

Commodity Prices And Speculative Positions

The white whale. The Holy Grail. Energy independence. Evil speculators causing higher prices and therefore bringing untold misery to those who really do not need untold misery, truth be told. All of these are examples of perpetual quests sufficient to drive those in search of them mad.

The searchers in the commodity speculation case include self-appointed consumer advocates, a goodly assortment of politicians and, in recent years, the Commodity Futures Trading Commission. The CFTC's weekly Commitments of Traders (COT) report used to be divided into Non-commercial, Commercial and Non-reportable categories with the number of contracts separating a reportable from a non-reportable position changing constantly. The original assumption made by many was non-commercial positions were more likely to be price speculations as opposed to hedges; a second assumption was commercial traders somehow had better information at their disposal and therefore were at an advantage to their more untamed and possibly unwashed non-commercial brethren.

As the author has experience on all sides of this divide, he can assure you this taxonomy is nonsense at its finest: Every price hedge has to be taken with a price view in mind as emplacing a long or short position tells the world in action of your opinion the market shall go no lower or higher, respectively. Moreover, the growth of long-only commodity index funds created a problem. Both these positions and the offsetting positions of swap dealers and other financial intermediaries really did not reflect an actual price opinion; no, they reflected someone getting "exposure" to an asset class.

The CFTC was thoughtful enough to create a Disaggregated report dividing the world into Managed Funds, Swap Dealers, Producers/Merchants, Small Traders and something called "Other Reportables," a classification that appears to be dominated by proprietary trading desks. The Managed Funds and Other Reportables are the two categories most representative of speculative flows even if on a weekly basis their net changes in various markets often offset one another.

The Test

The venerable CRB index has undergone numerous changes in ownership, composition and weighting over the years; at the time of this writing it is the ThomReuters/Jefferies CRB index and it has nineteen members. Two of these are London-traded nickel and aluminum and are out of the purview of the CFTC's reports; another one, frozen concentrated orange juice lacks a consistent underlying cash market. We can calculate weekly cash market averages for the remaining sixteen components using data from the CRB-Infotech CD-ROM. Cash market averages allow us to sidestep the effects of futures markets' forward curves and contract rolls.

We can split the data into two time periods, the first extending from the October 2005 nomination of Ben Bernanke to the chairmanship of the Federal Reserve through the adoption of zero interest rate policies (ZIRP) in December 2008. The second period extends from December 2008 through May 2012. The weekly cash market data can be regressed from the June 2006 introduction of the Disaggregated COT data against 1) the net position of the Managed Funds and 2) the net position of the Other Reportables using a four-week distributed lag of the position data over these two periods.

The table below displays, in order of ascending average weekly cash market return for the post-December 2008 period, the average returns and a statistical test to see whether the adoption of ZIRP changed the relationship between net positions and prices. If ZIRP was significant, the probability the two periods' regressions are different should approach 100 percent. This largely has been the case; as long-only index funds had been a major factor over the pre-December 2008 period, the most likely explanation of this different behavior is the rebound in global commodity demand in 2009. If the net positions of funds and prop desks were the answer, the probabilities of difference should be much closer to zero.

Average Weekly Return
 Oct. 2005 - Dec. 2008 Dec. 2008 - May 2012

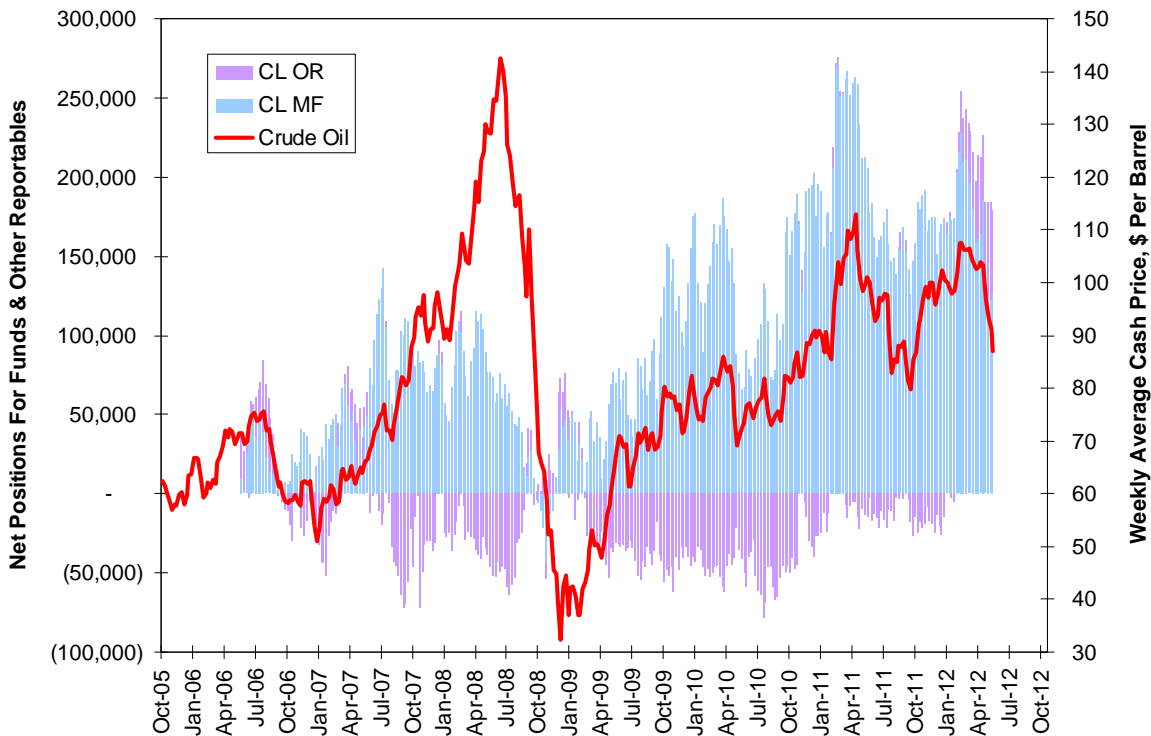
Probability of Difference
 Manged Funds Other Reportables
 Jun. 2006 - Dec. 2008 Dec. 2008 - May 2012

