One Foot Firmly On The Ocean

Throw an economic indicator up in the air, and Wall Street economists will shoot a forecast through it before it hits the ground. That is what they are paid to do, and no one should be faulted for doing their job. Traders, however, are or certainly should be a different story. They inexplicably are willing to wager good money both in anticipation of these forecasts being realized and to react with shock - shock! - when their economists are once again proven wrong. Why anyone should care about deviations from consensus forecasts that are in fact well inside a statistical error band, especially when these numbers are going to be revised several times before entering the history books is equally perplexing. Let's turn the whole thing around and ask ourselves, "If I can forecast the number correctly, will I win anything?" That the answer more often than not is a resounding "no" should preclude it from being asked again.

The same cannot be said of the economic data generated by the troops in the trenches. While we can question the consistency and veracity of supply managers and purchasing agents, it is very difficult to question real-time retail sales data. No instrument ever designed by human hands peers so deeply into the soul as the cash register. Everything else is an opinion and an attitude. Hard cash on the barrelhead is a fact and a behavior.

Our topic at present, ocean freight rates, falls into the cash-on-the-barrelhead category. Along with their cousin crude oil tanker rates these are both some of the best coincident indicators of general economic activity and leading indicators of where prices are headed. As we shall see, ocean freight rates have a profound impact both on aspects of the real economy and in turn on critical financial variables such as the strength of the dollar, global equity prices and long-term interest rates.

The Baltic Dry Freight Index

Despite the advances made in e-commerce, the general rule of "if you make it, you have to move it" applies for nearly all physical goods. Charles Dow and his later disciples parlayed this insight into the still-used and respected Dow Theory, which holds the Dow Jones Industrial and Transportation Averages must confirm each other's moves to new highs and lows for a general bull or bear market to be sustained. In the early part of the 20th century, the Industrials were in fact manufacturing firms, and not such present-day non-manufacturing entities as McDonald's, Citigroup, Disney or Microsoft, but the principle still holds.

As global trade patterns increasingly are dominated by the trans-Pacific routes, the key shipping indices are dominated by tariffs bringing raw materials into China and tariffs exporting manufactured goods out of China to the U.S. Chinese demand for raw materials especially began pushing the Baltic Dry Freight Index (BDIY) to record levels by late 2003. This surge coincided with both a similar rally in the prices for industrial commodities and with a decline in the dollar.

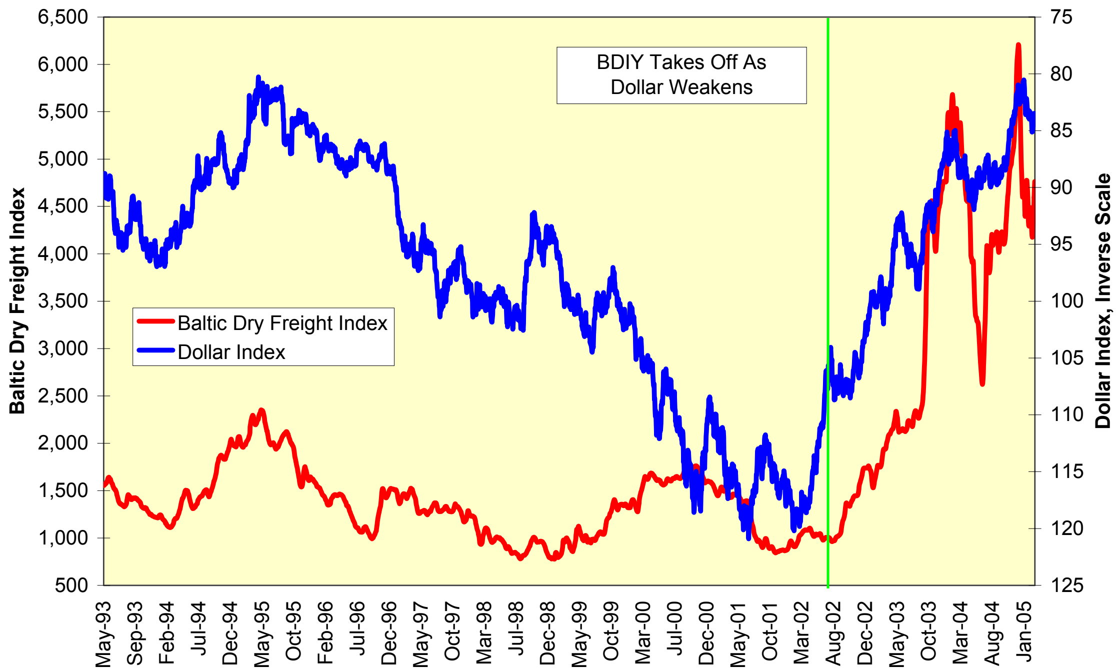
The BDIY itself is a composite index subsuming several smaller indices, each representing different vessel classes. The smaller ocean freighters moving a variety of goods, those between 35,000-50,000 deadweight tons, are tracked by the Handymax index. The next step up, vessels of less than 70,000 deadweight tons and capable of moving grain and coal through the Panama Canal, are tracked by the Panamax index. Finally, the larger vessels used for ores fall into the Capesize index. You can learn more about these indices at the Baltic Exchange's Website, www.balticexchange.com.

