Commodity-Linked Equities Are Not Commodities

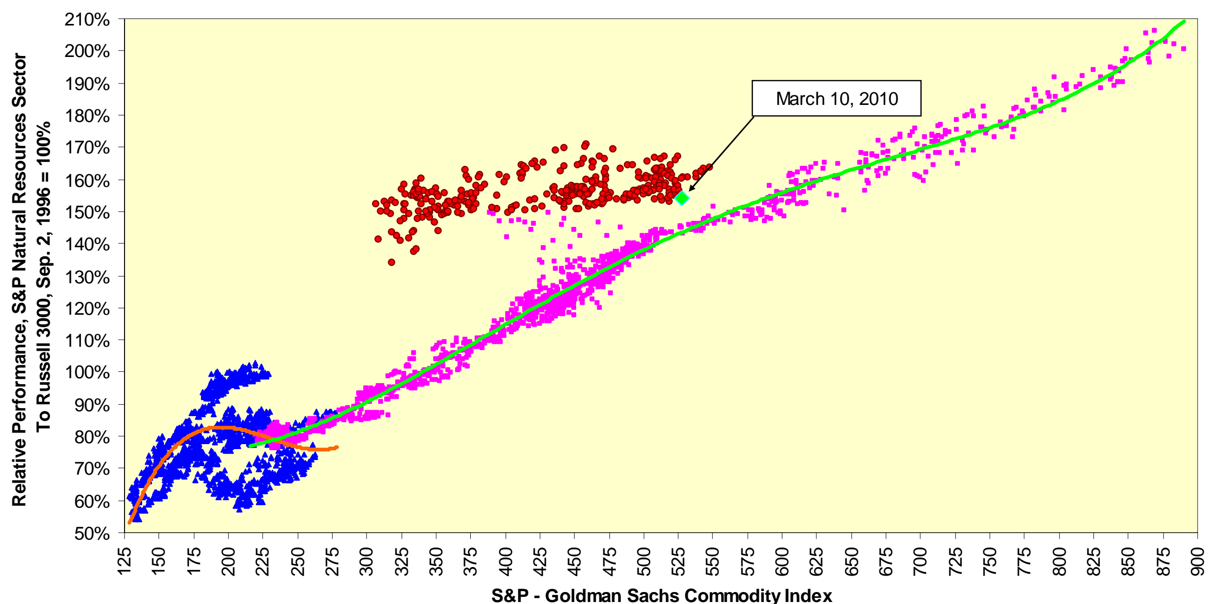
While some people might tire of playing whack-a-mole with those who disagree with them, I take a more *Queen*-like approach: "You brought me fame and fortune and everything that goes with it, I thank you all." This is not an indication of age-induced mellowing, just a simple recognition all protagonists need antagonists. I love the smell of a Hegelian dialectic in the morning; it smells like… oh, you really do not want to know.

Such has been my life opposite those who persist in trading commodity-linked equities as if they were the underlying commodities themselves. Even though I am such a "commodity guy," I have viewed these markets with suspicion as investments. A commodity is a process input; you grow corn not to generate a stream of returns from the corn itself but rather to feed it to people, hogs and yeast which in turn stand in other value chains. Think of it this way: While the various components of a computer have value, it is the assembled entity that generates economic returns.

Stocks represent the discounted stream of future earnings (work with me here) from a corporation. They are affected by numerous factors other than a commodity's price, including the general state of the market, production costs, forward interest rates, forward curves in the commodity, the political environment and management issues. In addition, while rising prices for a commodity serve to slow demand and stimulate new sources of supply and substitution, rising prices for stocks do nothing of the sort. It is far easier to sell stocks, ownership of which creates the forward liability to sell them some day, in a bull market.

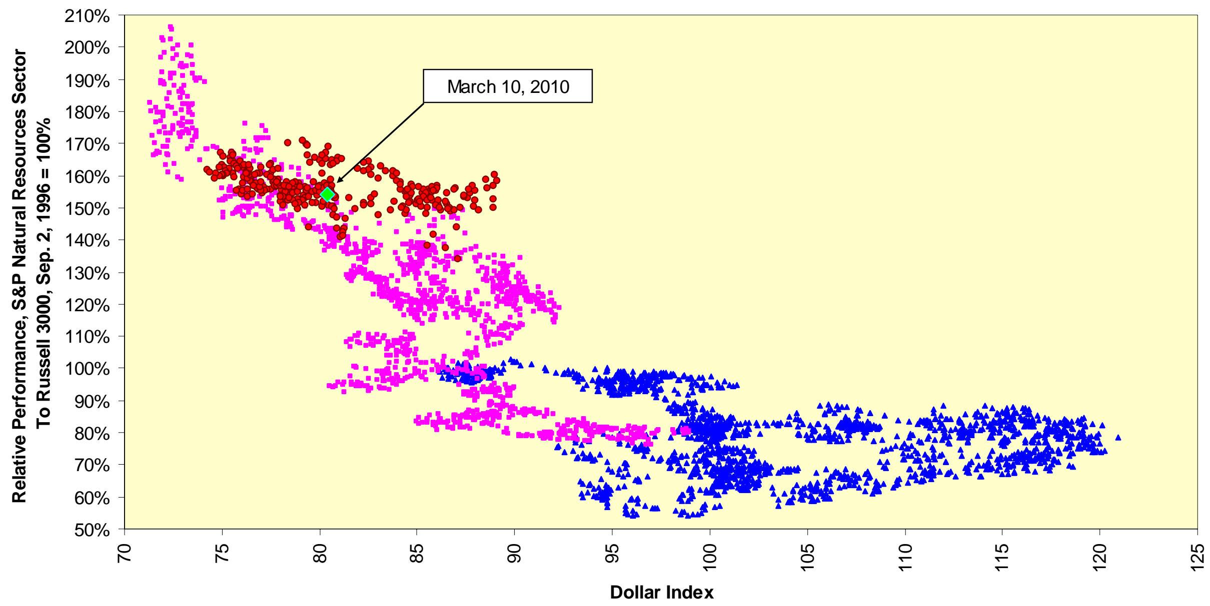
The Weight Of Money

Of course, the history of investing is replete with episodes where a sheer wall of money can alter behavior. If we map the relative performance of the S&P Natural Resources sector to the broad market as measured by the Russell 3000 index against the S&P-Goldman Sachs commodity index, we can divide its history into three segments. The first, marked in blue, was essentially (and properly) random before the Federal Reserve's first declaration of war on deflation in May 2003. The second, marked in magenta, which extended into the November 20, 2008 bailout of Citigroup and Tim Geithner's appointment as Secretary of the Treasury and all-purpose lightning rod, exhibited a strong linkage. The third, marked in red, shows a near-random relationship re-emerging. The golden age of throwing money at commodity-linked equities is behind us.



More Bang For A Weaker Buck

If we substitute the dollar index for the S&P-Goldman Sachs commodity index, a different picture emerges. Here the relationship since May 2003, the combined magenta and red markers, is clear: The relative performance of commodity-linked equities increases when the dollar weakens.



This places commodity-linked equities at risk. As the dollar index is 57.6% the euro by weight, a weaker dollar will involve a stronger euro by definition. This does not seem likely unless 1) the Eurozone solves its problems or 2) the Federal Reserve starts dropping dollars out from helicopters as mentioned in 2002 by none other than Ben Bernanke.

The conditions required for a weaker dollar plus the non-response by commodity-linked equities to commodity prices suggest this entire sector be underweighted.