Natural Gas	-0.52%	-0.49%		100.0%	100.0%
Cocoa	0.38%	-0.11%		100.0%	99.1%
Live Cattle	-0.03%	0.21%		100.0%	100.0%
Coffee 'C'	0.12%	0.22%		100.0%	100.0%
Wheat	0.25%	0.22%		92.5%	100.0%
Sugar	-0.01%	0.24%		100.0%	100.0%
Cotton	-0.14%	0.26%		100.0%	100.0%
Soybeans	0.27%	0.26%		90.1%	99.8%
Lean Hogs	-0.10%	0.26%		100.0%	100.0%
Corn	0.41%	0.27%		100.0%	100.0%
Gold	0.37%	0.34%		100.0%	100.0%
Heating Oil	-0.18%	0.37%		100.0%	91.4%
Crude Oil	-0.28%	0.44%		100.0%	100.0%
Copper	-0.22%	0.52%		100.0%	100.0%
Silver	0.22%	0.52%		100.0%	100.0%
Gasoline	-0.33%	0.60%		100.0%	100.0%

Case Studies

Let's take a few markets as an illustration starting with that perennial whipping boy, crude oil. The price spike from August 2007 through July 2008 will stay in the memory of officials for years even though no one has been able to demonstrate a causal link between speculative trading activity and the price surge. As an aside, the author is a former commercial crude oil trader and believes intuitively trading activity had something to do with the price spike, but anyone can have an opinion. Facts and analysis are what carry the day.

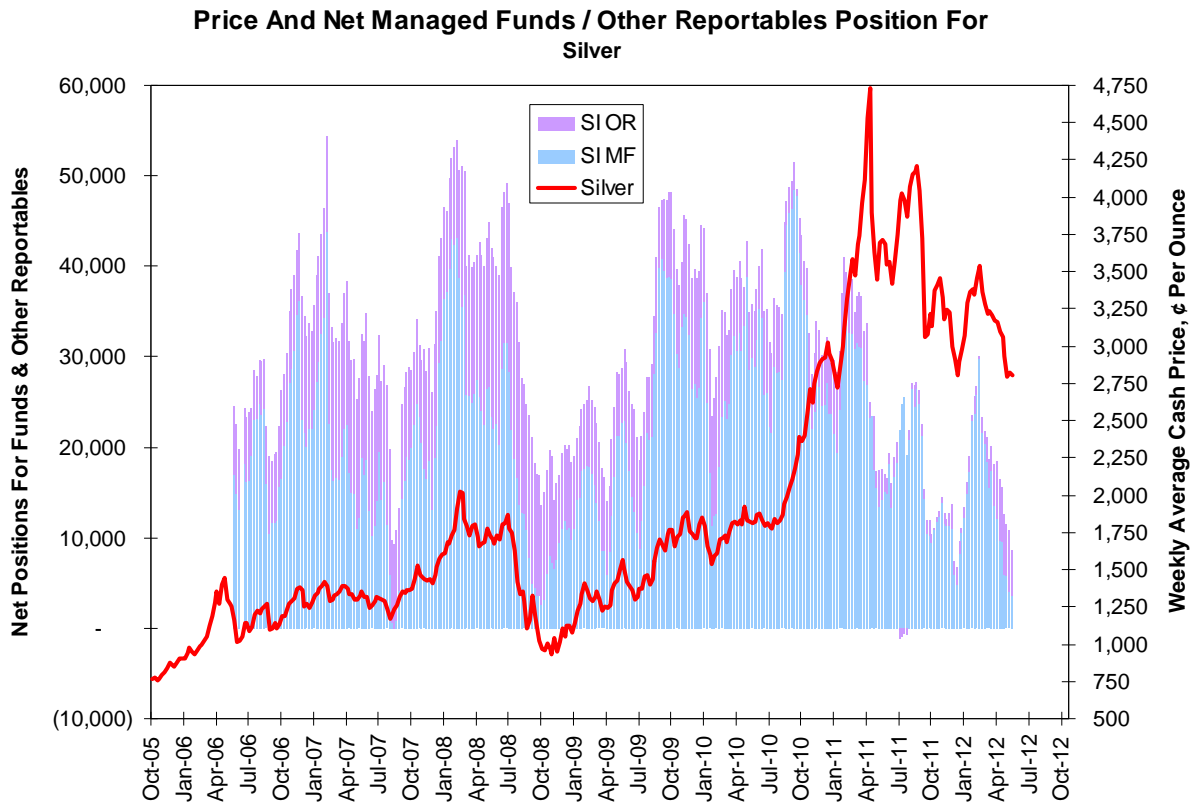
Price And Net Managed Funds / Other Reportables Position For Crude Oil



