No Commodity Darkness On The Edge of Town

An analyst cannot always be correct on market calls; right or wrong only can be established in retrospect and only after the intercession of unexpected events. But intellectual honesty is always achievable and can place you in the enviable position espoused by 19th century British Prime Minister Benjamin Disraeli who counseled his fellow statesmen to, "never apologize, never explain."

Of course, Disraeli's most lasting contribution to Western civilization may have the use of his name on the 1967 Cream classic *Disraeli Gears*. The seminal power trio is soon to be reunited in a series of concerts. Suffice it to say nothing in the past thirty-five years of lip-synching garbage by those unworthy of being their groupies has even approached their stunning live performances.

Industrial Commodity Linkages

But I digress. The topic today is to revisit a question posed back in December 2003 whether rising industrial commodity prices would derail key financial markets. I concluded, "If you believe, as I do, that the coming weeks and months will see a continuation toward higher commodity prices across all indices, be wary of comments attributing whatever happened that day to whatever happened in commodity prices, major news events excepted."

In retrospect, the advice turned out to be correct. No one in December 2003 foresaw crude oil's romp to $55 by October and a series of all-time highs in the Journal of Commerce-Economic Cycle Research Institute (JOC-ECRI) index of industrial commodities. Certainly no one would have added these developments to five increases in the federal funds rate, real GDP growth in excess of 4% and an uptick in inflationary expectations to their highest levels since the onset of the Asian crisis in 1997 and concluded that ten-year notes would have total returns better than 5%.

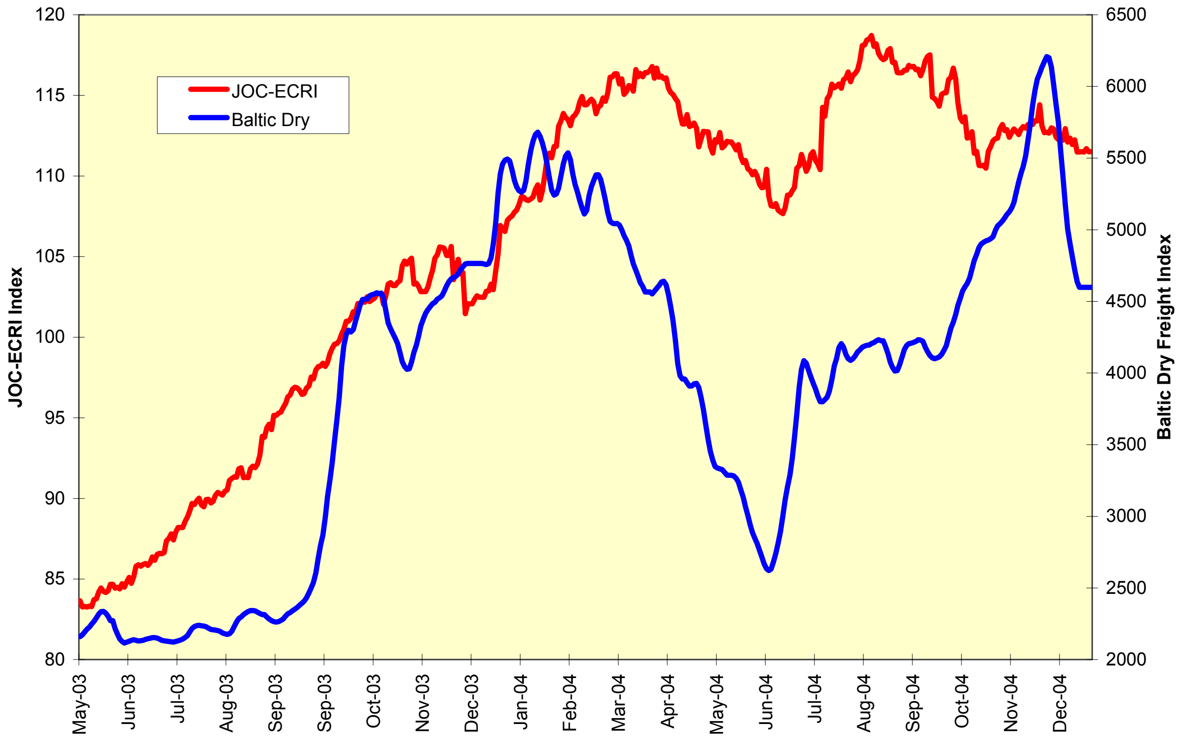
As noted in a January 2004 article on why, ironically, a stronger dollar posed a greater threat to financial markets than the shellacking ultimately endured by the greenback, "In markets, when you know what everyone else knows, you know nothing."

