Real Commodity Returns Often Negative

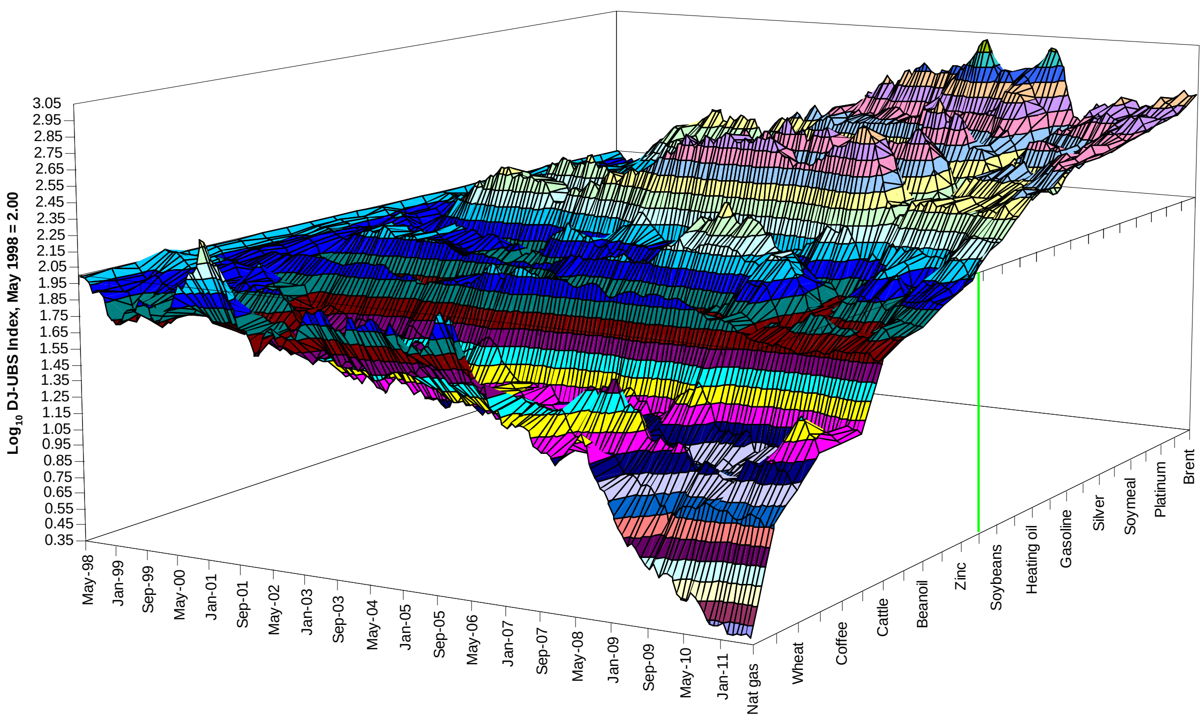
Garrett Morris of the original *Saturday Night Live* cast created the character of Chico Escuela, a Dominican baseball player who signature line was "Baseball been berry, berry good to me." In a most bizarre way, I feel the same way about gasoline prices and the entire subject of whether something called "commodities" as a collective entity is either the product of monetary excess or good protection against that same excess. A child born when I first began writing about these things would be eligible to run for U.S. president and promote something called "green jobs," hold your applause.

The simple fact of the matter is individual commodities, all of which are economic process inputs and not investment assets, are surprisingly poor hedges against inflation. At their most basic, all inert assets such as a handful of dirt, referenced in the immortal line, "Throw some dirt on it!" should rise in nominal price if expected inflation exceeds the holding costs over a period.

