Bonds Could Be Up The Ocean Without A Freighter

If people are creatures of habit, and markets reflect human emotion in the aggregate, then it should stand to reason that markets, too, should settle into comfortable routines. The liquidity-driven markets of March 2003 through March 2004 reflected comfort with several odd combinations. These included strong acceleration in global growth, particularly in the U.S. and in China, along with worries, at least on the part of the Federal Reserve, about deflation. Another odd couple was the general rally in physical commodity prices, the strongest one in decades, accompanied by a continued decline in bond yields.

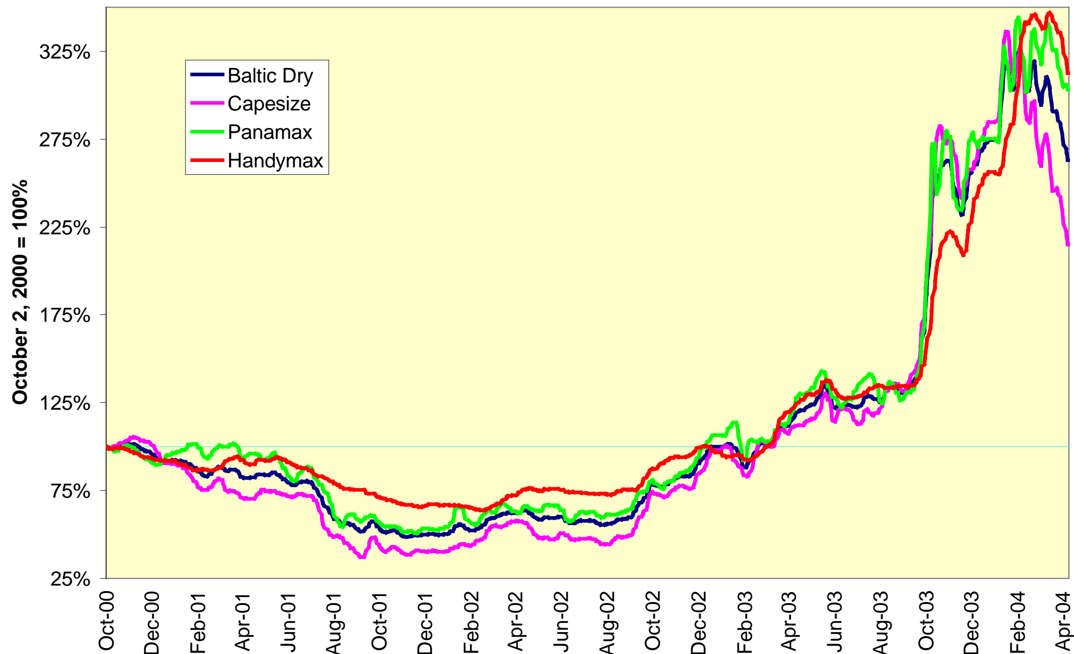
Yet as we saw briefly at the end of January, while investor behavior was in a familiar rut, attitudes were not. The mere changing of the FOMC's statement of risk assessments, highlighted by the use of "patient" instead of "considerable," triggered a quick, albeit short-lived, run for the exits. These attitudes reflected an awareness that the various surreal combinations of strange bedfellows would have to come unwound at some point, and that previous behaviors had resulted in the accumulation of risk in too many leveraged positions. The sudden abruption of the longstanding uptrend in REITs following the April 2nd employment situation report was a particularly spectacular and perhaps exaggerated reaction to prospects for de-leveraging, but it probably will not be the last one we see in 2004.

