Raising A Crop Of Misleading Signals

The conceits of IPO aficionados and bond traders aside, the original when-issued trade had nothing to do with financial assets, but rather with grain. Agricultural cycles dominated the origins of commerce, science and religion, and given the recent discovery of a Mesopotamian cuneiform tablet loosely translated as "sell in May and go away," dominated the origins of financial commentary as well. What treasures will future archaeologists find in the Hamptons?

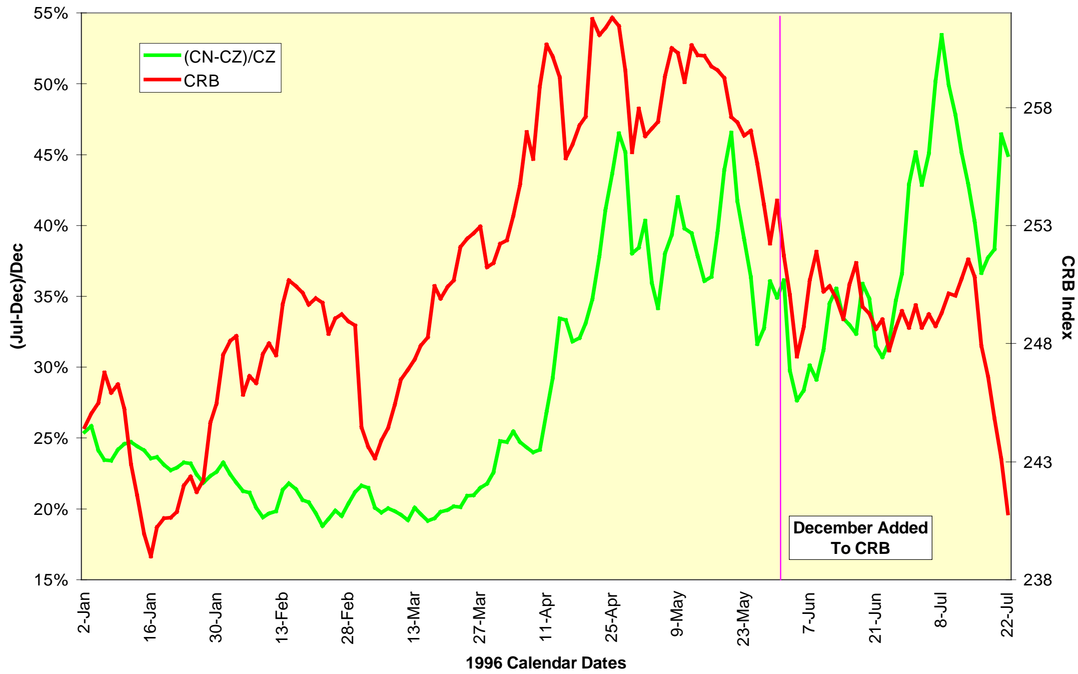
Agricultural crop cycles have an impact still on financial markets. Their variability is such that food prices along with energy prices commonly are subtracted from reported price indices to yield a core rate, a subtraction I always have found disingenuous in the extreme given the role both categories play in my household budget. Every dollar spent on either food or energy is a dollar unavailable elsewhere, and so whether you choose to recognize them or not, their macroeconomic impact on consumption patterns cannot be denied.

Old Crop, New Crop

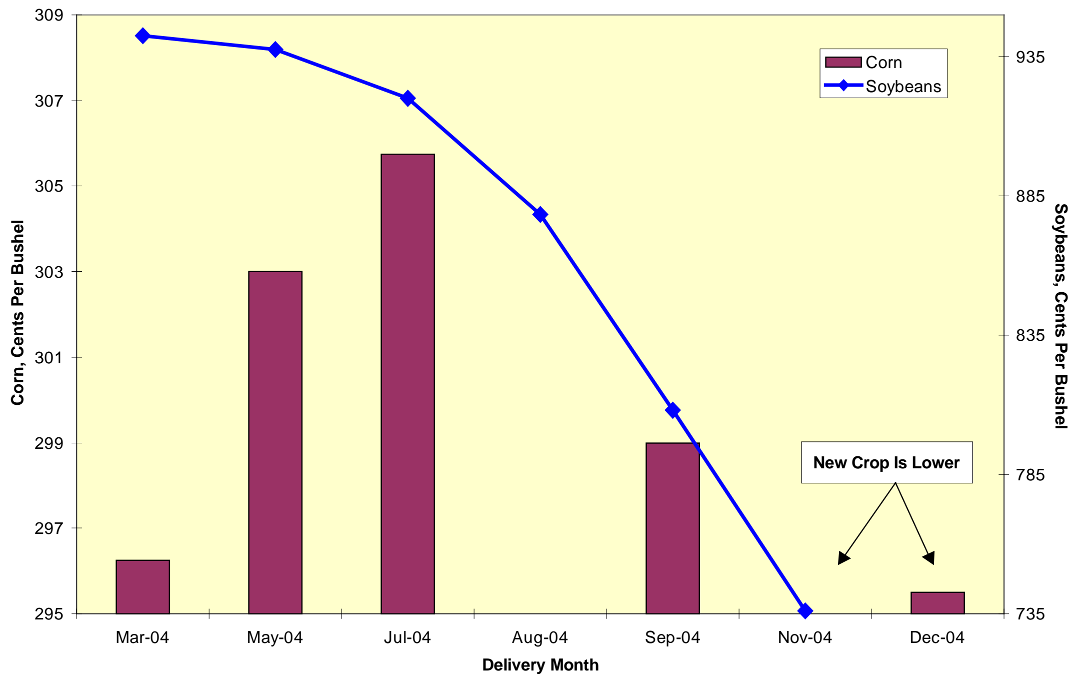
While financial assets can be created quickly and in the case of Treasury bonds in vast quantities, crops require a growing season, are produced in limited quantities and are subject to production uncertainties both within a given growing zone and on a global crop basis. A production shortfall in the Southern Hemisphere affects global inventories and prices during the Northern Hemisphere's growing season, and vice-versa.