Follow The Money

The best way to conceive of recent patterns in world trade is to think of China as the lowest-cost manufacturer in the dollar zone. The Chinese peg of the yuan to the dollar at 8.277 plus-or-minus a few basis points, has eliminated the currency translation risk for bilateral U.S.-China trade. It also has eliminated the investment risk for where to construct new plant and equipment. Quite simply, there is no way for a U.S. manufacturer to compete on delivered prices with a Chinese manufacturer unless the transportation and other delivery costs are high enough to eliminate China's advantages of cheap labor, newer capital stock and - how shall we put this delicately? - less restrictive health, environmental and safety regulations.

We can see an interesting pattern in Chart 1. Once the dollar index, shown on an inverse scale, began to decline in late 2002 under the weight of the Federal Reserve's aggressive rate cuts, the BDIY began its surge higher. The Federal Reserve had meant to stimulate the American economy, but did a far better job of stimulating the Chinese economy: The low interest rates here stimulated demand, and this demand was satisfied not by American production, but by the much cheaper Chinese production. The mechanism of increased raw material imports into China and higher finished good imports into the U.S. pushed the BDIY higher.

Chart 1:
Of Boats And Bucks



We can argue, and will, that the fabled U.S. current account deficit, which can be restated as an equal and opposite U.S. capital account surplus, has not created the weaker dollar. With only a minor and special exception created by various governments helping us pay for the 1990-1991 Persian Gulf War, the U.S. has been in a current account deficit nearly continuously for three decades and yet has witnessed several major dollar rallies during this period.

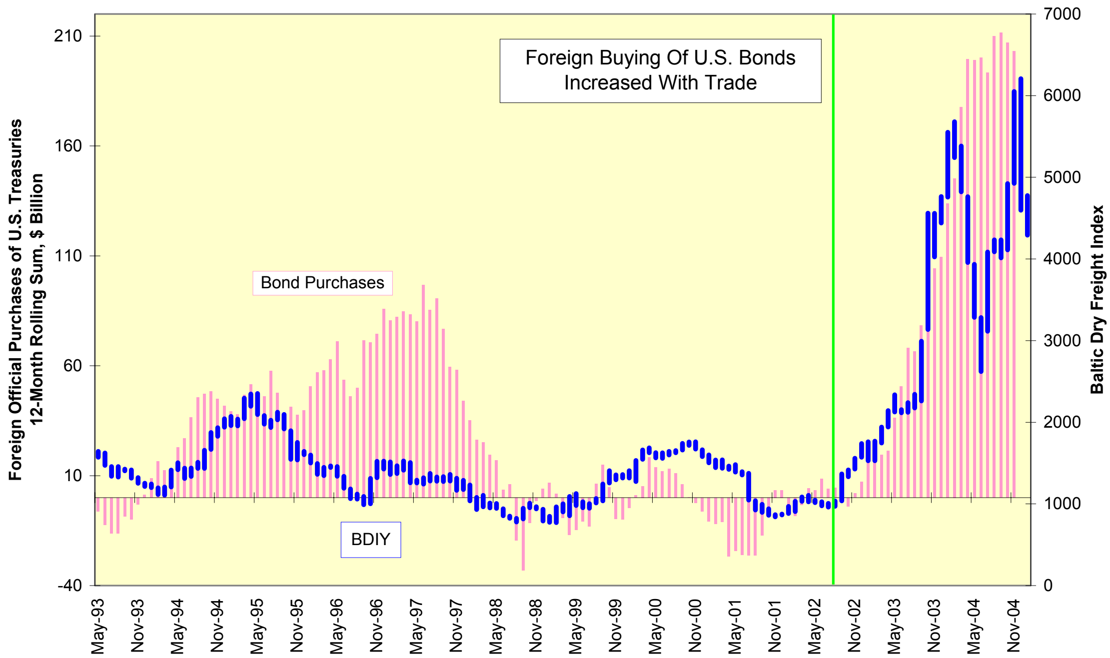
The same can and will be said for that other bugaboo of the unstudied, the U.S. federal budget deficit. Uncle Sam has been a net debtor since 1970, with only the Social Security-induced surpluses of the late Clinton years to break the chain. Once again, the dollar has rallied strongly during various periods of deficit, most notably during the early Reagan years.

