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Buy the CRB
Index futures are the best bull play

By Sholom Sanik

The following article first appeared in the November 29 issue of Barron's.

The bear market in commodity prices seems to have bottomed last summer. During the four-year slide, the Bridge-CRB Futures Index lost some 30% of its value. Although each of the 17 components that comprise the CRB has unique supply and demand fundamentals, there have been two constants: Technology has brought dramatic gains in productivity, which expanded supply. Then, the Asian economic crisis that started in mid-1997 triggered a sudden drop in demand. As a result, inventories of almost every commodity were bursting at the seams.

These bearish dynamics were so overwhelming that they have been able to offset the effects of monetary stimulation. Instead, we've arguably had the longest period of rapid money-supply growth that has not been accompanied by an uncomfortable rise in prices.

Although the inventory overhang and lackluster demand remain, bear markets in commodities ultimately beget bull markets. If prices stay close to the cost of production, producers are forced to downsize and reduce output.

There is not much evidence that this process has begun in earnest, but eventually supply will be brought into better balance with demand. So far, however, there hasn't been any meaningful reduction of carryover stocks. Indeed, cocoa and cotton, just two of the most prominent examples, have huge inventories.

As far as consumption is concerned, the framework for recovery is in place. While many emerging regions still are struggling, most have stabilized. In those countries that opened their economies earlier this decade, demand is slowly reviving for goods that are associated with greater affluence.

With demand slowly improving, production likely to be reined in, and liquidity abundant, it is likely commodity prices won't stay weak forever. Along these lines, a further assumption can be made. The phenomena that caused commodity prices to tumble did not discriminate among the various markets. If these processes reverse, it's likely the recovery in prices also will be virtually across the board.

For investors, the aim is to apply these macroeconomic fundamentals to a specific strategy. We believe traders should buy a broad spectrum of commodities.

Choosing the right commodities to buy is an onerous task. In sifting through the markets, some are challenging the high end of multi-year ranges, such as petroleum, coffee, and cattle. At the other end of the spectrum, the grains, cotton, and cocoa are hovering at multi-year lows. Others such as gold and copper, have rallied sharply from their bottoms but are sorting through conflicting fundamentals, groping for direction.

Collectively, however, the Bridge-CRB Index has climbed out of the cellar, as the chart here shows. Ahead of the Thanksgiving holiday, the CRB closed at 202.76, up 10.7% from its lows set back in July.

Buying the futures contract on the CRB itself would appear to be the best way to speculate on a general and unexpected rise in commodity prices resulting from the significant expansion in the money supply that central banks have aided and abetted. The index contains a diversified group of commodity markets that represent domestic and imported agricultural goods, heavy and light industry, and

In this issue

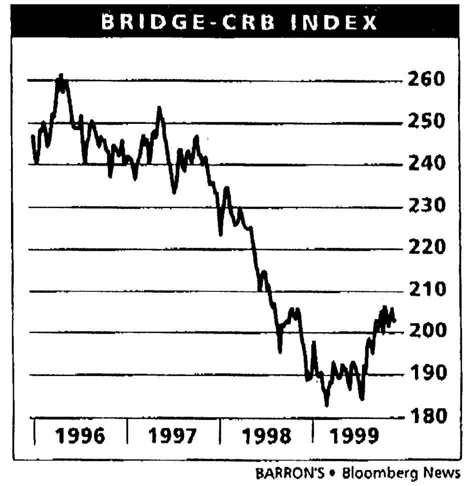
Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

representing the majority of commodity-related sectors of the global economy.

Of course, it would have been quite sweet to catch the rally in crude oil, and hats off to those who did. On the other hand, an understanding of why commodity prices fell so much – and why they must reverse at some point – makes it unnecessary to try choose the winner. All commodities will rise with the tide. When they do, the CRB index will map out a smooth and steady uptrend.

For a commodity trader, being stopped in and out of individual markets is a very frustrating, and often money-losing experience. The likelihood of being whipsawed in the CRB tends to be much smaller than in the individual commodities because countertrend reversals in the overall index tend to be smaller. That should help traders stay invested in the bull market we expect.

