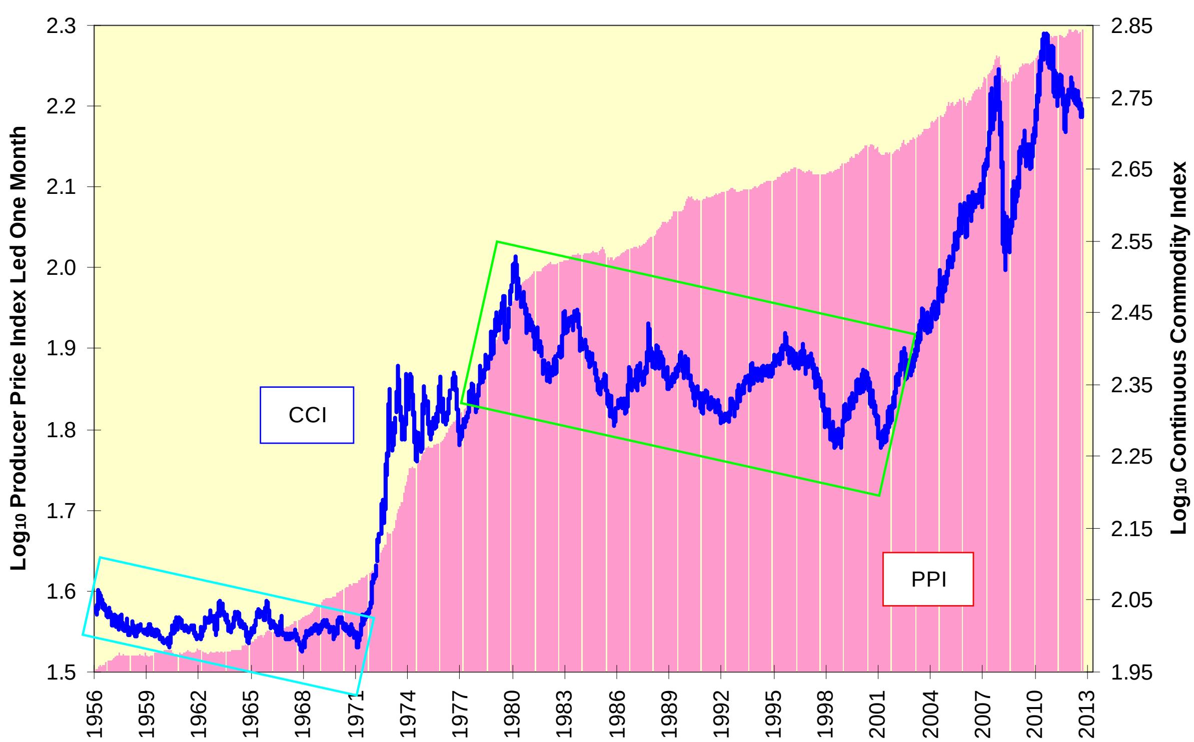
Downturn In Commodity Prices Will Not Reduce Producer Prices

One of the great parts about being a financial writer is you get to keep disabusing the same people who hold the same misconceptions by using the same data series extended by the time elapsed. Occasionally the data series used disappear, as has happened with my beloved nine-month LIBOR, sometimes they disappear and are replaced with newer versions, such as heating oil being replaced by ultralow sulfur diesel fuel, and sometimes the same concept is modified, such as the CRB commodity index has done over time. It is now the Continuous Commodity index (CCI).

Thus the index is different than the one I discussed in relationship to the Producer Price index (PPI) in March 2011. But, in homage to Raymond Chandler and other film noir auteurs, while the players change, the game remains the same. There is no demonstrable link between lower CCI levels and lower PPI readings. Please note how I said, "lower;" as you can see in the chart below, the history of this index has spent most of the time in downtrends, one between 1956 and 1971 and another between 1980 and 2001. The PPI rose through both downtrends. The PPI also rose during the 2002-2011 bull market in commodities, the one dubbed a "super-cycle" by various gasbags, but at a rate not materially different from 1980-2001.

