Did Energy Prices Blindside Industrial Commodities?

Financial markets move in fashions, and understandably so. After all, it is much easier to buy or sell bonds or stock index futures based on what crude oil prices are doing over any given five-minute period (fifteen minutes for you long-term investors) than to do the hard work common to all successful traders and investors.

And surely the fashion of the past three months has been to keep one key on the crude oil ticker. As anyone who has splurged on a tank of gasoline recently can attest, the money leaving your pocket is now unavailable for other purposes. But, after all of the grumbling and moaning is behind us, we look around with a "hmmpf, I'm still standing," and chalk up the higher energy costs to just another in a series of misfortunes life tosses at us to see whether we are still paying attention.

After all, pundits remind us, the constant dollar prices have been higher in the past, we have reduced the number of BTUs per dollar of GDP produced by 50% over the past thirty years, etc. Yeah, that's crude oil, not kryptonite, so bring it on!

Not so fast: The damage from higher energy prices may be contributing to a decline in other raw materials prices, a decline attributed to either a change in official Chinese policies toward growth or to the much-awaited first tightening by the Federal Reserve later this month.

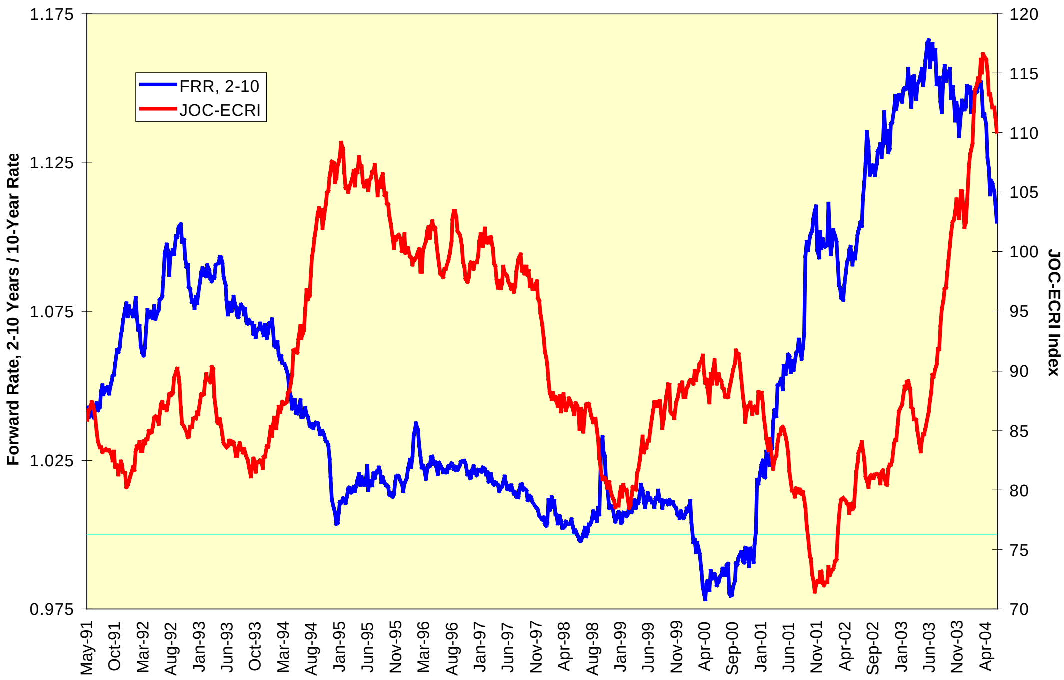
Monetary Policy And Commodities

As discussed here in May, there is no generic entity called "commodities" capable of moving the various physical markets higher and lower with identifiable betas the way stocks can rise and fall with an index such as the S&P 500. But an aggregation of industrial commodities, many of which are not exchange-traded, such as the Journal of Commerce-Economic Cycle Research Institute (JOC-ECRI) index discussed here last December, can provide a valuable corroboration of government-reported economic data as to the strength or weakness of global economic activity.

No one is going to engage in rank speculation on JOC-ECRI index components such as benzene, tallow, polyester or burlap; this is true as well for another of my favorite barometers, the Baltic Dry Freight index, an indicator that has been turning lower for most of 2004. And while I am on the subject of speculation, those who blame traders for pushing oil prices higher really should cease and desist: Speculation can produce short-term distortions in price in any market, but the price cannot stay at this artificial level for long in the absence of fundamental support. Just ask anyone who was holding the bag at Nasdaq 5000.

