

# Commodity speculators: Blame

The role of speculators in commodity futures markets has come under increased scrutiny this year, especially as food prices kept a historic pace alongside a financial meltdown and the US presidential election. Feed Tech asks experts about the positions of speculators and investment banks in the futures trade and how governments should—or should not—handle them.

By Nicholas Zeman |

Since trade rules made it more appealing for investment banks to enter the commodities field, more and more financial players have been supplementing their stock portfolios with plays in physical markets—wheat, corn and soybeans—as well as gold and oil. Flooding the market with billions, Wall Street firms have made it much easier for the ordinary investor to buy and sell grain and other commodities by offering futures-based indexes for sale.

This has not been a welcome trend however, for many commercial interests in the feed and farm world. In a conversation about hedging, one farm management firm in Kansas even tells Feed Tech, “Prices just don’t follow the rules of supply and demand as closely as they used to because of the amount of speculation in the market...so traditional thinking is kind of thrown out the window.”

This statement reflects a larger perception in the feed and farm sectors that speculative investment positions have created a bubble where market prices far exceed fundamental values of supply and demand. Because index fund speculation gambles on the premise that values will always rise over the long-term, it is accused of artificially inflating prices. This perceived force on the market has spawned proposals in the US Congress to officially curb speculation practices.

For evidence of the vilification of speculators in the press and politics consider this passage from a campaign speech made this summer. “We must purge the market of the reckless speculation, unrelated to any kind of productive commerce that has inflated the price of gasoline— at the expense of working men and women across our country. With new regulations, I intend to assure integrity in oil-futures trading, and to protect the public’s interest,” said Sen. John McCain (R-AZ). Crude oil and gasoline are often featured in “baskets” or index funds offered by Wall Street firms that also include wheat, feeder cattle, corn and other agriculture and feed related products. These indexes, sold by companies like Goldman Sachs, Pimco and



The largest commodities trading venue in the United States, the Chicago Board of Trade Building (now owned by the Chicago Mercantile Group), provides price discovery and risk management resources for feed markets throughout North America (Photos: Zeman)

others, have created a grand influx of money into the market that seems to make people nervous.

“There’s new species that has large amounts of money and sticks to the long side of the market,” says Scott Irwin, professor of agricultural economics at the University of Illinois (UI), in Urbana, Ill. “One of the primary concerns expressed by the industry is the magnitude of the commodity index activity. Presumably, the sheer size of the index fund positions may allow them to distort prices or price relationships across markets.”

## Contrary research

Since late last year, the controversy surrounding commodities speculation has led to a surge in research and debate on the influence of this activity on markets. Notably, “The Adequacy of Speculation in Agricul-

# them or embrace them?

tural Futures Markets: Too Much of a Good Thing,” was released in June and authored by Scott Irwin, Dwight Sanders at the University of Southern Illinois and Robert Merrin at the University of Maastricht, Netherlands. This study, which was sponsored by UI, says that speculators ultimately have not forced prices away from the fundamental values and that prices are still tracking ordinary patterns. The caustic world resource crisis, however, has led to unqualified accusations and analyses often based on politics rather than careful research and calculation. “Once politicians start talking about [markets and finance] you can be sure that they’re getting it wrong,” says Ernie Goss, professor of economics at Creighton University (CU). Based in Omaha, Neb., a financial centre of the Midwest, CU conducts a monthly survey of rural banks in several states and publishes their findings each month to forecast the growth of the agricultural sector in the Midwest. “More people are becoming bearish on commodities because of a global economic cool-down,” Goss tells Feed Tech. Speculators have been accused by politicians, energy companies, and feed traders of distorting markets because they have no physical stake in the supply chain. Because their involvement does not involve actual commerce, their place in the market is pegged as artificial and damaging. The experts say, however, regulating or removing the speculators activities would cause the real harm.

