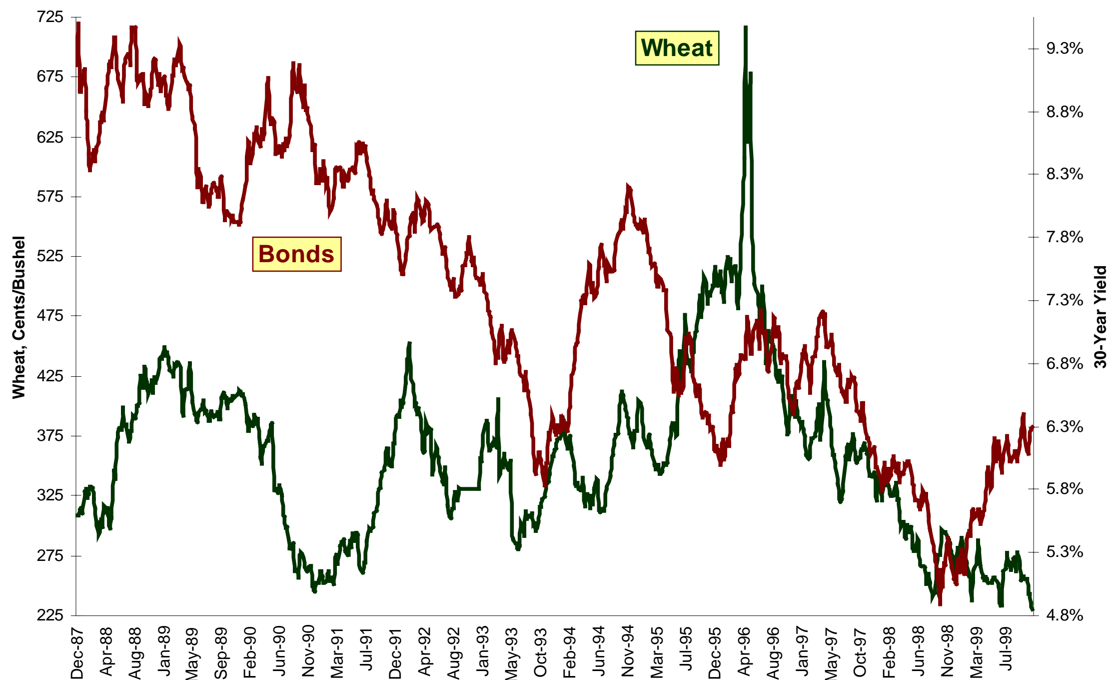
Thy Daily Bread

The subject of deflation, a serious concern for many during the two-year period between mid-1997 and mid-1999, has disappeared from most financial radar screens. The two most obvious reasons for this change in sentiment have been the resurgence of crude oil prices and the global recovery in economic activity.

One sector of the economy still affected by the syndrome of falling prices and increased production is agriculture. Higher grain prices were once as synonymous with inflation as higher energy prices. Floor traders in Chicago made a direct link: "When the beans fly, the bonds die!"

Well, it's been a long time since any bond trader glanced at grain prices for clues as to the direction of interest rates. This year has seen multi-decade lows in both wheat and soybean prices just as it saw multi-decade lows in heating oil prices. The grain markets have no equivalent of OPEC to come to their rescue, and so long as growing weather in major growing regions remains cooperative, grain prices should remain under pressure.

The extent to which grain prices and bond yields have disconnected would amaze someone awaking from a coma begun in the late 1970's. While bond yields fell steadily from the aftermath of the 1987 crash to the start of the Persian Gulf War, wheat price rose nearly 30%. A collapse in wheat during 1990 coincided with an increase in bond yields, and a long rally in wheat from 1993 through 1996 saw both a sharp rise and fall in bond yields. The two markets mirrored one another from the May 1996 through October 1998, but since have diverged.



Depends On What You Mean By "Inflation"

While we have chose wheat as a representative agricultural commodity, we could have chosen any number of others. Soybeans, sugar, cocoa, and hogs all have witnessed long-term price deterioration. Had this article been written in December 1998, the petroleum complex or gold surely would have been chosen for a

case study. The point is simple in any case, with some notable short-term exceptions like that seen for wheat in 1996, commodity prices are in a long-term decline. This should be the case; if producers did not become more efficient, they would be facing substitution from new supplies. While the world's population has doubled over the past four decades, food production has never been higher, and real food costs have never been lower.

The implications of this trend for producers of primary commodities are unpleasant. The economic value of a bushel of wheat has not increased significantly over any length of time, nor is it likely to do so. The equipment, fertilizer, pesticides, and genetic services a farmer buys all have increased in both productivity and price relative to farm output. The result is a permanent deterioration of terms of trade for commodity producers, both individually and collectively.

Commodity producers strapped for revenue often are forced into flooding new supply into the market. The Russians have been notably good at this, and have contributed to the price collapses this decade of such diverse commodities as aluminum, gold, and crude oil. While commodity price collapses lower price indices, they singular events, not longer term increases in efficiency. E-commerce, on the other hand, is a long-term increase in efficiency, and should aid in reducing inflationary pressures for a long time to come.

If we are to look for inflation -- and until the generation who grew up during the 1960s and 1970s retires, we will continue to look for inflation anywhere and everywhere -- we will need to look for evidence outside of base commodity prices. The exchange value of the dollar, the spread between nominal yields and inflation-adjusted yields, and even the risk premium for equities as opposed to bonds are likely candidates.

Reductions in supply, be they of labor or of crude oil, do not appear to be causal of true inflation. The alleged tradeoff between inflation and unemployment contained in the Phillips Curve has not operated in periods of high inflation and high unemployment, such as the 1970s, nor in periods of low inflation and low unemployment, such as the 1990s. Surging equity prices, a favorite worry of the Fed over the past few years, appear to reflect declining inflationary expectations, and certainly do not appear causal of future inflation. How else can be explain how warmly the stock market has greeted the series of rate hikes during 1999?

One fine day, the price of wheat will rise again, and this will contribute to an increase in certain price indices. Unless you see confirming evidence of inflation from financial markets, hang on to your bonds. Inflation it's not.