The StockCharts.com Market Message

Featuring our commentators, John Murphy and Arthur Hill

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FALLING COMMODITY PRICES ARE A BIG REASON WHY INFLATION IS SO LOW -- CRB INDEX FALLS TO LOWEST LEVEL IN MORE THAN A YEAR -- FALLING COMMODITY PRICES ARE HELPING PULL YIELD CURVE LOWER -- BOND TRADERS APPEAR SKEPTICAL OF FED FORECASTS FOR HIGHER GROWTH AND RISING INFLATION

By John Murphy

CRB INDEX IS TRADING AT LOWEST LEVEL IN MORE THAN A YEAR... Ever since Wednesday's Fed rate hike, and the press conference by Janet Yellen, I've been thinking a lot about inflation. I believe the Fed is underestimating how weak inflation really is. I also believe that's because it's looking in the wrong places. Or, more to the point, it's ignoring the weak signals hiding in plain sight. Namely, falling commodity prices. Chart 1 shows the **Reuters/Jefferies CRB Index** falling this week to the lowest level since the spring of 2016. Ms. Yellen may refer to that falling trend as "noise". To a chart reader, it's called a downtrend. The CRB Index includes 19 actively traded commodities which include energy, industrial and precious metals, and agricultural markets. [The Bloomberg Commodity Index has also fallen to the lowest level in a year]. Ms. Yellen said that the Fed views the recent decline in inflation as transitory. She referred to a temporary drop in the cost of cellphone plans as an example of why inflation could bounce. Is that really what the Fed is relying on? What about falling food and energy prices. Then again, economists don't include those in their calculations for "core" inflation. [They consider them too volatile, whatever that means]. But that omission helps explain why they've been so wrong for so long on inflation. The implications are important. If the Fed is wrong on inflation, then it's plan to keep raising rates is misguided. Falling bond yields, and a flattening yield curve, suggest that bond traders are already suggesting that.

(click to view a live version of this chart)

Chart 1

CRB INDEX HAS BEEN FALLING SINCE 2008... After falling for two decades between 1980 and 2000, commodity prices rose between 2002 and 2008. That rise was mainly the result of a plunging U.S. Dollar. Chart 2 shows a dollar 2008 bottom, however, coinciding with a major commodity peak. A second dollar rebound in 2011 produced another CRB downleg. A third dollar upturn in 2014 produced an even steeper commodity downturn (see arrows). At the start of 2016, the CRB fell to the lowest level since the 1970s which raised fears of a dangerous deflation. They rebounded during 2016, but are falling again. Here's why that matters. The inflation pipeline has three stages. The first stage is the price of raw materials. The second stage is the price companies pay for raw materials (producer price inflation). The third stage is what companies charge consumers for their products (CPI inflation). It all starts with the direction of commodity prices. Strangely, that's the part that economists (and the Fed) pay no attention to. How can economists expect to predict the final stage of CPI inflation, if they ignore the first stage which is the direction of commodity prices?

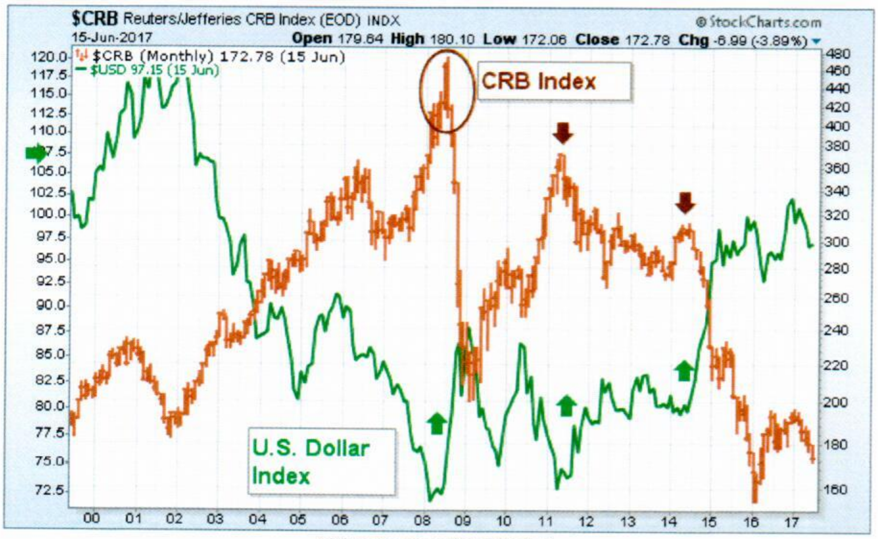

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Chart 2

COMMODITY PRICES EFFECT DIRECTION OF YIELD CURVE... One of the measures of economic confidence is the direction of the yield curve. The yield curve is the difference between 10 and 2-Year Treasury yields. A rising yield curve shows confidence in an economic recovery, which is usually accompanied by rising inflation. A falling yield curve suggests the opposite. The green line in Chart 3 shows the **yield curve** falling to the lowest level since last summer. That shows that bond traders are skeptical about economic growth and predictions for rising inflation. Commodity prices play a role there as well. Chart 3 shows that a falling **CRB Index** (brown line) over the last three years has usually been associated with a "flattening" yield curve. Both lines are falling together this year. Commodity prices are often used to measure the strength of the global economy. A rising economy usually increases demand for raw materials. That's why commodity prices usually start rising during a strong economic upturn. Some price inflation is healthy. That allows companies to pass some of their costs on to consumers. That increases their bottom line and allows companies to pay higher wages. Falling inflation prevents that from happening. The Fed keeps saying that higher wages produce higher inflation. I suspect it's the other way around, and that rising inflation is necessary to produce higher wages. And both will probably require higher commodity prices.

(click to view a live version of this chart)

Chart 3

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Falling Commodity Prices Are a Big Reason Why Inflation Is So Low

John Murphy | June 16, 2017 at 06:56 PM

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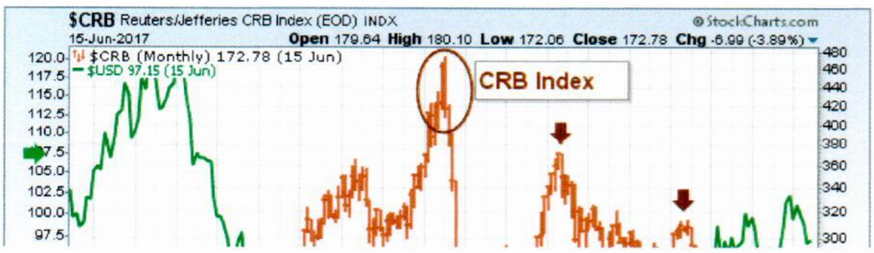

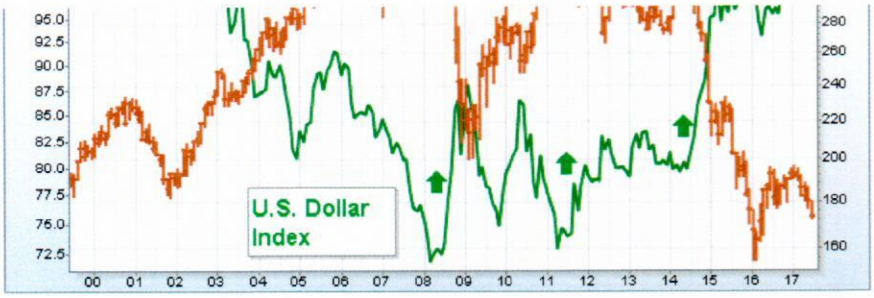

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