Food Stocks Shrug Off John Barleycorn's Demise

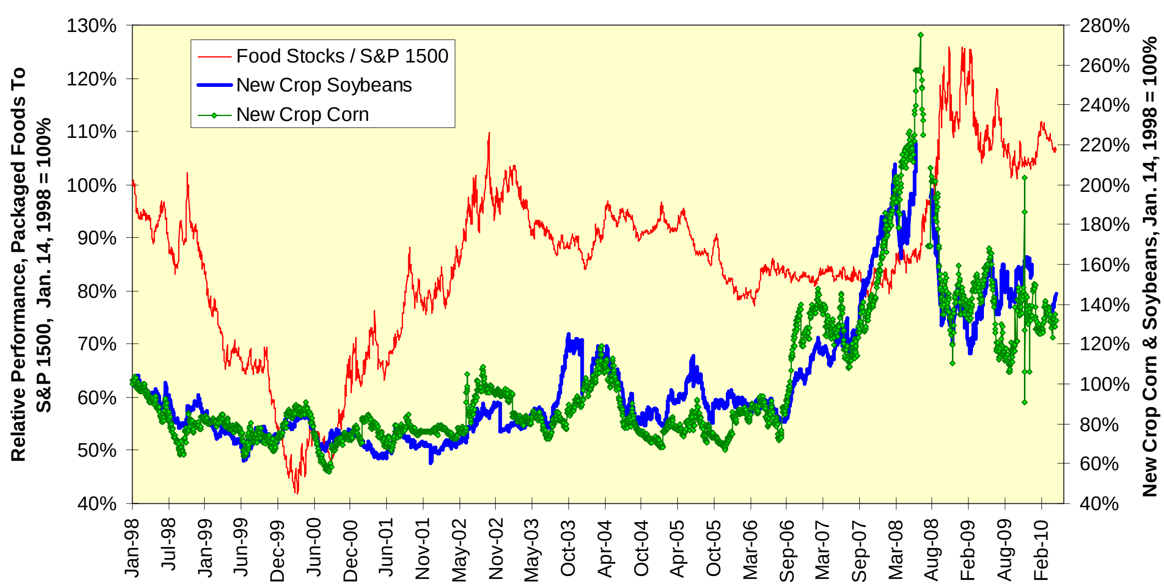
Ralph Waldo Emerson famously said, "A foolish consistency is the hobgoblin of little minds," or so I remember from a high school English class where we had to sit in a circle and I drew, by sheer chance I am sure, the best view across the way. I never did figure out what a Transcendentalist was, or why someone with the middle name of 'Waldo' (where is he now?) actually would use it, but some things in life must remain mysteries.

This brings us to those little rules we use for assessing commodity-linked equities, one of which is processing margins tend to get squeezed when feedstock costs rise. This used to operate quite well in the refining industry; if crude oil prices rose, crack spreads or the margin between the refined products such as gasoline and heating oil and the crude oil feedstock, would narrow. That went by the wayside a few years back when global refining capacity became scarce and refiners could pass on their higher feedstock costs, but that is a story for another time and place.

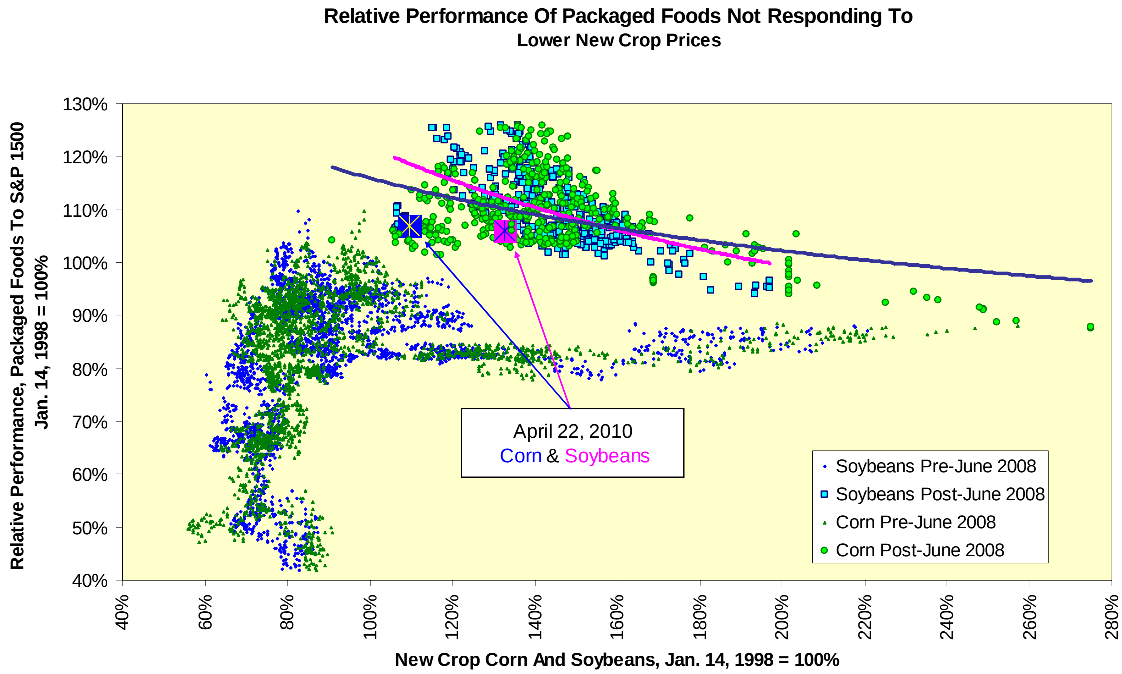
Sometime rules operate asymmetrically; higher feedstock costs squeeze margins on the way up, but do not expand them as much on the way down. The S&P Supercomposite Packaged Foods group, which includes firms such as Kraft, General Mills, Wrigley, Heinz, Kellogg, ConAgra, Sara Lee, Campbell Soup and Hershey Foods, seems intent on breaking the rules in both directions.

If we map the relative performance of this group against the S&P 1500 itself going back to 1998, we see it has seldom done really well on a relative basis – these are food stocks, not tech stocks – but they did very poorly back during the late 1990s tech bubble; the risk/reward has been skewed to the risk portion. The huge run-up in new-crop corn and soybean prices now represented by the December and November 2010 contracts, respectively, during 2007 and the first half of 2008 did little damage to the group's relative performance. Indeed, once the rest of the world fell out of bed in the second half of 2008, food stocks outperformed on the inarguable notion people would still eat. The group's relative performance then stalled with a downward bias as corn and soybean prices.

Packaged Foods' Relative Performance Declining
As Corn & Soybean Prices Stabilize



If we split the sample into pre- and post-June 2008 time periods, we see how the relative performance of the food group as a function of new-crop corn and soybean (small green and blue markers) stayed flat as prices rose. Post-June 2008, relative performance rose during the early phases of the price break, as highlighted by the indigo and magenta trend curves, but has stagnated materially since. The last data points used are well below the trend curves here.



The current relative performance of the group is still much closer to its high than it is to even the midpoint. In a memo to human resources (and if they cared about people, they would not call them ‘human resources’) commissars everywhere, you cannot induce higher performance by cutting costs. This group will need to see substantial growth in discretionary income and in exports to reward its shareholders without simply engaging in more mergers and acquisitions as Kraft has done with Cadbury. A bread-and-butter business is not always a bread-and-butter investment.