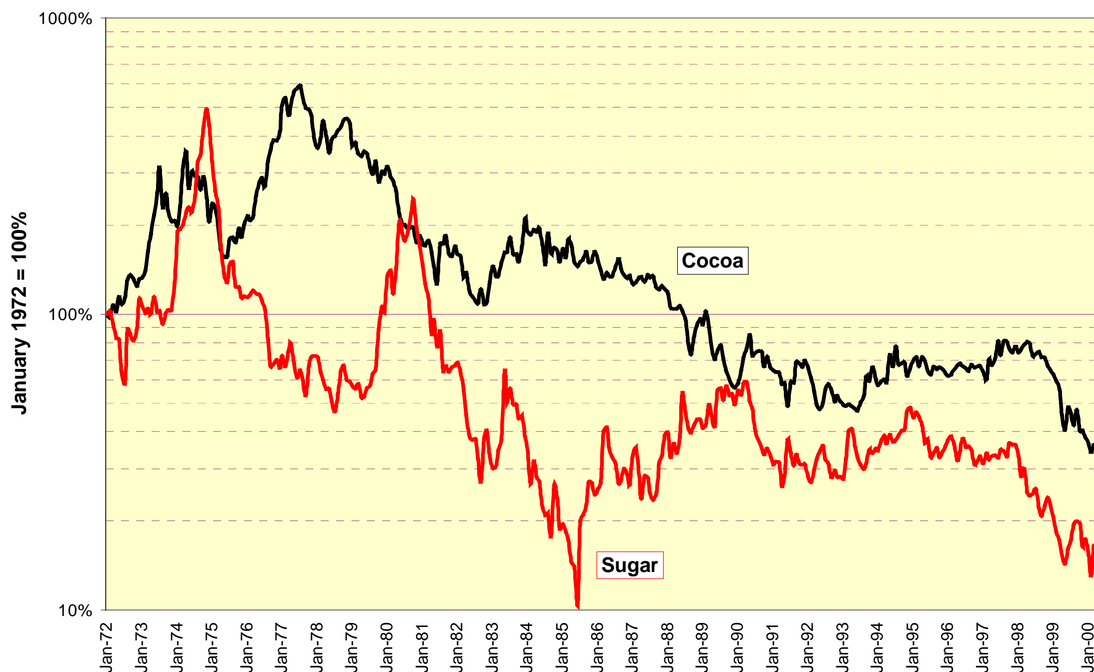
Toot, Toot, Tootsie, Good Buy (For Bonds)

The fear of resurgent inflation will continue to dominate financial markets no matter how tame actual inflation remains. This is well and good: Not only is inflation the single worst enemy of financial assets, but our vigilance against it occupies the attention of economists and assorted other Deep Thinkers who thus are prevented from doing some real damage to society at large.

This page has taken, and will continue to take, the position inflation leads eventually to higher commodity prices, not the other way around. By this construct, the commodity price jump largely confined so far to energy markets represent signals to reallocate resources within the economy -- this means you and your Godzilla-sized SUV, buddy -- and are not the harbinger of general price increases. The additional dollars you spend at the gasoline pump are dollars you can't spend elsewhere.

Food For Thought

We should remember just how bad the terms of trade are over time for commodity producers, especially those produced in countries dependent upon export revenues therefrom. Sugar, which has risen 50% in price since March 28, is an excellent example of this phenomenon. Let's take a long-term view and see where this rally has put the inflation-adjusted price of sugar, and while we're at it, let's throw the real-dollar price of cocoa, its partner in chocolate-based crime, in for good measure.



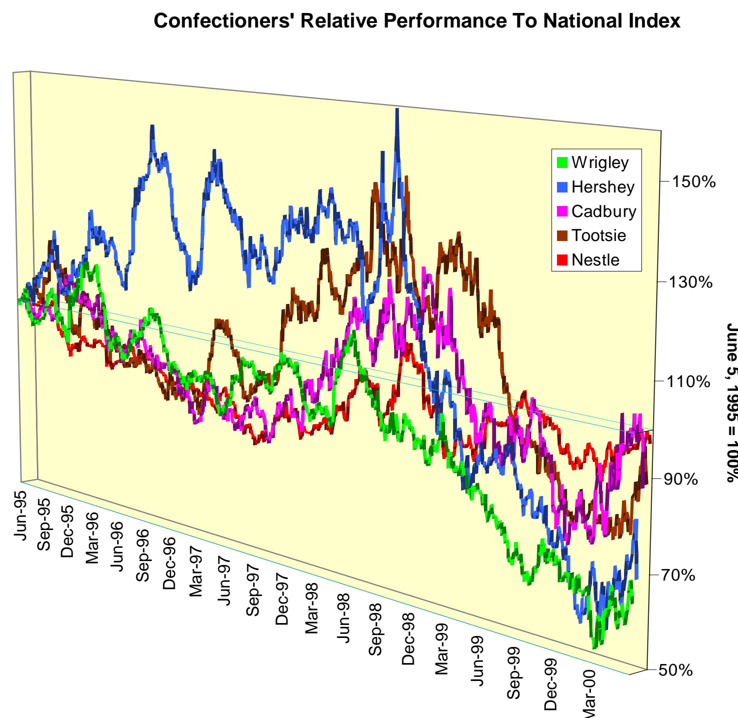
Sugar and cocoa are now at 21% and 38%, respectively, of their January 1972 real-dollar prices. And, the world's population has increased by two billion people in the interim, which must mean we have seen huge increases in productivity for these two commodities.