No Bids Found For REITs

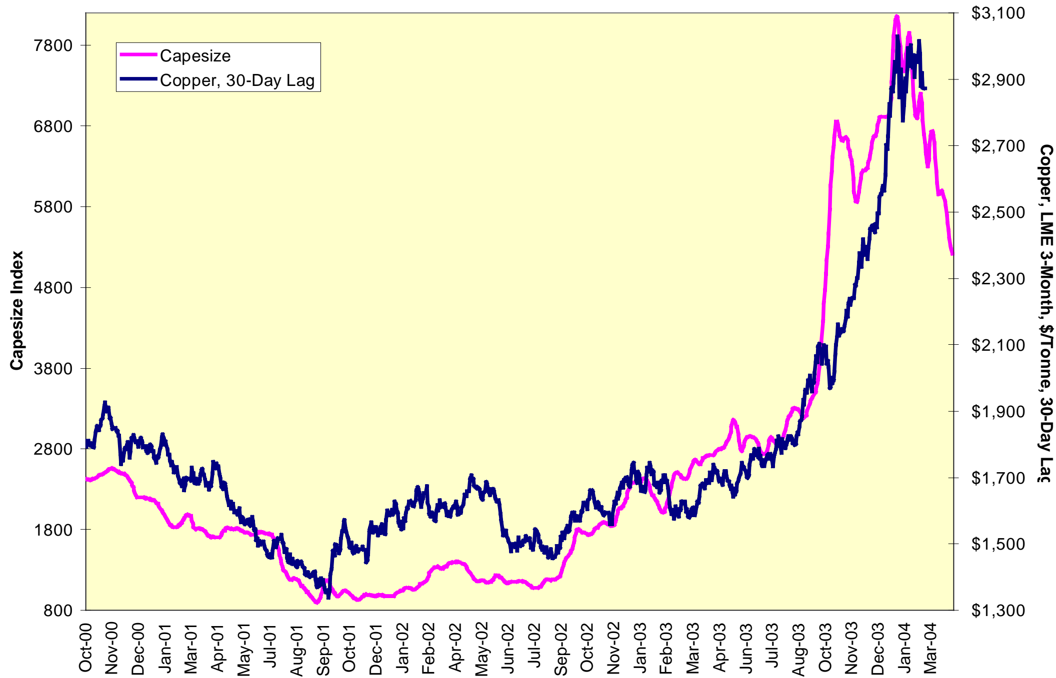
Commodities And The China Trade

Both commodity prices and emerging markets have been beneficiaries of the liquidity trade, and since activity in both sectors involves ocean freight, it is probably a good time to revisit an old favorite around these parts, the Baltic Dry Freight index (BDIY), last viewed here in detail in December 2002. The BDIY was emitting bullish economic signals then, and as Chinese demand for raw materials surged in the second half of the year, the index itself more than doubled.

The BDIY is a composite index subsuming several smaller indices, each representing different vessel classes. The smaller ocean freighters moving a variety of goods, those between 35,000-50,000 deadweight tons, are tracked by the Handymax index. The next step up, vessels of less than 70,000 deadweight tons and capable of moving grain and coal through the Panama Canal, are tracked by the Panamax index. Finally, the larger vessels used for ores fall into the Capesize index.



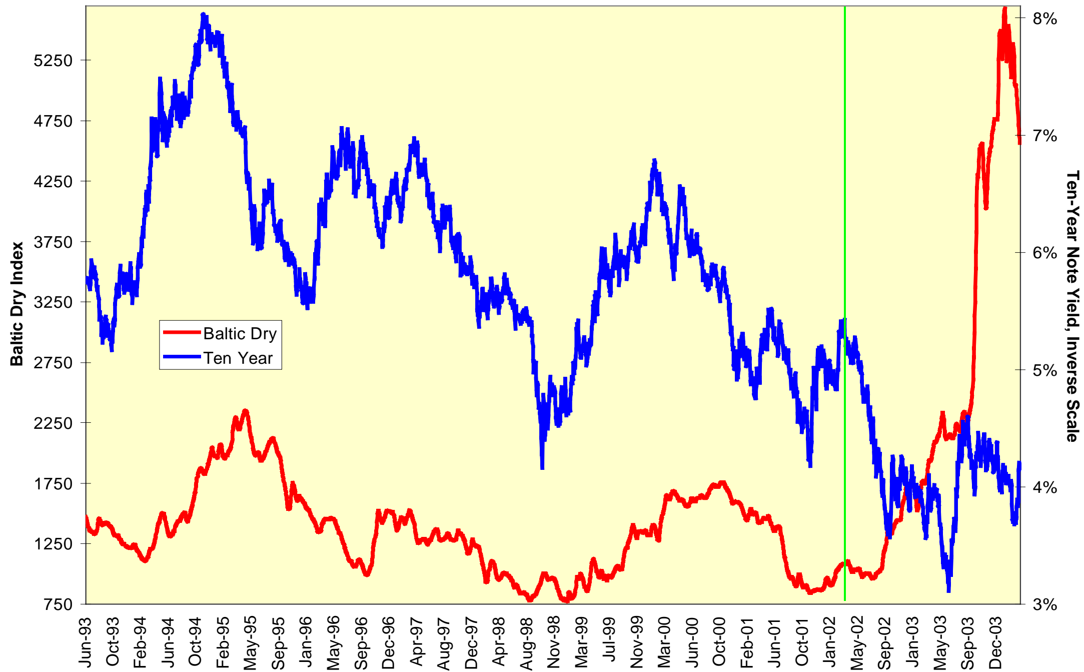
While all of these indices have retraced a significant portion of their late 2003 rally, the largest retracement has been in the Capesize index, the one most reflective of demand for industrial commodities such as iron ore and copper. Given the need for ore exporters to nominate vessels for their exports ahead of time, we should expect to see the Capesize index lead the price of an economically sensitive commodity such as copper, and this is in fact the case.



