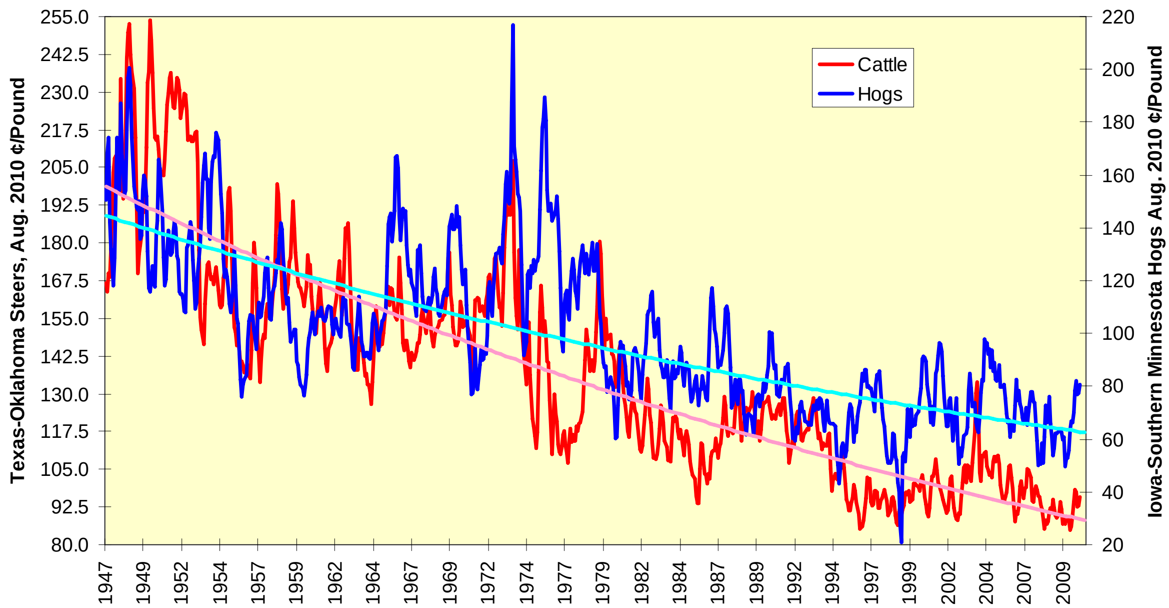
Livestock And Relative Food Price Inflation

My working model of the Federal Reserve's inflation targeting prowess involves the image of Elmer Fudd's backward-firing shotgun. The differences between hitting a target and hitting the desired target are subtle but profound. Unlike Fudd and his lovable Bugs Bunny protagonist, the Federal Reserve has proven itself of doing real damage.

One of the great fiascoes of the Great Inflation of the 1970s, a period that followed the Great War and the Great Depression and preceded the Great Recession, was Herb Stein's price controls on beef. Predictably the meat disappeared from grocers' shelves and I can recall Richard Nixon advising the nation that chicken and fish were alternatives. Let them eat Chicken of The Sea!

