated Telecommunications	-18.8%
Auto Parts & Equipment	-19.1%
Aerospace & Defense	-19.6%
Gas Utilities	-20.4%
Internet Retailers	-20.5%
Electrical Components & Equipment	-20.6%
Industrial Machinery	-21.1%
Wireless Services	-21.6%
Multisector Holdings	-21.9%
Publishing & Printing	-21.9%
Semiconductors	-22.0%
Home Entertainment Software	-22.2%
Electrical Manufacturing Services	-22.6%
Hotels	-22.7%
Commercial Printers	-24.5%
Industrial Gases	-24.6%
Computer Storage & Peripherals	-25.1%
Marine	-25.2%
Oil & Gas Storage	**-25.4%**
Oil & Gas Equipment	**-26.1%**
Oil & Gas Refining	**-26.9%**
Internet Software & Services	-27.4%
Specialized Finance	-27.8%
Semiconductor Equipment	-27.9%
Oil & Gas Drilling	**-28.1%**
Construction & Farm Machinery	**-29.2%**
Oil & Gas Exploration	**-30.7%**
Industrial REITs	-31.2%
Investment Banking & Brokerage	-34.8%
Construction & Engineering	**-35.3%**
Real Estate Management & Development	-35.7%
Casinos & Gaming	-40.8%
Tires & Rubber	-41.1%
Automobile Manufacturers	-42.6%
Coal & Consumable Fuels	**-43.3%**
Agricultural Products	**-44.7%**
Aluminum	**-46.2%**
Steel	**-48.1%**
Diversified Metals & Mining	**-48.1%**
Independent Power Producers	-54.6%
Commodity Chemicals	**-57.2%**
Multiline Insurers	-64.8%
Thrifts & Mortgages	-65.9%

If the message from the BDI holds, we are going to be in for a period of slower global growth and declining industrial production and commodity prices; the continuing downtrend in equity prices reinforces that conclusion. In such an environment, it is unlikely the weak-performing groups seen above will reverse.

Who have the strongest performing groups been since May 20, 2008? It is really a pretty motley crew:

Above-Zero Groups' Total Return Since May 20, 2008

Group	Return
Brewers	22.5%
Education Services	17.3%
Biotech	11.1%
Insurance Brokers	11.0%
Airlines	8.8%
Food Distributors	8.7%
Personal Products	7.7%
Water Utilities	6.0%
Hypercenters & Superstores	5.8%
Household Products	5.5%
Home Furnishings	5.4%
Other Diversified Financial Services	4.9%
Healthcare Equipment	3.7%
Residential REITs	3.5%
Packaged Foods	3.4%
Building Products	3.3%
Specialized REITs	3.3%
Healthcare Suppliers	2.9%
Distillers & Vintners	1.8%
Diversified Banks	1.6%
Paper Products	1.4%
Regional Banks	1.1%
Motorcycle Manufacturers	0.9%
Home Improvement Retailers	0.8%
Household Appliances	0.6%
Healthcare Services	0.4%
Homebuilding	0.1%

If you want to load up on REITs, smaller banks and some consumer staples stocks, go ahead. A safer alternative, one I prefer, is simply riding out the storm until we can see the worst behind us, and that may not be for quite some time. And to add to the depressing thought pile, the last stages of any bear market often produce the most precipitous declines.

That is economic signal. The carnival in Washington is noise in every sense of the word, a distraction that can change the date of the bottom but not its arrival. The sooner we realize this and quit hanging on every tidbit of news, the better off we will be.