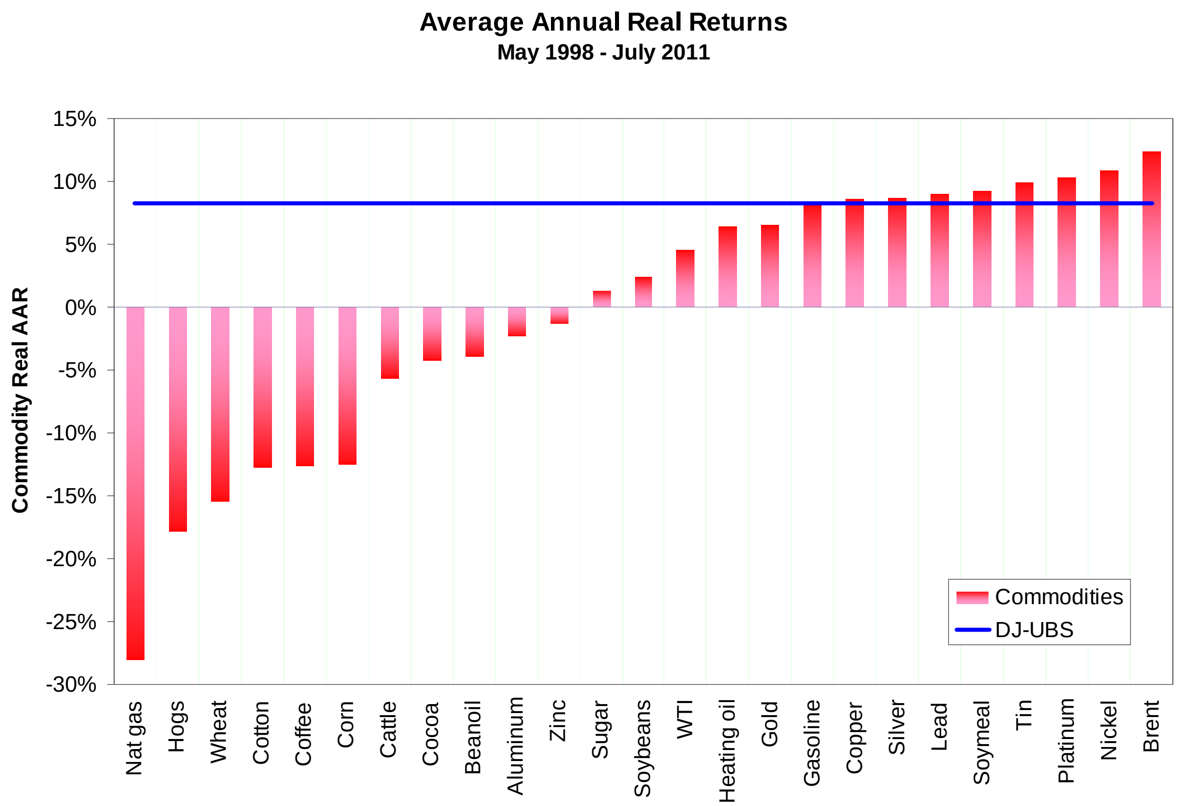
However, this relationship is destroyed once we shift from a static to a dynamic analysis. Higher prices attract new production on the part of sellers and both conservation and substitution on the part of buyers. Thus the constant-dollar price of a commodity should decline over time unless, and these are big exceptions, the resource involved is extracted without recycling or replacement, as is the case for crude oil or the resource involved is hoarded, as is the case for gold.

If we look at the return paths for 25 different commodity investment indices as calculated by Dow Jones-UBS and deflate them by the Producer Price index, we find eleven of them failed to match the PPI between May 1998 and July 2011. On the bright side of the equation, those who keep lamenting the lack of diversification should take heart in the wide dispersion of returns over time here.

Real Commodity Returns Highly Differentiated Over Time



If we rearrange the data above into average annual returns, we find 17 of the commodities in question underperformed the PPI-deflated average annual return of the DJ-UBS index itself. One of the arguments I have made over the years is if you want to hoard a commodity, be selective. Or, if you want to trade platinum, trade platinum and do not bother dragging hogs or cotton into the affair. Individual commodities whose linkages are confined to 1) tangibility and 2) being exchange-traded are not and never will be amenable to indexation no matter how slick the marketing presentation is.



By the way, the nominal period return on the DJ-UBS index over this period was 139.4%; if we extend it out to August for which the PPI data are not yet available, it is 141.78%. The total return for the Merrill Lynch index of 7-10 year Treasuries was a near-identical 141.91%. Imagine those marketing presentations in mid-1998 saying, "Invest in commodities! They're just as good as Treasury notes!"

Life can be cruel.