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MACROCOSM

Commodities: Don't Be Fooled

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The recent drop in commodities prices isn't an all clear signal for inflation, or for bond yields.

Update to strategic view
US MACRO: Prices in inflation-sensitive markets, especially gold, are still quite elevated, even after their recent decline. They indicate continued inflation pressures, leaving it still highly likely that the Fed will be forced to resume rate-hiking, possibly to growth-damaging levels. **US BONDS:** Rising bond yields have tracked the retreat in Fed rate-cut expectations. That retreat is likely to continue, eventually transforming into rate-hike expectations, driving even higher bond yields.
[see Investment Strategy Dashboard]

The moderate rollback of a broad spectrum of commodity prices has seemingly bolstered the case that inflation risk is clearly diminishing and that the Fed can be content to remain on hold indefinitely, if not actually begin cutting rates within the next several months. In fact, the latest declines in the prices of several sensitive commodities came as a direct response to a shift away from expectations that policy would soon be entering a fairly aggressive easing mode (see "A Break in Trend" January 8, 2007). But while the price action can be seen reflecting a reduced chance of a worst-case inflation outcome, that doesn't alter the fact that at current levels commodity prices manifest a decline in real dollar purchasing power that point to embedded inflation influences continuing to feed through the price system. Essentially the same can be said with regard to the dollar's weakened forex value versus other major currencies, regardless of the rally of recent weeks.

The forces currently at work in the commodity markets are probably best captured by the price of gold, the most monetary of all commodities. Following last Friday's above-expectations employment report showing payrolls expanding by 162,000 jobs last month, the price of gold fell by nearly $15, to around $607, in accord with a sell-off in interest rate futures reducing the odds on the likelihood of out-month Fed ease. As the flow of positive economic data has put the economic bears on the defensive, the expectations climate has been appreciably altered. Eurodollar futures, which early last month were priced for more than 75 basis points in rate cuts this year, are now implying just 30 bps in cuts, and that bet has been unwinding rapidly. The nearer term policy outlook is also shifting fairly dramatically. Up until last week's jobs data, June Eurodollar futures were still fully priced for a 25 bp rate cut. Today, the June contract is posting rate cut odds of less than 30%.

But were this expectations shift consistent with a non-inflationary outlook, indicating that the Fed has reached equilibrium at a 5.25% target rate, we'd expect to see a continued sustained rollback in gold and other forward-looking commodity prices. Above $600, gold is still some 90% higher than its level around $325 seen in late 2002 when the Fed's ultra-easy policy posture first

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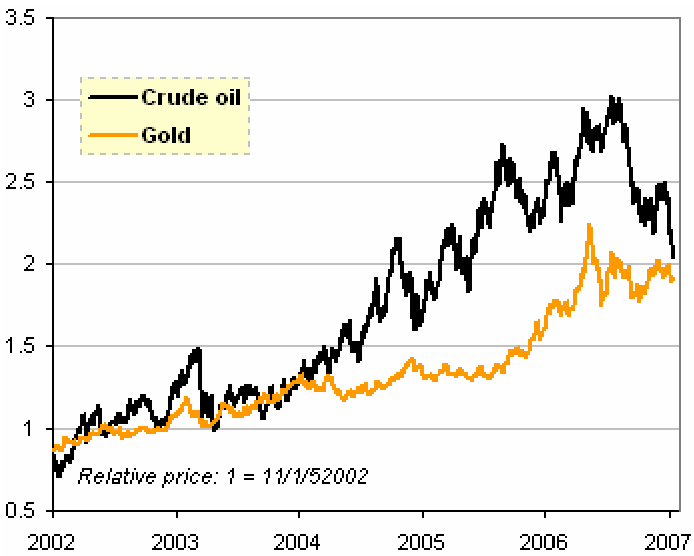
kicked in, and some 70% above its 10-year moving average -- and about 15% higher than even its year-ago price. Moreover, in trading since last Friday's sell-off, the upward bias in gold has clearly reasserted itself. Today, gold actually closed around $625, slightly exceeding its level prior to the jobs report. Merely seeing the easing option coming off the table, in other words, is not enough to restore market confidence that the Fed has gotten it right. Gold is telling us that the Fed remains accommodative, continuing to supply the marginal dollar of excess liquidity, and higher rates are still needed to quell the inflationary impulses.

As for crude oil, it should be noted that while petroleum has historically had a fairly stable long-term relationship with gold, and has proved useful at times as a market price indicator, that function pretty clearly broke down in this cycle. From a starting point in late 2002, when crude was around $25 per barrel and gold $325 -- close to the historic relationship between the two -- oil had more than tripled at its peak last summer. But gold -- briefly touching above $700 at its peak last May -- never showed that kind of wild abandon. In addition, gold has been trading in its current range for the past six months, indicating a considerable degree of stability in the elevated inflation expectations conveyed by the price, while crude has been highly volatile. We resist the notion that tagging a trading phenomenon as a "speculative bubble" ends up offering much explanatory insight. In this case, the Fed's excess liquidity posture clearly played a significant role adding fuel to the speculative fire.



BACK IN LINE WITH GOLD, THE SPECULATION IN OIL MAY BE WRUNG OUT -- LEAVING A CLEAR INFLATION SIGNAL

No question, the oil price collapse will continue to provide some respite in terms of reported headline inflation, but it's doubtful that such "relief" will mean much for underlying inflation fundamentals. The chart at left, plotting oil against gold relative to a common base in late 2002, suggests that crude is again approaching rough equilibrium relative to gold, which could mean that this price "correction" has come close to running its course. But like gold, oil prices at these levels continue to reflect substantial embedded inflation pressures. The crumbling oil price should in no way be read as signaling all clear on the inflation front.

Meanwhile, we took some comfort on that score from remarks this week by Fed Vice Chairman Donald Kohn, who indicated that the central bank remains cautious about the inflation outlook. Kohn noted that some of the recent declines in reported inflation reflect "one-time influences," and suggested it's "still too early to relax our concerns about whether the run-up in price pressures in the spring and summer of last year is truly unwinding." In addition to the restraining effect of energy price declines, Kohn also raised the prospect that "if a portion of the weakness in goods prices reflects efforts by producers to forestall or correct inventory imbalances, that restraint on pricing will dissipate as firms' corrective actions take effect." Kohn reminded his Atlanta audience that "core inflation is still higher than it was just a year ago," and allowed that he remains uncertain whether the recent decline resulted from "one-time changes in relative prices rather than an easing in underlying inflation pressures." Of course, while Kohn's honesty is welcome, the fact is the Fed would likely have put any such uncertainty to rest had it opted to remain in rate-hiking mode for another few FOMC meetings, rather than going on hold last August.

BOTTOM LINE: The unwinding of Fed rate-cut expectations has helped relieve concerns about a worst-case inflation error, but the fact remains that policy is still too easy, and a resumption of the uptrend in core inflation is nearly assured. At some point, this reality will leave the Fed with no choice but to resume hiking rates. But by that time policy could be so far behind the curve that an aggressive course of rate hiking will be unavoidable, putting the expansion at extreme risk. We continue to see opportunity in shorting bonds to capitalize on the sustained reversal of easing expectations while inflation-sensitive commodities will provide some upside up to the point when the Fed gives a clear indication that it is prepared to make a final push to subdue the inflation that it allowed to break out by remaining too easy for too long. TM