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## **Commodity Markets - - Another Regulatory Debacle?**

Last month, we discussed the serious run-up in prices for grains and other food stuffs in the context of the farm bills then under consideration in the Congress. Of course, those products are not the only ones that have gone up. The costs of almost all commodities, particularly oil and metals, have also increased dramatically. The question has been raised whether commodity market investors have played a significant role in those causing the increases.

Commodity markets are useful entities that permit users of various products to hedge their acquisition costs by buying contracts for future delivery at a known price. The role of those hedgers is supplemented by investors who seek solely to speculate on commodity prices; they can add beneficial liquidity to the markets. In recent years, large institutional investors have jumped into commodity markets in a big way now more heavily than the traditional speculators. Some think that those new entrants are helping prices to go up.

Many economists think not. They attribute rising prices to the good old market forces of supply and demand. Thus, as China and India need more oil, and supplies do not materially change, prices are bound to go up. Similarly, when a greater share of corn production goes into ethanol, you can expect those prices to go up, too.

Not so fast, say others. For example, Jack Ablin, Chief Investment Officer of the Harris Private Bank, recently pointed to data that could show a large role being played by the new commodities speculators. First of all, over the last ten years, new ways to invest in commodities have rapidly developed. Before that time, it would have been quite difficult even for the institutional investor to buy commodity futures; one was really limited to buying companies like Exxon or ConAgra, and those purchases would have no direct effect on commodity prices.

Today, however, there are plenty of commodity based mutual funds and exchange traded funds that permit investors to buy baskets of crude/natural gas, food and metals as easily as a share of stock. Those funds are backed by futures contracts and therefore have

a direct effect on prices. Thus, we have more buyers going into the commodity markets than before – not just China and India, but a host of private and institutional investors as well. Most of these new index buyers do not move in and out of the market – they buy and hold, just like consumers.

More buyers mean more demand. Indeed, it was estimated that the index funds have stockpiled some 1.1 billion barrels of petroleum over the last five years, eight times what our government has added to the Strategic Petroleum Reserve over the same period. They hold enough corn to supply the nation's ethanol industry for two years. While supplies can increase at the margins, crop levels and mine production can change only gradually, and most oil supplies are subject to the OPEC cartel's limits.

How big is the effect of the new speculators? One hedge fund manager testified in a Senate hearing in May that the total amount invested by large institutions in index funds grew from \$13 billion in 2003 to \$260 billion in March of this year. He estimated that the demand for oil from index funds had increased by 848 million barrels over that period; by comparison, China's consumption increased by not much more, 920 million barrels. Thus, the index funds represent almost as much increased demand for oil as the usual suspect that has been blamed for higher crude prices.

At the same Senate hearing, the head of the National Farmers Union charged that government oversight of commodities markets has not prevented evasion of regulations and has failed to prevent unexplained price spikes and drops that have deprived some farmers of the benefits of higher prices.

In addition to the Congress, the Commodity Futures Trading Commission is investigating the effects of institutional buy-and-hold commodity purchases as well as speculators. While one cannot predict what will turn up, it is entirely possible that we shall learn something uncomfortable about commodity trading that might remind us of the failure of regulators to address the foreseeable and foreseen problems in the subprime mortgage markets.

Here are some specifics for this month:

- Scrap and Pig Iron. Farm goods and oil are not the only commodities reaching stratospheric levels. The prices for #1 dealer bundles and #1 busheling (Chicago) continued to rocket upward, to \$780 and \$785 per mt, respectively. Three months ago, those prices were at \$480. Pig iron is also going crazy, jumping \$210 in a month to \$900 per mt for Brazilian product (cif New Orleans).

- Natural Gas. Prices spiked after Katrina in 2005, and many thought we wouldn't see the likes of those levels without incurring another disaster. Those hopes were misplaced, as the Nymex price reached \$12.71 per mcf the third highest level on record.
- Ocean Freight. The Baltic Capesize Index was also up last month, but only at a comparatively mild (!) 14 percent to 11534.
- Foreign Exchange. The dollar improved slightly against the euro, which now costs \$1.55. The pound was up a penny to \$1.96, while the Canadian dollar lost a penny to 97 cents.

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