Chart 1



STOCK INDEXES

Long stocks, but with great caution

On October 20 we issued a Flash Update on our trading Hotline, recommending a long position in December S&P. Many subscribers and clients did a double take. "Surely there must be some mistake. Perhaps all the volatility has driven them to some serious substance abuse. These guys have never had anything nice to say about the stock market, and now – 17 years into the bull market – they awaken?" These were some of the observations heard.

But no, there was no mistake, and we have not smoked, injected, or ingested anything illegal. Indeed, we went long the market and are feeling pretty smug about it, being on side by a nifty100 S&P points. We would, however, like to clarify the motivation.

There is nothing that has changed in the fundamentals of the market that would make us bullish. Yet another quarter of solid earnings by S&P 500 companies was not a shocking event. Although these bountiful earnings are representative of the ongoing economic expansion, it is not as if they have suddenly increased enough to rectify one of the primary problems with this market: the very high readings on the much-ignored – but traditionally vital – diagnostic tool, the price-to-earnings ratio.

The stocks that are leading the advance – or more appropriately the stocks that *are* the advance – are the worst offenders. What that means is that most US stocks are actually declining and have not participated in this recent rally that has brought the Dow Jones Industrial Average (DJIA) within 5% of its highs. The stocks that are pushing the indexes are trading at multiples that are not sustainable – by historical standards that is. About a third of the stocks in the DJIA are within 10% of their highs. About a third are officially in a bear market (being 20% or more off their highs). The balance are about 15% off their highs. The same pattern exists in the broader market and can be easily seen in a very weak advance/decline line even throughout the recent rally.

As an example of overvalued high-flyers, consider star performers in the DJIA newcomer Home Depot, trading at 59 times earnings and yielding .21% and Walmart, trading at 48 times earnings, with a .35% dividend yield. Both will require utopian conditions to justify their price.

The "36,000 boys" have changed the landscape. The idea introduced by market scholars James Glassman and Kevin Hasset that the risk premium demanded by investors is rapidly declining has given those that ignore traditional valuation methodology fresh ammo. Glassman and Hasset argue in their new book *Dow 36,000*, that if the risk premium was 0 and earnings grew at the same rate as the GDP, and the long bond yielded less than 6%, the DJIA should be 36,000, *today*.

The concept has been so well distributed in the media that articles containing rebuttals of the theories that build this futuristic projection have been reaching the general population in publications such as *Forbes* and *Newsweek*. It is obvious from the continued strength of the market that the authors of the rebuttals are just being viewed curiously. Almost half of all the households in the US own stocks. When the bull market began in 1983, the figure was 20%. The people that have been buying stocks these past two decades are probably ill-equipped to make risk-premium valuations. They buy stocks because it has become ingrained in the socio-economic culture of the day. And to boot, it's worked pretty well. So why not?

A rather simplistic glance at recent history would dispel any notion that the world has changed that much. Charts 2 and 3 show quite clearly that the DJIA has lived and died by the yield on the long bond. The movements of these two charts have an almost perfect inverse relationship to each other. The DJIA bottomed on October 18, just days before a huge drop in long-term interest rates was to get under way. A careful tracing of the rest of the information on these charts reveals the same relationship between stocks and interest rates. Perhaps the market is saner than we give it credit for and will eventually show it.

The underlying basis for remaining long stocks is the continued growth of money supply. Recent figures indicate clearly that little has changed. As long as the Fed continues to set monetary policy based on those indicators that they still consider tame, i.e. labor costs, they will remain accommodative. The complacency among stock market participants will stay intact until the Fed is forced to end the era of easy money, which will be triggered by the inevitable surge in commodity prices – sometime soon.

