Games With Commodity-Linked Equities

"When you trade a sympathetic market, all you get is sympathy." – Howard L. Simons

Stock traders like to trade stocks, and commodity traders like to trade futures. There is nothing wrong with either group's preference so long as confusion between the two worlds is avoided. And for the most part, this confusion was avoided prior to May 2003; this date coincided with both the end of active hostilities in Iraq and the Federal Reserve's so-far successful war on deflation. After May 2003, however, a general commodity boom – bubble, if you prefer – started to blur the line between commodity-linked equities and commodities themselves. As the quote above suggests, those who trade stocks as substitutes for commodities are likely to come to grief for their efforts.

Very briefly, commodity-linked equities should come in three flavors and exhibit three different behaviors. The first and most prominent in our minds are the stocks of commodity producers, such as Phelps Dodge for copper or Newmont Mining for gold. We should expect these stocks to act as call options on the commodity itself, rising early and quickly in a commodity move and then falling more slowly when prices turn lower as the firms get to shut in their highest-cost production first.

The second class of commodity-linked equities is that of commodity consumers, such as DuPont for natural gas or any airline for jet fuel. We should expect these stocks price patterns to resemble put options on the commodity itself, rising rapidly when the commodity falls and underperforming when the commodity rises in price. This last point needs to be emphasized: Even for heavy commodity buyers such as Kraft Foods or ConAgra, the commodity is still a relatively small part of the firm's cost structure. Very rarely do we see a headstone reading, "Killed By Soybean Oil." For the most part, firms are able to pass on higher commodity prices to their customers; chances are your local natural gas utility is accomplished in this art.

The final class is that of commodity processors such as petroleum refiners such as Valero or soybean crushers such as Archer-Daniels-Midland. These firms' fortunes tend to rise and fall like a call option on the overall process margin level, but the effect generally is muted. Barring a shock such as 2005's Hurricane Katrina pushing refining margins into uncharted waters, we generally do not see wild action in these markets.

Show Me The Index

So saying is there such a thing as "commodity-linked equities?" In this age of indices and exchange-traded funds, of course there is. The Goldman Sachs Natural Resources index (GSR) is sort of the partner-in-crime to the Goldman Sachs Commodity index (GSCI), a widely used benchmark for institutional commodity investors. The GSR, like the GSCI, is very heavily weighted toward energy issues.

Here is the industry group breakdown of the GSR is shown below. It is really an energy index with a few other things thrown in to be sociable.

Goldman Sachs Natural Resources Index Composition

Oil & Gas	**78.85%**	
Integrated		34.78%
Exploration & Production		21.24%
Services		11.05%
Drilling		6.26%
Refining & Marketing		3.55%
Equipment		1.96%
Mining	**11.01%**	
Gold		4.37%
Aluminum		2.66%
Diversified		1.93%
Copper		0.92%
Non-ferrous		0.92%
Diamonds/Precious Stones		0.14%
Precious Metals		0.07%

