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Limits of Monetary Policy

Buying $600 bln worth of US Treasuries, the Federal Reserve has flooded the market with liquidity and driven up asset and commodity prices.

Its Treasury purchases reduce the quantity of risk free assets, forcing investors to buy riskier assets. Commodities are among those risky assets.

By monetizing the debt, the Federal Reserve is debasing paper money and investors are seeking for tangible assets, things that hurt when you drop them on your foot, as one colorful commentator put it.

Federal Reserve Chairman Bernanke spent a great deal of time in a recent speech trying to refute those arguments. There is good reason to suspect he is correct, though it flies in the face of conventional wisdom. Do not worry, we don't have to discuss the finer points of the conduct of monetary policy and the fact that the reserves the Fed has created are still sitting there at the Fed. And we don't have to examine a bunch of charts that would show that commodities had turned up months before QEII was anticipated or signaled.

Those are, as they say, low hanging fruit, but let's not go further up the tree. Instead a return to terra firma is needed—a return to fundamentals. Here we'll explore three issues. The first is the non-homogenous nature of commodities and their divergent performance. The second is thinking about commodities in the way money managers do. The third is the role of the dollar.

Commodities are not Homogenous

The assertion that the price of commodities has done something is misleading. Some commodity prices have risen and some have fallen. And just like "politics is always local" so too when one looks at commodities, one is struck by the idiosyncratic nature and drivers.

Using the Bloomberg's ranking of commodity ranked returns, one learns that pork bellies have been the best performing commodity (that has a futures market) this year. Is monetary policy a reasonable explanation? What about relatively small herds and strong demand from Japan, in the wake of their disaster and South Korea, which culled a quarter of its herd due to disease and removed tariff barriers?

Oil prices are higher, but West Texas Intermediate Crude is up about 5.5% year-to-date, while Brent is up nearly 25%. Surely, the risks and disruptions emanating from the Middle East and North Africa, and especially Libya, are the primary explanatory variables. Meanwhile, the prices of the products, like gasoline, heating oil and diesel, have risen faster than oil itself. That, after all, may say more about refining capacity than easy monetary policy.

Corn prices are around 16.5% higher thus far this year. The US used to be able to act as a swing producer, the way that Saudi Arabia does in oil. However, due to tight inventories, planting delays and the huge take-down for fuel, its role appears to have been compromised. In addition, it is not just that modern agriculture is very fossil fuel intensive, now they compete. The price of oil underpins the price of grains, which are feed for both animals and humans.

Some commodities have seen significant price declines this year. Lumber is off almost 45%. Did not the wood industry get the note about QEII? The continued collapse in US residential construction is the most likely driver, and of course, it is taking place despite QEII, not because of it. Cocoa prices are lower this year. The Ivory Coast recorded a strong crop despite the political crisis. The world sugar contract (not the US contract which is down about 7%) is off nearly 25% this year as a larger than expected Thai crop helped ease a shortage.

Nickel and copper are lower as well. Indeed, China seems to be playing a more important role than the Federal Reserve. China, namely, has sharply increased its production of nickel and it pace of copper accumulation appears to have slowed. The prices of the soy complex (beans, oil and meal) have fallen this year amid good harvests.

Pork Bellies are No Substitute for Treasuries

On this level of analysis, commodity indices make it more difficult to appreciate that all commodities have not risen during QEII. Many are heavily weighted toward one set of commodities, like energy, that overly simplify what is actually happening.

Increasingly the investment banks are developing “active” or “dynamic” commodity strategies, which contemporaneously shift allocations between commodities. This represents the maturing of the commodities as an asset class. At the same time, it is not a fixed index as were initially available and altogether it is more sophisticated than the “enhanced indices” that were developed. Taken together, the evolution of this space has a logic based on market forces and regulations and there does not seem to be much of a role for the Fed’s Treasury purchases.

Those purchases, it has been argued, creates a type of “buyers’ displacement”. Those parties that would have wanted to buy Treasuries can’t because the Federal Reserve is buying nearly the entire new supply. They are forced to buy another asset; one that by definition will be riskier.

