The Great Disconnect:

Equities and Commodities

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26 August 2014

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The Great Disconnect: Equities and Commodities

Main Points

1. My thirty plus years in technical analysis can be divided into two halves. In the first fifteen years my focus were the energy markets and the inter-relationships of the various components of the energy complex. About fifteen years ago energy prices started becoming financialized. Price trends in crude oil and refined products began to be more and more driven by price trends in the key financial markets.
2. So for the last fifteen years my analysis has included observing how the price patterns in the energy markets blended into the price patterns of the financial markets. The dominating financial markets have been the US stock market and the US Dollar.
3. In the field of academics, organic chemistry was my first love. I found the mathematical order underlying complex chemical behavior deeply satisfying and I actually enjoyed balancing complex equations. So when I discovered Elliott Wave analysis I felt completely at home.
4. In organic chemistry if an equation refuses to balance out then it means something has been overlooked. Even in complex redox reactions where there are more unknowns than knowns and there is no simple resolution, even then the chemical reactions still makes sense. Even then one can still understand the complex processes involved and extract useful, predictive information
5. Since early 2012 I have been tracking a major disconnect in the global financial markets that has made less and less sense over time. Over time it has grown from an annoyance to a very serious problem. I refer to the disconnect between price trends in commodities and equities.
6. From early 2012 the US stock market took off to the upside like a rocket. Yet commodities continued to lose altitude. Three years later this disconnect persists. It has become a yawning chasm.
7. Yes, a historic commodity bubble did burst from a July 2008 peak. However a historic stock market bubble had already begun to burst from an October 2007 peak. A discrepancy of ten months (from October 07 to July 08) should not mean that three years later stocks are still soaring while commodities are still languishing.
8. If the continuing stock market rally is arising from a genuine economic recovery then it makes zero sense that commodity prices are poised for new multi-year lows. This equation does not balance. There must be something amiss about the bull market in equities. But what?
9. The beginning of an answer is in the unprecedented duration of record low interest rates engineered by the Federal Reserve. Never before in recorded history has money been this cheap. And I am talking back to the Bronze Age Sumerian civilization. As has been noted by many, these ultra-low interest rates have created major distortions on many levels in the financial markets.
10. One such distortion can be found at the heart of the still widening breach between rising equity prices and sinking commodity prices. For a corporation, and adjusted for inflation, money is free. This creates a tremendous incentive to buy back one's own stock. And corporations are doing so on a titanic scale. Over in commodities, producers have *not* been buying back crude oil, grains, hogs and silver - and then putting these various items back in the ground.

BSERVATIONS

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line on monthly close

S&P 500 Index

DJ-UBS Index

The widening breach

For these two indices it began back in late 2011. By then it was looking like the Fed would never allow interest rates to rise back to market levels ever again. It was beginning to look like free money was for the big boys was here to stay.

235.00 230.00 225.00 220.00 215.00 210.00 205.00 200.00 195.00 190.00 185.00 180.00 175.00 170.00 165.00 160.00 155.00 150.00 145.00 140.00 135.00 130.00 125.00 120.00 115.00 110.00 105.00

2000. 1800. 1600. 1400. 1200. 1000. 800.0

'05 '06 '07 '08 '09 '10 '11 '12 '13 '14 Month

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NYSE Composite Index

Reuters-Jeffries CRB Total Return Index

Once more unto the breach

For these two indices it began in late 2012. This chart makes very clear that the widening gap between equities and commodities has nothing to do with the structure of either the SPX or the DJ-UBS Index.

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'02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 Monthly

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Divergent

Looking at more history does not dispell the magnitude of the divergence since 2011. Prior to 2011 any price trend divergence between commodities and equities only lasted a few months and was of relatively minor degree. This divergence is spectacular in both duration and extent.

Of the S&P 500 corporations, from 2007 through Q1 of 2014 the following categories combined (in alphabetical order) were net sellers of equities.

- Broker / Dealers
- Closed End Funds
- ETF's
- Hedge Funds
- Households
- Mutual Funds
- Property, Casualty, and Life Insurance Companies
- Private Pensions

The dollar volume of these net sales:

$687 Billion

Of the S&P 500 corporations, from 2007 through Q1 of 2014 the following categories were net buyers of their own shares.

- Non-Financial Corporations

The dollar volume of these stock buy-backs:

$3.16 Trillion

Three trillion is real money.
$687 Billion goes into $3.1 Trillion 4.5 times

Source: Cumulative Net Purchases / Sales of Stocks by Participants, 2007 - 2014 Per Federal Reserve Z.1 Release (Table F.213)
Revisions as of 5th June 2014

Now $687 Billion goes into $3.16 Trillion 4.5 times. So there is no contest here. Corporations buying back their own shares have been obliterating any net selling influence of everyone else. Hence the unrelenting up trend in the S&P 500 Index. With this information the equation balances. Now we know why the commodity markets continue to deflate while the equity markets continues to inflate.