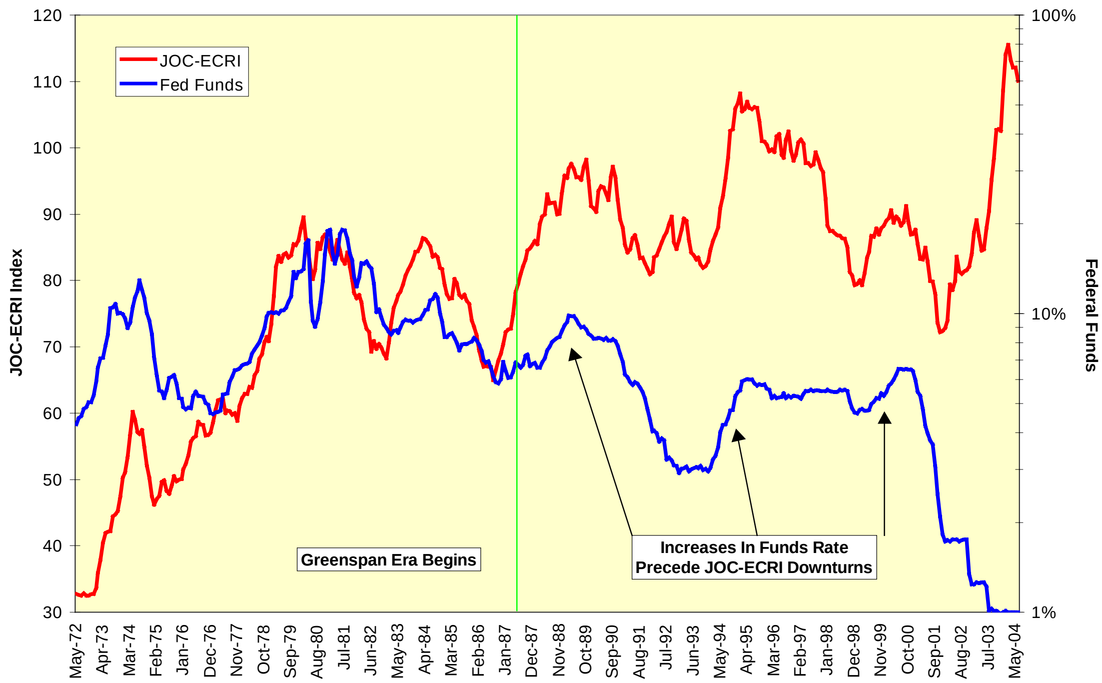
The JOC-ECRI index has turning lower, although not wildly so, since the end of March. This coincides with the almost-100 basis point increase in two-year note yields during the same period, a move made in anticipation of an increase in the federal funds rate. We can take the ratio of the forward rate between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now, to the ten-year rate itself, to proxy for the shape of the yield curve. This measure has led moves in industrial commodity prices.

Yield Curve Leads Industrial Commodities



We can get the same qualitative result simply by looking at the history of the federal funds rate. Each of the three previous tightening cycles of the Greenspan era precipitated a downturn in the JOC-ECRI index. The current transposition of events, the move in commodities ahead of the move in the funds rate, is what demands explanation.

