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Volume 18, No. 2 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

By Howard L. Simons (847) 304-1511

January 11, 2007

"Don't bet on the world ending. It's only going to happen once, and how are you going to collect?" – Howard L. Simons

Revisiting Commodities' Impact on Financial Markets

It was a scant four months ago when, in the face of another generalized commodity price decline, we concluded a Commentary:

> *We can conclude, however, that lower commodity prices are not the harbinger of a global downturn, a conclusion reached recently by some prominent economists who appear to specialize in being wrong on such matters.*
>
> *The recent spate of investment in commodity-producing industries will lead to higher credit stress and lower relative equity performance therein, and just the opposite will be true for consumer-related industries. This will not be the first business cycle in human history, and we urge others not to narrate it as such.*

Let's update the regression table of sector CDS returns against selected commodities. January 2007's data are presented first, with September 2006's data following immediately.

January 2007

Economic Sector	Crude Oil	Natural Gas	Copper	Gold
Basic Materials	(0.032)	0.001	(0.050)	(0.038)
Consumer Discretionary	0.012	(0.004)	(0.035)	(0.113)
Consumer Staples	0.037	(0.033)	(0.017)	0.025
Energy	0.036	0.014	0.001	(0.095)
Financial	(0.020)	(0.030)	(0.021)	(0.079)
Healthcare	(0.031)	0.012	(0.018)	0.054
Industrial	(0.027)	0.049	(0.093)	(0.109)
Technology	0.003	0.012	(0.043)	(0.075)
Telecommunications	(0.012)	0.004	(0.055)	(0.079)
Utilities	(0.022)	(0.010)	(0.025)	(0.067)

September 2006

Economic Sector	Crude Oil	Natural Gas	Copper	Gold
Basic Materials	(0.029)	0.018	(0.071)	(0.057)
Consumer Discretionary	0.019	(0.008)	(0.062)	(0.126)
Consumer Staples	0.063	0.007	(0.077)	(0.057)
Energy	0.031	0.012	(0.031)	(0.086)
Financial	(0.033)	(0.036)	(0.029)	(0.113)
Healthcare	(0.011)	0.031	(0.022)	0.033
Industrial	(0.010)	0.019	(0.033)	(0.048)
Technology	0.040	(0.024)	0.009	(0.067)
Telecommunications	(0.005)	(0.028)	(0.037)	(0.202)
Utilities	(0.025)	(0.016)	(0.038)	(0.081)