What is somewhat mystifying is how net speculative positions were declining into the price peak in 2008. In an equally mystifying turn, net speculative positions rose throughout a general trading range from mid-2009 through late 2010 and then dwarfed their 2008 levels as prices rose into early 2011. Once prices peaked, so did net

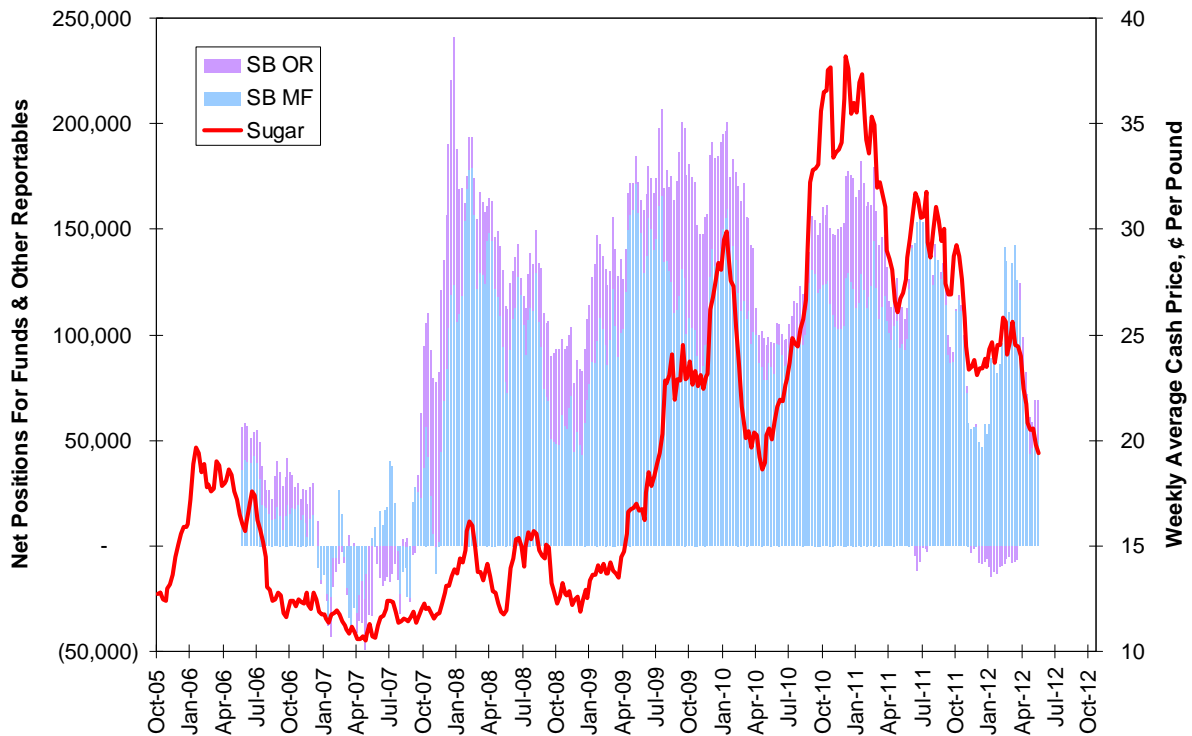
speculative positions, but prices seem to lead positions just as we asserted last month (see “Speculative Flows And Index-Level Prices,” October 2012).