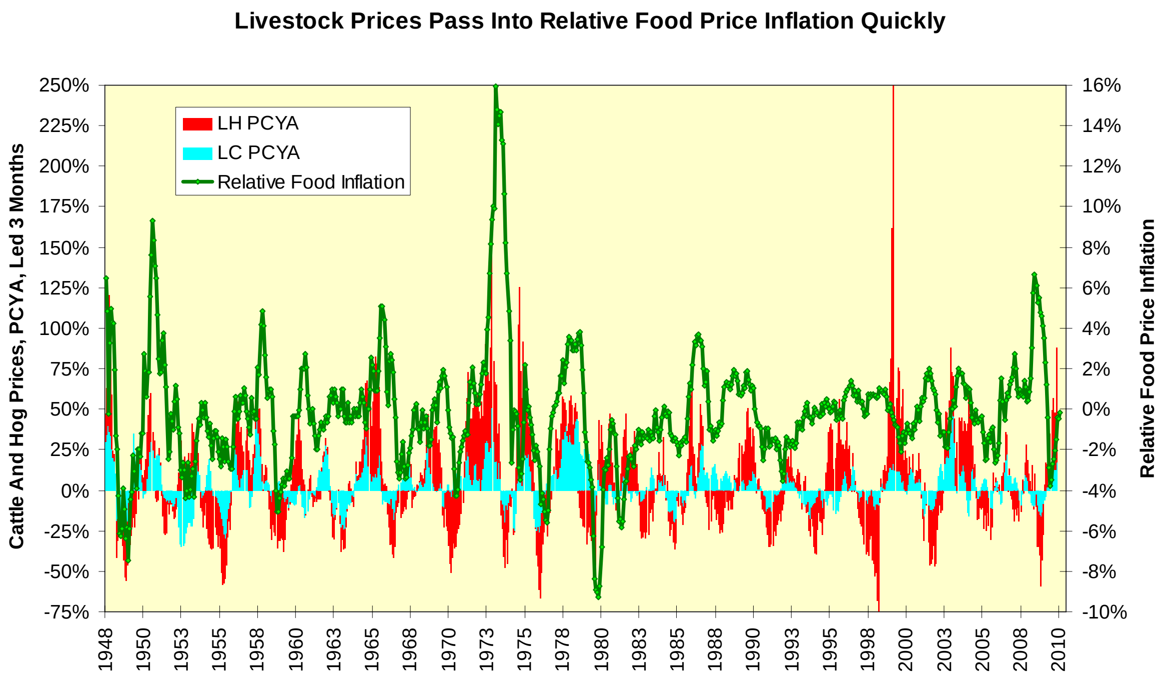
This era stands out in a map of constant-dollar cattle and hog prices going back to the end of World War II, home of the Greatest Generation. Even though the long-term constant-dollar trends for both markets is negative, -0.87% and -0.98% per annum for hogs, respectively, as represented by the trend curves below, the Nixon years do stand out as evidence of the power of economic mismanagement.

August 2010 Cattle And Hog Prices



Food Price Inflation

While Washington's statistics mills can pretend there is such a thing as core inflation, the ex-food and energy stuff you can live without, I plan on both eating and heating this coming winter. As the 1970s experience indicates, higher livestock prices get transmitted into relative food price inflation very quickly, in about three months. Relative food price inflation is the gap between the CPI sub-indices for food and ex-food (Memo to BLS: See, someone reads your stuff. Unfortunately, that someone is me).



The recent jumps in cattle and hog prices threaten to increase relative food price inflation in the fourth quarter and into early 2011. As the FOMC is on record as saying it wants higher inflation, they will be on the receiving end of the blame.

Hard To Play

Normally, higher prices create some winners, but the direct sellers of meat and meat products such as Tyson Foods, Smithfield Foods and ConAgra also are amongst the largest buyers of feedgrains. The disruption in wheat markets and increased Chinese purchases of corn, along with the goofy U.S. obsession with ethanol are doing to meatpackers today what happened to the meatpackers of the Nixon era; the firms are underperforming. New-crop December corn hit its low for 2010 on June 30th; since that date the Russell 3000 has returned 9.47%. Tyson, Smithfield and ConAgra have returned -3.67%, 7.45% and -6.77%, respectively.

The iPath Dow Jones-UBS Livestock ETF has underperformed as well, returning 3.87% over the period. Newcomers into the world of commodities often have to learn the hard way that intermonth spreads in livestock have no defined carry structure as livestock are not stored: You have to feed them and they die at a stochastic rate, making holding costs unpredictable. Add this to the roll mechanics vexing all commodity ETFs, and you are best off treating this as another animal: A bright orange tree frog.

This is not going to be fun for foodies. One of the many negative legacies of the Nixon years was textured vegetable protein, a faux-meat made from soybeans. Let's hope modern technology can come up with something better this time.