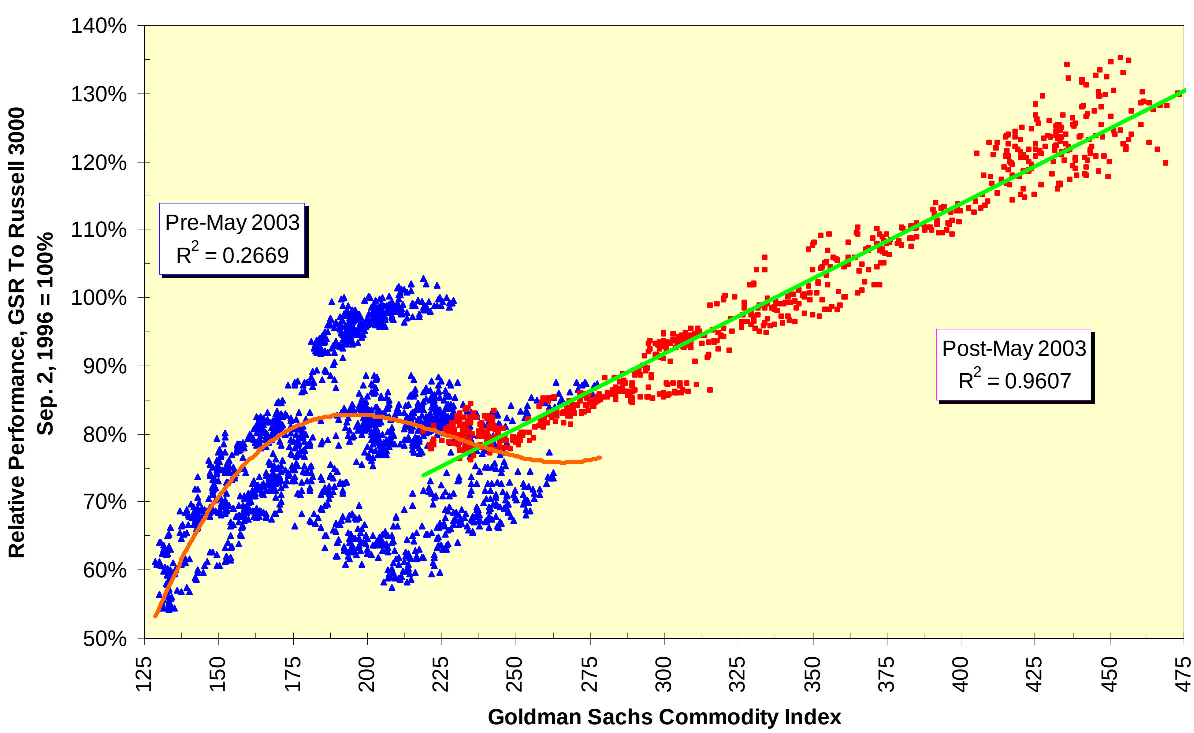
Pipelines	**3.95%**	
Forest Products & Paper	**3.69%**	
Paper & Related Products		2.29%
Forestry		1.40%
Coal	**1.55%**	
Chemicals	**0.29%**	
Engineering & Construction	**0.23%**	
Packaging & Containers	**0.15%**	
Iron/Steel	**0.14%**	
Energy-Alternate Sources	**0.09%**	
Miscellaneous Manufacturing	**0.07%**	

Go With The Flow

We live in a world where financial flows can push prices beyond fundamental valuations; this statement holds even if we have no idea what the fundamentals of any market imply for price. Throw enough money at tech stocks, residential real estate or copper, and its price will rise as sellers disappear in amazement. This is truer for commodities than many of us realize. Corn is the largest U.S. food crop. Let's use the generous figures of 10 billion bushels of corn grown at an average farm price of $2.50 per bushel for 2006 for a total gross crop value of $25 billion. That's a lot of money for most of us as individuals, but how would that entire crop rank amongst U.S. equities? At the time of this writing, that's the market capitalization of Franklin Resources, the mutual fund manager, and it is Number 111 out of the S&P 500. Corn, dare we say, is small potatoes.

It does not take much diversion of financial flows into commodities to produce major changes in prices and trading patterns. This is happening right now in commodities and commodity-linked equities. Let's map the performance of the GSR against the broad-based Russell 3000 index as a function of the GSCI in Chart 1. We can divide the comparison into two segments, the September 1996 inception of the GSR until the Federal Reserve's declaration of war against deflation in May 2003, and from May 2003 onwards. At the May 6, 2003 meeting of the Federal Reserve, the central bank promised to do whatever it took to prevent deflation. Mission accomplished, as they say.

Chart 1: Money Changed Trading Patterns



It would be hard to look at this division – and the pre-May 2003 points are in blue and the post-May 2003 points are in red on all charts - and not wonder why the expected weak relationship of 1996-2003 suddenly changed. After May 2003, the GSCI surged higher on strong economic growth worldwide and on the Federal Reserve's successful if unintended stimulus of China. Lower interest rates are supposed to stimulate consumption, and they did, but with the cheapest source of production in the dollar zone being China, the most immediately beneficiary of low U.S. interest rates were Chinese exporters. And those exporters needed raw materials, hence the commodity boom.