Our venture into the long side of this market was intended as a short-term trade or perhaps even a series of short-term trades using traditional overbought and oversold signals for getting in and out of the market. To that end we have moved our stop-loss up every time the market made a new recovery high. We do not believe that the stocks that compose the indexes that we purchase are necessarily worth what we're paying for them. The P/E ratio on the S&P of 34:1 and the dividend yield of 1.2% are not being ignored by us. Ultimately they will rule the day. *[November 15, 1999]*

CURRENT TRATEGY: *Remain long December S&P. Raise stops to 1395, close only.*

Chart 2 & 3

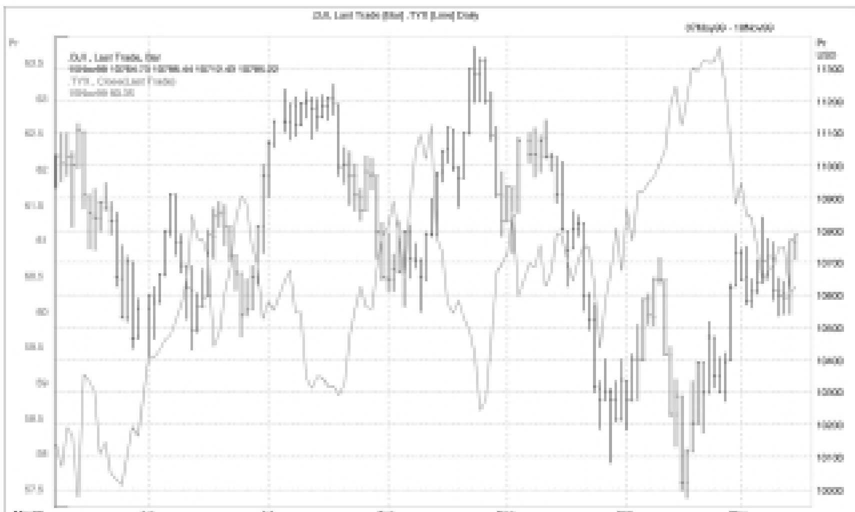


Chart 2: Bar Chart - Dow Jones Industrial Average
Chart 3: Line Chart - Yield on long bond
Charts courtesy of Reuters

PLATINUM

Tight supplies and robust demand, just the recipe for a bull market

The Russian supply quagmire has grabbed all the headlines in the platinum market lately. Legislation passed last December has stopped exports of platinum from Russia since early this year. An amendment to the law that would allow shipments to resume was scheduled to be debated on November 24, but the meeting was postponed. Indeed, this issue has been the catalyst responsible for the recent rally. What will happen if they settle this bureaucratic logjam? Are there other bullish fundamentals that underpin this market, or will it crawl back to the cozy confines of the $350-$360-an-ounce range?

On November 16 Johnson Matthey released its *Platinum 1999 Interim Review*. The information in this report contains the answers to these questions. Global consumption of platinum for autocatalysts grew steadily until 1996. By then, use of the other platinum-group metal (PGM), palladium, was growing and displacing some platinum consumption, partly because it was cheaper and partly because it worked better to meet more stringent hydrocarbon emission standards that were spreading across North America and Europe. For 1999, demand for platinum in autocatalysts is expected to fall to 1.75 million ounces, or 7% below where it was in 1996. Investment demand is estimated to drop by 115,000 ounces from last year, but accounted for only 5% of total consumption.

That, however, is the end of the bearish news. Demand for platinum jewelry has taken the leadership role from autocatalysts. Jewelry consumption has been growing much faster than the consumption of autocatalysts did this past decade, doubling since 1990. This year alone, demand for platinum by the jewelry industry grew by 320,000 ounces, or 13% more than last year.

In what is likely the most startling tidbit of information in the Johnson Matthey report, it is estimated that China will use 850,000 ounces for jewelery fabrication in 1999. This would represent an increase of 230,000 ounces, or 37%. The report does caution, though, that Chinese demand is certain to taper off if prices continue to be as strong as they are currently. Even in the autocatalyst sector, the news is not all bad. The decline in consumption should slow down. Cars with diesel engines – which require platinum catalysts – have become increasingly popular in Europe and make up 26% of all new car sales.

The sum total of these statistics gives us a market that will see its biggest production/consumption deficit ever. With production of 5.06 million ounces and consumption of 5.59 million ounces, stocks will have to be drawn down by 530,000 ounces. Even this estimate is somewhat optimistic, because it assumes that Russia will continue shipments before the end of the year. If it doesn't – and at the moment it doesn't seem promising – the deficit will be even larger.

