Swap Dealers Corner Wheat Market; Film At 11:00

Every Other Category of Trader Is Net Short

Many years ago my compatriots and I were watching what I refer to as a “weenie roast” going on the in the market, one of those days when everything is taken out and shot. Those were the glorious days when all trading was manual and lunch was a mastodon captured especially for the occasion. It also was the era of the specialist, someone who was obliged to make a market in return for the privilege of seeing everyone else’s orders and capturing the bid-ask spread.

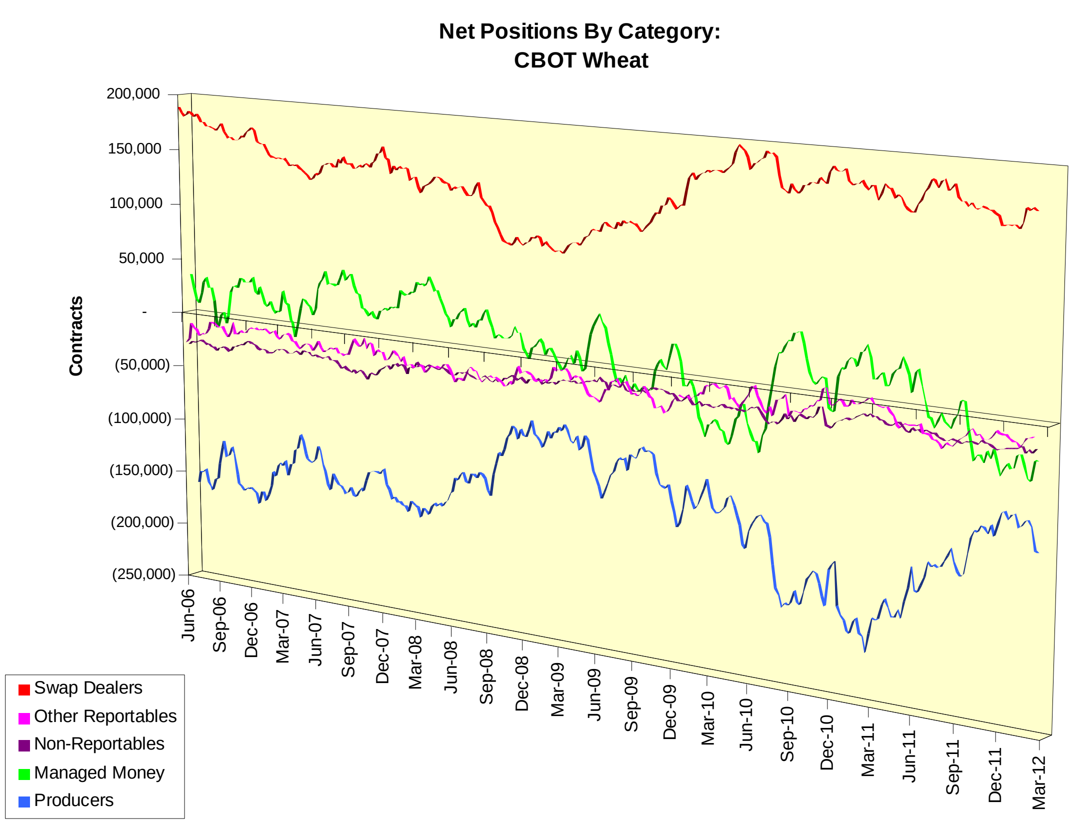
I looked at the screen and mused, “Who’s buying?” A colleague said, “You’ll see a headline tomorrow, ‘Specialist buys IBM.’”

It was about that point I started to muse about the nature of the “who’s buying?” question and its relationship to technical analysis. If price represents a search by a market for an unknown and transient underlying economic value, then value has to move before price. Price then has to chase value either higher or lower; it is those price patterns picked up by all market analysts that form the basis of all technical signals. Once the signal is recognized, positions are adjusted accordingly. By definition, value precedes price, price precedes technical signal and technical signal precedes changes in positions.

Commitment of Traders

Hopefully I have made the point looking at other traders’ positions makes you late to the party, but the Commodity Futures Trading Commission’s weekly Commitments of Traders report has acquired a following over the years. The CFTC added various “disaggregated” categories in 2006 in what I suspect was an attempt to snare some speculative mopes pushing gasoline prices higher. As I noted in Commodities Market: Where Are the Speculators?, they failed to round up the rascals.

Worse, these data point to some absurdities in markets, one of which I shall highlight below. The disaggregated report shows only the category called Swap Dealers has been net long the Chicago Board of Trade’s wheat futures since September 2011. All other categories are net short; these include Managed Money, Producers/Merchants and something called Other Reportables, which appears to be proprietary trading desks.



Economically, what does this mean? Well, for starters, the physical wheat trade is net short the futures market against its long position in cash wheat. So far, so good. Both Managed Money and Other Reportables, the two classes of speculative institutional traders are net short, which is a legitimate price opinion. Small, or Non-Reportable positions, which is where your individual account would be if you were not subject to the Buffett Rule, are net short as well. Restated, the people who are trying to make money by trading wheat do not like it.

As the Dow Jones-UBS total return sub-index for wheat has lost 17.3% since the Managed Money position turned negative in September 2011 and 33.4% since their positioned peaked in September 2010, congratulations are in order.

But the real question is if the Swap Dealers are net long, who is on the other side of their trade and why? A long-only index fund, a commodity-based ETF such as the PowerShares DB Agriculture Fund (DBA) or some other relatively passive vehicle may be a floating-rate receiver on a wheat position (otherwise known as net long; sorry for the inside baseball). The swap dealer takes a floating-rate payor position and then hedges itself with a long futures position.

The implications are astounding: The people involved in the physical wheat market, professional speculators and money managers and small futures traders are betting on a decline in wheat. The people who want “exposure” to commodities are net long. In other words, the less reason you have to be long wheat, the more likely you are to be long it. Is this a great country, or what?