Consider for a moment that you are a pension fund manager or the treasurer of your condo board, or a retiree. You put some part of your savings in US Treasuries. You would like to buy some, but the Fed has displaced you. Real yields are essentially negative. What are you going to do with that portion of your savings that you typically invest in the lowest risk and most liquid instrument you can find? Buy pork bellies? Corn? Oil? Or are you more likely to buy a triple-A corporate bond or a CD at a FDIC insured institution?

You want to push it further; surely some buyer down the chain is displaced and buys commodities. It seems intuitively true but intuition can be misleading. The financial capacity is large and supply of financial instruments and derivatives appear quite elastic. More important, the critical point is that supply issues explain the movement in commodity prices, not investor demand.

Role for the Dollar

Some argue that the Fed's monetary policy has undermined the dollar and it is through this transmission channel that commodity prices have risen. This too is problematic because not all commodity prices rose. What is needed is an explanation not of the increase in commodity prices, but why some prices rose and some fell. A macro-argument does not do justice to the divergent prices.

It is not clear that QEII explains the dollar's movement. Recall, for example, that the euro was trading near $1.27 at the end of August when Bernanke signaled QEII. There were some gyrations of course; we are talking about a bilateral pair that has a daily turnover of $1.5 trillion. On the eve of the ECB meeting in mid-January where Trichet first signaled a coming ECB rate hike, the euro was trading $1.28.

The euro's rise against the dollar since the start of QEII has been less than 4%. QEII has been a given. There have been two changes, both on Europe's side. First are the interest rate hikes by the ECB. Even without QEII, this would be a euro positive development, at least in the short-to-intermediate term. Second, is the unresolved nature of the European debt crisis. When it flares up, it triggers safe haven flows into the short-end of the German curve and this results in a shift in interest rate differentials which is more supportive of the dollar.

Since QEII began, the Swiss franc has been the strongest of the G10 currencies, gaining more than 17.5% against the dollar. The worst performing currency on the other hand has been the Japanese yen, which is essentially flat over the same time period. US monetary policy is too blunt of an explanatory variable.

The Swiss franc's out performance cannot be attributed to its high interest rates relative to the US. Its overnight rates are quoted around the effective Fed funds rate. Rather, the dollar's losses against the Swiss franc likely are a function of the demand for a safe haven in Europe, given the uncertainty surrounding the euro zone.

Lastly, let's turn our attention to the dollar itself. In the foreign exchange market, one knows the dollar's value only relative to other currencies. The correlation between the dollar's bilateral pairs and commodities is not stable. Many of the arguments about the dollar and commodities assume a causal connection which requires stable correlations.

Consider, for example, the euro and gold. Conducting the correlation study on the rolling 60-day percentage change basis, the euro's movement against the dollar was inversely correlated with gold from mid-May 2010 through late September and then was again inversely correlated from mid-March 2011 through late April.

Consider another example: the Canadian dollar and oil prices. Most of last year, the Canadian dollar (against the US dollar) had a 60-day rolling correlation above 0.60 with oil. In fact, the correlation peaked near 76% in December and then collapsed and went inverted from late February through mid-March.

In the same way, look at the Brazilian real and soybean prices. Last August, the 60-day rolling correlation was slightly positive and then from mid-September through early October, the correlation became inverted. It then proceeded to climb and finished the year near 0.46. Since the start of this year, the correlation has fallen and now stands below 0.2.

Conclusion

US monetary policy can be a powerful tool, but it has limitations. Some commodity prices have risen and some have fallen since the Federal Reserve signaled QEII. The point is not that monetary policy cannot cause commodity inflation, but more modestly, that the recent run-up in some commodity prices does not seem to be the work of QEII. The explanatory power of supply shocks is greater than demand shocks over the past couple of quarters.

The anticipation of QEII did weigh on the dollar, but against some of the leading major currencies, the dollar was little changed net-net until the ECB shifted its monetary stance. This coupled with the European debt crisis seems to be a larger driver in the foreign exchange market than QEII.

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