The problem that we are witnessing with Russian platinum exports highlights the age-old problem with this rare metal. Ninety percent of production comes from politically and economically challenged regions of the world. A few years ago, when South Africa was undergoing its transformation from minority-white to majority-black rule, the market believed that the greatest vulnerability for supply disruptions lay in that country. As it turns out, South Africa smells like a rose compared with Russia's maze of bureaucracy and corruption. Even though South Africa produces 75% of world supply, the Russians' 15% share – or lack of it – is far more than enough to throw the global balance way out of kilter.

The classic indicators associated with extreme tightness are present in this market. Steep backwardation and one-month lease rates that have soared to an extraordinary 50% make it quite clear that physical supplies are genuinely hard to come by. New York Mercantile Exchange warehouse stocks have plummeted from 140,000 ounces in September to their current level of 68,000 ounces.

In conclusion, even after the Russians sort out their legislative problems, this market can remain tight. A likely scenario would include a selloff upon an announcement that shipments are forthcoming. Given the budding demand and tight supply prospects discussed above, such a selloff would be nothing more than a buying opportunity.

[November 25, 1999]

STRATEGY: *Remain long January platinum as per Flash Update of November 24, placing initial stops at 363.50, close only.*

NOTE: *As we go to press with this article, there is fresh news that some progress was made by the Duma's budget committee with the drafting of amendments to the law that is restricting exports. The market slipped a few dollars on the news, but maintained the general price level.*

Chart 4 – Platinum

UPDATES

Stocks: long and a little nervous, Gold: just getting warmed up

Stocks

Since our last discussion of the stock market on November 15, the popular indexes have forged ahead. Naturally, the star of the show continued to be the Internet-laden NASDAQ, surging a mind-boggling 18% for November – and who knows, there are still two trading days left. Has anything changed? Can traders continue to ride the long side comfortably?

The big picture, to be sure, hasn't changed much. Easy money abounds and with the Fed very unlikely to change policy until we're clear of Y2K paranoia, there are at least a couple of months until that changes. Interestingly, though, this very foundation on which the bull market in equities continues to rest may be its undoing. In this weekend's *Barron's*, Warburg Dillon Read economist Joseph Carson writes about a theme that has been well covered over the years in *Friedberg's Commodity & Currency Comments*. He argues that the Fed has been ignoring asset-price inflation. He develops a model in which the real Fed Funds Rate is actually negative if asset prices, such as stock prices, were included in the yardsticks by which the Fed measures inflation. Regardless, the market is still quite complacent.

Some intermediate-term problems have surfaced. Some of the sentiment indicators that we watch have jumped to their highest level in months. The breadth remains very poor. To illustrate, consider that in the most recent leg of this rally, the Dow Jones Industrial Average (DJIA) rose just shy of 400 points, or 3.7%. During the 10 days it took for that push, the breadth was positive for 4 days and negative for 6 days. Even for the four positive sessions, the best day showed advances over decliners at a ratio of 1.28:1. The worst of the negative days showed decliners over advances at a ratio of 2.37:1. Hardly the stuff of a genuine bull market. The ratio of new highs to new lows is also extraordinarily pathetic.

So we continue to ride with pack, but with a stiff neck from turning to check what hazards might be creeping up behind us.

STRATEGY: *Remain long December S&P. Raise stops to 1395, close only.*

Gold

Tomorrow, The Bank of England will hold its third gold auction of the year, at which it will be offering 800,000 ounces for sale. The first auction back in July pushed prices to 20-year lows. The second auction, which was eight times oversubscribed, sparked a powerful rally that in all likelihood marked the end of the bear market in gold. What can we look for this time?

Well, it probably doesn't really matter. While the process of demonetizing gold has not been completed, its effect on prices will be limited. The gold that was provided to the market by central banks these past years only served to make up the shortfall in the balance between mine production and fabrication and investment consumption. The constant fear of when the next central bank will unload tonnes of gold on an unsuspecting market kept pushing prices lower. Although difficult to measure, this fear probably had as much to do with the bear market in gold as the disinflationary environment or any other factors that contributed to gold's decline.