Fed Has Not Tapped The Brakes Yet

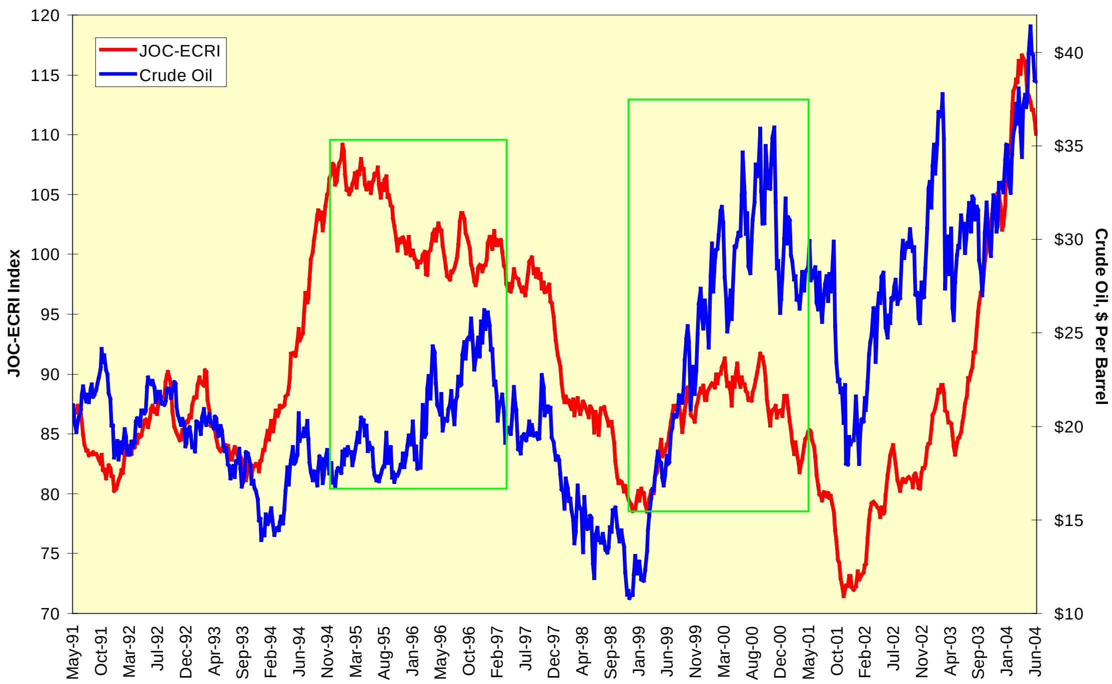


Oil Prices Up, Industrial Commodities Down

If the Federal Reserve has been doing everything in its power to remain as stimulative as it possible for as long as possible, our friends in OPEC have been less cooperative. Just as tighter credit conditions dampen the demand for industrial commodities, so too do higher oil prices. They are a tax, and therefore cannot be stimulative to manufacturing activity.

The two periods of rising crude oil prices since the Persian Gulf War prior to the present market, 1995-1996 and 1999-2000, were both associated with declining values for the JOC-ECRI index. That the JOC-ECRI continued to rise in the face of record oil prices is a testament to both the Federal Reserve's aggressive lowering of interest rates and the magnitude of China's entry into the world materials markets.

Rising Crude Oil Prices Dampen Industrial Commodities

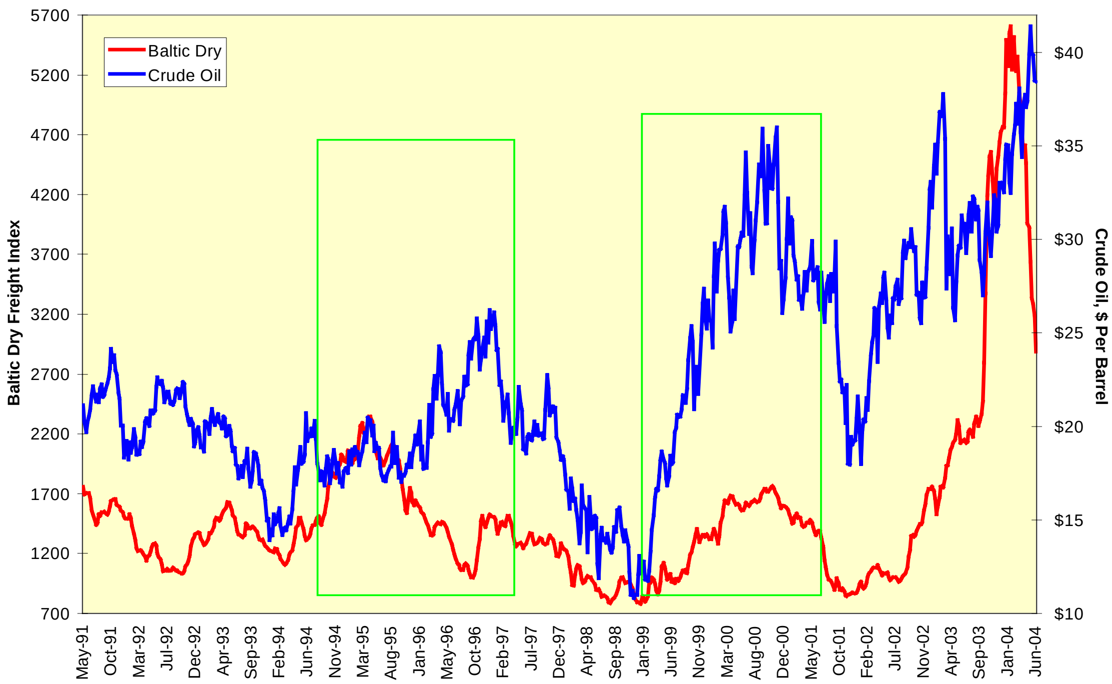


Oil And Freight Rates

Monetary policy, we are told, operates with long and variable lags. While fiscal policies are alleged to operate more quickly, markets have to luxury of watching governments deliberate various alternatives and can anticipate their effects. Higher energy prices are seldom so anticipated, and often are not believed to be enduring even when persist for months on end.

That markets are conditioned to disbelieve higher energy prices is evidenced by the Baltic Dry Freight index. It continued to rise for several months into the two previous periods of higher crude oil prices noted on the chart. Once again, the 2003 moonshot of this index can be attributed to the combined effects of Chinese demand and monetary policies that were measured and patient for a considerable period. The precipitous drop of the Baltic index in recent months is not at all consistent with strongly growing demand for industrial materials.

Freight Rates Respond Slowly But Surely



Threading The Needle

The combination of developments above leads us in a roundabout way to conclude that higher oil prices may have done some of the Fed's work. The threat of higher interest rates and the implied tax of higher oil prices have cooled industrial indicators such as the JOC-ECRI index and the Baltic Dry Freight index. If the Fed can remain measured and patient for a considerable period - and hasn't it promised this in all or part several times? - we might yet duplicate the only soft landing in our history, that of 1994.