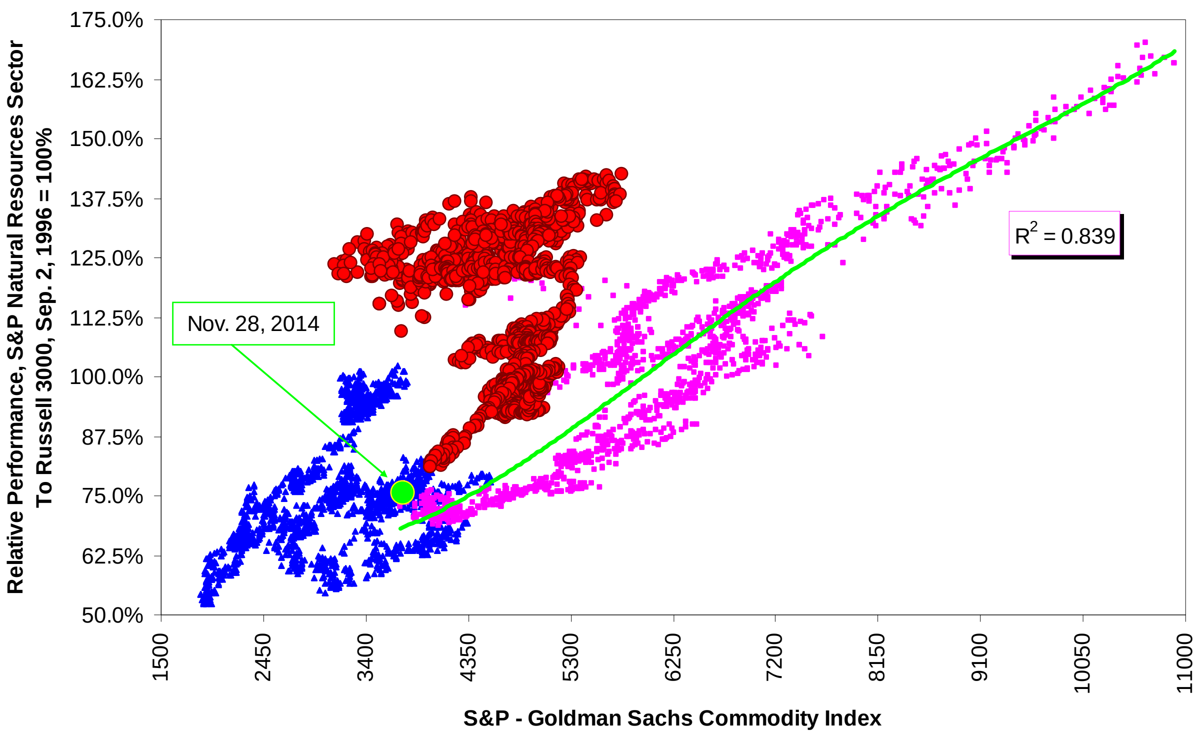
Commodity-Linked Equities' Reaction To Monetary Stimulus

At the always satisfying risk of saying, "I told you so," the much-ballyhooed commodity super-cycle proclaimed more than a decade ago has completed its orbit of the earth and shot itself in the derriere. Let's dive right into some numbers to see what has happened and why.

Let's create a series of the relative performance of the S&P North American Natural Resources Sector index vis-à-vis the Russell 3000 and divide it into three time segment. The first, marked in blue, extends from the September 1996 startdate of the resource-stock index to the Federal Reserve's first declaration of war on deflation in May 2003. The second, marked in magenta, extends from there to November 2008, the time when Citigroup was backstopped and the U.S. was about to adopt its zero percent interest rate policy. The third, marked in red, extends from November 2008 to the present.

If we map this relative performance against the S&P-Goldman Sachs Commodity index' total return, we see one remarkable feature, highlighted with a green trendline, and that is the linear relationship between 2003 and 2008. Investors were trading commodities with commodity-linked equities and were able to force a commonality of behavior between the two by dint of money-flow.

Commodity-Linked Equities Return To Pre-May 2003 Trendless Cluster



Well, as anyone who has ever tried to corner a market has found out eventually, you can put it there but you cannot keep it there. At the end of last week, both relative performance and the S&P-GSCI total return index were ensconced within the pre-May 2003 trendless cluster.

I should note, so I will, relative performance has declined by more than the retreat in the S&P-GSCI index or the gain in the *Bloomberg* correlation-weighted dollar index since the downside breakout in the euro began on May 8, 2014. Relative performance has fallen by 23.39% while the commodity index has lost 9.93% and the correlation-weighted dollar has increased 11.26%.

The Great Monetary Misdirection

The deterioration of relative performance in the face of historic monetary stimulus and competitive devaluation of currencies goes counter to many investors' prior expectations. A common thought process, never accepted here, was monetary stimulus would be inflationary and physical commodities would provide a hedge against that inflation.

Those expectations were acted upon, as illustrated with the trendline above, with the result capacity was increased and prices were driven lower by the supply overhang. No version of Say's Law, supply somehow operates to create its own demand, operates in the world of non-hoarded physical commodities. While the demand for resources be they energy, metals, agricultural products or timber encounters limits imposed by income elasticities, the demand for consumer goods and financial services is less bounded. Demand for information-based services is even more elastic. Restated, there is a limit as to how much food you can eat or how much steel an economy needs but there is no significant limit on how much time you can spend fiddling around with your smartphone.

The result has been commodity-linked equities have underperformed as monetary stimulus has increased demand for non-resource goods and services and as previous investments in resource production have expanded supplies and eroded margins. As global monetary expansion and competitive devaluations and resources supply overhangs appear likely to continue in a slow-growth environment, we should expect commodity-linked equities to continue underperforming.