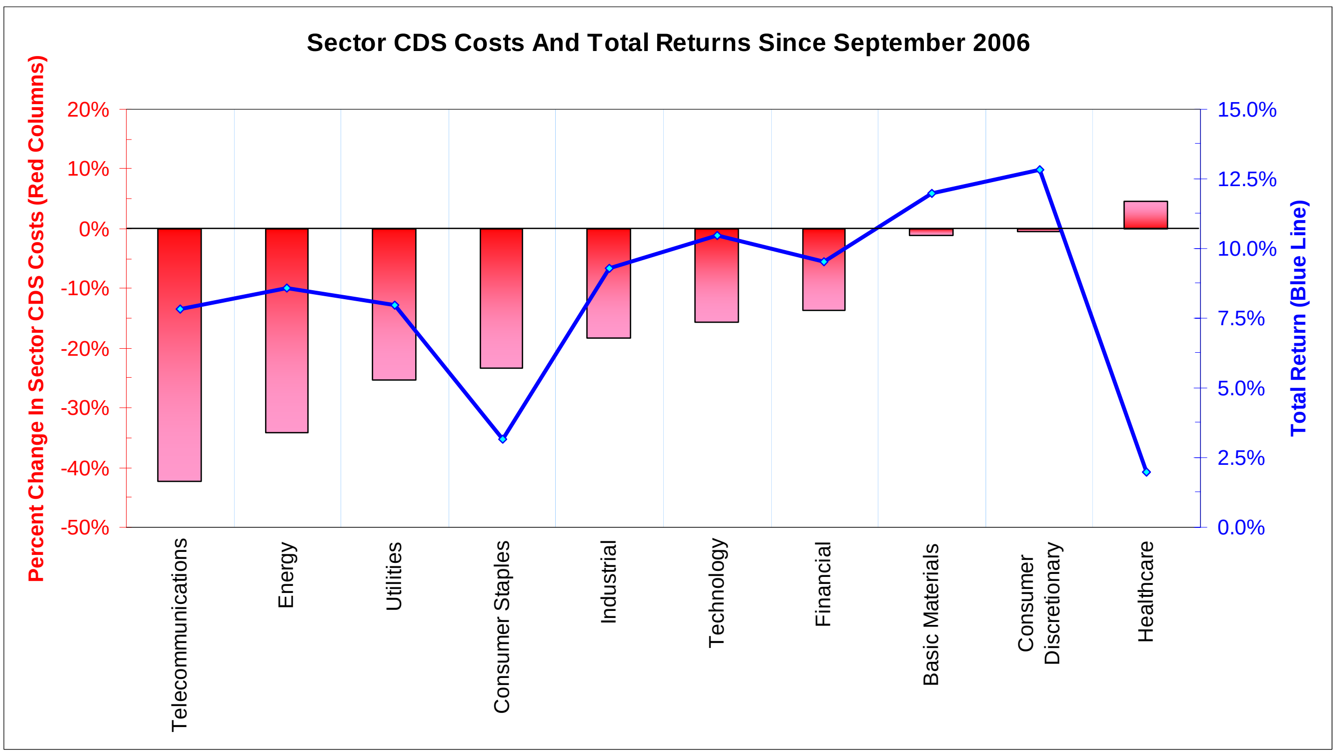
Credit Market Impact

A more negative or less positive coefficient for commodities whose price has fallen sharply since September, such as crude oil or copper, means credit stress has increased. The partial contribution of lower crude oil prices to sector CDS costs has been to increase stress in all sectors but Financials, Utilities and, paradoxically, Energy. We have noted this odd effect on the Energy sector before; as crude oil and natural gas prices rise, the firms' costs and capital budgets rise apace. This tends to raise the risk of a misstep and hence pushes CDS costs higher. The other seven economic sectors' credit stress levels have increased as crude oil prices have fallen; we do not impute causation.

The drop in copper prices has had an opposite set of associations. Credit stress has increased in the Industrial, Technology and Telecommunications sectors as a function of lower copper prices and has fallen elsewhere.

Once again, we do not impute causation. It is important to note CDS levels in general fell across nine of the ten sectors (red columns), with the Healthcare sector being the only exception. Total returns (blue line) were positive for all ten sectors during the past four months. The partial contributions of selected commodity prices were overwhelmed by a general bull market over a short span of time.

However, these observations are consistent with previous conclusions commodity prices are far less significant and often counterintuitive in their impact than we are predisposed to believe; this was detailed in previous Commentaries on crude oil and copper. Financial variables, long-term interest rates in particular, have a greater impact but seem to garner fewer headlines.



Positive Industry Group Impact

If we move down from the economic sector level to the industry group level we can, using the analysis detailed in a March 2005 Special Report, see which groups are affected positively by falling commodity prices relative to the S&P 500 (table below). The list is dominated, unsurprisingly, by Consumer Discretionary and Consumer Staples issues. Lower energy prices do put more spending power in the hands of the consumer. **Along with rising equity prices, lower energy prices may explain why the much-discussed downturn in residential real estate has yet to have a significant macroeconomic impact.**

Relative Performance Of Industry Groups To S&P 500 As A Function Of Selected Factors

