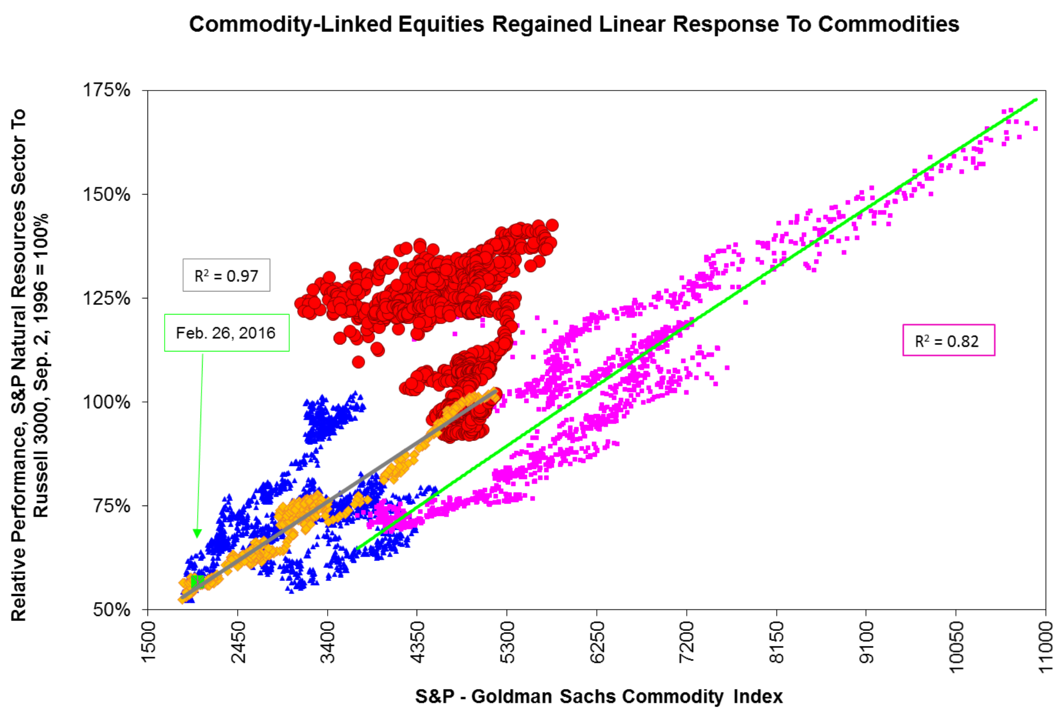
Commodity-Linked Equities Once Again A Robo-Trade

Computers, phones and other consumer electronics have become so standardized in recent years that many younger people remain blissfully and blessedly unaware of just what a Tower of Babel the business used to be. I will skip the war stories and move straight to the punchline given to a long-ago colleague who was always trying to cobble together a system from offbeat brands: “There are three words you should never use for computers. Emulate, compatible and should.”

While this lesson long has been absorbed for computers, it has been forgotten a second time in the realm of commodity-linked equities. Here for the second time in as many decades investors are trying to trade commodities via commodity-linked equities despite the fact only a handful of firms’ profit profiles are a direct and linear function of some underlying commodity price.

Index-Level Comparisons

Let’s illustrate this by mapping the relative performance of the S&P North American Natural Resources Sector index vis-à-vis the Russell 3000 as a function of the S&P – Goldman Sachs Commodity index going back to the start of comparable data in September 1996.

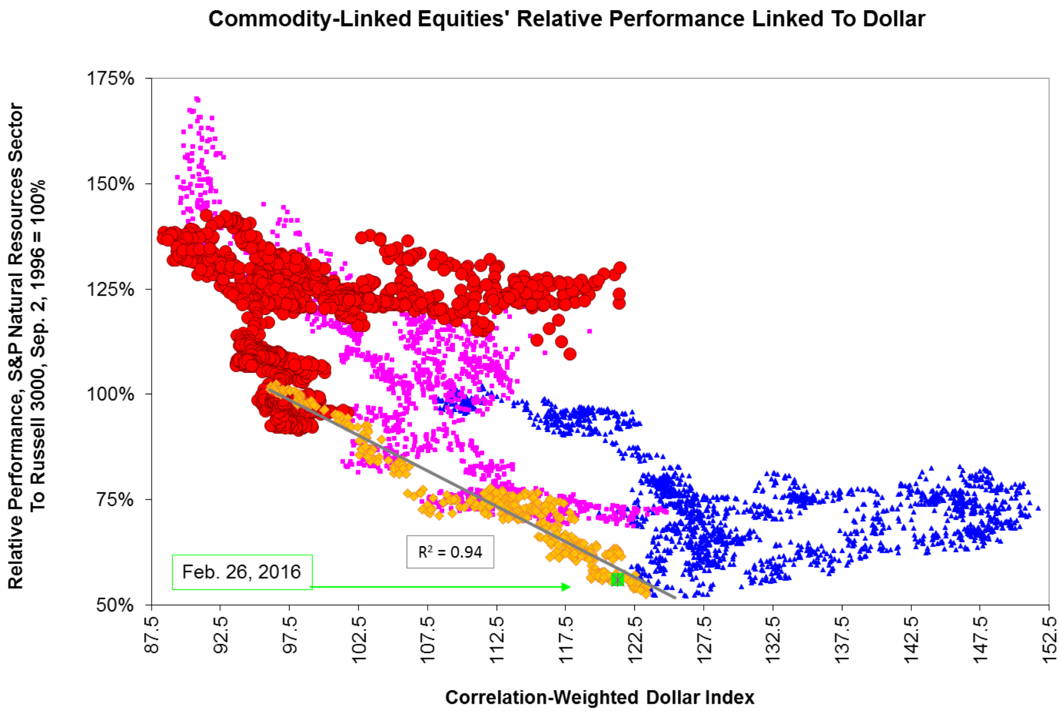


We can divide this into four periods. The first, extending from September 1996 to the Federal Reserve’s first declaration of war on deflation in May 2003 (blue markers) was trendless, as it should be. The second, encompassing the long bull market in commodities from May 2003 through the November 2008 financial crisis low (magenta markers) was strongly linear and had an r-squared or percentage of variance explained, of 0.82.

The third period, marked in red, extended to the start of the bear market in crude oil at the end of June 2014, was essentially random. The present period, marked in orange, is even more linear than the May 2003-November 2008 market; it has an r-squared of 0.97. Investors once again are treating commodity-linked equities as proxies for the underlying commodities themselves.

The Dollar Effect

Now let's replace the S&P-Goldman Sachs Commodity index with the Bloomberg correlation-weighted dollar index and repeat the exercise. This relationship has always been a little convex, that sort of hyperbolic shape you vaguely remember from high school geometry and never expected to see again. However, the post-June 2014 period has been linear, and robustly so, with an r-squared of 0.94. Before you run off saying, "yeah, of course, a stronger dollar is bad for commodity prices and vice-versa," consider this was not the case for almost eighteen years of data. What may seem like a message from Captain Obvious really is not one after all.



As physical commodities are a cyclical business, their price will advance again at some point, although that point may be frustratingly long in coming given the debt overhang in China. The dollar, too, will weaken someday again if the rest of the world decides to put the minus-sign back in the attic and allow positive interest rates. Until then, the underperformance of commodity-linked equities will remain intact.