

## Commodities' Merry Poppings

The difference between good traders and bad traders is not how often they are right; it is how long they let their profits run and how quickly they exit their losses. What about market commentators? Speaking for myself, I cannot let it bother me when I am wrong, especially if unforeseen events blow an analysis out of the water. All I can do is admit it, correct it and keep on keeping on.

What bothers me more than anything else is when I append, "But I hope I'm wrong" to a forecast and turn out to be right. Some people seem to take pleasure in watching a negative outlook come to fruition; I do not.

Consider an [October 2001](#) column on how I thought commodity prices, high-yield bonds and emerging markets would rally over the following three years in response to lower interest rates. The high-yield rally is long behind us, the emerging market rally never really paused and the commodity rally, which has had several stops and starts, is now moving like someone attached a rocket to a key body part. What is behind the latest surge?

### A Market Of Commodities

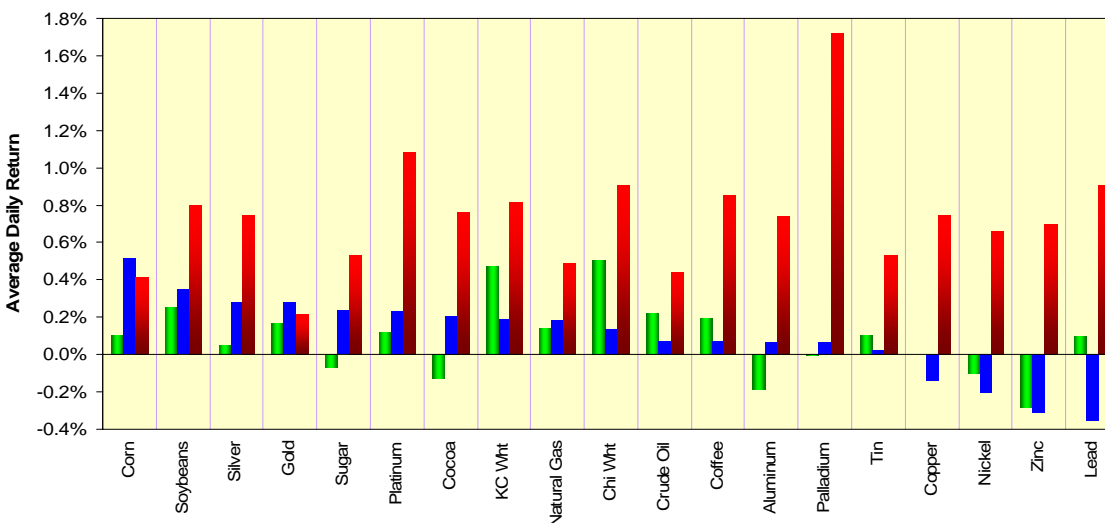
First, let's return to a point made first in [May 2004](#) and repeated several times since, and that is there is no such thing as "commodities" as an undifferentiated asset class. We have a collection of unrelated markets, often with negative correlation of returns between them, whose only linkages are they are tangible and traded on an exchange. For this reason, let's use a set of 19 different cash markets (except for coffee, where a continuous front-month future will be used) instead of an index. Cash markets eliminate the distortions of contract rolls.

Second, let's ask the very simple questions whether the spectacular leaps seen in a number of physical commodity markets in recent weeks have been the result of three obvious causes from financial markets, higher expected inflation, a weaker dollar and lower short-term interest rates. In the case of the dollar, the same split away from an index approach will be taken, and we will use the Chinese yuan and the euro as the markers.

Let's set up a small comparison across three time periods. The color-coding scheme will remain uniform throughout.

1. July 19 – October 17, 2007 (green). This is the period between the July global bull market high and China's acquiescence to a more-rapid revaluation of the yuan. As I noted in [January](#), a stronger yuan is a powerful fundamental in our financial markets;
2. October 18, 2007 – January 30, 2008 (blue). This is the period extending to the most recent cut in the target federal funds rate. All charts are sorted on this period; and
3. January 31 – February 29, 2008 (red). This period encompasses the latest commodity surge.