Now that we have found $3.16 Trillion dollars pouring into the stock market, it should be asked where this $3.16 Trillion came from. It was borrowed. And it was effortlessly borrowed because, for the five hundred largest US corporations that compose the S&P 500 Index, money is free. Money is free because the Fed is bound and determined to reignite inflation regardless of how much their efforts screw-up the financial markets. The Fed craves inflation because it is their view that our debt heavy economy would collapse in a deflationary environment. After seven years of zero real interest rates the Fed is still running scared.

Why can the Fed not see the distortions that they are creating? It is a physiological fact that fear shuts down the pre-frontal cortex. When fear is triggered the brain instantly becomes physiologically incapable of rational thinking. So people do crazy things when they are scared. Police shoot unarmed civilians and governments commit crimes against humanity. And there is an entire industry that makes sure voters cast their ballots out of fear. So we have deeply flawed Fed policies and deeply dysfunctional governments. But perhaps I digress.

Why issue shares?

Back to that 3.16 Trillion US Dollars. If money is free, then why issue shares in the first place? And if money is free then why should a corporation not buy back all of its outstanding shares? Why bother with those pesky dividends? Why hassle with those irritating investors and those troublesome annual meetings with shareholders? Why be inconvenienced by all those nagging reporting requirements? After all, investors are clamoring for ***any*** yield on a corporate bond. So why not give the investors what want - bonds, and take away what upsets them - equities? The beauty of it all is that while some corporations are borrowing from banks to fund buying back their shares, many are issuing bonds to investors to fund buying back their shares. Of course issuing a bond is a form of buying, but investors have proven to be far more gullible than banks.

In a central bank mandated zero interest rate environment there is only one factor that prevents a stock market from becoming 19th century obsolete. The only reason owners would ever take their company public is if they can sell it for more than it is worth. Yes, corporate bond issues can be over-subscribed, but bond issues have never proven capable of generating the mania of issued shares. So when money is free the only thing keeping the stock market alive is the gullibility of investors.

As it is, the stock market has primarily become a platform for buying back shares, not issuing new ones. If that is not a fundamental distortion of the financial markets then I do not know what a distortion is.

Buy-backs are not a long position

In theory a corporation can do one of three things with the shares they have repurchased. The first and least likely usage is granting the shares to employees as compensation or benefits. The second option is holding the shares in reserve to be re-issued at a later date. The third option is to retire the shares. They are cancelled, erased from existence. So buying back shares does not create a long position.

The only equivalent in the commodity sector would be if and when a commodity price falls below the cost of production, a producer would decide to buy the commodity on the open market rather than grow it, raise it, drill and pump it, or dig it out of the ground.

Investors buy shares because they are bullish on the economic outlook. They sell shares because they are bearish on the economic outlook. This makes the stock market one big voting both where the results of the balloting stream live almost 24/7.

Corporations buy back their own shares when the cost of borrowing is less than the cost of paying out dividends. Corporations do not buy back their own shares because they are bullish on the economic outlook. Buy-backs are not the result of a bullish forecast for the economy. Buy-backs are an accounting decision. And in large enough doses the repurchase of shares destroys the ability to gauge the economic outlook from stock market price trends. Another market distortion.

Buy-backs are not a function of the economic outlook

Once the bean counters have decided to buy back their shares, the only concern is the cost of money. They could care less about Europe sinking into recession, or Putin gobbling up the Ukraine, or the Mid-East descending into anarchy, or the bursting of the Chinese real estate bubble, or the growing opportunity gap in the US, or how the Fed is going to unwind it's gigantic balance sheet. Accountants do not care about such things. They are irrelevant factors.

Fringe benefits

Of course buying back shares in a difficult economic environment has some serious fringe benefits. Decreasing the amount of shares floating in the market increases the earnings per share and therefore the stock price. And driving up the stock price is a wonderful thing for the top brass whenever executive compensation is tied to the share price. In an uncertain economic environment driving up share prices through buy-backs is much easier than growing the company. Here is yet another serious market distortion created by central bank free money.

When corporations are done with buy-backs?

How much longer can corporations continue exchanging equity for debt? Because that is exactly what they are doing. They are going into debt via either outright borrowing or bond issuance to retire equity. And what happens to the stock market when the spigot of trillions of dollars of funds flowing into the market to buy back shares is turned off?