Can there be a better business than manufacturing candy? The combination of intense brand loyalty, low research & development expenses, a complete lack of technological obsolescence, steadily growing demand, and the raw material cost structure noted above should make other industries weep with envy. Moreover, while the products are semi-addictive, you only have to put up with the fear of unfortunate

diabetics, the disdain of dentists, and the scolding of the easy-to-ignore Politically Correct. So, how have things been going for the world's Willy Wonkas?

First, please keep in mind that one of the largest and "purest" candy plays in the U.S., M&M/Mars, is privately held. In addition, many of the largest international confectioners, such as Cadbury Schweppes and Nestle, are diversified across dozens of product lines. Tootsie Roll Industries and Hershey Foods come closer to pure confectionery plays now that the latter has shed its San Giorgio pasta business.

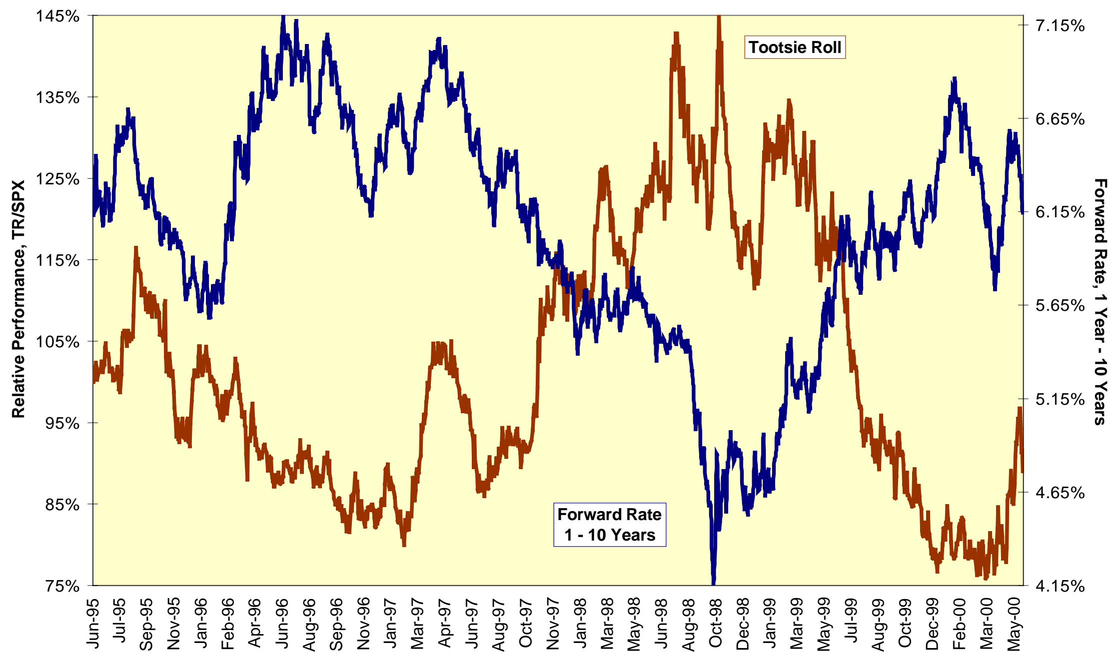
If we compare the relative performance of selected confectionery stocks to their national benchmark index -- the S&P 500 for Hershey, Tootsie Roll, and William Wrigley, the FTSE 100 for Cadbury Schweppes, and the Swiss Market Index for Nestle -- we find general underperformance over the last five years.



As a group, their one period of good performance came during the second and third quarters of 1998, an occurrence not explicable by either a general flight to consumer non-cyclical stocks or by any general coincident movement in commodity prices. The group sank on a relative basis throughout 1999, with Hershey getting hit especially hard due to a snafu with its new enterprise software system.

Now, the group is rising just as sugar prices have turned sharply higher and cocoa prices have stabilized after a long slide. If these stocks were sensitive to the price of their raw materials, this behavior would be nonsensical in the extreme. Something else is suggested by the above history.

The group rose as interest rates sank in 1998, and the group fell as interest rates rose in 1999. The turning point in 2000 has coincided with (hopefully) the end of the Fed's current tightening cycle. The relative performance of confectioners, represented below by Tootsie Roll, has mirrored movements in the forward interest rate curve, represented below by the forward rate from 1-year to 10-year Treasuries.



The statistical relationships between the relative performances of Tootsie Roll and the other confectioners and the prices of sugar and cocoa were random. On the other hand, we can explain 56% of the variance in the Treasury forward rate structure with the relative performance of a candy company stock over a period of surging stocks, plunging commodities, and various international financial crises.

Why should this relationship be so strong? After all, none of these firms has a high debt level, and few consumers borrow to buy candy bars. The answer is quite simple: High interest rates depress the value of growth stocks and consumer cyclical issues, but not the value of small-ticket consumer non-cyclical issues. Moreover, high forward rates and inverted yield curves are a good time to buy bonds as they signal a slowing economy.

There you have it, a market-based indicator that flashed a buy signal on bonds while most Fed watchers were diving under the table. The Tootsie Roll Indicator still is flashing a buy signal, which is great news for bond investors to take to the beach this summer.