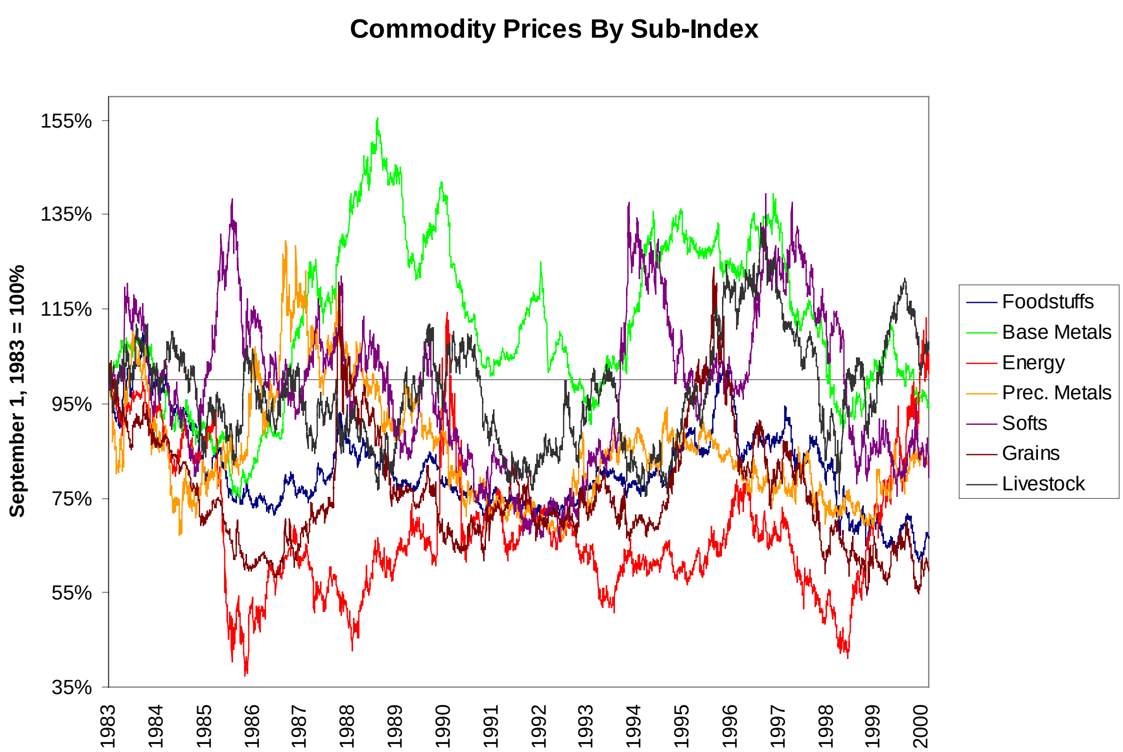
A Commodity Rally: What Would It Take?

One of the troubles with being subtle is contrasting yourself with the fellow next to you beating on a big bass drum and shouting through a megaphone. This has been the trouble with non-energy commodities in general over 1999 and 2000: While natural gas and petroleum are making a lot of headlines and a lot of noise, much of the world of primary commodity production is still stuck in a deflationary spiral.

Of course, the energy commodities deserve the attention they're getting. After all, three of the last three recessions can be traced in all or part to rising oil prices, and recent events highlight the continued vulnerability of oil consumers to supply disruptions. However, central bankers are no different than generals in their instinct to fight the last war. They associate their lassitude in response to the first oil crisis of 1973-74 with the inflation of that period, and they have vowed to remain preemptively tight in the face of higher energy prices. However, inflationary pressures had been building since the late 1960's, and it is probably more appropriate to say inflation led to high oil prices than the other way around.

