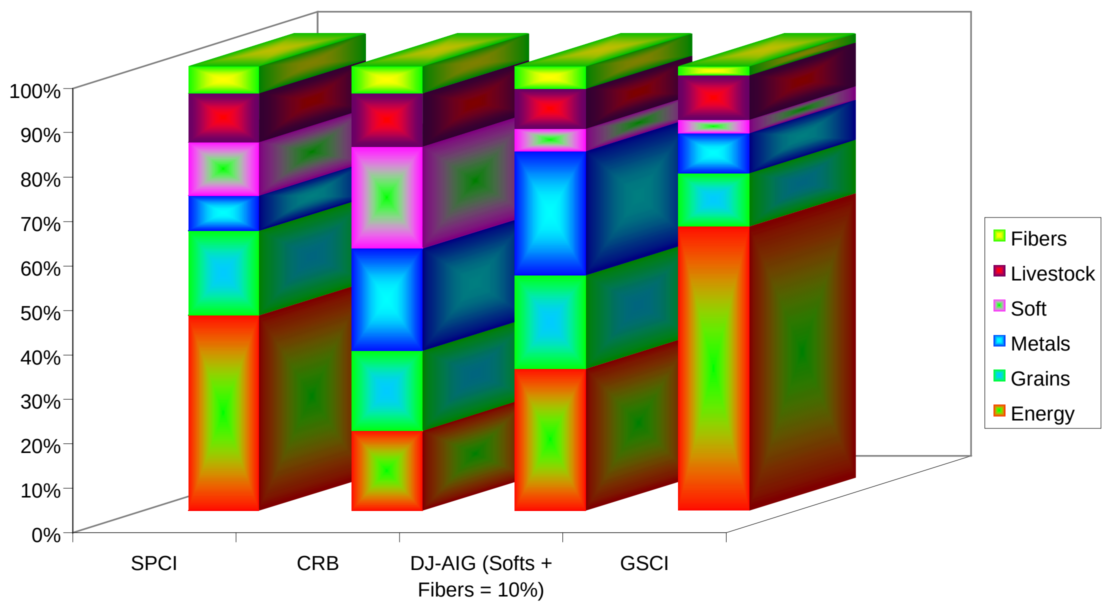
Commodities! Huh! What Are They Good For?

Absolutely something! Cynics long have accused the editors of Dow Jones of trying to salt their benchmark Industrial Average with hoped-for winners so that they, too, could be the stock market for the next 100 years or something like that. It wasn't so long ago, for example, that Bethlehem Steel, now headed to the recycling furnaces of Chapter 11, was a Dow stock, as was Venator, nee Woolworth's. Sometimes this alleged strategy backfires, as it did in October 1999 with the inclusion of Microsoft and Intel near the end of the long tech boom.

Commodity exchanges must be forgiven the same impulses. The New York Board of Trade (NYBOT), pluckily doing business in Long Island City (LICBOT?) after the destruction of the World Trade Center, began trading a commodity index future based not on the Bridge/Commodity Research Bureau's unweighted CRB index, but rather on a S&P index (SPCI) weighted to reflect economic importance. Gold, interestingly, is excluded on the grounds it is not consumable. Both the CRB and SPCI are geometrically weighted, while the Dow Jones-AIG and the Goldman Sachs (GSCI) indices are arithmetically weighted. Those of you thinking about constructing a commodity index in your garage as a weekend project should note how different the weighting schemes of these indices are.