Given all this windup, are the present downturns of favorite indicators such as the JOC-ECRI and Baltic Dry Freight indices cause for concern? From a macroeconomic perspective, the answer is a guarded "yes." From a financial market perspective, the answer is, "no; markets do fine with slow growth, thank you very much."

The JOC-ECRI index had been moving in a virtual straight line higher going into April 2004, the time at which the need for the Federal Reserve to start raising rates became apparent. It peaked in late August, the time of crude oil's first approach of $50, and has declined gradually since.

The Baltic Dry Freight index has spent the last five calendar quarters undergoing some dramatic swings, most of which have been attributed to China's on-again, off-again policies on cooling its economic growth rate. Its 26% plunge since December 6, 2004 is indisputable evidence of a slowdown in shipping demand; the JOC-ECRI index declined a hefty 10.7% over the same four-week period.

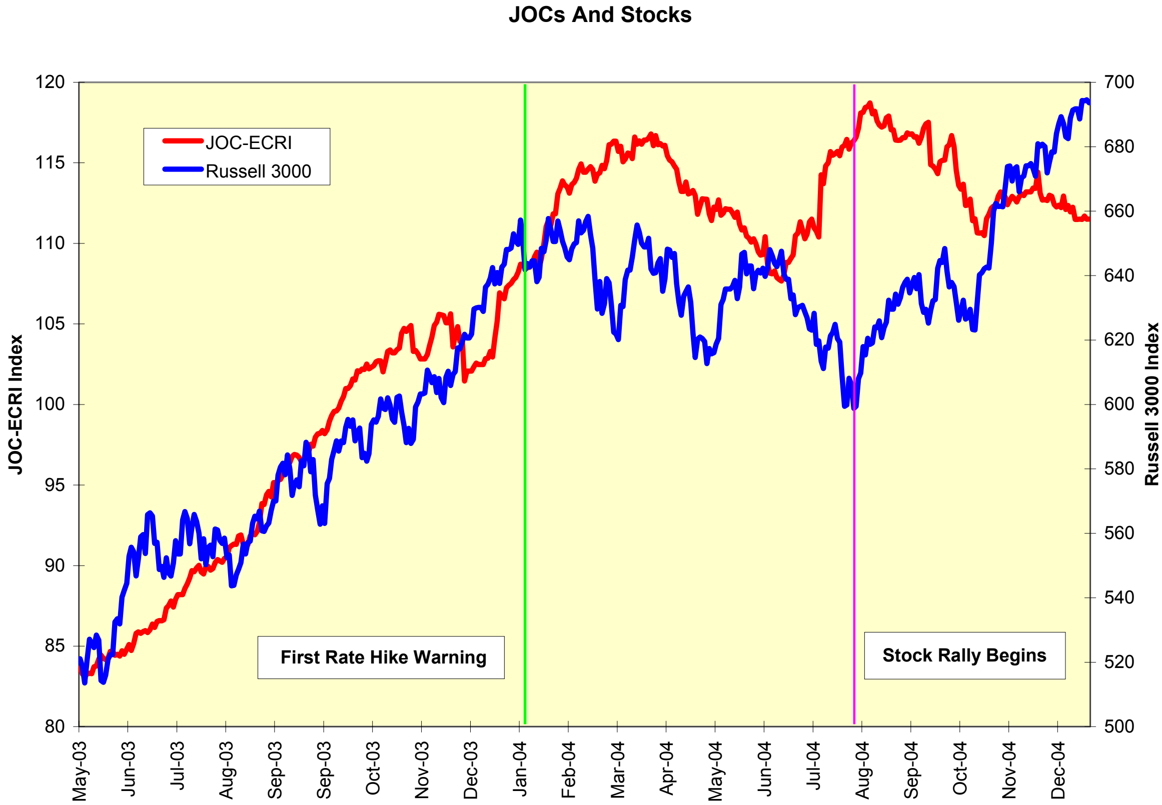
Not A Downturn Of Significance - Yet



Market Impact

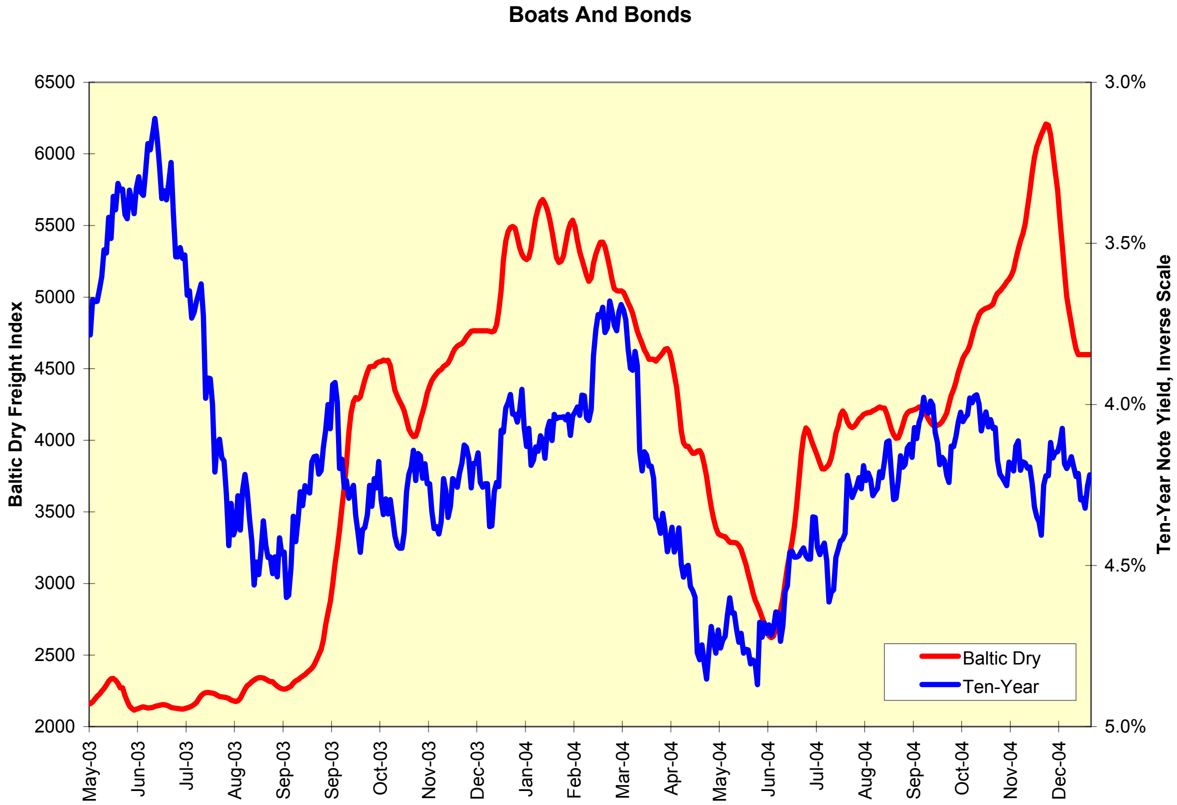
The relationship between industrial commodity prices and stocks is anything but constant. Both stocks, as represented by the Russell 3000, and the JOC-ECRI rose in a parallel manner during the market liquidity rally of 2003. Once the Federal Reserve began to warn of impending rate hikes at the end of January 2004, the relationship diverged and became an inverse one. A casual glance at the relative paths of the two indices since stocks bottom in August 2004 indicates that the stock market is anything but worried about the downturn in commodity prices.

The situation would be different if there were a catastrophic decline in commodity prices. This would not be out of the question if Chinese demand implodes under the weight of, say, a banking collapse or a botched revaluation of the yuan.