Crude Oil		Natural Gas		Copper		Gold	
Group	Beta	Group	Beta	Group	Beta	Group	Beta
Airlines	(0.205)	General Merchandise Retailers	(0.045)	Internet Retailers	(0.081)	Drug Retailers	(0.203)
General Merchandise Retailers	(0.104)	Internet Retailers	(0.040)	Home Entertainment Software	(0.080)	Home Improvement Retailers	(0.176)
Healthcare Distributors	(0.090)	Automobile Manufacturers	(0.037)	Drug Retailers	(0.067)	Hypercenters & Superstores	(0.176)
Drug Retailers	(0.078)	Healthcare Suppliers	(0.035)	Brewers	(0.063)	General Merchandise Retailers	(0.155)
Computers & Electronics Retailers	(0.075)	Drug Retailers	(0.035)	Healthcare Facilities	(0.057)	Food Distributors	(0.149)
Automobile Manufacturers	(0.073)	Thrifts & Mortgages	(0.033)	Diversified Commercial Services	(0.053)	Healthcare Distributors	(0.147)
Hypercenters & Superstores	(0.070)	Airlines	(0.033)	Computers & Electronics Retailers	(0.049)	Leisure Products	(0.146)
Semiconductor Equipment	(0.065)	Distributors	(0.031)	Home Improvement Retailers	(0.049)	Food Retailers	(0.131)
Home Improvement Retailers	(0.062)	Auto Parts & Equipment	(0.031)	Multiline Insurers	(0.043)	Motorcycle Manufacturers	(0.120)
Environmental Services	(0.062)	Photo Products	(0.029)	Food Distributors	(0.039)	Healthcare Suppliers	(0.120)
Tobacco	(0.058)	Hypercenters & Superstores	(0.029)	Leisure Products	(0.038)	Specialty Stores	(0.112)
Department Stores	(0.057)	Environmental Services	(0.029)	Restaurants	(0.037)	Airlines	(0.105)
Data Processing & Outsourcing	(0.057)	Broadcast & Cable TV	(0.029)	Environmental Services	(0.036)	Automobile Manufacturers	(0.104)
Air Freight & Logistics	(0.057)	Computers & Electronics Retailers	(0.027)	Systems Software	(0.036)	Biotech	(0.094)
Systems Software	(0.056)	Diversified Banks	(0.025)	Hypercenters & Superstores	(0.034)	Department Stores	(0.085)
Apparel Retailers	(0.055)	Hotels	(0.025)	Household Products	(0.033)	Pharmaceuticals	(0.084)
Communications Equipment	(0.055)	Department Stores	(0.024)	Pharmaceuticals	(0.032)	Healthcare Equipment	(0.082)
Auto Parts & Equipment	(0.053)	Regional Banks	(0.024)	Publishing & Printing	(0.032)	Household Products	(0.082)
Application Software	(0.051)	Diversified Commercial Services	(0.024)	Healthcare Equipment	(0.029)	Air Freight & Logistics	(0.080)
Leisure Products	(0.049)	Commercial Printers	(0.023)	Life & Health Insurers	(0.029)	Data Processing & Outsourcing	(0.079)
Multiline Insurers	(0.049)	Industrial Conglomerates	(0.023)	Computer Hardware	(0.029)	Integrated Telecommunications	(0.078)
Wireless Services	(0.048)	Integrated Telecommunications	(0.022)	Specialty Stores	(0.027)	Healthcare Services	(0.077)
Integrated Telecommunications	(0.048)	Home Improvement Retailers	(0.022)	Integrated Telecommunications	(0.026)	Casinos & Gaming	(0.074)
Photo Products	(0.047)	Leisure Products	(0.020)	Data Processing & Outsourcing	(0.025)	Apparel Retailers	(0.074)
Specialty Stores	(0.047)	Tobacco	(0.019)	Property & Casualty Insurers	(0.024)	Managed Health	(0.071)
Distributors	(0.046)	Restaurants	(0.019)	Packaged Foods	(0.022)	Systems Software	(0.067)
Semiconductors	(0.046)	Data Processing & Outsourcing	(0.019)	Soft Drinks	(0.021)	Publishing & Printing	(0.064)
Household Appliances	(0.045)	Packaged Foods	(0.018)	Regional Banks	(0.017)	Personal Products	(0.064)
Casinos & Gaming	(0.044)	Consumer Finance	(0.018)			Distributors	(0.063)
Food Retailers	(0.044)	Household Appliances	(0.018)			Healthcare Facilities	(0.063)
Electrical Equipment Manufacturing	(0.043)	Household Products	(0.017)			Soft Drinks	(0.060)
Pharmaceuticals	(0.043)	Air Freight & Logistics	(0.017)			Commercial Printers	(0.058)
Computer Hardware	(0.042)	Multiline Insurers	(0.017)			Advertising	(0.056)
Office Electronics	(0.042)	Movies & Entertainment	(0.015)			Property & Casualty Insurers	(0.056)
Household Products	(0.041)	Property & Casualty Insurers	(0.015)			Industrial Conglomerates	(0.054)
Personal Products	(0.041)	Soft Drinks	(0.014)			Environmental Services	(0.054)
Regional Banks	(0.041)	Other Diversified Financial Services	(0.012)			Diversified Commercial Services	(0.052)
Thrifts & Mortgages	(0.041)	Pharmaceuticals	(0.012)			Packaged Foods	(0.049)
Diversified Banks	(0.040)	Asset Management & Custodial Ban	(0.012)			Broadcast & Cable TV	(0.047)
Consumer Finance	(0.039)					Regional Banks	(0.046)
Computer Storage & Peripherals	(0.038)					Computer Hardware	(0.043)
Industrial Conglomerates	(0.037)						
Asset Management & Custodial Ban	(0.035)						
Hotels	(0.035)						
Property & Casualty Insurers	(0.035)						
Other Diversified Financial Services	(0.034)						
Diversified Commercial Services	(0.034)						
Biotech	(0.034)						
Investment Banking & Brokerage	(0.033)						
Healthcare Equipment	(0.029)						
Aerospace & Defense	(0.027)						
Movies & Entertainment	(0.027)						
Specialty Chemicals	(0.026)						
Restaurants	(0.025)						
Diversified Chemicals	(0.025)						
Office Services & Supplies	(0.024)						

