Will Reality Bite Commodity Stocks?

It is nice to let reality intrude into your life every now and then. Maybe those deeply held and factually supported statements you made not so long ago are not working as they once did.

One of those statements made early and often in this space was commodities and commodity-linked equities are different, that if you want to trade the commodity, trade the commodity and quit (fooling) around with a stock you think is related. That message was reinforced in March 2004 in reference to the Goldman Sachs Natural Resource index (GSR) of commodity-linked equities.

That index underperformed the rise in commodities at the time, and well that it should have. Commodity-linked equities, after all, are *or should be* affected by rising costs of production, by the forward curves of their underlying commodities, by interest rates, by indexation effects and by risk multiples.

Here is the industry group breakdown of the GSR is shown below. It is really an energy index with a few other things thrown in to be sociable.

Goldman Sachs Natural Resources Index Composition

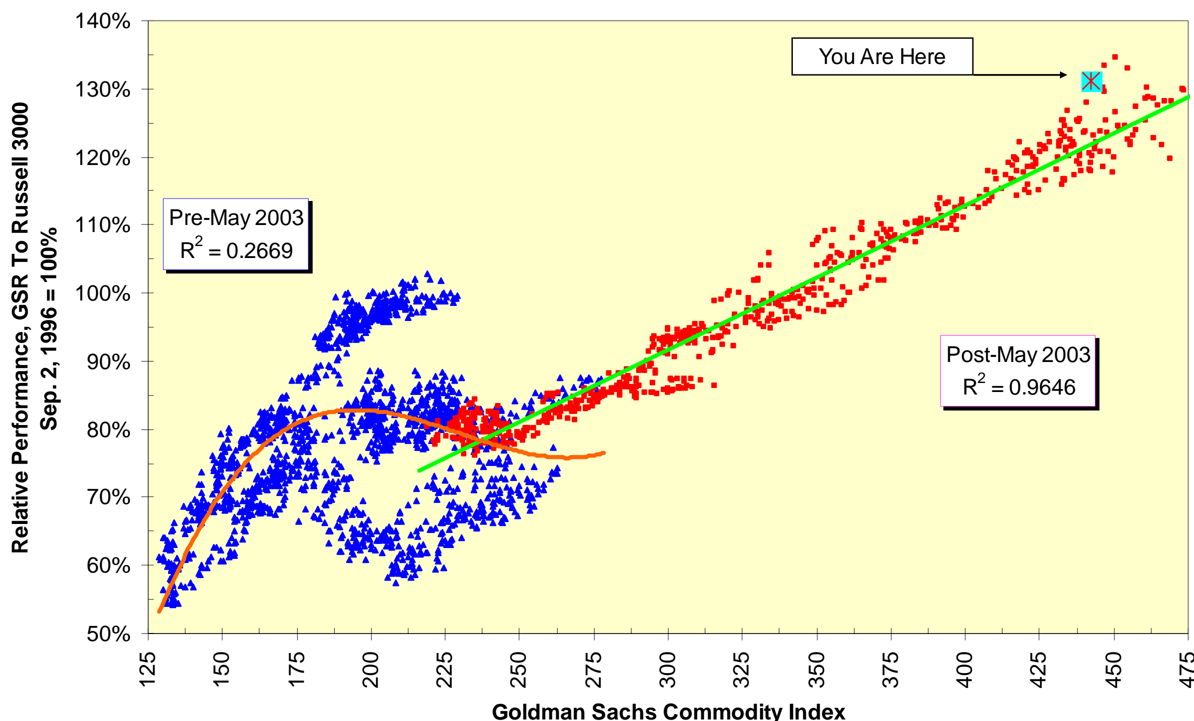
Oil & Gas	**78.85%**	
Integrated		34.78%
Exploration & Production		21.24%
Services		11.05%
Drilling		6.26%
Refining & Marketing		3.55%
Equipment		1.96%
Mining	**11.01%**	
Gold		4.37%
Aluminum		2.66%
Diversified		1.93%
Copper		0.92%
Non-ferrous		0.92%
Diamonds/Precious Stones		0.14%
Precious Metals		0.07%
Pipelines	**3.95%**	
Forest Products & Paper	**3.69%**	
Paper & Related Products		2.29%
Forestry		1.40%
Coal	**1.55%**	
Chemicals	**0.29%**	
Engineering & Construction	**0.23%**	
Packaging & Containers	**0.15%**	
Iron/Steel	**0.14%**	
Energy-Alternate Sources	**0.09%**	
Miscellaneous Manufacturing	**0.07%**	

Get Off The Tracks

But if there is anything all traders learn sooner or later, standing in front of a moving train is your problem, not the train's problem. Throw enough money at any market and you can distort the expected relationships for the duration. Eventually, the market will return to normal; think of our recent and unlamented experience with the dotcom bubble of the late 1990s.

This is happening right now in commodities and commodity-linked equities. Let's map the performance of the GSR against the broad-based Russell 3000 index as a function of the Goldman Sachs Commodity index (GSCI). We can

divide the comparison into two segments, the September 1996 inception of the GSR until the Federal Reserve's declaration of war against deflation in May 2003, and May 2003 onwards.



