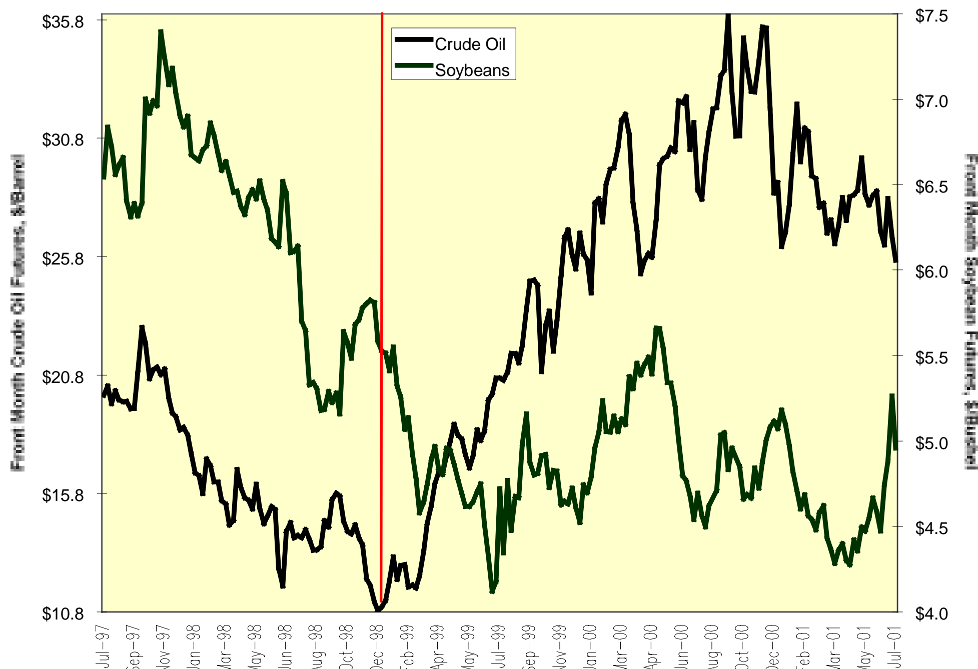
Sheik, Prattle, and Roll

Want some good, clean fun in financial markets? Stay away from stocks and bonds, and focus on commodities. As odd as this may sound to the casual observer, commodities are pretty incapable of putting in the daily percentage price changes exhibited by such movers as Veritas Software, which had a 19% gap between its close on July 17th and its opening on July 18th. Microsoft pulled the same stunt twice in different directions, with a 6.3% close-to-open gap higher over July 11-12, followed by a 6.2% gap lower over July 19-20. If you can't trust Microsoft, whom can you trust?

The musings below are inspired by two events in commodity markets last week. The first was the collapse, for the time being, of this year's weather-related rally in soybeans. The second was the $1.16 rally in September crude oil on OPEC's threat, one of dubious credibility, to cut production by 500,000 barrels per day in response to lower prices. The single-day moves on Friday were 4.2% and 4.7%, respectively. Over the past four years, which takes us back to the first Asian financial crisis, neither of these key commodities has exhibited an inflationary trend. Moreover, their trends diverged after crude oil hit its low in the winter of 1998-1999.

It Helps To Have A Cartel



Physical Commodities: Value Before Value Was Cool

The reasons for commodities' relative quietude are pretty direct. The fundamental value of a stock, so we're told, is the discounted stream of future dividends, and what could be easier than that? All you need to know is everything about the company's future earnings growth rate, its relative position in the industry, the path of future interest rates, and investors' appetite for risk. No wonder the cynics amongst us regard stocks as pieces of paper with someone's picture on them, regardless of the indisputable fact this asset class has outperformed all others over time.

The fundamental value of physical commodities is far easier to ascertain. At the end of the day, 5,000 bushels of soybeans is still 5,000 bushels of soybeans, and while you can dream a little about droughts and Chinese imports, the price can go only so high before people stop feeding soymeal to chickens. End of story, and sadly, end of chickens. The little pearl of trading wisdom, "Can't go there" and "Can't stay there" are two different things applies quite well here.

