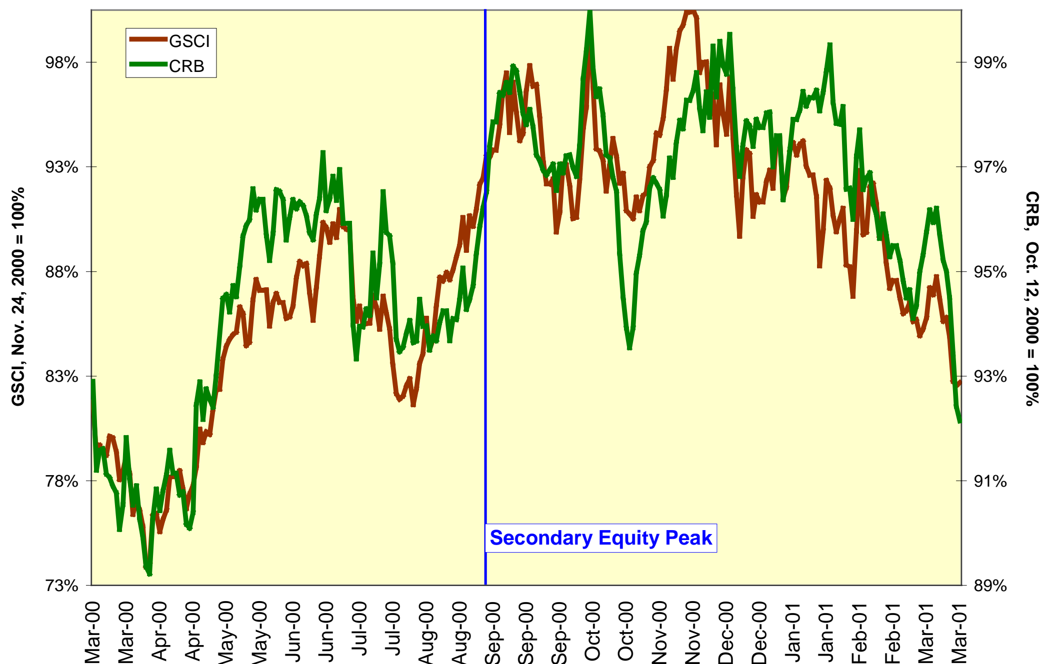
Some Cheer From Commodities

It was a dreadful week at the end of a year that had seen explosive moves higher, moves into uncharted territory, and finally erosion back to levels first visited years ago. We are talking, of course, about the principal commodity indices, the Bridge/CRB and the Goldman Sachs (GSCI). The CRB index is weighted more heavily toward agricultural commodities, while the GSCI is weighted more heavily toward energy and metals.

Financial markets have developed a pathological, Pavlovian focus on the Federal Reserve: When markets soar, we're afraid of getting spanked. When markets swoon, we expect – nay, demand – a quick monetary fix to get us through the day. This Wall Street obsession with the Wizard is a convenient substitute for doing homework and real analysis. It is symptomatic of our larger social problem with due diligence: Has anyone else wondered why so many scoops on both sides of the Atlantic are being broken by old-style reporters for the tabloids, and not by the self-styled celebrity reporters?

Commodity Price Downturns Accelerate



Both indices have paralleled equities over the past year, a most unusual and somewhat puzzling occurrence. Commodities reflect current economic conditions, while equities are alleged to discount future economic conditions. Commodities peaked after the stock market hit a secondary peak on August 31, 2000; this was due almost solely to the incredible jump in natural gas prices last fall. Both stocks and commodities have, ahem, struggled in 2001. The present downturn in commodity prices can be attributed to a number of special causes, such as the mad cow and hoof-and-mouth scares roiling European livestock markets, but these are the temporary excuses that pass for fundamental analysis. Inevitably, a collapse in commodity prices is associated with the end of a too-tight monetary environment, an ongoing downturn in demand, or both. The recession part still isn't clear, but there can be little doubt, as noted several times in this space, that monetary policy was way too tight for too long in 2000, a mistake being unwound at present.