When this situation occurs, the price for existing inventories, or old crop, rises relative to the price of the crop in the field or yet-to-be-planted, called the new crop. Given the inability of suppliers to deliver new crop grain into an old crop month - how could the corn crop for 2004, which has not been planted yet, be delivered to anyone yet? - the spread between the old crop and the new crop can expand dramatically. In metals and energy, this spread is referred to as backwardation; in grains, livestock and other physical commodities, it is called an inverse.

The inverse in corn in 1996 between July (CN), the last old crop month, and December (CZ), the first new crop month, widened quite sharply during the late spring of 1996. Significantly for financial markets, the CRB index of commodity prices, a measure watched widely for inflationary pressures, widened along with the inverse.

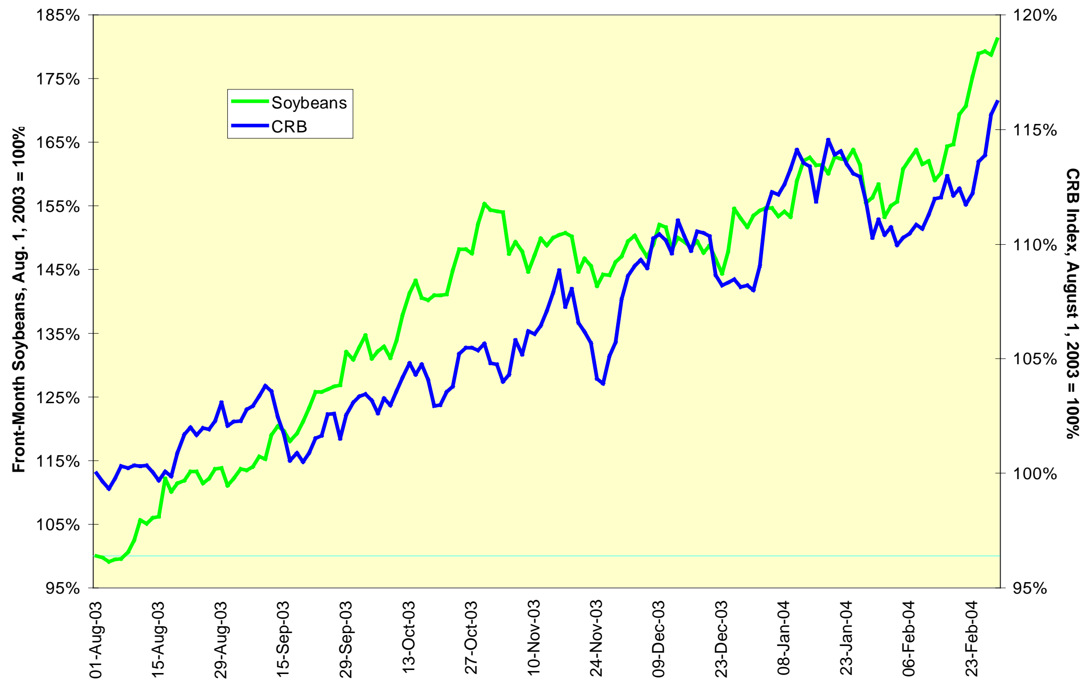


The expansion and subsequent contraction of the CRB index along with the corn inverse was an artifact of the index' calculation. The corn component of the 17-commodity index is an arithmetic average of all futures prices that expire on or before the sixth calendar month from the current date. For corn at present this would include the contract months of March, May, July and September, but not December. For soybeans at present, this would include March, May, July, August and September, but not November, the new crop month for soybeans. Both markets are inverted heavily at present.