The only linking variable that matters here between the BDIY and the dollar is U.S. monetary policy. The Federal Reserve's grand experiment in ultra-low interest rates between 2001 and 2004 produced both the weak dollar and the rising demand for trade into and out of China, which has imported our monetary policy by virtue of its yuan peg.

The relationship depicted in Chart 2 between the BDIY and foreign official purchases of U.S. Treasury bonds is clear: The explosion of freight rates as trans-Pacific trade grew coincided with an expansion of the U.S. capital surplus. While it is true that most of these central bank purchases were from the Bank of Japan, not from the Bank of China, this is really a distinction without a difference. The U.S. dollar is a freely convertible reserve currency, one that can circulate as a medium of exchange throughout the world.

Ultimately it is a claim on U.S. assets; who exercises the claim is irrelevant. The Bank of Japan chose to exercise the claim as part of Japan's longstanding and massively unsuccessful policy of export-led growth. Regardless, the dollars would have found their way back into the U.S.; the alternative would have been for other countries' export engines to slow considerably. The perpetual worry that foreign investors will not buy U.S. Treasury debt is based on the yet-to-be substantiated claim these same countries are willing to engage in bizarre form of economic suicide.

Chart 2:
Trade Flows Drive U.S. Capital Surplus



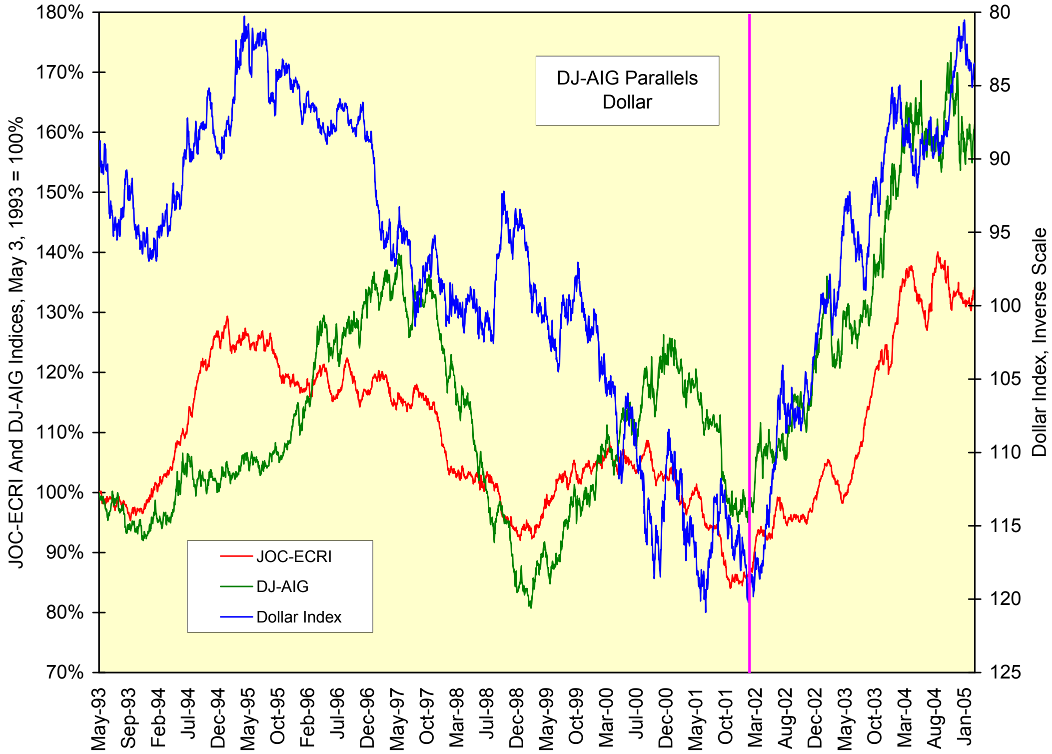
The trading implications created by these international flows permeate all markets and are profound. If you believe the Federal Reserve is going to continue on its path of raising interest rates back toward a 3.50-4.00% range, then you should expect the great trade engine into and out of China to slow and for the dollar to firm. The former development will have serious global macroeconomic consequences; the latter will have serious implications for commodity prices, as we shall see next.

Commodity Prices

To paraphrase a recent President, it depends on what you mean by "commodities." Let's take two very different commodity indices, the balanced Dow Jones-AIG (DJ-AIG) index of exchange-traded futures and the Journal of Commerce-Economic Cycle Research Institute (JOC-ECRI) index of industrial commodities. Only three components of the JOC-ECRI index, crude oil, cotton and copper, underlie futures contracts. The remainder, which include such goods as hides, tallow, red oak, benzene and polyester are sensitive barometers of industrial demand but are hardly speculative favorites.

