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LO! IN THE HEARINGS, A STAR APPEARED

By Wayne Jett

The scene was neither the heavens nor Bethlehem, but a star appeared on May 20 in Washington, D.C., to speak truth about the price of crude oil and other commodities. At a hearing of the Senate Committee on Homeland Security, hedge fund manager Michael W. Masters testified that “index speculators” are driving up the world price of crude oil by increasing capital devoted to commodities futures contracts regardless of price.

Masters classifies as “index speculators” institutional investors who use strategies to buy and hold commodities futures, as contrasted with traditional speculators who buy and sell such futures and consumer investors who buy the futures, take delivery and consume the product. Index speculators (IS) include government and private pension funds, university endowments and other institutional investors. IS allocate capital in weighted proportions across the 25 major commodities, and have increased these capital allocations from $13 billion at year-end 2003 to $260 billion at the end of March, 2008. In the process, they have driven the sharpest increase in commodities prices in history, with the S&P GSCI Commodity Spot Price Index soaring from about 250 to about 650 in that interval.

“Buy and Hold” Conquers Price-Demand Elasticity

Masters emphasizes that prices of commodities in the aggregate have increased more over the last five years than at any other time in history, *despite the fact that supplies have been plentiful!* Moreover, despite the spiking prices for commodities, *demand remains very high and increasing!* Historically, commodity prices are sensitive to supply and demand, and *vice versa*, with demand dropping as prices rise.

Masters explains the current phenomenon by reporting that IS strategy is to buy and hold commodities futures, rolling the contracts over repeatedly and *never selling*. Though IS futures buyers do not consume the commodities, these investors have created a new class of demand for all commodities. This new class of demand, in the case of crude oil, almost equals the total growth in demand of China during the past five years (920 mbbls of demand growth for China, 848 mbbls for the IS). Masters says the IS investors have injected $55 billion more into the commodities market during the first 52 trading days of 2008, and have many billions more on the sidelines ready for deployment.

The Swaps Loophole in Position Limits

Masters reports a loophole is being exploited to evade existing limits on investment positions in commodities. By buying a swap option contract from a bank, the bank buys the commodity position for the investor without regard to the position limit. For example, the position would prevent an investor from buying a futures contract covering $600 million of wheat. But by buying a swap from the bank, the bank buys the $600 million of wheat and the swap buyer effectively controls it. Masters recommends legislation to eliminate the loophole with a "look-through" to the swap investor, although the CFTC economist suggests he thinks his agency can solve the problem with "suasion" of the self-regulatory organizations.

Worthwhile news came from the May 20 hearing that the farm bill passed by Congress (subject to veto by the president) contains a provision repealing the "Enron Clause" enacted in 2000. The Enron Clause, as reported previously in *The Supply Side Guide*, allows institutions to trade crude oil futures (thus setting the price of oil) without reporting large transactions to the CFTC. Its prospective repeal is welcome news, although it may be illusory action because the farm bill may not survive presidential veto in the Senate. Clearly, this is a matter of such urgency and importance that Congress should rush a stand-alone bill to the president to repeal the Enron Clause, close the "swap loophole" on commodities position limits, and prohibit investment in commodities by pension plans.

Artificial Demand for Commodities

In the Senate hearing, the question was raised whether pension plans shouldn't be allowed to invest in commodities to benefit their retirees. The question is a fair one, since investment judgments are not well made by legislators. Masters responds that this speculation is doing great damage to the national and global economies, and getting pension plans out will assist a solution.

Both the question and the answer miss the point that must be considered by investors and by Congress. Is the investment strategy of index speculators sound? IS investors have created a new, large category of demand for commodities by buying and holding futures contracts, *but the demand is artificial!* The commodities controlled by the increasing futures contracts have not been consumed and must, at some point, be released to the real demand of consumers. Until that time, additional capital can continue to build the price spike. In the process, IS demand increases as a portion of total demand, amid signs that real demand for energy is dropping (farmer uses mules to avoid high fuel prices).

When the artificial IS demand begins releasing resources into the consumer markets, prices will collapse in a rush for the door. Almost certainly, pension funds are regarded as the slow-footed investors who will be bag-holders for investment banks and hedge funds which originally primed the pump of crude oil prices to get the run on crude oil going. Do not be surprised if those same pump-primers wind up on the short-selling side of the collapse in commodities (as Goldman Sachs was short-selling sub-prime mortgage derivatives while still underwriting sale of the derivatives into the markets) when the investment strategy of buying and holding commodities is ready to fold.

Crude at $35 to $65

Elsewhere in the Senate, the Judiciary Committee heard Shell Oil Co. president John Hofmeister testify that the price of crude oil "should be somewhere between $35 and $65 a barrel." That is truthful and near accuracy, although the witness may not fully appreciate the extent of dollar devaluation relative to gold and its relevance to the price of crude and future costs of production.

With these economic conditions constricting productive activity globally and inducing starvation in some populations, Congress has no more pressing legislative concern. Congress and the president should act urgently. Nonetheless, some will continue pausing to ponder effects of high gasoline prices on November elections. ~

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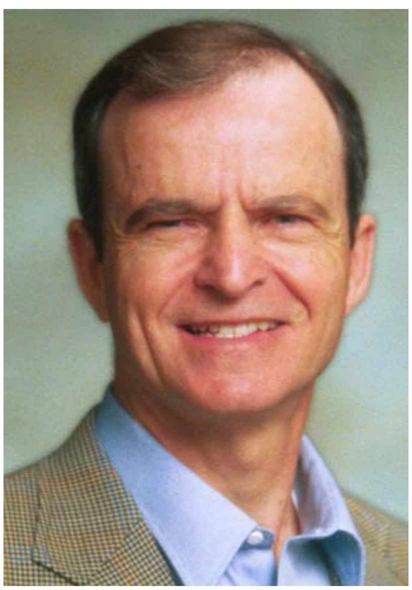

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