Negative Industry Group Impact

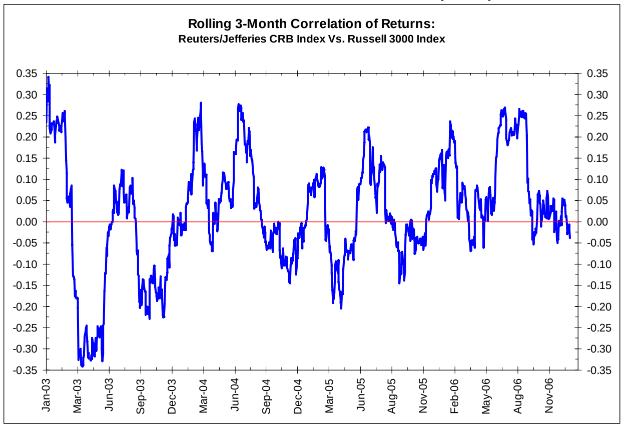
Groups whose relative performance to the S&P 500 has been hurt by declines in commodity prices are concentrated almost exclusively in the Energy and Basic Materials sectors for crude oil and natural gas (table below). **Lower copper prices are associated with lower relative performance for a few Industrial groups such as Construction & Farm Machinery and Construction Materials, but if anyone is looking to build a case for a strong connection between lower copper prices and a collapsing economy, they will not find it here.**