**Average Daily Returns For Commodities Over Selected Periods**

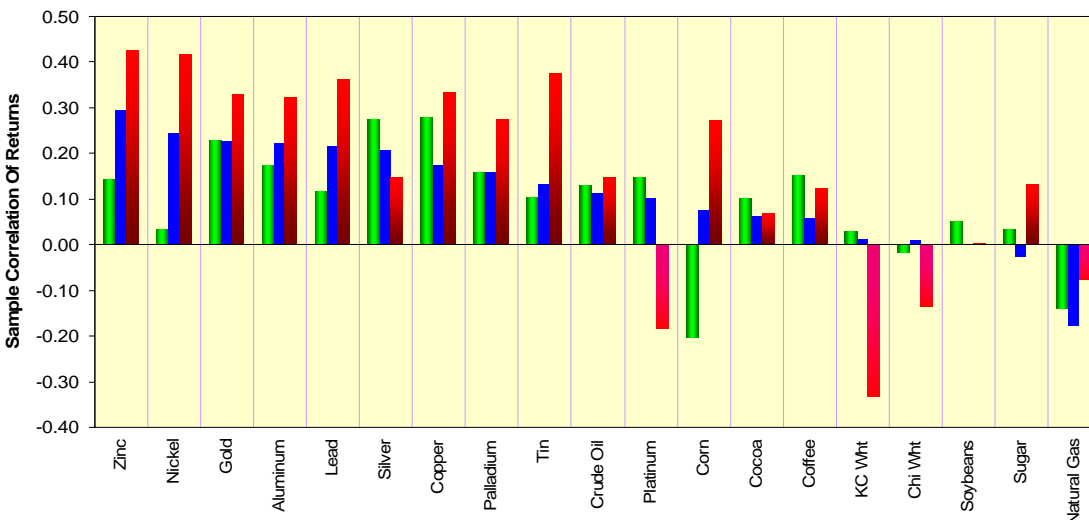


The only commodities whose returns declined between Period 2 and Period 3 are corn and gold, both of which are still in identifiable bull markets. Did the financial markets trigger the commodity price increases?

### The Yuan

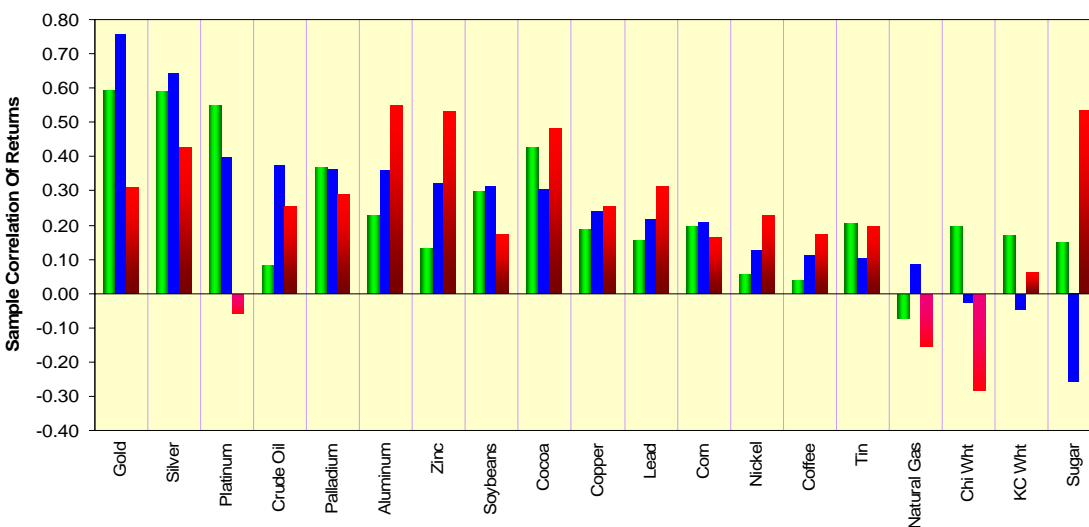
A stronger yuan buffers commodity price increases for Chinese importers, so we might expect this to be a powerful factor, especially for those industrial materials of which China imports vast quantities. Period 3 correlations of returns for the commodities against the yuan fell only for silver, platinum, and both hard and soft red winter wheat.

**Comparative Correlation: Commodities Vs. Chinese Yuan**



The euro, which gets so much of the attention when people talk about the dollar, has been less of a factor. Its Period 3 correlations of returns against the commodities rose for aluminum, zinc, cocoa, copper, lead, nickel, coffee and natural gas. Interestingly, Period 3 correlations declined versus those for Period 2 for those two “headline” commodities, gold and crude oil, whose movements often are attributed to changes in the euro.

