

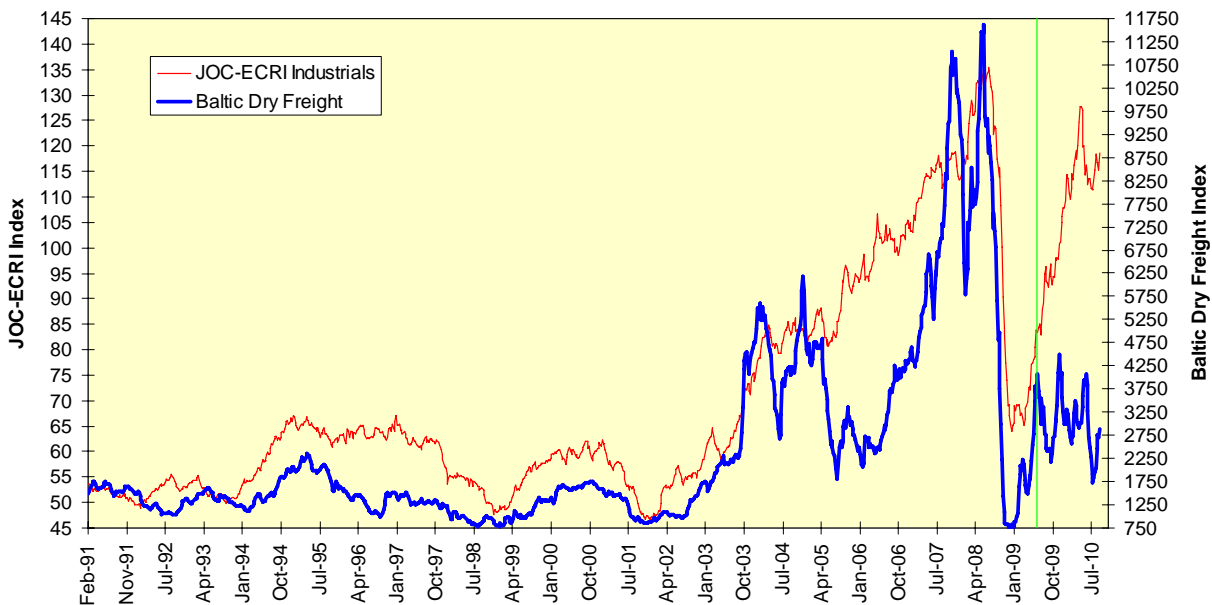
Freight Rates' Mixed Connections

An occupational hazard for most professions is outsiders asking apparently simple questions that have no matching simple answers. I am sure the stock-pickers on this site are asked constantly for a no-risk four-bagger by every podiatrist they meet. For me, the question generally comes in the form, "What indicator...?"

In reality, I always have something I am looking at intensely at the moment, something that has crept into view and appears to explain some anomalous action in the market. However, I know if I give an answer that is correct for the here and now it will change in the near future.

Such an indicator and one that maintained its veracity for a number of years before it became "hot" was the Baltic Dry Freight index (BDI), a compendium of shipping rates for vessels of the Handymax, Panamax and Capesize classes. As the Capesize ore boats were an excellent barometer of shipments from Australia to China, they rose and rose spectacularly into the commodity peak of 2008 and then plunged just as spectacularly into December 2008. The link between the BDI and global equity prices and raw materials prices as measured by the Journal of Commerce-Economic Cycle Research Institute index was unmistakable.

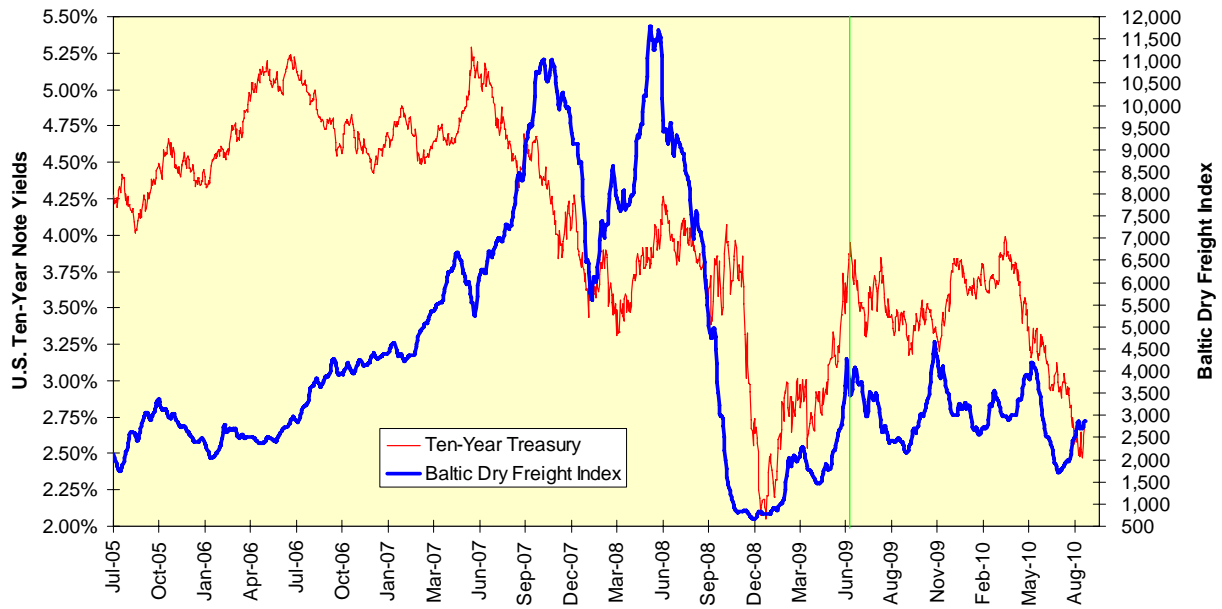
Freight Rates Disconnect From Industrial Materials Prices



Inevitably, the rise in vessel tariffs led to a shipbuilding spree and a spate of harbor infrastructure improvements that increased the supply of shipping capacity and changed the simplistic demand-dependence of the BDI. As the global economy recovered in 2009, the JOC-ECRI raw materials index rebounded but after June 2009, the BDI disconnected.

What remained connected, however, was a long-observed link between the BDI and U.S. long-term interest rates. While this may seem like a case of spurious correlation, it really is not: As Chinese demand for materials increases, exports and earnings therefrom follow. Those earnings need to find a home, and so long as the U.S. is willing to run a massive current account deficit, China must run a capital account deficit with its biggest customer. The flow of funds into the U.S. has helped keep long-term interest rates here well below where they would be otherwise.

Freight Rates And Treasury Rates



This bizarre linkage across unrelated markets is one of the reasons why long-term interest rates in the U.S. have been in a three decade-long downtrend while the supposedly fearsome twin deficits have done nothing but balloon higher.

It is also why the knee-jerk reaction so often seen in the bond market of selling Treasuries on the slightest hint of economic growth is so silly. Simple answers are just that, simple. I am sure the podiatrists get similar questions; every profession does.