TIPS Jump Commodity Gun

Time-travel has been a staple of science fiction for most of the 22nd century, and I am convinced the person who invents the perfect “un-send” function for e-mail, a form of time-travel, will have all the money in the world. Yet it should no place in financial markets as it has no place in economic reality. Try though you may, you cannot cause the future.

Yet the TIPS market refuses to stop trying. This market wants to capitalize, instantly, every little twist and turn in the commodities markets into its expectations for long-term consumer inflation. The relationship between commodity prices and producer prices is tenuous at best, and the direct passage of producer prices into consumer prices is not what it was in a distant past when the U.S. manufactured most of its consumer goods.

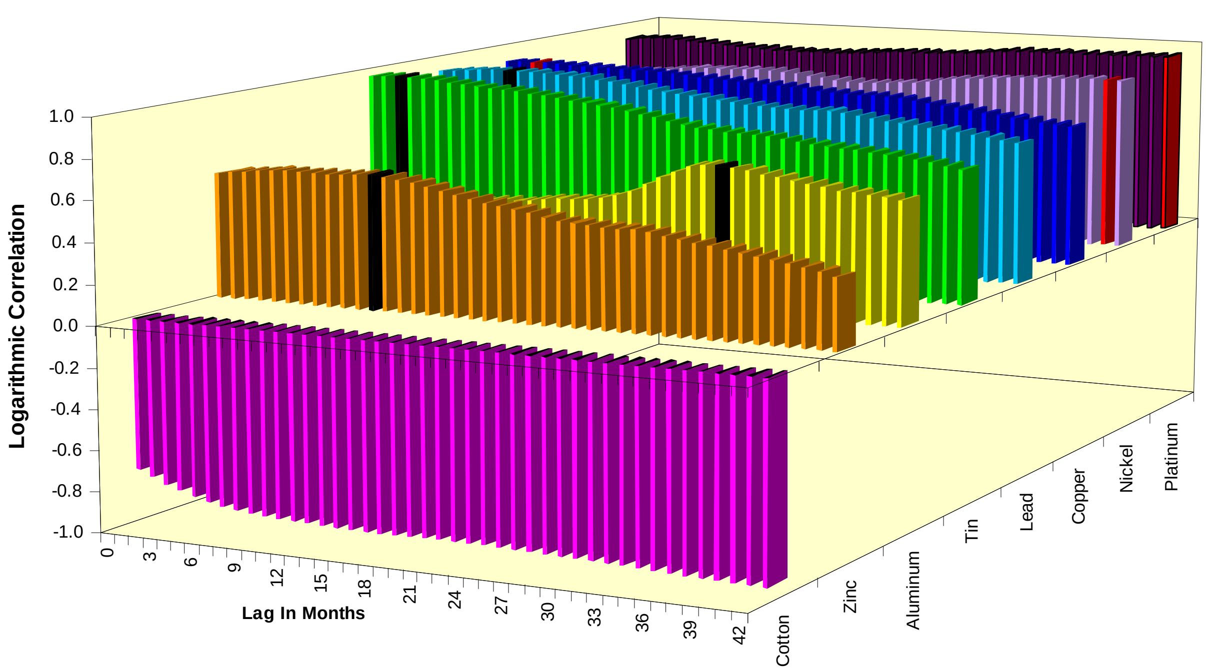
A Simple Test

Commodities, the most fervent hopes of financial product designers notwithstanding, are process inputs and not investment vehicles. It takes time for a price increase in a futures or forwards market to reach the processor and then it takes more time to be reflected in producer goods and still more time to be reflected, imperfectly, in consumer goods. How much time? I analyzed a range of 25 different markets with investable indices as compiled by Dow Jones-UBS and found it was not at all unusual for the transmission lag between commodity changes and PPI changes to exceed 30 months, or two and one-half years. You are spared the methodological details.