**Comparative Correlation: Commodities Vs. Euro**

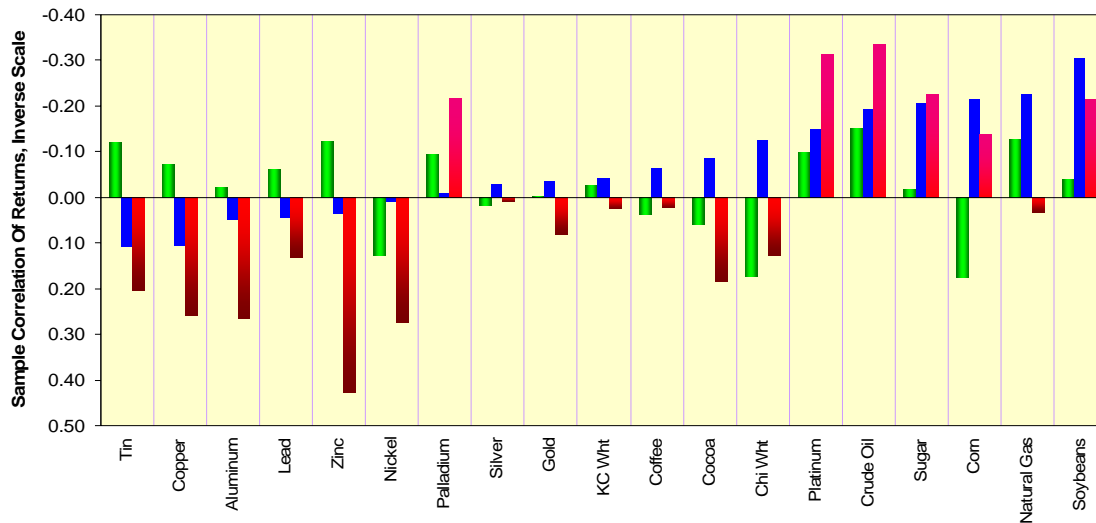


### Repo Rates

The short-term interest rate markets have been distorted by the flight to quality, risk aversion and the credit crunch affecting LIBOR at the end of 2007, but we can use the repo rate as a relatively clean measure of short-term interest rate trends. The repo rate is secured by collateral, lies just over the T-bill rate on the risk curve and is the most appropriate rate for commodity futures. If we convert the repo rate into a 90-day instrument price and correlate those returns against commodity returns, can we blame monetary largesse for what we see in the markets?

As a rule, no. Period 3 correlations, plotted inversely to account for the price-yield relationship, jumped for palladium, platinum, crude oil and sugar, but that is it. As much as many of us would like to blame irresponsible monetary policy for commodity inflation, the connection is not a strong one.

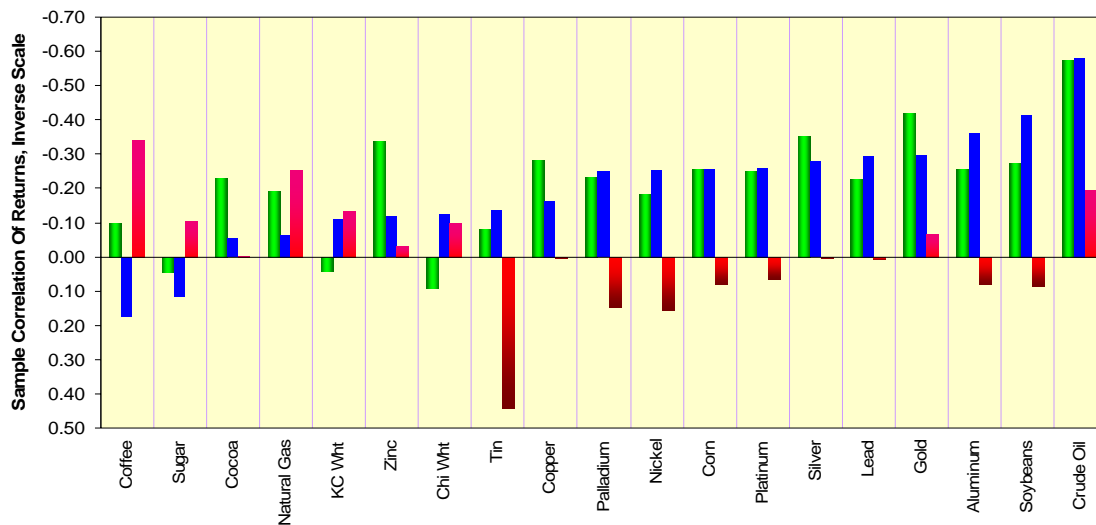
**Comparative Correlation: Commodities Vs. Three-Month Repo**



**Short-Term Inflation Expectations**

What if we repeat the exercise for short-term inflation expectations, here measured by the two-year TIPS breakeven rate of inflation? We can convert expected inflation into a note and plot the correlations inversely as we did for repo rates. Here Period 3 correlations jumped for coffee, sugar, natural gas and crude oil. No more; for all those who believe commodity prices and inflation are one and the same, this must be a great disappointment. Please see an [October 2005](#) column on the weak relationship between inflation and commodity prices.

**Comparative Correlation: Commodities Vs. Two-Year TIPS Breakeven**



**Investment Implications**

Will the cure for higher prices be higher prices? So often in the past this was the case as commodity producers rushed to expand capacity and killed their own boom. My answer now is, "No." Those private firms were profit-maximizers; the state firms increasingly dominating resource production are revenue-maintainers. They tend to distribute their revenue back to their governments or, as noted [last week](#), to Swiss banks. We could be in for years of higher prices barring a global economic implosion. If that's the case, close your eyes and overweight basic materials and energy stocks, both in the U.S. and abroad. Sometimes it is just that simple.