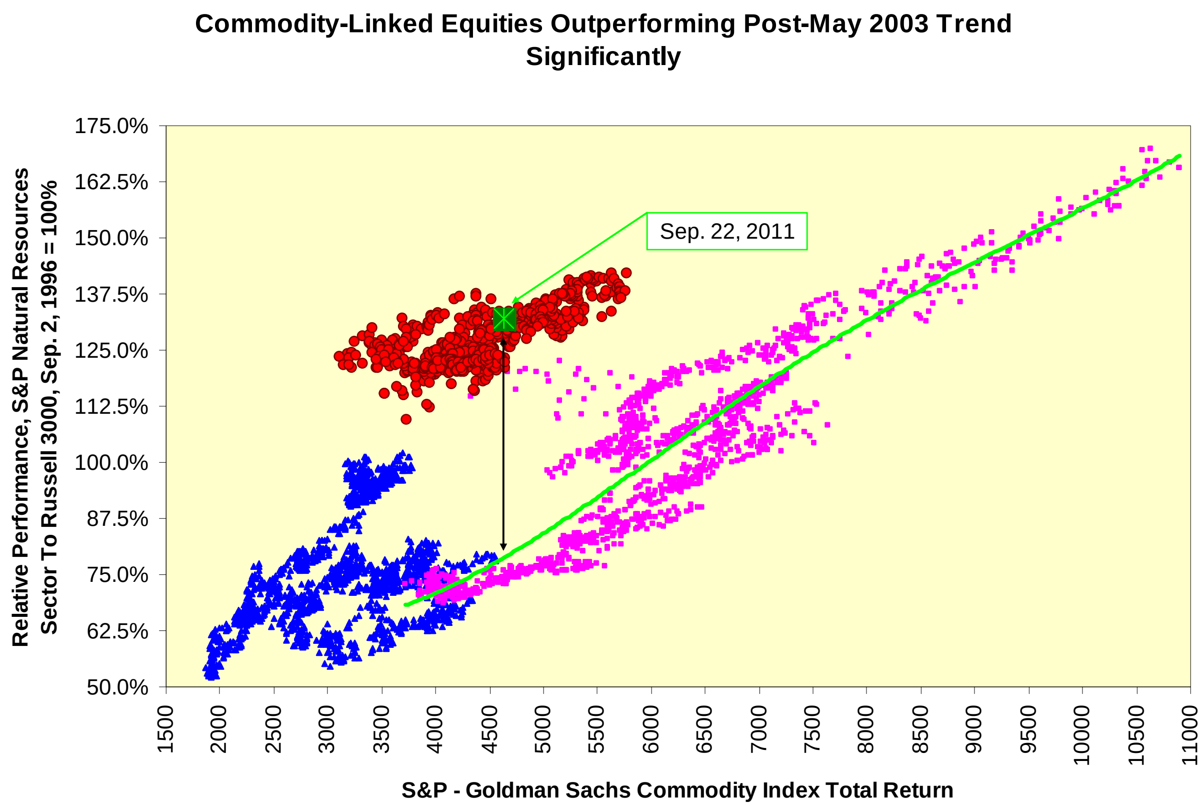
Commodity-Linked Equities No Port In Storm

Remember those poetry classes from those long-ago days when someone, somewhere was convinced your life would be enriched if only you could remember what iambic pentameter was? One term that stuck with me was, "onomatopoeia," a word with a very descriptive sound. One example, definitely not derived from a poem is "schmeissing," a word derived from the German MP40 submachine gun of World War II vintage developed by the eponymous Hugo Schmeisser and often called the "burp gun". The Schmeisser could really schmeiss people downrange, hence the word schmeissing to describe conditions such as last week's selloff.

Even before the combined stock and commodity schmeissings, I was going to revisit a column from March on why the relative performance of commodity-linked equities was going to turn lower. That was a reasonably bold call considering how most commodities were sailing higher at the time and a bet against monetary sobriety seemed to be a fool's errand and one from a stupid fool at that. Has the outlook improved? In a word, "No;" commodity-linked equities remain well over their longer-term relative performance measure and long since have ceased providing protection against dollar weakness. Even worse, dollar-weakness may be yesterday's news given the pressures to unwind carry trades.