Moreover, long-only commodity index funds really took off as an investment vehicle at this time, and have been distorting markets ever since. While "buy low, sell high" is a proven money-making technique, anyone who has ever tried to sell any investment knows "buy after the price has risen, sell when you can't take it anymore" is a more common investment strategy in actual practice. Professional investors are no exception to this herd mentality; investment funds chase performance in financial markets. And commodities were performing.

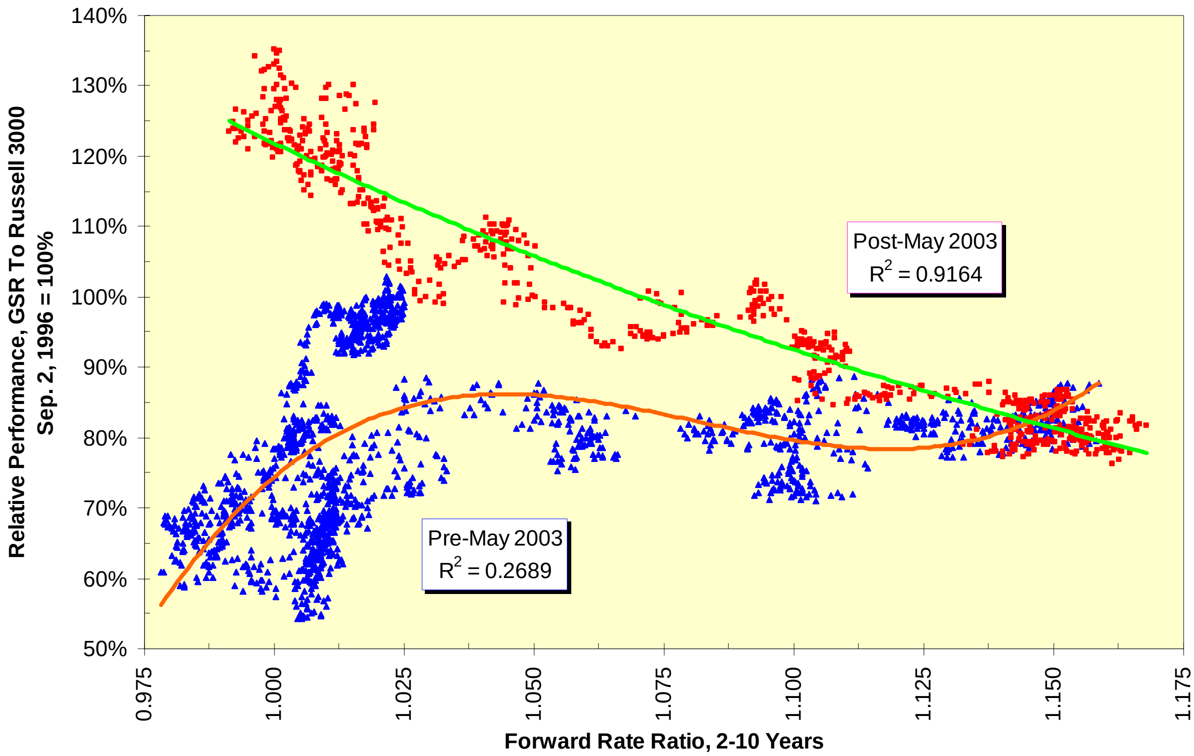
As the U.S. financial regulatory system treats securities accounts and futures accounts are treated differently, many investors who are quite aggressive in their securities trading do not even have a futures trading account. If the bull run in commodities could be accessed by a securities vehicle, great. The end result is the pattern seen in Chart 1. Instead of trading crude oil, investors bought ExxonMobil, or instead of trading copper, investors bought Phelps Dodge. That forced the GSR into looking like the GSCI. The two will look alike for as long as the commodity bull market continues.

The Money Game

If the combination of strong economic growth and a Federal Reserve willing to err on the side of stimulus coincided with the start of the commodity boom, should we expect to see a reversal of these developments when the Federal Reserve began raising interest rates?

Let's map in Chart 2 the relative performance of the GSR to the Russell 3000 against the shape of the yield curve as measured by the forward rate ratio between two and ten years. This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve; values less than 1.00 indicate inversion.