Now let’s turn our attention to silver, which enjoyed a spectacular run higher from late 2010 into mid-2011. While the price was shooting higher, net speculative positions were declining. Moreover, these positions were higher in most of 2007 and 2008, while the price was a good deal lower. Finally, with the exception of a few weeks in July-August 2011 where the net Other Reportable positions were negative, net speculative positions for silver are always net long.



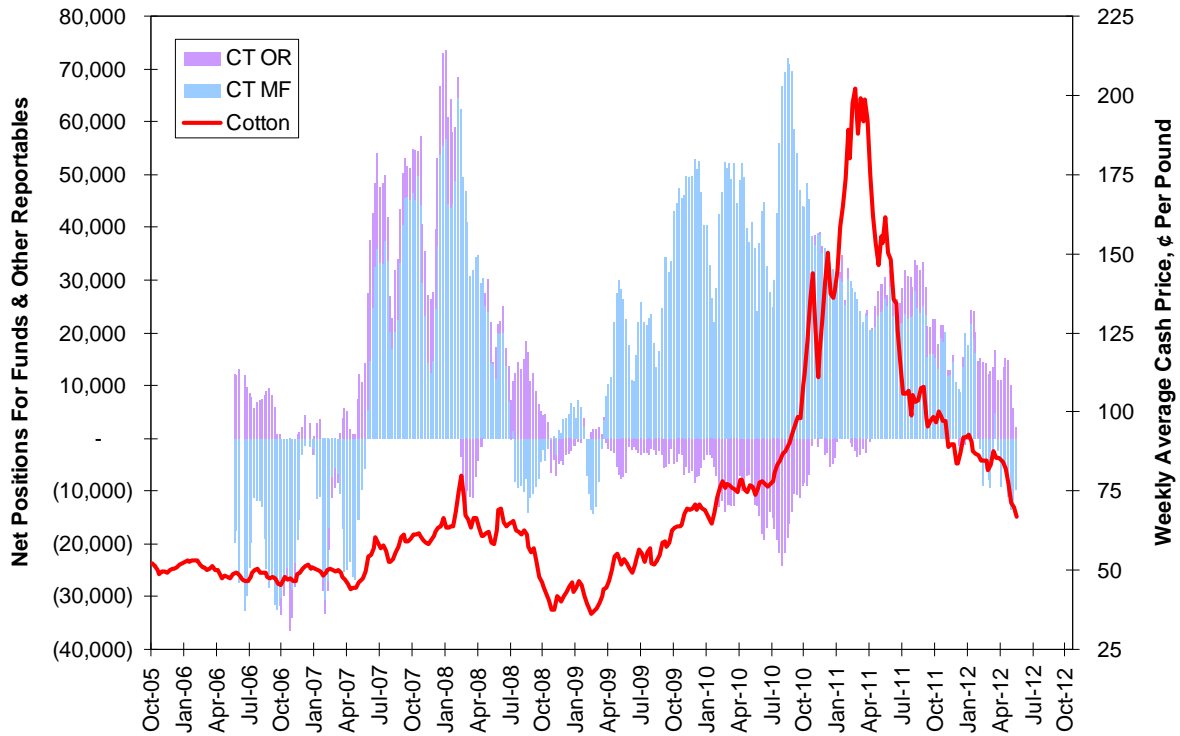
Other markets have something of a teaser relationship with net speculative positions. Both Managed Funds and Other Reportables fell in love with sugar in early 2008 only to watch its price go nowhere. They shed these positions by early 2009, again only to watch the price go nowhere. This was followed by a large buildup in net long positions months in advance of the eventual rise in sugar’s weekly average cash price – a possible sign of the futures market anticipating supply problems – but that was followed in early 2010 by the exact opposite phenomenon, prices falling in advance of net speculative positions. By mid-2010, sugar prices and net speculative positions were rising and falling in tandem.

Price And Net Managed Funds / Other Reportables Position For Sugar



The last market we will examine is one with no discernible relationship between net speculative positions and prices, cotton. Large negative positions in 2006-2007 did not produce downward price action, and while a large upturn in net long positions in 2007-2008 did precede a price advance, the gains were well within cotton's long-term trading range. The Managed Funds and Other Reportables stood on opposite sides of the market in 2009-2011, but the funds' net long positions peaked in September 2010, far in advance of cotton's record-high price in March 2011. Once prices started to collapse, net speculative positions scarcely budged and Managed Funds did not become net short until the end of February 2012, well into the price collapse. If there is a causal link between net positions and prices in cotton, it is well-hidden indeed.

Price And Net Managed Funds / Other Reportables Position For Cotton



The conclusion we should draw is simple and straightforward: Prices are not set by net positions or even by net flows; the mutual fund flow data produced by the Investment Company Institute confirms this for both stock and bond funds. Prices are set by the more anxious party to the transaction, the buyer willing to bid more or the seller willing to accept less. This is simply how markets work and why this principle should confound inquisitors is unclear.