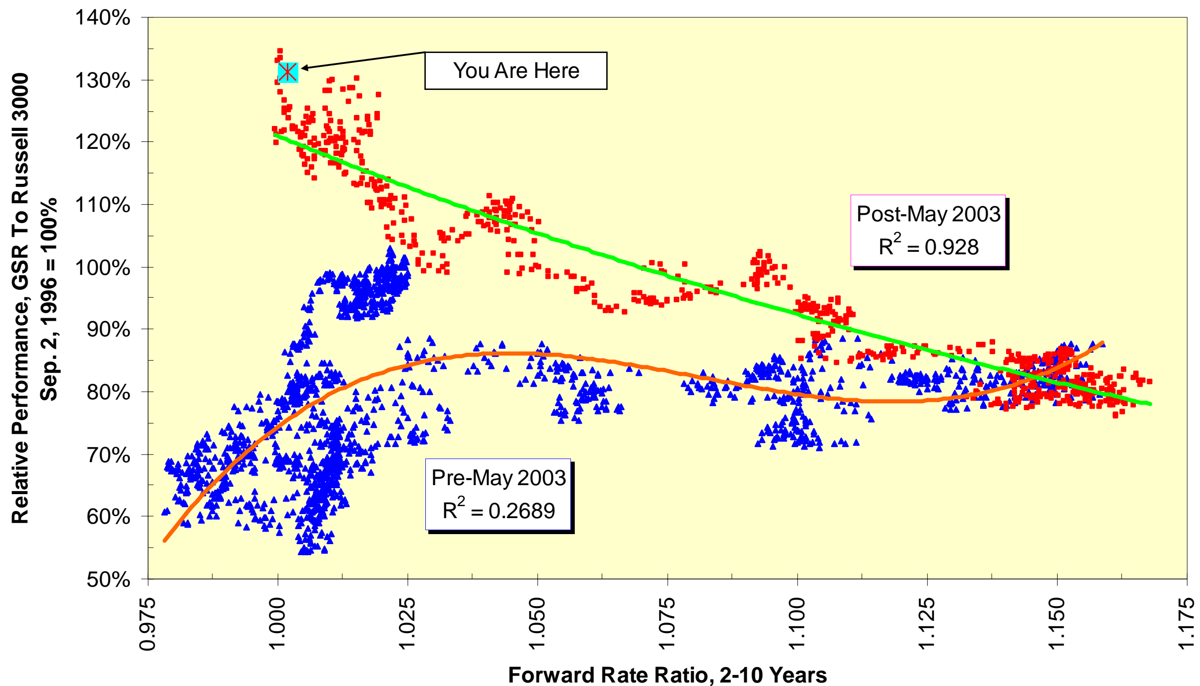
It would be hard to look at this division and not wonder why the expected weak relationship of 1996-2003 suddenly changed. After May 2003, the GSCI surged higher on strong economic growth worldwide and on the Federal Reserve's successful if unintended stimulus of China. That is no typo: Lower interest rates are supposed to stimulate consumption, and they did, but with the cheapest source of production in the dollar zone being China, the most immediately beneficiary of low U.S. interest rates were Chinese exporters. And those exporters needed raw materials.

And as noted here several times, most recently in May 2005, long-only commodity index funds really took off as an investment vehicle at this time, and have been distorting markets ever since. Investment funds chase performance in financial markets, and commodities are no exception. But what is an exception is the U.S. financial regulatory system wherein securities accounts and futures accounts are treated differently. Many investors who do not think twice about taking a flier in stocks, bond or options recoil from the very act of opening a futures account. Judging from reader e-mails I have received over the years, many *RealMoney* readers simply do not want to get involved in futures at all.

The end result is the pattern seen above. Instead of trading crude oil, investors bought ExxonMobil, or instead of trading copper, investors bought Phelps Dodge. That forced the GSR into looking like the GSCI, and the two will look alike so long as the mania continues.

The Yield Curve

Too many commentators make the fast and easy assumption that commodities reflect loose money or at least a positively sloped yield curve. Let's map the relative performance of the GSR to the Russell 3000 against the shape of the yield curve as measured by the forward rate ratio between two and ten years. This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve; values less than 1.00 indicate inversion.



Prior to May 2003, the GSR lagged the broad market when the yield curve flattened. After May 2003, the opposite occurred; as the yield curve flattened, these supposed harbingers of easy money shot higher. The reasons are obvious: The same strong global growth that pulled commodity prices higher encouraged the Federal Reserve to keep on raising interest rates.

The Real World

The last two years have been the best of all worlds for the GSR. But as we saw with the GDP report on Friday, the Federal Reserve's interest rate hikes eventually will crimp growth, and it is the nature of higher commodity prices to be self-defeating. Demand growth will slow and new supply will be stimulated.

At some point, these stocks will leave their little Shangri-la and return to what college students still refer to as "the real world." That means they will have to adjust to not being substitutes for the commodities themselves and to recognize the effect of higher short-term interest rates. This point is not imminent, but when the oil stocks and their fellow travelers start rolling downhill, do not make the mistake so many made with technology in 2000-2002. Reality will bite.