Lower Grain Prices Not Benefiting Food Processors

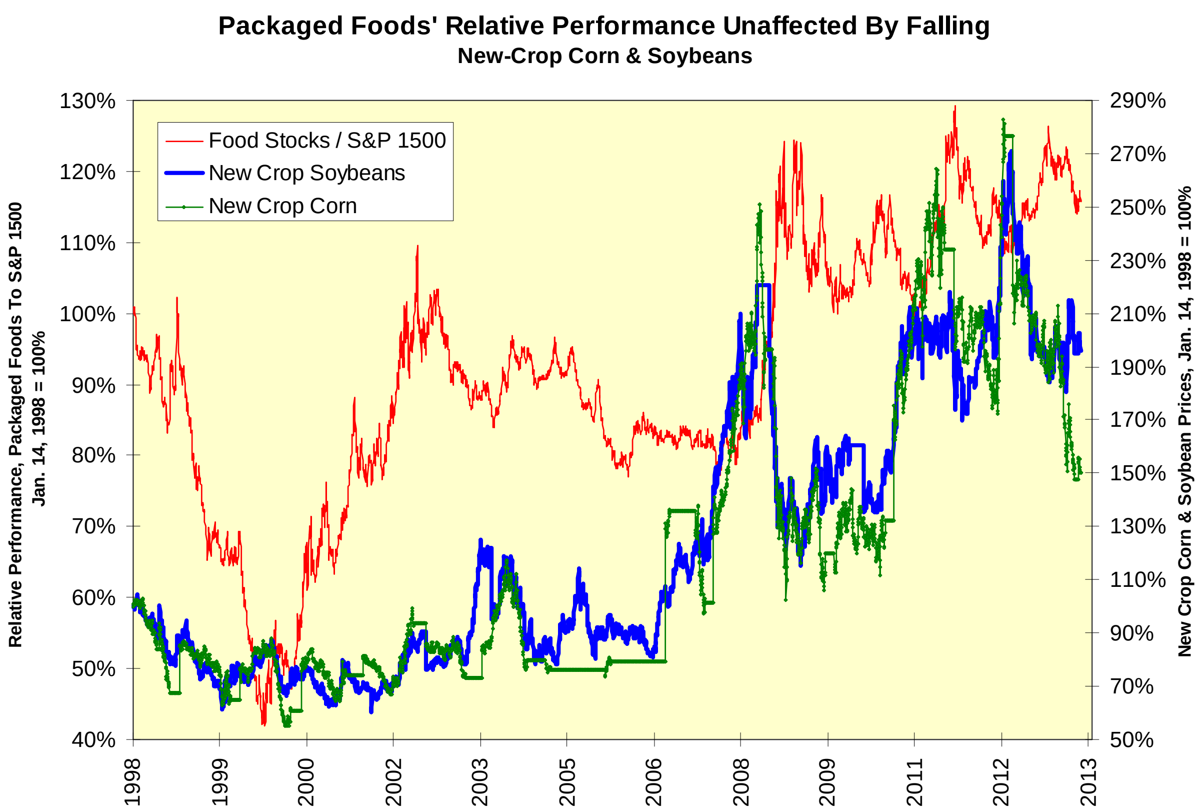
Isaac Newton might have been on to something with that whole "for every action there is an equal and opposite reaction" thing in the realm of mechanics, but it does not operate reliably in the realm of trading and investment. I might add Newton, a true giant in the history of physics and mathematics, got clocked in the South Seas Bubble of the early 18th Century. Izzy the Great lamented, "I can calculate the movement of heavenly bodies but not the madness of men."

Many investors assume a Newtonian clockwork response in commodity-linked equities. The assumption is rising prices for commodities sold should push the price of producers' stocks higher and vice-versa for consumers' stocks and lower commodity prices. Were it only the case; not only are the stocks affected significantly by their beta to the market as a whole, management issues, interest and exchange rates, investors at the margin tend to do a very good job of discounting short-term commodity price volatility and focus instead on long-term smoothed trends. Moreover, commodity feedstock costs often represent a smaller portion of total costs than assumed. No one denies the importance of jet fuel prices for airlines, but even these take a (cramped) backseat to labor costs.

Packaged Foods

The recent experience of the S&P Packaged Foods group, whose members include ConAgra (CAG), General Mills (GIS), Hershey Foods (HSY), Tyson Foods (TSN) and Kraft Foods Group (KRFT), inter alia, provides a case in point. I forecast in July 2012 drought-induced higher new-crop corn and soybean prices would depress this group's performance relative against the S&P 1500 Supercomposite. They did, briefly, by 6.63% between late June and mid-September, before grain prices themselves stopped soaring.

Where are we today? New-crop corn prices have tumbled in 2013 as farmers responded to last year's high prices by increasing plantings. New-crop corn at Memphis, Tennessee, has declined 33% since December 2012; new-crop soybeans at Osceola, Arkansas, have declined 13.5% over the same period. The Packaged Foods group has underperformed the broad market by 0.12% since then, and we are seeing stories such as Kellogg (K), the breakfast cereal maker and an iconic company, reducing its workforce by 7% to save costs.



The map of relative performance since January 1998 reveals something else: The two periods where Packaged Foods' relative performance increased rapidly were the two great bear markets of 2000-2002 and 2007-2009.

Relative performance rose not as a function of these stocks doing absolutely well but rather as a function of other stocks in more discretionary and income-sensitive industries doing poorly.

You have to eat, yes. However, this does not make a generally defensive industry group a good all-weather investment. Finally, if you want to trade corn or soybeans, trade them directly via the futures market and not indirectly in the stock market.