Lower CCI Will Not Translate Into Lower PPI

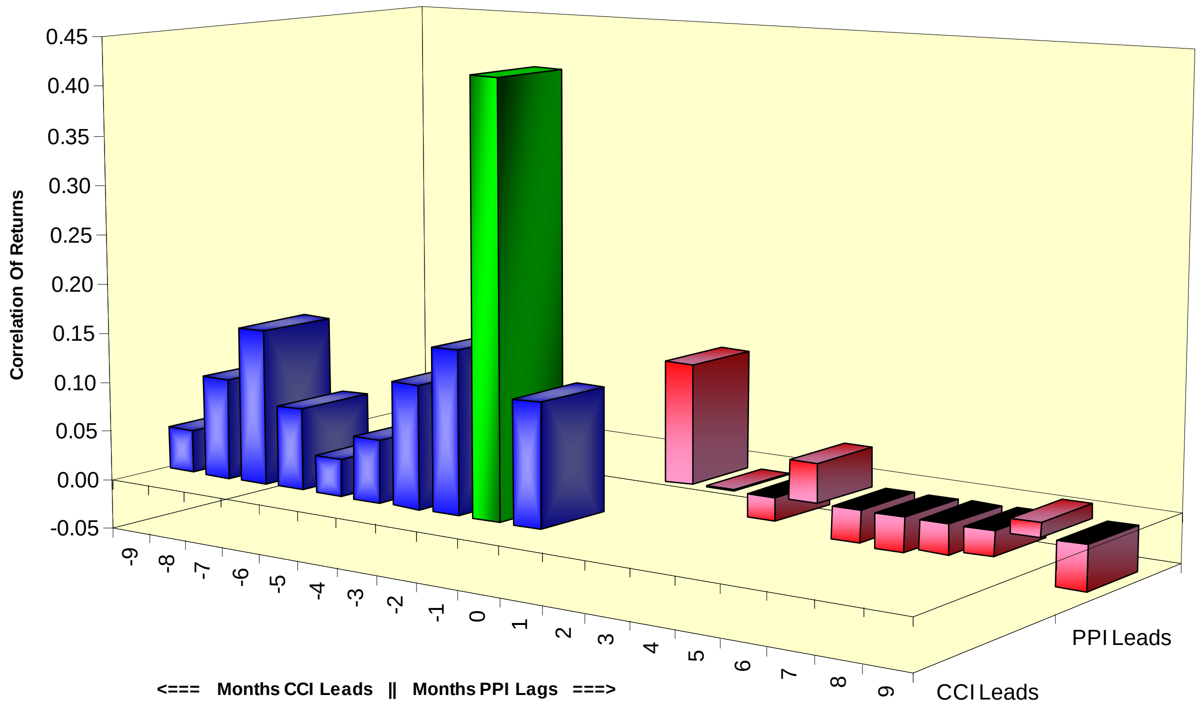


If I did not label the chart above and simply asked you whether the blue bars led the pink columns higher, your answer would be, "No." However, the indelible mental association between higher commodity prices and higher producer prices remains and I think it always will.

The Mystery Lead

So saying, the monthly returns on the CCI lead the monthly returns on the PPI by one month, highlighted with the bright green column in the chart below. While the data are what they are, this is economic nonsense of the first order: The commodities underlying those futures contracts will not be delivered for months and will not move through the processing chain until later. The quick reaction to visible futures prices may represent management gamesmanship; how many times have you heard some excuse about a consumer goods company, say a Procter & Gamble (PG), raising prices on coffee and blaming it on higher coffee futures prices? You take what you can get in this world.

Do Commodity Futures Really Affect PPI Immediately?



Who Benefits From Lower Prices?
The real reason a lower CCI will not translate into lower producer price growth is processors capture most of the economic rent from lower prices in the form of higher margins. The actual producer gets stuck with the lower price. When costs rise, the processors pass them along to consumers. All of these transactions are modulated by the various elasticities of both supply and demand.

There is a reason why no statues have been built to the proverbial “middleman;” after a while, non-middlemen start to get grumpy about this heads-I-win/tails-you-lose behavior. Perhaps this is why middlemen industries susceptible to Internet disintermediation have been pressured over the past two decades; you can replace a broker with a Website, but try doing it with a refinery or metal-processing plant. These materials processors have retained a great deal of pricing power.