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“...déjà vu all over again”. Just a little over a year ago I initiated some coverage surrounding index funds in the Monthly Market Profile. It’s a very thorny issue and it deserved some extended exposure. Little did I know that the issue would blow up all again. Moreover, the controversy is seemingly even more awkward this time around given the over-arching issues of the financial crisis. As such, it’s my intent to provide some very basic discussion within AgSight over the next several months relative to index funds, futures markets and risk management within agriculture. We’ll begin this month with a broad policy overview.

The Commodity Futures Trading Commission (CFTC) plans to release a new review this month which apparently will reverse previous findings regarding the role of investors and oil prices. It’s an important story and merited leading headline coverage on the *Wall Street Journal* (July 28): “Traders Blamed for Oil Spike”. Chairman Gary Gensler noted the agency must “...consider setting strict position limits in the energy markets.”

However, Mr. Gensler also refuted claims of any new reports by CFTC – the hearings would be the sole source of insight into “excessive speculation”. Interestingly enough, though, that very morning CFTC Commissioner Bart Chilton appeared in an interview with Carl Quintanilla on CNBC’s Squawk Box noting that indeed a report will be forthcoming. Moreover, Chilton went further to assert that, “Last year we didn’t have complete data...and secondly I think we spun it to say that speculators had no influence...we’re not going to minimize the role speculators are playing. And I think they have had an impact over the last year as we’ve seen this commodity roller coaster go up and down.”

OK...but what does any of that have to do with agriculture? That action comes on the heels of renewed controversy regarding index funds beginning in late-June. Primarily, renewal stemmed from a Senate report entitled, *Excessive Speculation in the Wheat Market* (Permanent Subcommittee on Investigations: Carl Levin (D-MI), Chairman and Tom Coburn (R-OK), Acting Ranking Minority Member). The report serves as follow-up from previous analyses released in 2006 and 2007, respectively: “The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat” and “Excessive Speculation in the Natural Gas Market.” The subcommittee asserts that, “These and other reports offered a number of recommendations for legislative and regulatory actions to enable the Commodity Futures Trading Commission (CFTC) to fulfill its mission under the Commodity Exchange Act to prevent excessive speculation from “causing unreasonable or unwarranted fluctuations in the prices of commodities in interstate commerce.”

More notably, the subcommittee evaluated the impact of index traders upon the wheat futures market in Chicago with the following conclusion:

This report finds that there is significant and persuasive evidence to conclude that these commodity index traders, in the aggregate, were one of the major causes of “unwarranted changes” – here, increases – in the price of wheat futures contracts relative to the price of wheat in the cash market. The resulting unusual, persistent, and large disparities between wheat futures and cash prices impaired the ability of participants in the grain market to use futures market to price their crops and hedge their price risks over time, and therefore constituted an undue burden on interstate commerce. Accordingly, the Report finds that the activities of commodity index traders, in the aggregate, constituted “excessive speculation” in the wheat market under the Commodity Exchange Act.

Mr. Gensler has made it clear that hearings apply not only to energy markets but will also have application to other commodities – particularly, the wheat market.

Regardless of the commodity in question why the sudden attention and/or momentum to address index funds? A recent *Wall Street Journal* op-ed piece addressed that very question:

So the Gensler CFTC is now poised to issue a follow-up repudiating the commission's earlier findings. This week's hearings are being held without the benefit of the CFTC's actual findings, which are due out in August—but no matter. The CFTC's about-face is all about the politics, not the economics, of price discovery. And the real goal is not to blame the evil speculators for last year's price spike or this year's oil rally, but to lay the groundwork for explaining away the commodity-price bull run that we're likely to see as a result of the Federal Reserve's easy money and the Obama Administration's spending and debt party....No, what we really have here is the age-old scapegoating that our superstitious ancestors would have recognized. The only twist in Mr. Gensler's case is that he's trying to scape the goats pre-emptively. On our current fiscal and monetary policy course, the dollar is not done falling and interest rates have barely begun to rise. Both of these market moves will be felt in the commodities markets, as they were after Alan Greenspan cut short-term rates to 1% in 2003-2004. So better to send the posse after the speculators now than to confront the consequences of Washington's policy errors. Regardless of whether you agree with that assessment, the broader point being it illustrates potential for the issue to become increasingly dicey in the months to come – perception is reality and anytime there's politics involved, real or perceived, things can become rocky. Meanwhile, the hearings and potential implications become even more significant for agriculture given ongoing hearings relative to OTC derivative markets and considerations about the broader economy, currency values, etc...

Perhaps most surprising to me is the emotion, misinformation and errant conclusions about the issue and the cause/effect relationships upon the market. For example, this snippet ran in a recent *MarketWatch* (July 13) article entitled, "Speculators Leave Oil Market as Regulator Mulls Crackdown":

Long, or buying, positions held by non-commercial traders, a category the regulator uses to classify big speculators, dropped by 16,382 contracts in the week ended July 7, according to the weekly Commitments of Traders report released by the Commodity Futures Trading Commission late Friday. That's the biggest drop in four months in oil futures traded on the New York Mercantile Exchange according to COT historical data. Long positions held by speculators now stand at the lowest level since the week ended May 26. Meanwhile speculators increased their selling, or short, positions, resulting in a 60% slump in net long positions....The change in speculation positions came as the CFTC said, also on July 7, that it's considering setting limits in the number of positions speculators can take in the energy futures market.

That's all well and good. But one day, or week, does not a market make. Note that crude oil made a near-term low on July 14 at a price of \$59.52...it closed out the month at \$69.45 and was trading in excess of \$71 on the first trading day of August.

Perhaps the irony or all ironies sourced from Federal Reserve Chairman Bernanke's town hall meeting in Kansas City (PBS, July 27). Among those guests included Mr. Peter Cabell who asked the Fed Chairman about investment strategies: "As we go forward, is there a good engine to invest in as an alternative to the stock market that would be reasonable to look at?" Mr. Bernanke provided a disclaimer about giving investment advice and then summarized with the following: "...generally speaking, unless you're very close to retirement, you probably ought to have some stocks and equities in your portfolio, but you can diversify through a whole range of different things, including bonds or CDs, including even perhaps commodities and other types of investments."

Those are solid recommendations. But catch the diversification strategy which includes commodities? And how does an individual investor include such a strategy in his/her portfolio? Well, very readily through the plethora of index-driven ETFs. Of course, doing so then makes him/her a complicit contributor to "excessive speculation". Obviously, Mr. Bernanke hasn't scripted his answers with Mr. Gensler. More next month.