Next Civilization, No Commodities!

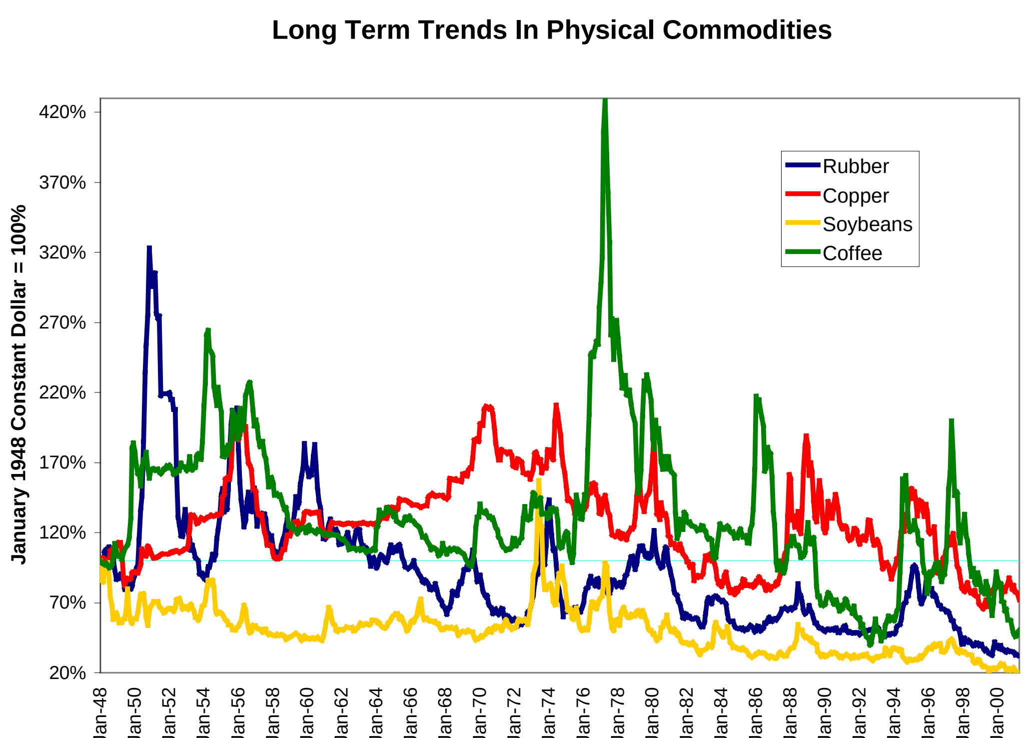
OK, class, time for a quiz: How many cultures throughout history have failed to extol the virtues of the simple farmer? If you answered anything other than zero, you fail and fail miserably. Despite our ability to summarize the history of humanity as "people leave the land and don't return," we not only celebrate the farmer and his commodity producing cousins, but Western civilizations subsidize them to the hilt.

The Western model is probably a good thing, at least in comparison to the common Third World practice of subsidizing urban consumers at the expense of producers. While the Western model has created a history of commodity surpluses, the Third World model has created mega-cities like Lagos, Nigeria, Mexico City, Saõ Paulo, Brazil, etc., which need to be fed by Western surpluses. Is this a great world, or what?

The implications for long-term commodity price trends and international terms of trade and their implications for global investing and currency exchange rates are profound. Quite simply, economies dependent on commodity prices always are going to be in trouble themselves and create trouble for others. Not only does this create trading opportunities, but it should affect the way commodity traders approach price analysis.

Which Way For Commodities?

While it may be news for anyone who paid their natural gas bill last winter or their gasoline bill today, the long-term price trends for all physical commodities is lower, and significantly so. It doesn't matter whether we are talking about a food crop such as soybeans, a tropical soft commodity such as coffee, an extracted mineral such as copper, or an agriculturally-produced industrial commodity such as rubber, the pattern will be the same. In all cases, a long-term secular decline in price will be punctuated by some explosive and short-lived moves higher. These price spikes will encourage new production, substitution, and conservation in demand. In short order, supply overwhelms demand, and the price reverts back to its long-term downtrend. A "famous last words" prediction is offered here and now: The price of natural gas will be lower in July 2005 than it is today. Let's take a look at the long-term price charts of the four commodities mentioned above.