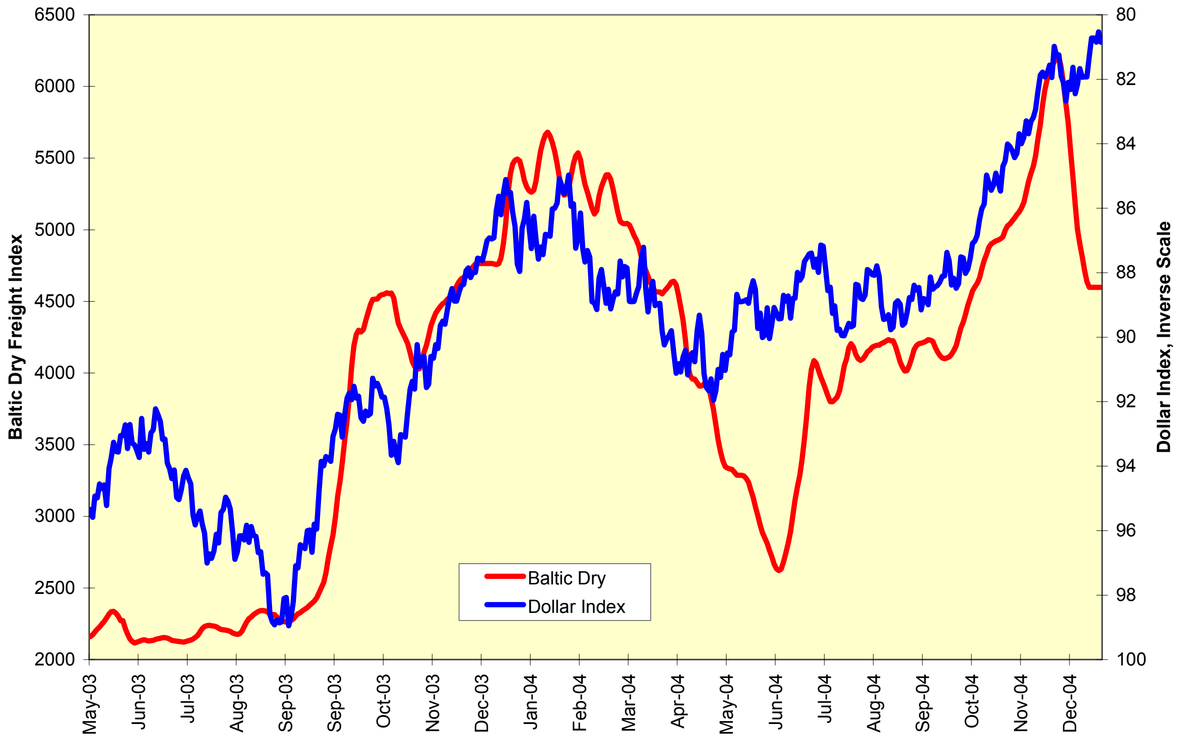
Let's take a look at another relationship, that between ten-year note yields and the Baltic Dry Freight index. Here ten-year note yields, depicted inversely, appear to lead changes in the freight index. The large jump in yields in both the summer of 2003 and the spring of 2004 preceded upturns in the freight index. Similarly, downturns in yields in both late 2003-early 2004 and again in the late summer-early fall of 204 preceded downturns in the freight index. Viewed in this context, the current dive in the Baltic Dry Freight index is nothing more than a delayed reaction to what the bond market perceived four months ago.

Once again, all bets will be off if there is a catastrophic decline in bond yields as the result of a global financial crisis (think China; it is the answer to all questions these days).



Finally, let's compare the Baltic Dry Freight index to the dollar index displayed on an inverse basis. The two have tracked each other reasonably well over the past two years, and with an interesting twist for those who persist in the fallacy that a weaker dollar will lead to lower U.S. imports. Each downturn in the dollar has been accompanied by a surge in the freight index, although declines in the freight index have not led to concomitant increases in the dollar.

Boats And Bucks



So do not look toward either industrial commodity prices or the Baltic Dry Freight index as a barometer of global economic health unless either one just collapses. The retreat in the JOC-ECRI index should take cost pressure off of corporate margins. The retreat in the Baltic Dry Freight index may signal a welcome cooling in Chinese raw material demands, which in turn will take some of the downward pressure off the dollar and the upward pressure off the euro.