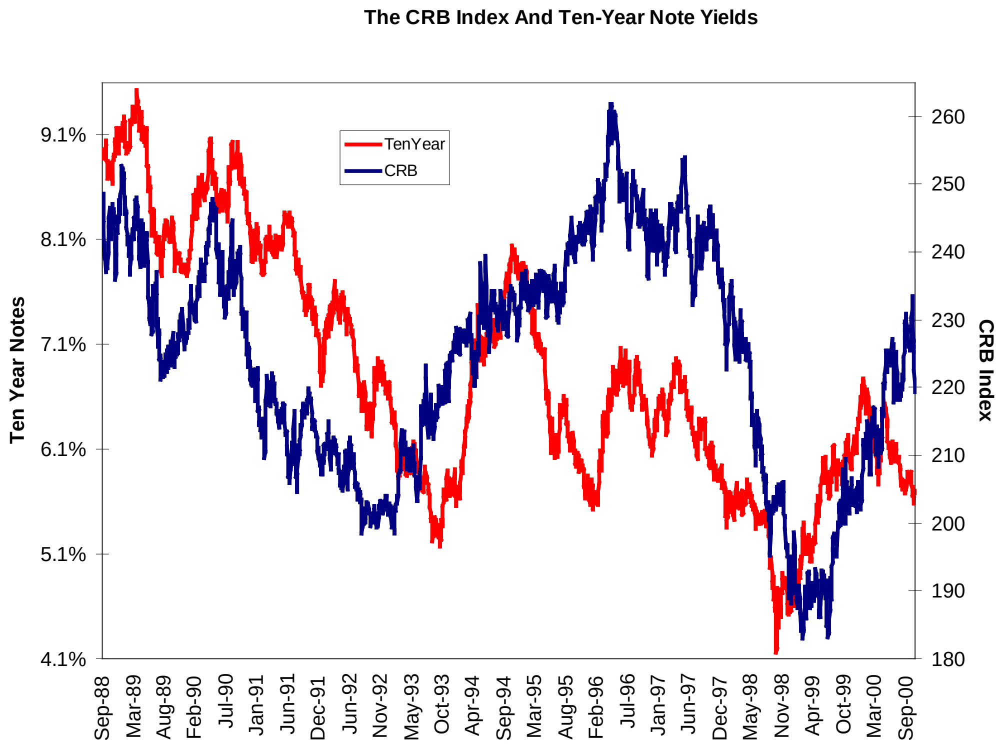
Find The Missing Trend

Regardless of our interpretations of history, the notion commodity prices rise over time is seated deeply in our culture despite massive evidence to the contrary. The simple fact of the matter is that we are very good at improving our production efficiencies and driving prices lower across a wide range of goods. If we examine the various commodity sub-indices published by the Commodity Research Bureau, we find only two groups, livestock and energy, trading at higher levels, 106% and 101%, respectively, than they did in September 1983. Both the Grains & Oilseeds and Foodstuffs sub-indices are trading at less than 70% of what they did more than seventeen years ago. Nothing here suggests anything resembling an inflationary trend; moreover, if you were to tell someone in 1981 that crude oil prices would be less than $35 per barrel in 2000, his reaction would have been one of relief, not panic.



The bond market is alleged to trade in an inverse manner to commodity prices, although this relationship often is honored more in the breach. If we look at the movement of Treasury note yields against the aggregate CRB index since 1988, we find periods such as September 1988 - December 1992, when both commodity prices and interest rates were falling, and period such as September 1999 - January 2000, when both measures were rising. We also see periods such as January 1995 - June 1996, when the CRB was rising and interest rates were falling. Crude oil prices were rising during this period, but the bond market simply didn't care. This has been the case as well for much of

2000; crude oil and natural gas prices have soared, while bond yields have been falling since January in anticipation of slower economic growth.



A Global Link

Much of the deflationary pressure on commodities, in addition to tight monetary policies, derives still from the Asian and Russian financial crises of the 1997-98 period. The combination of slowing global demand and increased need for export earnings led to a supply/demand imbalance for commodities as diverse as livestock, coffee, cocoa, soybeans, and of course, crude oil. The supply overhang for crude oil was dissipated by OPEC's production cutbacks beginning in March 1999; no other commodity has such a production restriction mechanism, however, and prices have remained soft.

Once it became apparent that the world was not going to totter into a financial abyss, the central banks began tightening credit, and this has maintained downward pressure on commodities through both an impending economic slowdown and through a stronger dollar.

Of course, all economic cycles contain the seeds of their own undoing, and this one will be no different. At some point, probably in the aftermath of the November election, the Fed is going to have to relax monetary policy, if for no other reason than to avoid disarray in the corporate bond markets and a perpetual decline in the euro. This will inject more liquidity into the system and increase the supply of money available to chase goods. At the same time, little new investment is going into acreage expansion on farms or new mining facilities, and this will decrease the supply of goods available.

The result will parallel the fiascoes we have seen to-date in the natural gas market and in the electricity market, where demand increases overwhelmed existing production capacity. This isn't to predict a 150% increase in soybean prices like we have seen for natural gas, but all it would take for a huge grain rally at this point is poor growing weather in one major farming region around the world. After all, as the bumper stickers say, things happen.