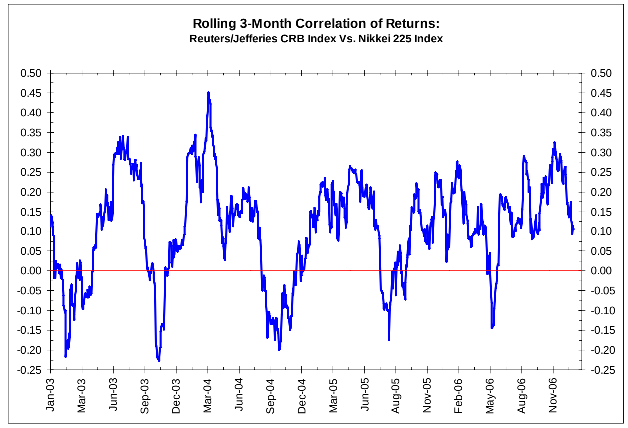
Relative Performance Of Industry Groups To S&P 500 As A Function Of Selected Factors

Crude Oil		Natural Gas		Copper		Gold	
Group	Beta	Group	Beta	Group	Beta	Group	Beta
Oil & Gas Drilling	0.480	Oil & Gas Exploration	0.177	Diversified Metals & Mining	0.529	Gold	1.077
Oil & Gas Exploration	0.439	Oil & Gas Drilling	0.168	Gold	0.312	Diversified Metals & Mining	0.932
Oil & Gas Equipment	0.436	Oil & Gas Refining	0.156	Steel	0.270	Oil & Gas Equipment	0.477
Oil & Gas Refining	0.425	Oil & Gas Equipment	0.155	Oil & Gas Drilling	0.178	Oil & Gas Drilling	0.468
Integrated Oil & Gas	0.284	Diversified Metals & Mining	0.090	Oil & Gas Equipment	0.170	Steel	0.456
Diversified Metals & Mining	0.263	Integrated Oil & Gas	0.088	Aluminum	0.164	Oil & Gas Refining	0.427
Gold	0.250	Gold	0.082	Oil & Gas Exploration	0.158	Oil & Gas Exploration	0.403
Steel	0.168	Steel	0.071	Oil & Gas Refining	0.139	Aluminum	0.286
Construction & Engineering	0.100	Construction & Engineering	0.031	Construction & Engineering	0.113	Integrated Oil & Gas	0.269
Agricultural Products	0.095	Aluminum	0.027	Integrated Oil & Gas	0.104	Fertilizers & Agricultural Chemicals	0.171
Aluminum	0.094	Gas Utilities	0.013	Construction & Farm Machinery	0.089	Construction & Engineering	0.151
Gas Utilities	0.063			Homebuilding	0.078	Agricultural Products	0.145
Homebuilding	0.051			Railroads	0.064	Construction Materials	0.116
Multiline Utilities	0.041			Agricultural Products	0.062	Forest Products	0.108
Construction & Farm Machinery	0.037			Fertilizers & Agricultural Chemicals	0.057	Electrical Manufacturing Services	0.107
Electric Utilities	0.026			Forest Products	0.055	Trading Companies	0.093
				Construction Materials	0.055	Construction & Farm Machinery	0.086
				Paper Packaging	0.046	Industrial Gases	0.062
				Industrial Machinery	0.040	Investment Banking & Brokerage	0.057
				Paper Products	0.039	Specialized Finance	0.054
				Diversified Chemicals	0.038	Asset Management & Custodial Banks	0.036
				Electrical Components & Equipment	0.034		
				Industrial Gases	0.033		
				Household Appliances	0.028		
				Investment Banking & Brokerage	0.027		
				Specialty Chemicals	0.022		