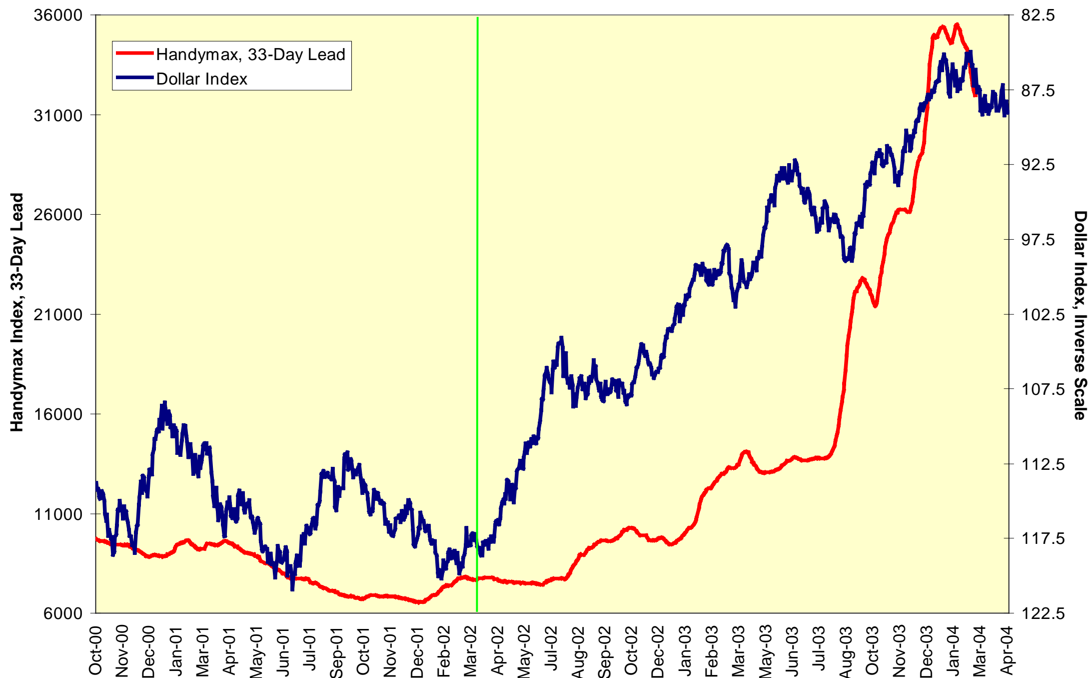
The downturn in Capesize rates led the late 2003 rally in copper by 30 days, and since its peak on January 19, 2004, has led the top in 3-month copper forwards on the London Metals Exchange. This is not a recessionary development, but merely one reflective of a slowdown in the rate of demand for copper and other industrial commodities.

Impact On Financial Markets

At one point, it would have been quite simple to look at the drop in indicators such as freight rates or copper prices and conclude interest rates would be falling apace, or at least not rising. However, given the experiences of the past year where expanding exports from Asia to the United States coincided with massive central bank purchases of bonds by those countries to support the dollar, we need to be careful about making any sort of knee-jerk conclusions. The relationship between ten-year note yields and the BDIY, predictably positive prior to April 2002, has been strongly inverse since that date.



The transmission for this inverse relationship has been the movements of the dollar and the aforementioned efforts of the Bank of Japan and others to support it by buying vast quantities of U.S. debt. The dollar began its strong decline at the April 2002 point noted above. Interestingly enough, the Handymax index has led the end of the bear market in the dollar by 33 days, roughly the nomination lead time for smaller vessels.



The dollar's decline was precipitated by the Federal Reserve's aggressive rate-cutting campaign. For whatever criticisms we can level at the Fed, we cannot quibble at their success in forestalling deflation and in setting the stage for the strong commodities and freight markets that followed. However, the prospects for higher short-term interest rates in the United States may lead to a stronger dollar and an end to the interventions. As suggested here in early January, a dollar rally may do more to torpedo the bond market than actual credit tightenings by the Federal Reserve would warrant.

Freight rates, unlike the semantic virtuosos of the FOMC, give clear and unambiguous warnings. A further decline in the indices should lead to lower commodity prices; this signal is being confirmed by the lackluster performance of the Goldman Sachs Resource index and its ETF, the IGE. While this may be welcome in many quarters, if it is accompanied by prospects for higher short-term rates we could be in for a massive de-leveraging of fixed income investments that would make last week's selloff in REITs look like a day at the beach.