Chart 2: Tighter Monetary Policy Was Ignored

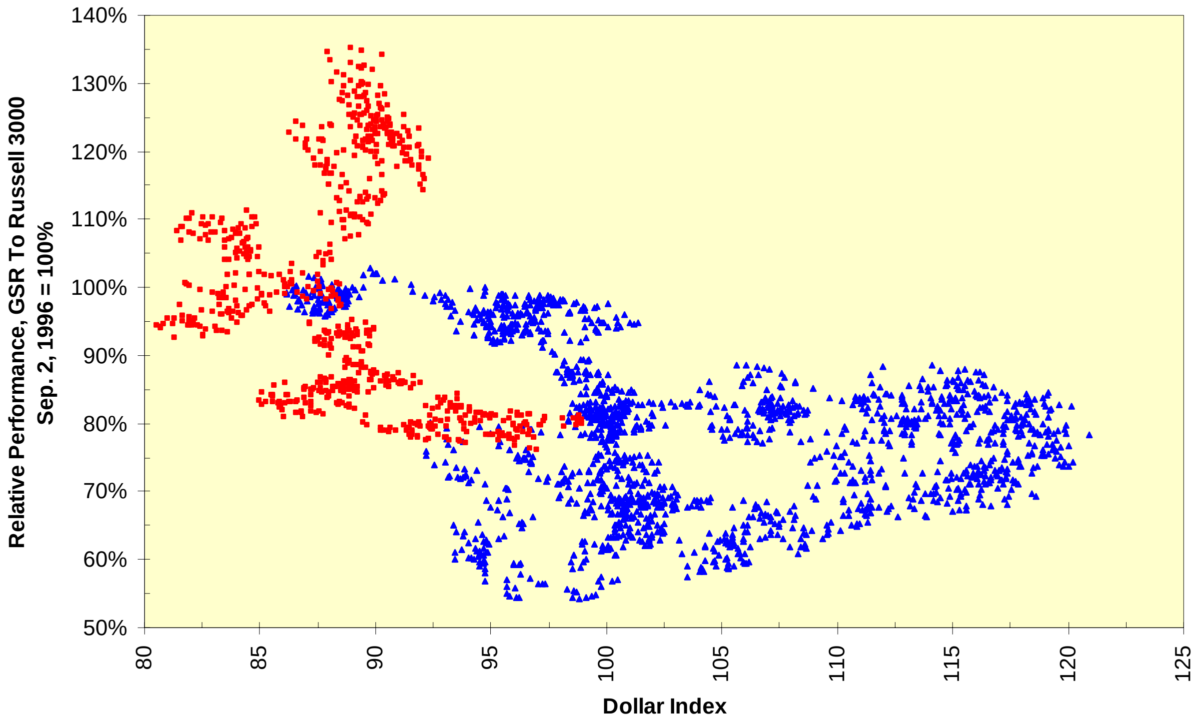


Prior to May 2003, the GSR lagged the broad market when the yield curve flattened. After May 2003, the opposite occurred; as the yield curve flattened, these supposed harbingers of easy money shot higher. The reasons are obvious: The same strong global growth that pulled commodity prices higher encouraged the Federal Reserve to keep on raising interest rates. Until and unless long-term interest rates start to rise or the world encounters a global recession, commodity-linked equities will be able to withstand tighter monetary policies.

Closely related to the yield curve and the question of whether higher commodity prices are a monetary phenomenon is the relationship between the dollar and commodities. Despite years of evidence suggesting commodity indices such as the Reuters/Jefferies CRB index and the dollar index are unrelated over any time span of your choosing, the myth persists and will persist. After all, if the dollar is a claim on stuff, and each dollar buys less stuff, then the dollar price of stuff should rise. Nice theory; too bad it has not worked for the 35 years of floating exchange rates.

As we can see in Chart 3, the relative performance of the GSR to the Russell 3000 did not change after the May 2003 switch point. Just as the dollar affects commodity prices much less than we believe, it does not appear to affect commodity-linked equities at all.