The monthly average cash market data is used to sidestep the problems created by futures contract intermonth spreads. Each one of these commodities is deflated by the more appropriate producer price index, and the deflated series is presented as a percentage of its January 1948 value. The results are a bit astonishing on one level and quite encouraging on another. In January 1948, the world's population was less than 2.5 billion; today it exceeds 6.1 billion. Global wealth and consumption levels certainly are higher today than they were in 1948. And yet with a larger population consuming more resources, the real prices of physical commodities have fallen in the described manner. In fact, soybeans have only exceeded their real January 1948 price once, and that was during global inflation of the early 1970s. Today they stand at 20.3% of that price.

Of course, real commodity prices *should* fall over time. Not only does each mouth come with a pair of hands; those hands come equipped with a brain. Productivity increases allow us to feed more people with a better diet. If real prices didn't fall, the forces of competition would ensure the obsolescence of that given commodity: Who still uses whale oil for illumination? For this reason, the Malthusians and their tiresome arguments starting with "the world's running out of..." are, have been, and always will be wrong. More than 60% of all crude oil ever consumed has been consumed since the first oil shock of 1973, and yet proven reserves of petroleum stand higher today. If it seems we create resources by consuming them, that's correct. Markets do wonderful things when given the chance.

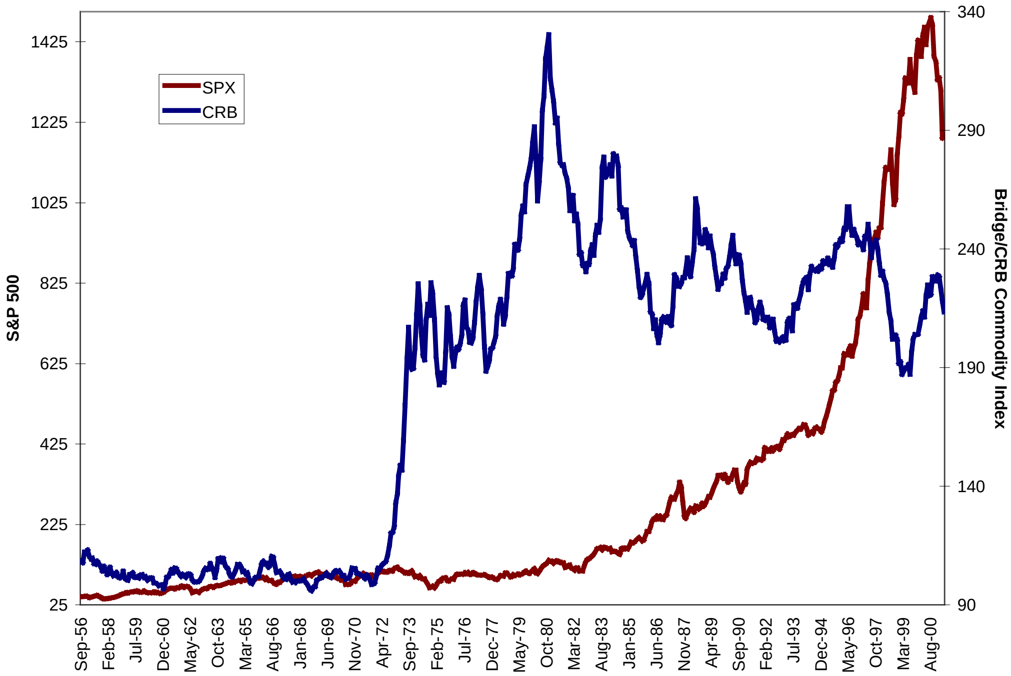
Terms of Trade

Now let's return to our principal topic, why you shouldn't be a primary commodity producer. Terms of trade define a nation's competitive advantage. If we define wealth to be the capacity to consume, and not a stock of money, we must consider imports to be an economic benefit and exports to be a cost. Why are exports a cost? The workers in the exporting country do not get to enjoy the products of their labor. Imports, on the other hand, are enjoyed as consumed. Consider the long-term U.S. trade deficit with Japan: The U.S. got the cars and televisions, while the Japanese got to invest in U.S. securities.

