Do Fundamentals Matter?

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It is not uncommon to hear the comment that fundamentals are no longer important in determining prices of agricultural commodities. Soybean prices, in particular, have been the subject of such comments. Rather than fundamentals of supply and demand, it is believed that prices are determined by such things as the whims of fund traders and/or technical indicators. In fact, fundamentals are very much at the center of price determination. Prices of commodities like corn and soybeans must reflect the fundamentals of supply and demand because someone must produce those commodities and someone must consume those commodities. Price directs those decisions so that there is neither a long term surplus nor shortage. There is a reason, for example, that corn prices are currently at $2.00 per bushel and not at $5.00. The price level reflects fundamental value that cannot be permanently altered in an arbitrary fashion. This is not necessarily true for other commodities, such as gold. Gold has much less intrinsic value than agricultural commodities, since it has limited commercial use. The value of gold is in the eye of the beholder, typically seen as a hedge against inflation. Agricultural commodities, on the other hand, derive value from utility in commercial use.

The belief that fundamental factors are not the primary determinant of prices of agricultural commodities may stem from two sources. First, the behavior of a group of traders may result in daily price movements that appear to be at odds with known market fundamentals. While this phenomenon does occur, there is a limit in terms of the magnitude and duration of price deviations from fundamental value. This kind of trading activity likely contributed to the increase in soybean prices from mid December 2005 to early January 2006. That rally quickly faded and most of the price increase had dissipated by the end of January.

A second factor may be the failure to recognize that demand for inventory of agricultural commodities, either physical inventory or ownership of futures contracts, is as valid as the demand for feed or food use. The demand for ownership may result in prices that appear to deviate from fundamental value. Using soybeans as an example, cash prices during the period 1998-99 through 2001-02 averaged about $4.60. Such low prices were surprising given the modest level of US and world stocks. Conversely, the average cash price of soybeans during the current marketing year may be near $5.75, surprisingly high given the record large world surplus. The difference may be in the demand for inventory. Demand was apparently weak from 1998 to 2001 because of deflationary pressures and lack of concern about production. Inventory demand may be stronger now because of concerns about inflation and future soybean production due to
adverse weather, soybean rust, etc. Whether such demand is justified is not known at this time. If it is not, prices could decline sharply late in the growing season.

The problem is not that fundamentals don’t determine price of agricultural commodities, the problem is anticipating how the fundamentals will unfold. How many acres of soybeans will be planted in the US in 2006? What will growing conditions be like? What is the potential soybean demand in China?