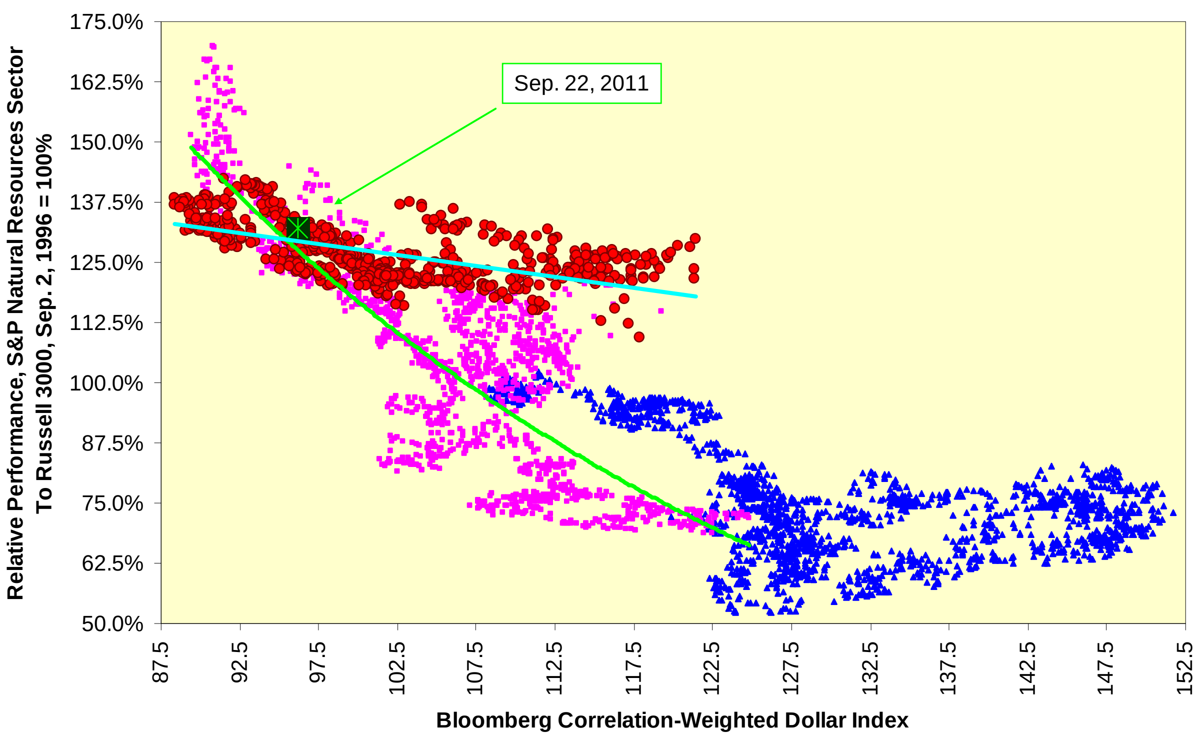
As before, we will use the S&P North American Resource index to represent commodity-linked equities and the Russell 3000 index to represent the U.S. broad market. The two indices' returns since March have been -18.81% and -13.77%, respectively. We can map this relative performance over three different 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 red, 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 32%; if we were following the previous period's trendline, we would be underperforming by about 24%.



Now let's map relative performance against the *Bloomberg* correlation-weighted dollar index; this was chosen as its weight in the euro is only 16.41% as compared to the ICE dollar index' 57.6% euro weight. Please note how the slope of the current turquoise trendline is much flatter than that of the previous period's green trendline, -0.0045 as compared to -0.024. The dollar's strength or weakness just does not matter to commodity-linked equities' relative performance anymore.

Commodity-Linked Equities Weakening As A Dollar Trade



If the global economy is going to slow, a statement and not a prediction, we should expect the margins of resource-producers to get squeezed. They have expanded their fixed-cost structures in recent years and will have to sell ever-greater quantities of material to generate the revenue to cover those costs. As they are relatively expensive to start and cannot get a currency boost, they are going to be in relative trouble and are at a risk of an absolute schmeissing.