
Speculators, Index Investors and Prices

On 29th June, a report was released on "Speculators, Index Investors and Commodity Prices" by Goldman Sachs' David Greely and Jeffrey Currie. It reached some general conclusions on the roles played by speculators and investors in determining commodity prices, although the data referred to were only for WTI crude oil and those soft commodities that have been covered in detail, since January 2006, in the CFTC's "Weekly Commitments of Traders".

The most interesting conclusions of the report are:

1. that speculators do move commodities prices, but by much less than many people believe;
2. that index fund investment longs partly offset a bias in commodity markets in which there are more producer hedge shorts than there are consumer hedge longs and thus index funds represent a helpful balancing item rather than a distortion;
3. that index funds do not move commodity prices;
4. that today's prices are not a bubble because they are not causing stocks to rise.*

The authors are clearly very knowledgeable and it would be interesting to hear their views on why, after a long period of stability, price to stock relationships changed so steadily in crude oil from 2004 to today; changed so suddenly in copper from mid 2005 to early 2006; changed so suddenly in aluminium from late 2005 to early 2006; changed in zinc in January 2006 (and perhaps now being reversed). See charts for each opposite.

What does Goldman Sachs believe caused these dramatic changes? Why were the timings different in the various commodities? Indeed, why did copper and aluminium prices rise so sharply from June 2005 through March 2006, when both metals were in commercial surplus, with exchange stocks rising?

BME's view that index fund holdings of long positions were part of the story is well known. However, we have until now been puzzled by the sudden onset of changed price to stock relationships at different times in different markets. Learning from the excellent Goldman Sachs report, we would certainly be receptive to the view that index fund holdings of futures might have little impact as long as they do no more than partially offset a bias in the futures market whereby producer hedge shorts exceed consumer hedge longs in volume. Such a situation may prevail today in the agricultural commodities studied by Goldman Sachs and may well have prevailed in base metals until mid-2005. However, if index fund holdings came to exceed producer hedge

shorts, then counter-parties to index longs would then have to be speculative shorts. Then, as index fund holdings grew (or producer hedging was reduced) more speculators would need to be persuaded to go short. This would only happen at higher prices.

In copper, index funds' holdings of futures, mostly with maturities one to two months out, are around one million tonnes. Mines only produce 1.3 million tonnes of copper per month, so for their hedge positions to offset index fund longs, they would need to be hedging almost all of their production, using forward sales rather than options. Copper producers today are, on the contrary, very reluctant hedgers. Goldman Sachs' conclusions on index funds' non-effect may be correct for soft commodities (**though we are not fully convinced: see footnote), but not for copper. In copper, the counter parties of index fund longs are speculative shorts. The equilibrium price of copper is that at which the speculators will hold and roll forward enough short positions. The different timings of the start of new price behaviour in the various metals seems to us to reflect the different points in time at which producers of the various metals drastically cut back, or eliminated, hedge selling. And given the partial reversal in zinc of the change in price to stock relationships, one must ask whether zinc producers have started to hedge again?

We re-iterate our view that index fund holdings change price to stock relationships. In the short term, this results in price rises at constant stock levels. In the longer term, when production and consumption have time to adjust, that higher price either proves to be sustainable - i.e. not resulting in a physical market surplus - or it provokes excess production and proves not to have been justified. In copper, we think that index funds got prices to where they needed to be much quicker than would otherwise have been the case. In aluminium, we think that the resulting price was slightly too high, as it has drawn out a surplus, despite a demand boom. In iron ore, where prices were not moved in advance (or at all) by index funds, adequate supply response has still not arrived.

By Peter Hollands, July 3rd 2008

* Is aluminium a bubble under GS criteria

** While GS cites evidence that index fund buying of grains does not simultaneously drive up prices, this does not prove there is no causal relationship. Rising index fund longs might only affect prices after a delay - the next time that speculative shorts run scared again, or when grain producers stop hedging.