Various Index Sector Weights

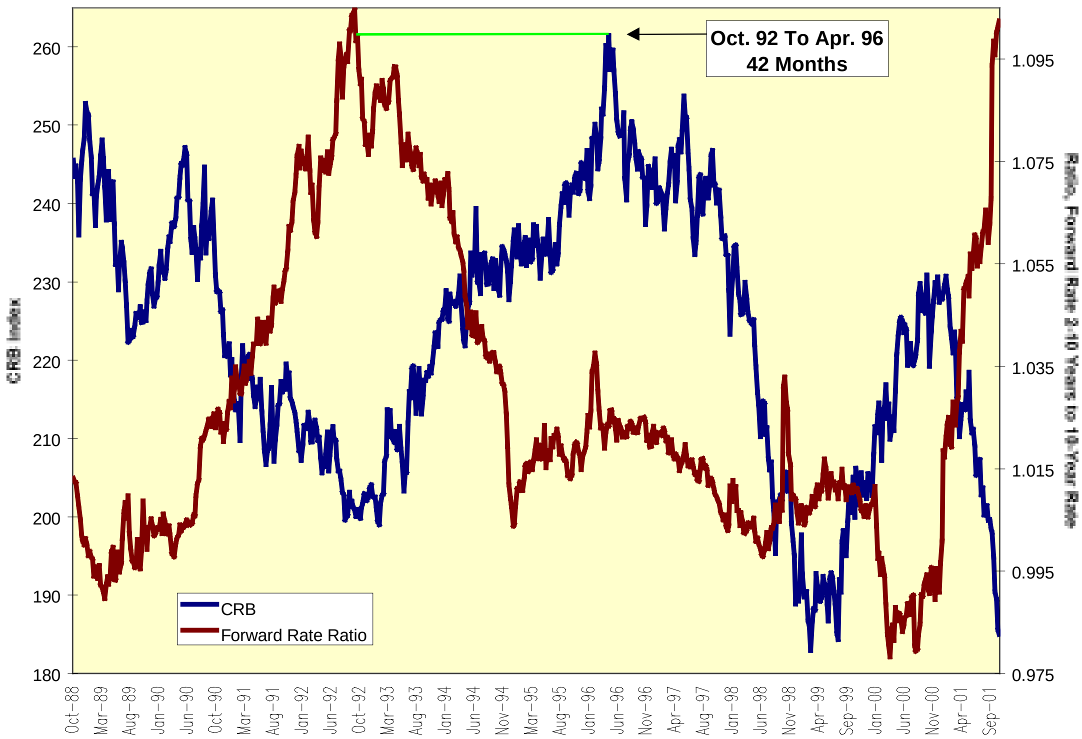


They're Bearish Until They're Not

No matter what you put in the index or how you weight the components, one answer is inescapable, and that is commodities are still in a very long-term bear market. How long, you ask? Go back to the Neolithic, buddy, and say hello to Jerry Falwell for me when you get there: Ever since the first accidental farmer planted some seeds, we've been figuring out how to produce goods more efficiently. The next Egyptian miscreant willing to fly a civilian aircraft into a civilian office building should pause to wonder how his country can support 70 million people, nearly all lined up in the I-formation along the Nile, with a higher standard of living and less hunger than ever before in its history. It's called human ingenuity: Not only does every mouth come with a pair of hands, it comes with a brain. Use it properly, and we all benefit. What a concept, huh?

OK, back to business. The Fed's aggressive-but-belated campaign of interest rate cuts has put short-term interest rates, 2.5%, below consumer inflation, now at 2.6% on an annualized basis. This is significant in the world of commodities; a holder of a asset such as gold may be able to realize a nominal gain simply by holding the tangible asset and letting inflation work its evil magic.

Maybe not now, and maybe not even next year, but eventually we will see commodity price inflation as a consequence of present monetary policies. If we look at the shape of the yield curve, here defined as the ratio of the forward rate between 2 and 10 years (the rate at which we can lock in borrowing today for a period starting in year 3 and extending to year 10) to the 10-year rate itself, we see how it leads commodity prices eventually. The last cycle between peak monetary loosening and peak commodity prices took 42 months. If this cycle is repeated – and there's nothing magic about 42 months – we'll see a period of rising commodity prices between now and April 2005.



Investing Implications

What's the point of being an emerging market if you can't emerge? Or, more precisely, who is going to be helped by a combination of rising inflation and rising commodity prices? The answer is the same globally. Debtors, including governments, are helped by inflation as they get to pay back their obligations in depreciated currency. Primary commodity producers, be they wheat farmers in Saskatchewan, coffee growers in Brazil, copper miners in Zambia, or opium growers in Afghanistan also benefit from the short-lived monetary illusion that they somehow have acquired an advantage in the terms of trade. Please recall the tiresome and oh-so-wrong bloviations of various Third World loudmouths during the inflationary 1970s about how the sun was about to shine on their self-inflicted decrepitude.

Forget about investing in any of these folks for the long-term. The meek shall not inherit the earth, and neither will those in hock or those wedded to the land or to their mines. As noted so often in this space, commodity consumers can add far more value than can commodity producers. But long-term verities need not get in the way of short-term opportunities to make a raid into the debtor/commodity producer/emerging market sectors.

The bear market in stocks has created a bull market in cash and government debt. Turn the yield chart over, and we're in irrational exuberance time for short-term rates. Unless events conspire to produce an economic collapse – and the betting here is that we're going to bend, not break, economically barring something unforeseen – risk is underpriced, and accelerating demands are going to convert recent monetary largesse into higher price levels.

For those of you who still subscribe to the quaint notion of buy low / sell high, it's time to start thinking about high-yield bonds, natural resources stocks, and emerging markets. These sectors are likely to be the leaders, such as they will be, over the next three years. Every now and then, commodities are good for something.