

Commodities And Financial Markets Mix. Sometimes

As the holiday shopping season moves into its final crescendo, and where human life or at least a decent personal injury case can be measured in terms of a \$29 DVD player at Wal-Mart, let us pause to reflect on the differences between fashion and style. Go to an art museum or flip through a coffee table book of old portraits, and look at what the subjects were wearing. Chances are you will have absolutely no idea whether the clothes were in fashion at the moment, but you will recognize instantly whether the wearer had style.

Markets and the players therein are no different. On any given day a stock may be fashionably hot and the object an impassioned desire by a crowd of touts who have no more style than a dog chasing a car down the street. It holds true for intermarket relationships as well, and accounts for such recent puzzlers to the rigid of thought as the simultaneous rallies in stocks and gold or the simultaneous drops in the dollar and bond yields.

One need not be perplexed by the changing fashions on intermarket analysis. The key is to focus on those basic and irreducible factors - monetary policy, credit demand, energy prices - which are elemental and therefore can never go out of style. Think of them as primary colors: A change in the weights used to mix a paint changes the outcome; some perfectly valid outcomes may not be observed as they were overwhelmed by the recipe - the fashion - used at the time.

These changing fashions, incidentally, account for the long-term non-relationships observed frequently in this space between the strength of the dollar and either stocks or bonds. Whenever such apparently logical relationships cannot be demonstrated statistically, it is because one or the other markets involved is not elemental.

A Good Idea At The Time

In an August 2002 [column](#), referenced again last week, I cited the following from John Murphy's 1991 *Intermarket Technical Analysis* (page 9, original italics):

1. The *inverse* relationship between commodities and bonds;
2. The *positive* relationship between bonds and the stock market; and
3. The *inverse* relationship between the U.S. dollar and the various commodity markets, in particular the gold market

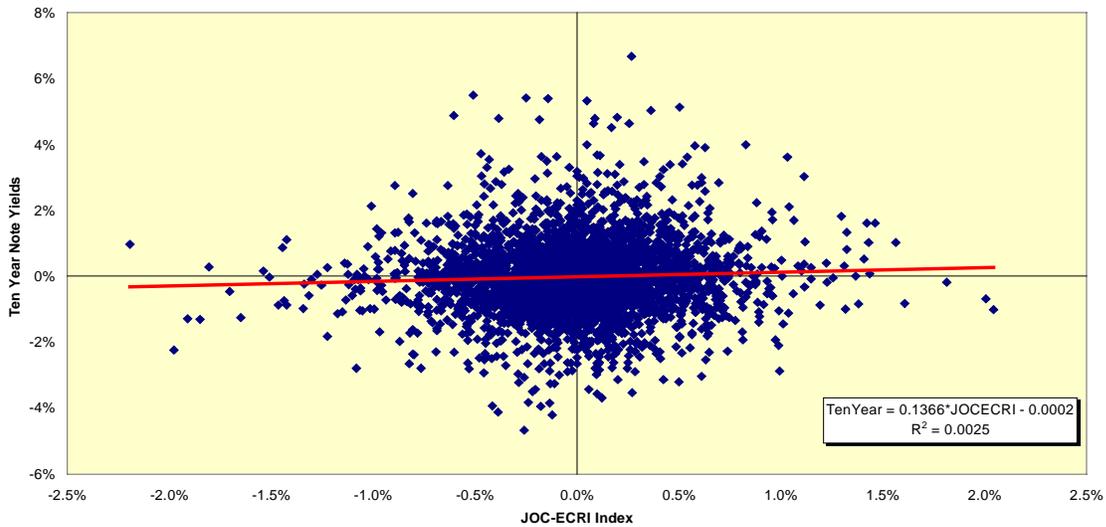
By extension, a weaker dollar should lead to higher commodity prices, which should then push interest rates higher and exert downward pressure on stocks. These relationships certainly existed over the late 1980s and were no doubt contributors to the 1987 stock market crash. But, in retrospect, these were not primary rules as much as they were observed fashions, a heavy-handed inclusion of one color in the mix that simply overwhelmed everything else in the process.