Consumption, the real definition of wealth, is limited in an agricultural economy. In an agricultural economy, increasing output does little good for consumers; after all, how much more can you eat, even if you raise your dietary standards? In an industrial economy, we can and do create a much greater variety of goods, and we can keep improving those goods and creating new ones. The capacity to consume, or wealth, therefore can grow much faster in an industrial rather than an agricultural economy. Finally, an information economy has no real limits on what can be consumed, and since production costs are low, the limits to wealth can become quite high, the recent dot-com massacre notwithstanding. The resulting disparity between information economies and production economies will keep getting wider.

As a proxy for the two concepts, let's take a look at the monthly averages of the S&P 500 and the Bridge/CRB commodity index. The S&P 500, which reflects the dynamic changes within an economy and its capacity to add value, has a profound trend over time. The CRB had a couple of shocks upward during the inflationary 1970s, but has gone nowhere otherwise. At best, it's been a mean-reverting market. Yet it's probably a safe bet most commodity traders, and certainly most large CTAs, are trend-followers. Whether most stock traders are countertrending mean-reverters is uncertain; it is safe to say that the shorter a stock trader's time horizon, the more likely he is to be a countertrend trader. The venerated buy-and-hold investor is nothing but a long-term trend follower. We know this is the toughest thing to do in stocks.

A Tale Of Two Indices:
One Trends, One Reverts To A Mean



The end result has the sort of inevitability that would make a Marxist proud: As the terms of trade for commodity producers worsen, they'll have to keep producing more and more, at ever-lower prices over time, to get the total revenue needed to finance their imports. The vicious cycle emerging from this dire situation will result in periodic trade finance crises; the 1997 Asian and Russian crises were but the latest in a long and sorry list going back to David Ricardo's seminal 18th century description of the cloth/wine trade between England and Portugal.

