

Food And Fuel Still A Bad Combination

One of the bad things about intermarket analysis is it leads you down a blind alley every now and then. You wind up, as they did in the late 1970s and early 1980s, trading silver off of soybeans, or trading Treasury bonds off of soybeans as they did in 1988. Who ever thought stock traders would regard rising crude oil prices as bullish, as happened during much of the 2009 rally?

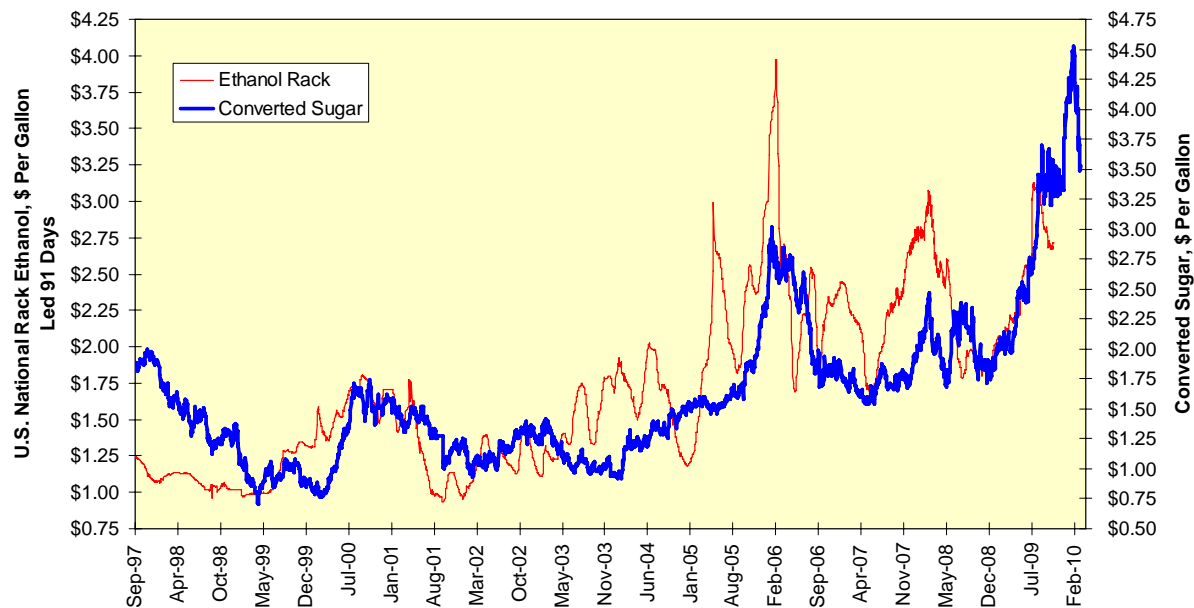
You need some actual economic relationships or some common factors or substitution points between markets to sidestep what may be spurious correlation. But actual substitution or a process margin relationship does not turn a bad economic policy into a good idea. Take the relationship between two foodstuffs used to distill ethanol, sugar and corn, and the relationship between the resulting ethanol output and gasoline.

A Bad Idea

If you age bad wine, you get old, bad wine. Let's just stipulate in the interests of time and space converting foodstuffs into motor fuel is a net energy loser. It is simple thermodynamics: Each step of a conversion process requires a net loss of energy. As fossil fuels allow us to "harvest" millions of years of stored sunshine at time, they spread the conversion costs out and allow us to gain usable energy in the process. Moreover, environmental issues notwithstanding, they do not involve the diversion of food into fuel. The economics of food versus fuel are such that in a rational economic sense all of the nation's corn crop could be diverted to ethanol production at a higher return than using it for livestock and human food.

The spectacular rise and ongoing collapse of sugar prices in 2009-2010 as the result of poor growing weather in Brazil and India led to higher ethanol prices here in the U.S. after a 91-day lag. That's right: A dry monsoon season in India in 2009 led to more expensive ethanol blendstocks for motor fuel in the U.S. If the impending growing season for sugar is normal, the opposite, a drop in global ethanol prices, will occur.

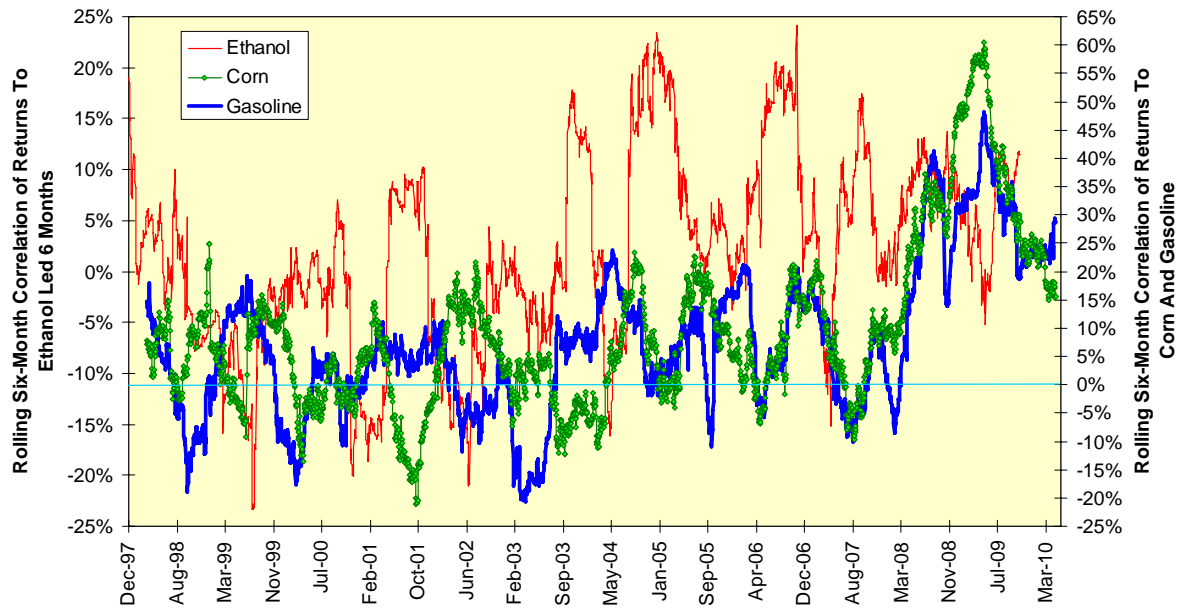
Ethanol Prices Trail Sugar



But Wait, There's More

An American corn farmer deciding whether to plant corn or soybeans has to base that decision partially on distillers' demand for corn. If sugar prices fall and pull ethanol prices down with them, corn prices will fall, too. If we map the rolling six-month correlation of returns of sugar against corn and gasoline – and as a veteran of the oil industry, I still find the concept of watching corn and sugar prices a tad odd – we find they peaked about a year ago and have declined steadily thereafter. However, the values are still positive, a situation that did not prevail prior to March 2008.

**Sugar Increasingly A Biofuel Commodity:
Correlation Against Selected Markets**



The rolling six-month correlation of returns between sugar and ethanol prices led six months remains strongly positive; the recent dual declines in sugar and ethanol only will strengthen this relationship.

What a sad chapter in that whole the-world-is-flat-but-my-heels-are-round story: American farmers and American motorists are dependent on sugar-growing weather in India and Brazil all because of an addle-brained idea we could divert foodstuffs to fuel in the name of energy independence. What is next, chopping down rainforests in Borneo to grow oil palm so European trucks can operate on biodiesel? No, too late: They have been doing that one already.

Distilling corn and sugar into ethanol is a great idea so long as the end products are bourbon and rum, respectively.