Deflationary Signals From Commodities -- At Present

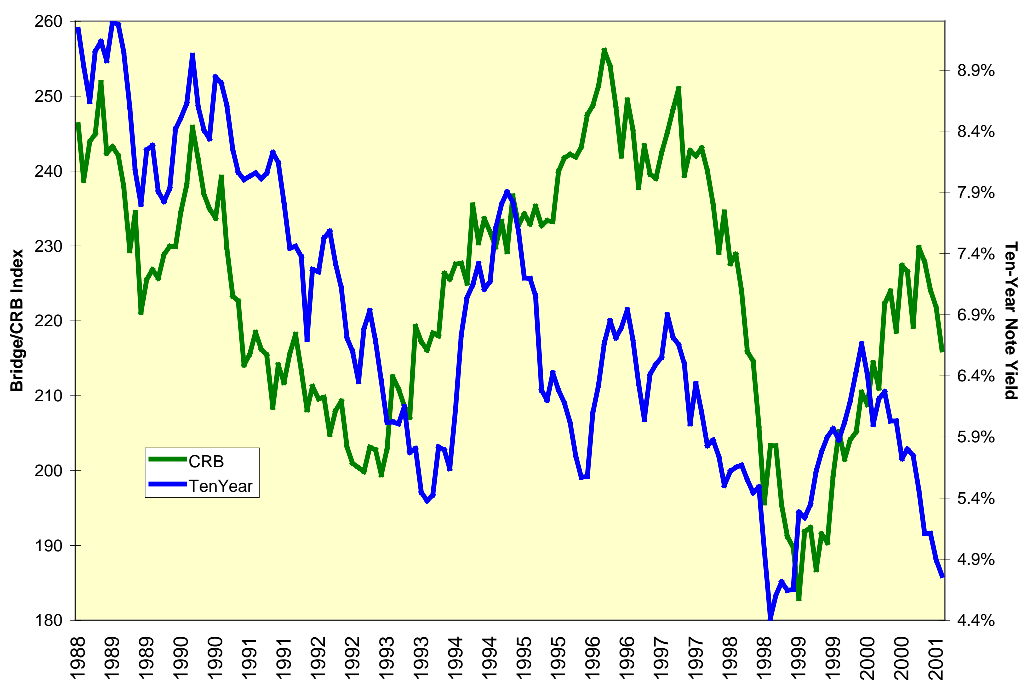
One of the toughest concepts to teach students with financial market experience is the forward curve in physical commodities. These curves reflect both current supply/demand balances and price expectations for the future. It is not at all unusual for a market in a rocketing uptrend to exhibit backwardation, or a declining forward curve; this can be interpreted as the market expecting a price decline in the future. The opposite holds in the situation called

contango; here a supply glut and falling prices can be accompanied by expectations for strongly rising prices in the future.

While many commodity prices outside of the energy and livestock sectors are still quite depressed, they are either exhibiting decreased levels of backwardation or outright contango. Moreover, the forward curves and intermarket spreads of many financial futures share this viewpoint: Yield curves are becoming steeper, indicating both modestly higher inflationary expectations and increased credit demands in the future. The U.S. dollar uncharacteristically has strengthened in the face of the recent stock market selloff. In other words, things are bleak now, but the futures markets expect them to get better.

A commodity price deflation caused by production efficiencies is good news for all but primary commodity producers. These situations inevitably are associated with a fall in interest rates and a subsequent increase in equity prices. If, however, the fall in commodity prices is due to a collapsing economy, all bets are off: This is the sort of deflationary recession seen globally in the 1930s and in Japan from 1990 to the present. Despite the pronounced weakness in many sectors, there's still no evidence of such an economic calamity on the horizon, so we will dwell no further on this unhappy scenario.

The longer-term relationship between the CRB and ten-year note yields is interesting. Interest rates have tended to fall before commodity prices, and only once, in 1993, did an upturn in commodity prices presage a rise in interest rates. Yet note yields continued to fall between 1995 and 1997 even as the CRB rose; this is consistent with the view expressed here many times that higher commodity prices do not cause inflation if monetary policy is stable. Only one conclusion can be drawn with certainty: Downturns in commodity prices always lead to further declines in interest rates, and this is unalloyed good news.



A Do It Yourself Tax Cut

The huge jump in energy prices that started with crude oil in March 1999, continued with natural gas all through 2000, and manifested itself so spectacularly with the self-inflicted California electricity crisis acted as a massive tax increase on an already over-taxed economy. Since more than half of our petroleum is imported, nearly 12.5 million barrels per day, each $1.00 per barrel increase contributes more than $4.5 billion per year to our trade deficit. Crude oil prices are down more than $10 per barrel from last summer's highs, so that's a $45 billion tax cut.

The news from natural gas is even better. While the present $5.00 per million BTU price is still higher than anything seen prior to 2000, it's half of the peak reached in early December. With the U.S. consuming more than 2.2 trillion BTU per month, each $1.00 decrement in price works out to a saving of $26.5 billion a year.

Throw these commodity price tax cuts on top of monetary stimulus and whatever tax bones Congress throws our way, and we should see macroeconomic stabilization and growth come our way soon. Maybe that won't translate into tech stock profits next week, but it's a start.