## Speculator facilitates

Corroborating findings from the University of Illinois, Fred Seamon, analyst for the Chicago Mercantile Exchange (CME) Group, says that speculators certainly facilitate deals between producers and processors. “If a farmer knows he can make money at a certain price he sells that price to the speculator,” Seamon says. “Then the speculator will in turn sell it off to an ethanol producer [or another processing interest] at a price they’re also comfortable with...so the speculator certainly is a facilitator of deals.” Speculators can actually help to soften blows in periods of economic downturns because they assume risks that the farmers and processors wish to avoid. For that reason, CME maintains that the government should be very careful in regulating speculation. “Even if every economist and every member of Congress had genuine evidence that excess speculation was distorting prices, it would be a monumental mistake to try to cure that problem by

mandating an arbitrary increase in performance bond, commonly called margin, above prudent levels,” said Terrence Duffy Chairman of CME Group in testimony before the US House of Representatives in July.

## Facts and figures

The average position size of the index trader can be over ten-times the size of positions held by interests in different trading categories, and the average number of banks participating in the agricultural commodity markets ranges from five in feeder cattle to 14 in wheat. Consistent position by commercial banks in the livestock futures markets began in mid-to-late 2005, and since that time hoards of more futures contracts have been exchanged in US trade scenarios. Wall Street has learned that building a portfolio containing stocks as well as commodity futures promotes risk diversity. “The stock market and futures markets aren’t connected—or at least they’re uncorrelated,” Irwin says. “So investing in commodity futures reduces the risk of a stock and bond portfolio.”

Open interest, the total number of outstanding contracts that are held by market participants at the end of each day and measures the flow of money into futures contracts, doubled or even tripled between late 2004, through 2006. During this period, The Chicago Board of Trade made it more amenable for financial players to enter the market. “Their main objective is to increase trading volumes,” Irwin says. “So two things happened: companies offering these indexes got hedge exemptions and relief from speculative position limits.”

## Standing long

Before these changes, hedge exemptions had been restricted to commercial players, like elevators or processors, who are bona fide participants in the physical markets. The index funds, whose positions are only financial, are offered these benefits for different reasons. “They are allowed to increase their positions to offset payments on returns to the customers who buy the indexes,” Seamon says. “It’s a financial hedge.” Index funds don’t do much wheeling and dealing. They stand long, meaning they bet that commodity prices over the long-term will rise steadily. Index funds operate believing that the market will recover and values will maintain a gradual growth rate. Therefore, the current debate in the field now is whether there is a positive result for standing long. “Some thought

standing long in the housing markets would have perpetual positive results, but they were wrong. Lehman Brothers, Washington Mutual...they got it," Goss says. "There were heavy bettors on rising land and housing prices who lost."

### **Paucity of evidence**

Over the sample period Irwin and his colleagues studied, index traders comprised over 20% of the open interest in live cattle, lean hogs and wheat. In all other markets index trader positions tended to be between 10 and 20%. "While this is not an insignificant share of open interest, in no market is the index share larger than either the commercial or non-commercial categories," the UI study states. "Rather, the index share of open interest tends to be closer to that of the non-reporting traders." One problem in agricultural markets right now, Irwin says, is that cash and futures prices are not converging during the final month of a contract. "The spot price and the price of the futures contract that expires for that month should come very close together. The futures price in the last month of the contract has been higher than the cash price...some blame it on the indexes and maybe there is a connec-

tion." UI and CME, however, tell Feed Tech that there is little or no evidence that commodity prices are not following fundamental values.

When observing the debate on the adequacy of speculation in futures markets, Irwin says he is "struck by the paucity of evidence typically used to justify such positions, mostly negative, on the impact of speculation." If speculators, for instance, create a bubble in futures prices for storable commodities, there would be an incentive for storage because prices in the future exceed levels normally required to compensate inventory holders for storage. "We should therefore observe an increase in inventories when a bubble is present. In particular, Irwin says policy initiatives in Congress or elsewhere could severely compromise the ability of futures markets to accommodate hedgers and facilitate the transfer of risk.

"Our research at CME has given no evidence that speculators distort prices," Seamon says. "In fact, with these last major movements in prices, we actually saw index fund activity decreasing." |

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