Updating Commodities' Effects

The analysis offered in August 2002 used the CRB index as the proxy for commodity prices, which may have explained why the observed statistical effects of commodity prices were so weak. Now let us replace the CRB with the Journal of Commerce - Economic Cycle Research Institute (JOC-ECRI) index, which as we saw last week remained much stronger than the CRB during the post-1980 disinflationary era. A long data sample, daily observations back to September 1988, is used in all charts below.

Murphy's first relationship, the inverse relationship between commodities and bond prices, does in fact appear to exist, albeit weakly. Returns on ten-year note yields, which move inversely to prices, have a positive and statistically significant (T-statistic of 3.16 on the beta coefficient; a T-statistic of 1.96 is a 95% confidence interval) relationship with daily returns on the JOC-ECRI index.

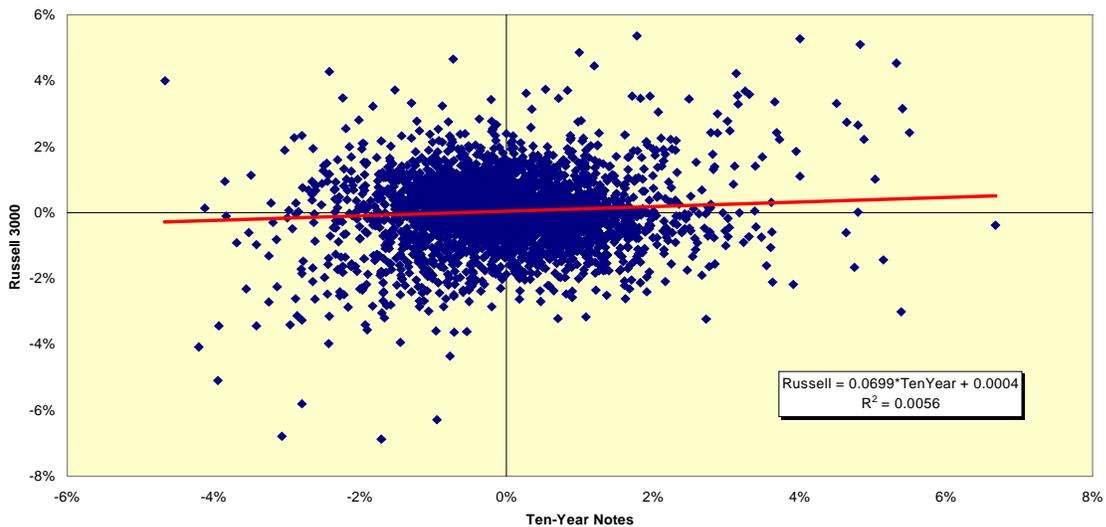
Daily Returns On Ten-Year Note Yields Vs. JOC-ECRI Index



The second relationship, that of bonds and the stock market, is completely inverted from the positive one described by Murphy and familiar to all who traded during the 1980s. Returns on the broad-based Russell 3000 index have a positive and statistically significant (T-statistic of 4.64 on the beta coefficient) relationship to returns on ten-year note yields.