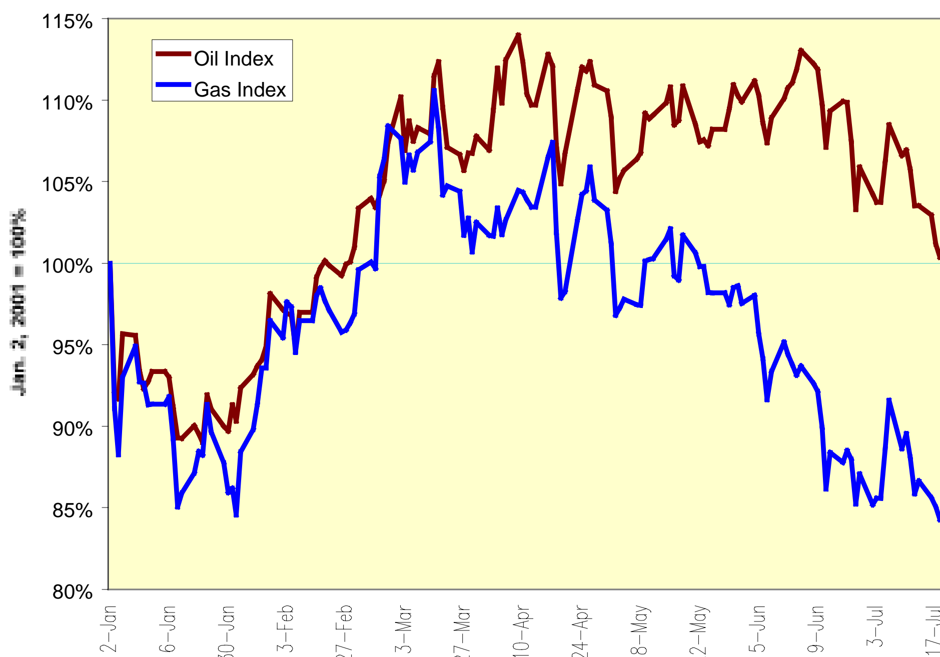
The story is the same, as we've seen, for energy. Sure, natural gas quadrupled to $10.00 per million BTU in 2000, but it's since pulled a NASDAQ-like collapse back to $3.00. Remember the scare stories about $3.00 per gallon gasoline? Didn't happen and won't for a while. The beauty of commodity markets is how the best cure for high prices tomorrow is high prices today. Had Gov. Gray Davis really wanted to ensure a generation of low electricity prices in California, all he needed to do was allow all of the power producers to chase high prices by investing in new supplies.

Don't Have A Cartel? Get One!

Unfortunately, free markets produce losers as well as winners. Much of modern politics, from the traveling circus of anti-globalization protestors last seen in Genoa to the goofy populists in the U.S. Congress who fret that a tax cut might actually devolve to those who paid the majority of taxes in the first place, is about postponing the inevitable fallout from market processes. The OPEC cartel interferes in markets by attempting to control supplies. They've succeeded in this endeavor twice in the past four decades, in 1973, and again in 1999. In both cases the common denominator was surging global demand following a prolonged period of low prices.

OPEC failure is more common, however. Non-OPEC producers such as Mexico, Kazakhstan, Russia, Norway, and the U.K. can increase production while OPEC decreases its output; the result is a loss of market share for the cartel. If global demand growth is slowing, and the International Energy Agency has been cutting its demand forecast continuously this year, OPEC will fail.

Oddly, this weakening outlook for oil prices is supporting the AMEX Oil Index (see "Backwardation In Oil Stocks Rewards Patience," March 8, 2000). Since most oil companies are net buyers of crude oil, their refining margins expand and their production costs fall when crude prices soften. The opposite cannot be said for the AMEX Natural Gas Index; here lower prices have led to serious underperformance in 2001.



Deflationary Pressures Remain

The fall in global commodity prices – the CRB and Goldman Sachs indices are down 10% and 17% this year, respectively – reflects both slowing demand and excess supply. In some sense, this is stimulative for the U.S. economy as lower oil prices act as a tax cut, but deflationary pressures damage commodity producing sectors, such as agriculture and mining. Until this trend reverses, and there is little evidence that the much-forecasted recovery is going to happen anytime soon, we'll be better off positioning ourselves with the commodity consumers than with the

producers. The long refiner/short natural gas producer trade suggested above is but one example of this play. We'll visit some others in coming weeks.

In the meantime, don't worry about our friends in OPEC. If you can't trust them, whom can you trust?