Equity Index Impact

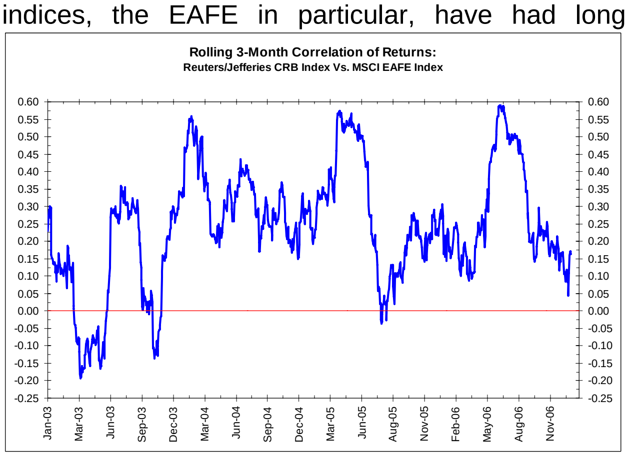
With all appropriate disclaimers in place regarding commodity indices, let's use the Reuters/Jefferies CRB index as shorthand for commodity prices in aggregate. If the recent plunge in this index, down 5.84% year-to-date, is associated with lower equity index levels, we should see an abrupt upturn in the correlation of returns between the CRB and various equity indices. **In the case of the U.S. and Japanese markets, represented by the Russell 3000 (left-hand chart) and Nikkei 225 (right-hand chart) indices, respectively, no impact is visible.**

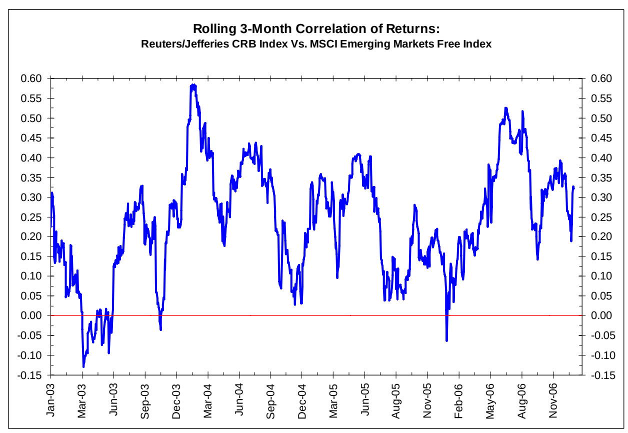




We cannot say the same for the MSCI Europe, Australasia, & Far East (EAFE, left-hand chart, following page) or the MSCI Emerging Markets Free index (right-hand chart). Both of these indices crumbled at the start of the year.

This is most likely coincident with, not caused by, commodity price movements. After all, both indices, the EAFE in particular, have had long periods of much higher correlation of returns with the CRB than recently. If either index was simply a proxy for commodity price movements, we would have seen both higher and more stable levels of historical correlation between their returns and those of the CRB.





Conclusion

A criticism we have offered is when people say "commodities" they mean "exchange-traded representations of physical commodities." This excludes huge, important physical markets without futures contracts or without futures contracts of importance, such as steel, paper and cement. It also excludes the far more important financial markets.

This perhaps is a legacy of the 1970s and its economic mismanagement. We associate that era's inflation, recession and poor financial markets with higher commodity prices, but they simply were outward manifestations of policy rot. If we should have learned anything from the ability of the global economy to prosper between 2003 and today it is higher commodity prices induced by demand growth are not significant detriments to either the economy or to financial markets.

Many of the same people who proclaimed the dangers of $70+ crude oil or $8,000+ copper are now proclaiming their regression toward lower price levels is equally dangerous.

Our advice is simple: Find these people. Then ignore them.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511
Fax (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Ryan Spokas rspokas@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 625-1860
Fritz Handler fritz.handler@arborresearch.com
Norma Mytys norma.mytys@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560
Fax (847) 304-1595

e-mail inforequest@arborresearch.com
http://www.arborresearch.com

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602
Daniel Lustig dan.lustig@arborresearch.com
Phone (866) 877-0266

New York Sales Office

The Chrysler Building
405 Lexington Ave
New York, NY 10174
Edward T. McElwreath ed.mcelwreath@arborresearch.com
Phone (212) 867-5326
Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

Director of International Sales (847) 304-1560
James L. Perry james.perry@arborresearch.com
Brent E. Glendinning brent.glendinning@arborresearch.com

London Sales Office

4 Broadgate
2nd Floor
Room 57
London England EC2M 2QY
Phone 44-207-965-4784
Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com