Commodity-Linked Equities' Relative Gains To Slow

Almost exactly a year ago I issued my standard admonition about treating commodities and commodity-linked equities as one and the same. As it turned out, you would have fared well with anything related to the 'C'-word as the S&P North American Resource index outperformed the Russell 3000 index by 12.1% over this period while the total return on the S&P/Goldman Sachs Commodity index was an even lustier 23.0%.

But trees do not grow to the sky, and as crude oil gushes northward of $100 per barrel, as metals prices hit records and as food is being transformed from a necessity to a luxury, it may very well be the best days of the cycle are behind us for now.

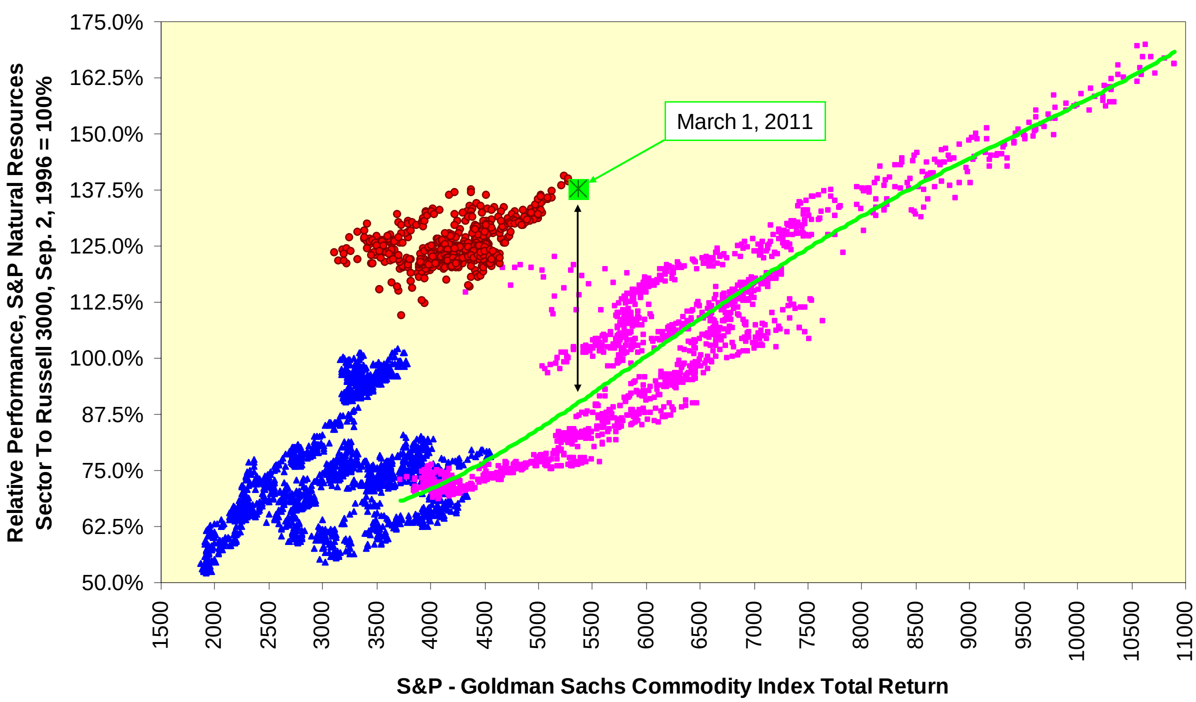
Investing is a funny business, sometimes intentionally so but most times not. If you want to sell something, if you want to really move the merchandise off the shelf, raise the price and keep on raising it. You will attract buyers, all of whom virtually have guaranteed themselves of achieving lower long-term returns. Of course, as there is never a wrong time to get on the right side of a market, (I am going to offer an on-line course in Wall Street clichés) most people are content to get on the train after it has left the station and hope they can get off before they realize that rail tunnel was painted on the cliff-side by a roadrunner with a wicked sense of humor to match his artistic design skills.

Already Expensive

Commodity-linked equities have already advanced substantially on both a relative and an absolute basis. Let's map this relative performance over three different time periods. The first, marked in blue, goes to the Federal Reserve's first declaration of war on deflation in May 2003. The second, marked in magenta, goes from there until the November 2008 local minimum in the SP-GSCI. The third, marked in read, extends through the present.

Now let's map these three periods against the total return of the SP-GSCI. The present datum indicates a relative outperformance of about 38%; if we were following the previous period's trendline, we would be underperforming by about 12%.

Commodity-Linked Equities Outperforming Post-May 2003 Trend Significantly



Now let's repeat the exercise with the *Bloomberg* correlation-weighted dollar index on the X-axis. I am using this index to de-emphasize the euro and its histrionics; while the ICE dollar index has a 57.6% fixed weight for the euro, the *Bloomberg* index' euro weight floats over time and is presently 16.62%.

The current datum is sitting just over the previous period's trend curve, but the current regime is characterized by a much flatter and linear trend. The message here is clear: Commodity-linked equities already have discounted further dollar weakness while they simultaneously are expensive given the level of the commodity index itself.

Does this mean you should run out and sell everything you own linked to energy, mining or forest products? Not necessarily. Many times the strongest moves occur right at the end of the trend and in complete disregard to fundamental valuation. Raise your hand if you have not seen one of these self-fulfilling prices surges, also known as "bubbles." What it does mean is we are late in the game and now is not the time to buy.