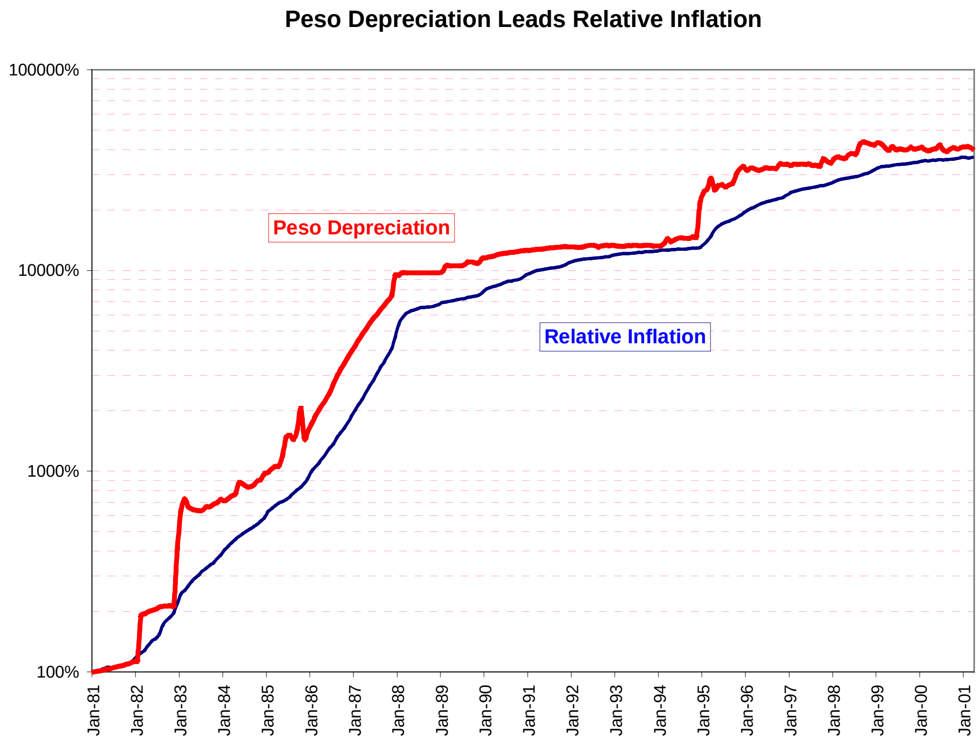
Financial Market Implications

Just as day follows night, differentials in terms of trade create balance of payment crises. In the old gold standard or U.S. dollar and British pound systems, this meant a habitual deficit nation eventually ran out of gold/dollars/pounds with which to pay. Of course, this meant the exporter had a problem as well. Thus the central bargain of international finance emerged, one known intuitively to every casual poker player on the planet: You've got to keep the sucker in the game (this is occasionally described less directly and more elegantly in formal texts). International finance developed a bewildering array of supplier credits, often backed by the exporter's central bank, to finance continuation of trade. Ultimately, the exporter's taxpayers financed their own jobs with loans to importing consumers, loans that would never be repaid.

In the modern floating exchange rate system, you can't run out of money, but your currency can depreciate to the point where inflation is triggered and the deficit country becomes impoverished and unable to continue importing. What to do, what to do? Recent practice has been to have the International Monetary Fund – read a group of exporting country's taxpayers – extend credits, more loans that will never be repaid, to the importers. Sometimes, as in the case of Brady bonds, the U.S. Treasury puts its faith and credit, a.k.a. your money, behind these financing instruments. The debt keeps getting rolled forward with cute names like "interest in arrears bonds" and "floating-rate past-due interest bonds," but the end result is the same: You'll get paid back on the 31st of Never.

The vicious cycle of currency depreciation and runaway inflation can persist for a very long time, and can be very difficult to break. Let's take the case of Mexico, the third-largest trading partner of the U.S., and a country that under the central bank leadership of Guillermo Ortiz and President Vicente Fox appears determined to right past wrongs. In fact, Mexico may not even be the most extreme example of commodity dependence despite the importance of its oil reserves; we could use a cocoa exporter like the Ivory Coast, but most of these countries have neither reliable economic data nor freely traded currencies.

The weakening of the Mexican peso under the weight of its poor terms of trade led Mexican inflation higher relative to the U.S. level over the past twenty years. Inflation is the cruelest tax of all, and this eroded the ability to consume, the wealth, of Mexico's citizenry. In twenty years, the peso lost 99.75% of its purchasing power relative to the dollar, which had some inflation problems of its own. This impoverishment forced Mexico, and other producers of primary commodities like crude oil, sugar, and coffee, to export more just to meet revenue requirements. Only now, under their new leadership, is this cycle being challenged.



Implications For Traders

Let's distill the above into a few trading and investing principles, some suitable for framing:

1. Over time, physical commodities are bearish. Once a bull cycle starts, don't fight it, but always stand ready to exit. Stocks can grow to the sky on a dream, commodities can't.
2. Over time, equities are bullish. The same human ingenuity that produces lower commodity prices in the face of an exploding population produces greater profits as well.
3. The relative performance of countries is like a currency trade. Buy strength and sell weakness. Maybe that's not nice, but you're not being paid to be nice.
4. Watch for the commodity-producing country being touted as mankind's next best hope. Then sell the stuffing out of it. See Point 3 on matters of etiquette.
5. Learn how to create developing nation debt securities. Then sell them to someone else.
6. Keep praising the farmer/miner, etc. Encourage others to do what you wouldn't do on a dare yourself.