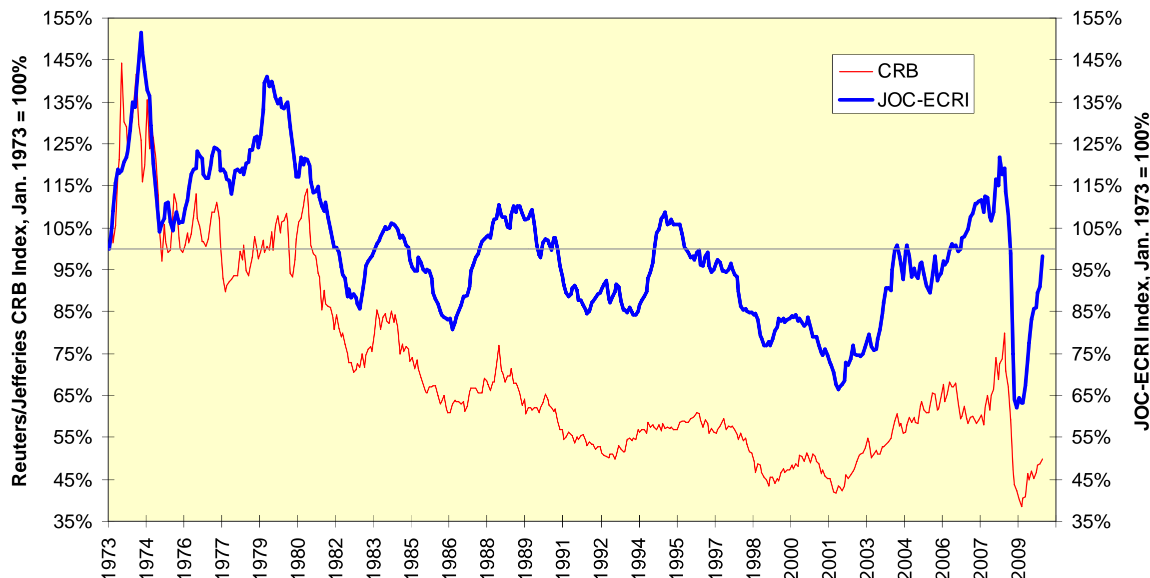
Commodities Are Poor Inflation And Currency Hedges

Some things just seem so obvious to everyone that they are accepted without further examination. Take the role of "commodities" as hedges against either inflation or dollar depreciation, please. First, let's stipulate there is really no such thing as "commodities." These are separate markets we tend to lump together when they are 1) exchange-traded, and 2) tangible. Suffice to say the covariance of these individual markets is so low or even negative and so unstable over time they might even be better suited as hedges for each other rather than macro variables such as the dollar or producer price inflation.

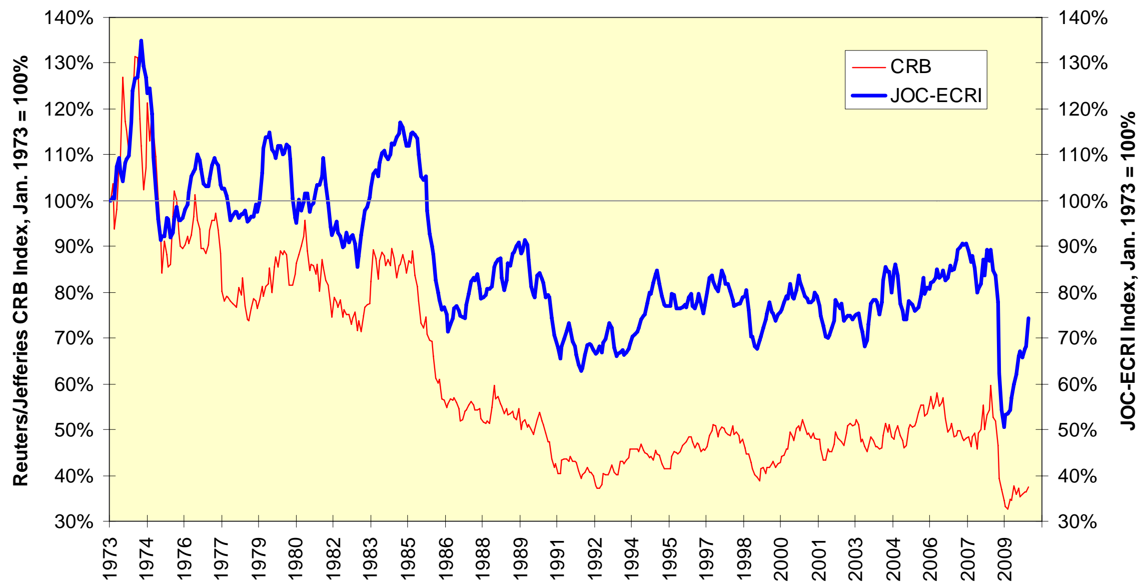
But that is a separate issue, really. Let's turn right around and take two broad-based commodity indices with very long histories, the Reuters/Jefferies CRB index and the Journal of Commerce/Economic Cycle Research institute index. The former is a blend of futures contracts, the latter includes numerous commodities such as tallow, burlap, polyester, benzene and red oak on which no futures contracts exist. The JOC-ECRI index, incidentally, is designed to duplicate the year-over-year changes in the PPI.

Neither of these indices is the basis for most index-based commodity investing. That honor goes to the Dow Jones-UBS and S&P-Goldman Sachs commodity indices. Both of these can be measured on a total return basis, which includes interest earned, the roll yield on contracts when they shift from month to month and any rebalancing yield as the indices are reconstituted. As the roll yield in particular has been negative in recent years, the spot price indices shown below actually overstate the effectiveness of commodities as inflation and dollar hedges.

Let's go back to the start of the Federal Reserve's trade-weighted dollar index for major currencies in January 1973; this differs from the dollar index traded on ICE Futures U.S. by virtue of its lower weighting in the euro and its predecessors. If we deflate the two commodity indices by the PPI over this period, we see the CRB and JOC-ECRI indices lost 50% and 2%, respectively, of their price level. This is not much of a hedge, is it?



Now let's adjust the PPI-deflated series for changes in the trade-weighted dollar. Here the results are even bleaker for the long-only commodities crowd: The CRB and JOC-ECRI lost 62% and 26% of their price level.



So many people forget the simple reason why this must be so: Commodities are process inputs. You buy crude oil to refine it into usable products, you buy corn to feed people, livestock and yeast, etc. If the constant-dollar price did not decline, it would imply no one was getting more productive. This is nonsense of the first order and quite possibly the second order, too. The efficiency of the U.S. economy in energy consumption alone, BTU per constant dollar of GDP, has been increasing at a 2% average annual rate of almost 2% since 1973 according to the Energy Information Administration.

Just because the value of paper money is declining does not mean the value of a static asset has to be increasing at an equal and opposite rate. Nor will wishing it make it so. If someone tries to sell you “commodities” as an investment, be very careful indeed.