Now that the big gold sales are out in the open – particularly with the UK auction, with the timing and amounts to be sold known to all – their significance is diminishing.

The gold market is getting back to its centuries old job of being a harbinger of inflation or deflation, as the case may be. As such, it should be pointed out that despite losing about $30-an-ounce from the top of the move, gold prices have maintained a $50-an-ounce rally since the September UK auction and the European Central Bank's announcement of a cap on its gold sales for five years. This may indicate that the price of gold was indeed hiding "$50-an-ounce worth" of inflation.

There has been progress in clearing gold up from the recent volatility. The open interest has shed over 30,000 contracts, which indicates that much of the short covering by producers who oversold their production and funds that were caught short has been seen to. This allows the gold market to begin an era in which prices can reflect commodity-type market fundamentals, which for gold would include its investment value as a hedge against inflation.

Actually, to balance our bullishness, there is a bearish note to take heed of. The market did not require much of a rally off the recent lows to spend the bulk of the open interest that was lost. This indicates strong overhead resistance, which might require some formidable new buying power before we can move through the recent highs.

Nonetheless, our bias towards higher commodity prices in general, borne of our belief that the Fed has been too easy for too long provides the backdrop for a long-term bull move.

[November 28, 1999]

STRATEGY: *Roll long December positions to February and adjust stops to 290, close only.*

Chart 5 – Gold

Chart 6 – S&P 500

HOTLINE UPDATE

***Flash Update:* Thursday, November 4, 1999:**
Good morning for Thursday November 4, 10:15 am. This is a Flash Update. We have purchased the January CRB Index future at 205.50, placing an initial stop at 195.50 close only.

***Flash Update:* Friday, November 5, 1999:**
Good morning for Friday November 5 11:15 am. This is a Flash Update. We have purchased July CBOT wheat at 295 3/4, placing a stop at 285 3/4 close only.

Friday, November 5, 1999:
Good afternoon for Friday, November 5, 4:30 pm. The following is a review of our current open position recommendations, and our latest stop levels.
• We are long March corn, with a stop at 202 1/2.
• Long December S&P with a stop at 1360.
• Long December gold, with at stop at 287.60.
• Long January CRB Index, with a stop at 195.50.
• Long July wheat, with a stop at 285 3/4.

***Flash Update:* Wednesday, November 10, 1999:**
Good afternoon for Wednesday November 10, 1:40 pm. This is a Flash Update. We have liquidated our July wheat position at 285 3/4.

***Flash Update:* Friday, November 12, 1999:**
Good morning for Friday, November 12, 9:30 am. This is a Flash Update. We have sold short March copper at 79.45, placing an initial stop at 84.00, close only.

Friday, November 12, 1999:
Good afternoon for Friday, November 15, 5:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels.
• We are long March corn, with a stop at 202 1/2.
• Long December S&P with a stop at 1360.
• Long December gold, with a stop at 287.60.
• Long January CRB, with a stop at 195.50.
• Short March copper, with a stop at 84.00.
All stops are close only.

***Flash Update:* Friday, November 19, 1999:**
Good morning, for Friday November 19, 11:35 am. This is a Flash Update. We have liquidated long March corn positions at 202 1/4.

Friday, November 19, 1999:
Good afternoon for Friday, November 19, 4:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels.
• We are long December S&P, with a stop at 1360.
• Long December gold, with a stop at 287.60.
• Long January CRB Index, with a stop at 195.50.
• Short March copper, with a stop at 84.00.
All stops are close only.

***Flash Update:* Monday, November 22:**
Good morning, for Monday November 22, 9:05 am. This is a Flash Update. We have covered our short March copper position at 80.80.

***Flash Update:* Wednesday, November 24, 1999:**
Good morning, for Wednesday November 24, 8:45 am. This is a Flash Update. We have purchased January platinum at 403.50, placing our initial stop at 363.50, close only.

Friday, November 26, 1999:
Good afternoon for Friday, November 26, 2:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels.
• We are long December S&P, with a stop at 1395.
• Long December gold, with a stop at 287.60.
• Long January CRB Index, with a stop at 195.50.
• Long January platinum, with a stop at 363.50.
All stops are close only.

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