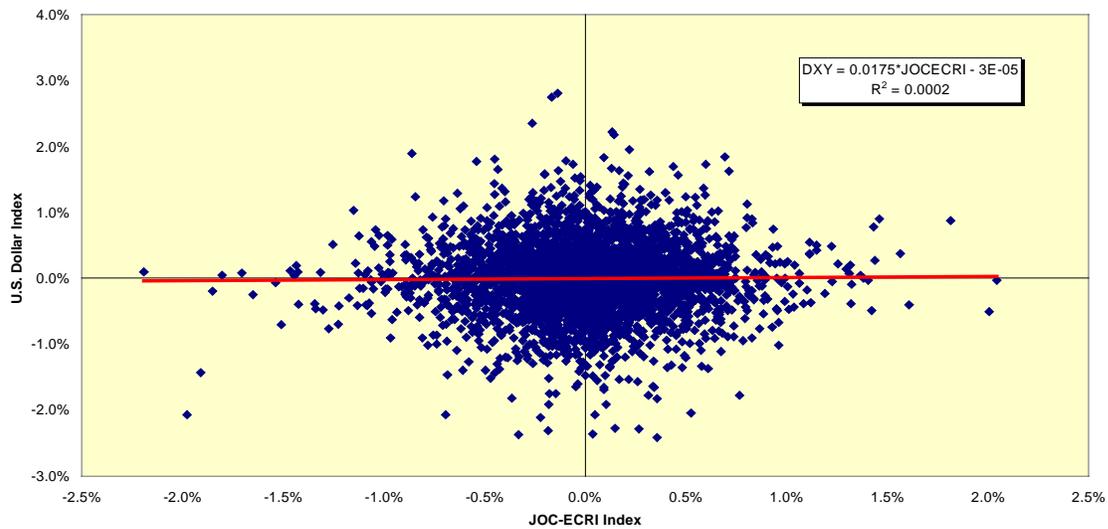
This indeed has been the fashion statement du jour since the early 1990s, but it is not elemental: Stocks are discounted earnings, and this observed relationship should not be construed as stocks benefiting from higher interest rates. It can be construed as expected earnings have grown faster than interest rates over this observation sample.

Daily Returns On Russell 3000 Vs. Ten-Year Notes



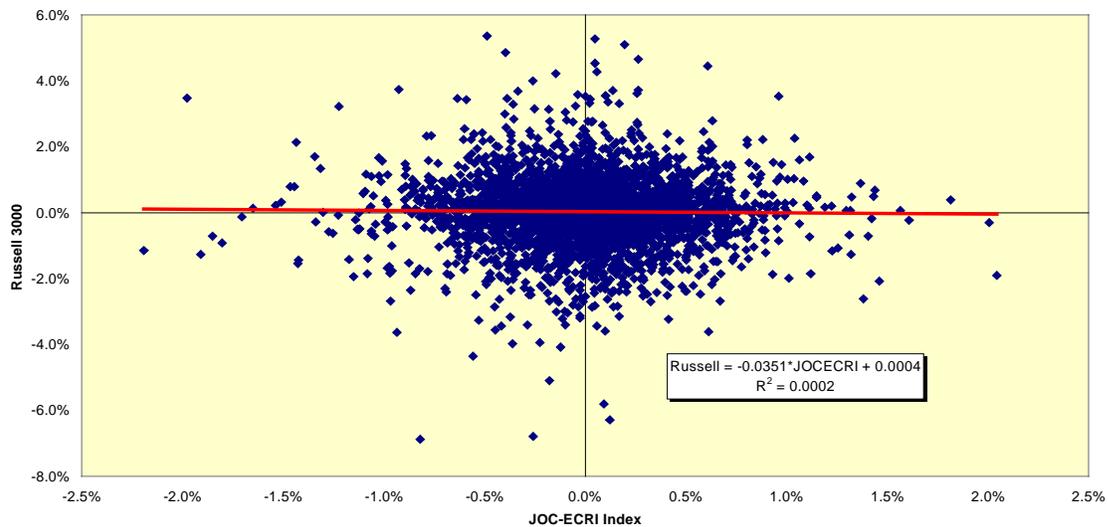
The third relationship, that of commodity prices to the dollar, does not have a statistically significant (T-statistic of 0.82 on the beta coefficient) relationship to commodity prices. This does not mean that there are not individual commodities, such as gold, with a notably inverse relationship to the dollar, but that industrial commodities as a group are not driven by dollar strength or weakness.

Daily Returns On Dollar Index Vs. JOC-ECRI Index



Finally, are stock returns a function of industrial commodity prices? The mind aches to say yes; after all, you might assume that a strong economy would push both stocks and commodities higher, or you might assume that higher commodity prices squeeze profit margins and would push stocks lower. No one wins this tug-of-war: The beta coefficient of (0.85) is statistically insignificant.

Daily Returns On Russell 3000 Vs. JOC-ECRI Index



The Inconclusive Conclusion

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. And watch what the commentator is wearing: It could be both out of fashion and completely lacking in style.