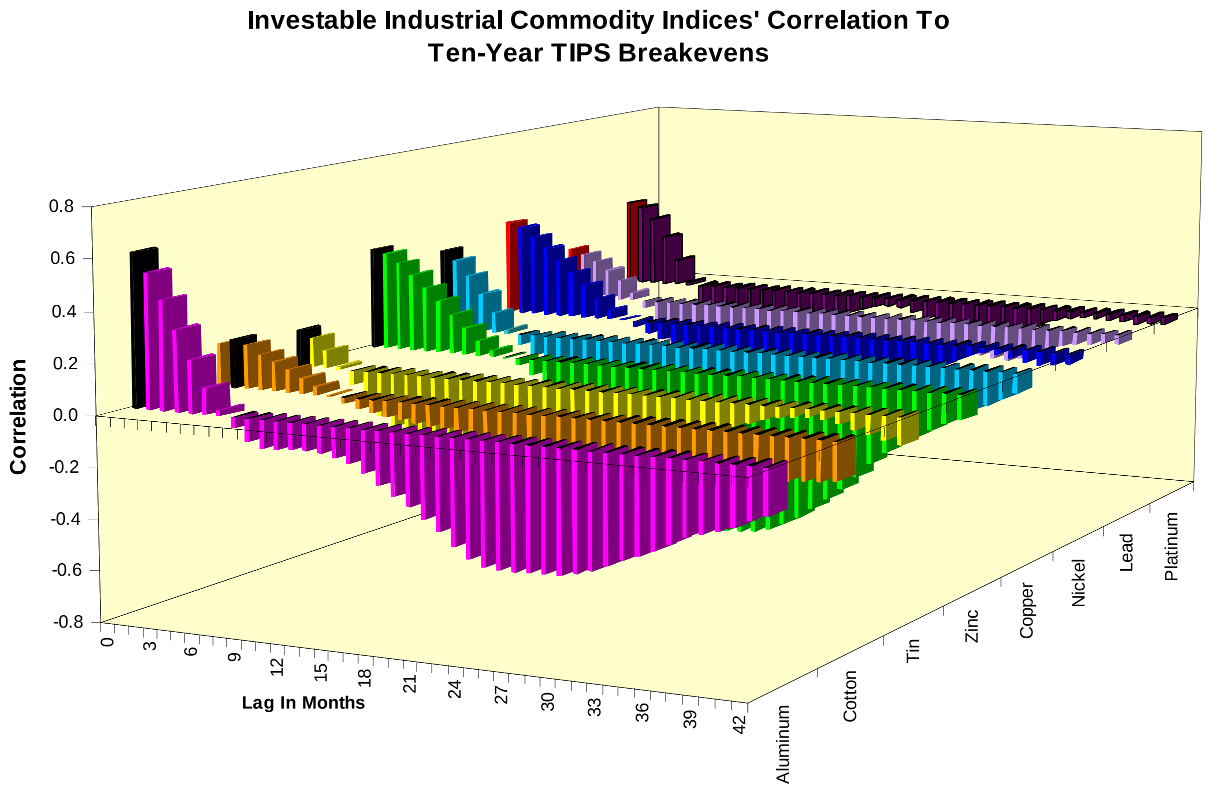
Let’s focus on one set of markets, industrial commodities; unlike the energy or soft foods markets, these do not turn into consumer goods directly. You have bought gasoline or sugar; chances are you never had an urge to start stockpiling zinc just to see what would happen (see silver for a hint). However, and this is surprising, the lead-times between commodity price increases and the PPI is far longer on average for the petroleum complex than it is for any of the industrial commodities below save for nickel and platinum.

The chart below highlights the maximum correlation lag between the commodity indices and the PPI in either red or black. Cotton never has a positive transmission into the PPI. Those for lead, tin and copper are surprisingly short, 5, 2 and 2 months, respectively, but please note the long and slow decline path of these correlations.

Investable Industrial Commodity Indices' Correlation To PPI



Now let's shift to the transmission into the ten-year TIPS breakeven rate of inflation. Now every market but cotton's transmission peaks at lag 0, which is to say an increase in three-month aluminum forwards has an immediate and profound affect on the ten-year forward consumer inflation. Cotton peaks at lag 2, which is equally absurd.



Please note as well how quickly these correlations decline after the first few months. The TIPS market is a very twitchy animal, apparently, and it likes to react to things that may be in the future as if they were a clear and present reality.

This is not a market inasmuch as it is a collection of neuroses.

The real danger here is the Federal Reserve has told the world it is following inflation expectations to set policy. This sort of reminds me of the bumper sticker, "Don't follow me, I'm lost."