Commodity Price Implications

The much lower new crop prices, which could turn higher should the weather not cooperate, will not join the CRB index calculations until May for soybeans and June for corn. Given the inability of anyone to create more old crop soybeans and the tendency of buyers to wait for the last minute to assure themselves of a supply - thank you, just-in-time inventory management - the prospects for a continuation of a soybean-led rise in the CRB through May remains strong. Once November, now trading at 78% of March's price, joins the calculation, the CRB will fall and send what no doubt will be construed as a disinflationary or even deflationary signal to financial markets.

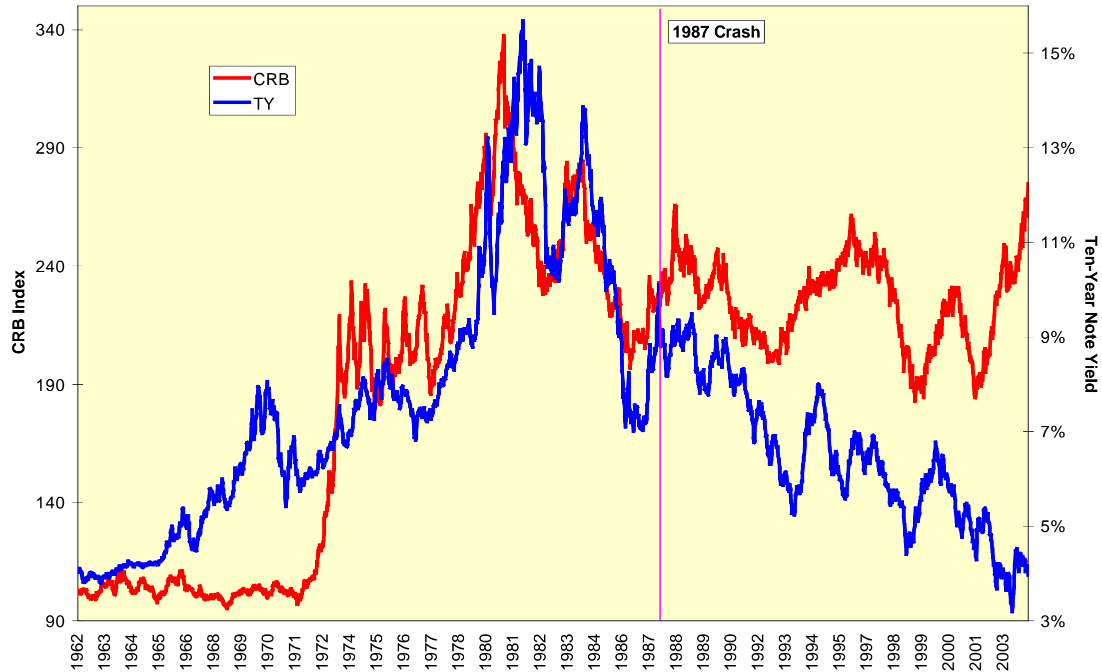


Beans And Bonds

There was a time when soybeans were considered, improperly in my opinion, the ultimate barometer of inflationary pressure. In fact, many commodity traders in the 1970s traded silver off of soybeans, and vice-versa. There was also a time when the commodity price increases seen over the past year would have triggered either an actual Federal Reserve tightening of credit or certainly an anticipatory selloff in bonds. Neither has occurred, nor is either expected to occur in the near future. After all, the very same monetary policies are pushing both commodities and bonds higher simultaneously, although one has to wonder whether the low federal funds rate would keep bond yields low were it not for the large purchases by Asian central banks.

This linked movement would have been unthinkable prior to the 1987 stock market crash, but has become increasingly common since, and stands as a stunning rebuttal to all those who regard higher commodity prices as the cause, rather than the effect, of inflation.

The Old Correlation No Longer Exists



While Mae West might have proclaimed too much of a good thing as wonderful, that probably is not the case in markets. Higher commodity prices will change both consumption and production spending worldwide, a process that while successful ultimately will not be without its frictions in the short-term. The money spent on copper today is not being spent on something else, and the capital going toward mine expansion similarly is being diverted from another, possibly more productive, alternative. The gap between the CRB and ten-year note yields seen in the chart above is yawning a little too much for comfort.

The yawn will continue for months and then will break, barring bad weather, as the new crop months get included in the CRB calculation. Just as brains should not be confused with a bull market, an indexation methodology should not be confused with a macroeconomic development. Even those who thought their forecasts caused the Nile's flood every year might have understood this one.