Chart 3: The Dollar Has Not Mattered Yet

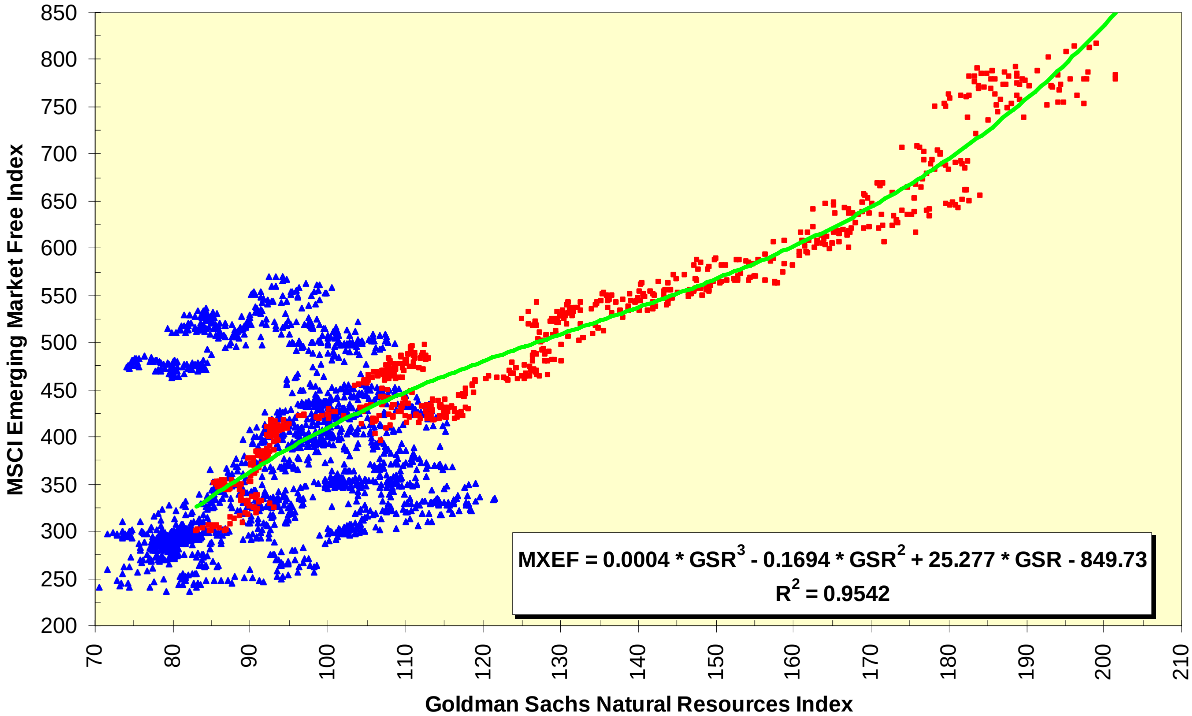


A Small World After All

If you still want to play commodities via equities, one of the best ways of doing so is through the indirect beneficiaries of the indirect beneficiary of the Federal Reserve's loose money policies. China was the indirect beneficiary, and since Chinese equities have been notoriously bad investments over the past five years, losing more than 10% annually, the best way of trading China is trading China's suppliers. These include many of the emerging market economies of South and East Asia such as Korea, Taiwan, India and names last seen imploding during the 1997 Asian crisis, Indonesia, Thailand and Malaysia.

If we map the Morgan Stanley Capital International Emerging Market Free index (MXEF) against the GSR and use the same May 2003 dividing line in Chart 4, another remarkable pattern emerges. Prior to May 2003, no relationship exists; we cannot even force one and pretend. After May 2003, the relationship becomes cubic: The more the GSR rises, the more rapidly the MXEF rises. These economies have accelerated to the point where higher short-term interest rates, the direct cause of the 1997 Asian crisis, have not hurt them. Restated, emerging markets are acting as if they have emerged after all these years.

Chart 4: Commodities And Emerging Markets



Of course, all this good clean fun of trading commodity-linked equities and emerging markets instead of commodity futures will come to an end someday. The party will be over, and as they start mopping the counter and turning the chairs upside-down on the tables, you will still have great trading opportunities in commodities: Unlike stocks, they are easy to trade from both the long and the short side.