The common perception is we have been living in a bull market for commodities, and that no doubt has been true since the start of 2002, if not earlier. But what may not be so commonly understood is the extent to which the rally in commodity futures has been nothing more than a reflection of dollar weakness. As we can see in Chart 3, where the dollar index is once again displayed inversely, the DJ-AIG index has underperformed the dollar. The JOC-ECRI index, far more sensitive in measuring industrial demand, has increased only about half as much as has the DJ-AIG. Should the Federal Reserve tap on the brakes a little too hard in coming months - and they certainly have a history of doing so - a combination of weaker Chinese trade and a stronger dollar could lead to a violent retracement lower in the DJ-AIG.

Chart 3:
The Dollar And Commodities

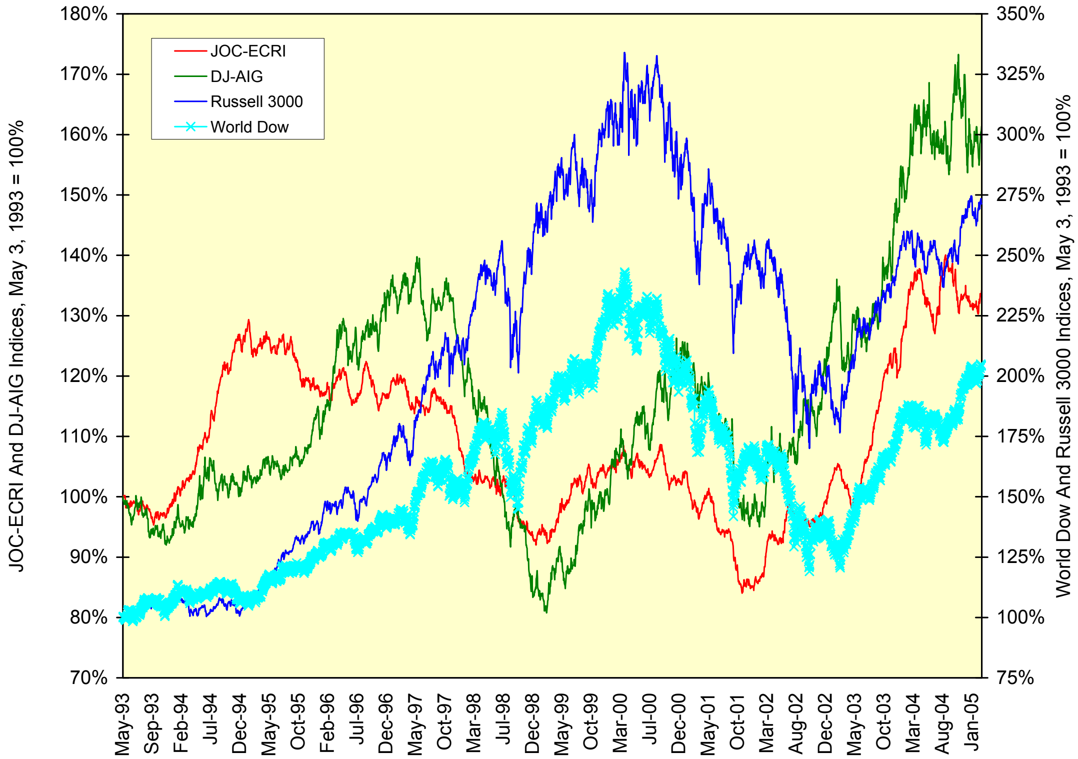


The Equity Link

Once upon a time there lived in the forest a race of analysts who were certain that commodities were the anti-equities. This myopic view reflected a belief that commodity prices rose as a function of some combination of inflation and supply shocks. The experience of the 1970s, wherein commodity prices rose under this combination and equities suffered through a sideways market, was seen as sufficient evidence.

But commodity prices can and do rise along with equity prices and in the absence of either runaway inflation or a supply shock. The experience since 2002 confirms this; here both equities and commodities rose as a function of excess liquidity in the system and strong global growth. The very same lax monetary policies discussed above that produced the surge in the BDIY, the U.S. capital surplus and the weaker dollar also produced a non-inflationary commodity rally and a liquidity-driven stock market. We can see these parallel trends in Chart 4, where the broad-based U.S. Russell 3000 index and the Dow Jones World index, both expressed as percentages of their May 1993 starting value, rose in parallel with the JOC-ECRI and DJ-AIG commodity indices.

Chart 4:
Stocks And Commodities



Nothing in financial markets happens in a vacuum. We can link international trade flows with capital flows by paying attention to two critical variables, monetary policy and freight rates. The former sets the stage for interest rates, exchange rates and inflationary expectations, while the latter confirms how well official policies have affected actual economic activity around the world. Even as the U.S. and China become ever more linked economically and financially, there is still that little problem of the Pacific Ocean separating the two of us. Anything and everything moving across that ocean can be counted, and those who count a little bit better than everyone else can reap the rewards in a host of markets.