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Commodity crunch

Resource retreat hits TSX

May 6, 2011 – For markets, one of the most active weeks in recent memory drew to a close this Friday. Collapsing commodity prices – especially crude oil and silver – got the attention of Canadian investors, eclipsing the election of a business-friendly federal Conservative majority government and the death of the world's most wanted criminal, Osama bin Laden.

The price of North American benchmark West Texas Intermediate crude oil fell nearly ten bucks a barrel last week, as nearby futures prices dropped to US$98 per barrel. In a straight-line cause-and-effect relationship, Canada's energy subindex, the S&P/TSX Capped Energy Index, dropped some 6% on the week by the time all the smoke had cleared.

It was a case of irony of ironies, of course, because Canada's largest energy company, Suncor Energy Inc., had just reported its first-quarter operating income rose to $0.94 per share from $0.24 in the same period last year. That's a 292% year-over-year increase in quarterly profit. You'd expect that, given that for the past year, and most noticeably in the past quarter, oil prices have been on the rise. Higher production from oil sands and improving returns from refineries mostly contributed to Suncor's guesstimate-beating performance. Still, the share price fell about $4 last week in the general energy sector rout. Sometimes, you just can't win!

Plenty of reasons were offered up for the sudden urge to sell oil. The removal of fugitive terrorist Osama bin Laden from the world stage "with extreme prejudice" might have contributed to a shrinking of the risk premium on oil. That's a stretch, though, because al-Qaeda, the terrorist organization he headed, lives on and has any number of new "leaders" ready to take his place. The more reasonable explanation for the commodity selloff can be found, as always, in the markets' herd mentality. Large hedge funds began liquidating long positions in most commodities *en masse* last week after the price of silver plunged on fears of rising real interest rates following the end of the Fed's quantitative easing program in June. (The price of silver is inversely correlated with real rates, and it's widely believed that real rates will begin edging up after June.) Adding fuel to the fire was a report in *The Wall Street Journal* citing unnamed sources that billionaire George Soros, head of Soros Fund Management, had been selling precious metals assets.

The markets' mood wasn't helped any by declines in the pace of growth in both the manufacturing and service sectors in April. The Institute for Supply Management's

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widely followed manufacturing index dropped slightly, to 60.4 in April from 61.2 in March. It still indicates impressive expansion, though at a slower pace than the previous month. Similarly, the ISM's services index declined to 52.8 in April, from 57.3 in March, the slowest pace in eight months. The reading is worrisome, because it's edging back down towards 50, the threshold between expansion and contraction in the sector.

On the other hand, the US Labor Department reported Friday that 244,000 more jobs were added in May, with private companies doing much of the hiring. That indicates a steadily improving labor market as businesses continue to expand, albeit at a fairly sluggish pace. The unemployment rate inched up to 9.0% from the 8.8% recorded in March.

By contrast, Canada's unemployment rate edged down again, to 7.6% in April, as full-time employment returned to levels last seen in October 2008, according to Statistics Canada. In addition, 58,000 new jobs were created in April, extending a trend of robust job creation over the past year. Another month or two of job growth like this, and the Bank of Canada will almost certainly revisit its stand-pat interest rate policy, possibly as early as July.

And while all this was going on, let's not forget the eurozone. Fiscal troubles among the peripheral nations haven't gone away. They've simply been relegated to page C-17 of the business section for the time being, next to the ads for foreclosed Florida real estate. In fact, beleaguered Portugal agreed to a US$115.5 billion bailout package from the European Union and the International Monetary Fund to backstop the country's deficits and keep its banks afloat for awhile longer.

Meanwhile, the debate continues over how and when to restructure Greek debt, now, according to some observers, really only a matter of "when," not "if." Yields on short-term Greek government bonds were recently over 20%. And prices on credit default swaps increasingly are building in a higher probability of a Greek restructuring within two years. The EU has so far been unable to settle the debate over Greek debt, and is likely to continue its bailout package for the time being – or until Germany's taxpayers revolt. And feeling that discretion is the better part of valour, the European Central Bank left its benchmark rate unchanged at 1.25%, while issuing a warning (again) to basket-case peripherals to get their houses in order.

The pullback in commodity prices, which saw the Thomson Reuters/Jeffries CRB Index lose about 7% this past week, weighed on the heavily resource-weighted S&P/TSX Composite Index. For the week, the index lost 2.7%, dragged down by energy, materials, metals and mining, and global gold sectors, each of which dropped between 6% and 7% on the week. Financials, by contrast, retreated 2%.

On Wall Street, the Dow Jones Industrial Average dropped 1.3% week over week, while the S&P 500 Composite Index lost 1.7%.

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Last week, we suggested that there might be just a touch of complacency in the air, with the CBOE Volatility Index (VIX) down below 15. Interestingly, it closed this past Friday at 18.40, closer, but still below, it's longer-term average of 20. Increasing implied volatility means options investors are willing to pay a higher premium for protection, which, according to the theory, they are becoming more nervous about the outlook for the market. Last week's events gave investors plenty of reasons.■

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