DESPERATE HOUSEWIVES (EPISODE 4)- IN THE COMMODITIES CORNER

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"Ooh, see the fire is sweepin'
Our very street today
Burns like a red coal carpet
Mad bull lost its way." The Rolling Stones, "Gimme Shelter"

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LOOKING OUT THE WINDOW

Even during the festive holiday season, most households do not happily greet sustained high commodity prices. The United Nations Food and Agriculture Organization's "Food Outlook" notes: "The FAO Food price index has gained 34 points since the previous Food Outlook report in June, averaging 197 points in October, only 16 points short from its peak in June 2008." (November 2010, p1; see also pp114, 116). The FAO Food Price Index over the past few years has advanced notably from 2000-03 levels. The food import bill at the global level in 2010 of around one trillion dollars hovers near the 2008 food crisis sum (p112). Paralleling the advance in the benchmark NYMEX crude oil march toward $90 per barrel, gasoline and distillate have flown higher.

Consumers, whether in the United States or elsewhere, derive little joy in having net incomes tightened and efforts to repair net worth undermined by lofty values for food, fuel, and other key commodities. Around the globe- and despite shouts about good fellowship and the brotherhood of man and the wonders and benefits of the free market- millions of people live on the edge, desperately struggling day by day (or paycheck to paycheck) to get by.

Of course, numerous intertwined factors touch commodity prices, and opinions differ regarding these variables. Supply/demand considerations obviously vary between commodities. Current worldwide petroleum inventories seem sufficient to most observers. However, many agricultural marketplace players now worry about a global food crisis. Inventories for several crops are currently low, with some risking slides to dangerous depths. See the FAO report and the USDA's World Agricultural Supply and Demand Estimates (next WASDE is 12/10/10).
http://www.fao.org/docrep/013/al969e/al969e00.pdf
http://usda.mannlib.cornell.edu/usda/current/wasde/wasde-11-09-2010.pdf

Though specific commodities and their sectors vary in their stories, let's dance across three fascinating stages relevant to the overall commodities theater. This performance, though brief, will highlight specific corners of agriculture and energy and related "investment" issues.

THE FED'S EASING CHAIR

Quantitative easing by the Federal Reserve Board represents a valiant effort to support the US (and worldwide) economy, increase US nominal GDP, and repair consumer balance sheets via boosting real estate and stock prices. Yet all else equal, this extravagant money printing policy presents notable risks for further US dollar depreciation. See "Barnum, Bailey, and Bernanke- Taking Stock ('Desperate Housewives', Episode 3), 11/17/10; "Desperate Housewives (Episode 2: The Home Front", 11/3/10; "Desperate Housewives- 21st Century Economic Housekeeping", 10/20/10.

Maybe real estate and equities will jump upward. However, to the extent that a weaker dollar translates into more elevated food and fuel prices, consumer budgets are stretched and confidence injured. Such upward commodity action could help to produce economic weakness.

Whereas the Fed (and the US Treasury) can print more money, they cannot print more land, even with a weak dollar. And US agricultural land acreage arguably will not increase much, though perhaps sustained stratospheric prices will change that scenario. The Department of Agriculture's "USDA Agricultural Projections to 2019" (February 2010; Table 17, p67) forecasts America's planted and harvested acreage for eight major crops. These include corn, wheat, soybeans, and cotton. In 2009, the planted total was around 248.7 million acres, the harvested amount 226.7 million acres. The official weathervane indicates 2010 through 2019 plantings in a narrow range for individual years, from 246.1 to 247.4mm acres. The 2009 US harvest covered 226.7mm acres. Long run harvest predictions vary little from that total; even the peak of 226.5mm (for 2018) never climbs over it.

Remember that a growing world population yearns to improve its standard of living. For many, that means eating more food in general and protein in particular. The US is not the whole world, but it is a crucial agricultural exporter. Perhaps substantial long run price rallies for several key crops will increase acreage around the world, and even in the US. Perhaps crop yields will keep edging higher. But at least voyeurs recalling "America the Beautiful" should ask what the limits are for additional "amber waves of grain", especially within the US. So especially if the dollar sags, consumers may well tend to pay more in nominal terms for agricultural goods.

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Financial sorcerers eagerly scan a cornucopia of inflation indicators. The Fed is not always clear regarding how much emphasis it places on inflation measures that include food and energy. Anyway, the Fed's mandate aims at stable prices. Nowadays that probably translates into about two percent inflation. Its enterprising money printing circus hopes to produce sufficient inflation (in relation to its opinion regarding what constitutes appropriate, so-called price stability).

The Fed recently paraded its Economic Projections in its Minutes (11/2-3/10; Table 1). Note the central tendency for both personal consumption expenditure (PCE) inflation and core PCE inflation for 2011 through 2013. Not only are levels for these two measures very close to each other, but also the midpoint of the range for those years is around 1.5pc. Though food and energy are outside of core inflation statistics, sustained high and rising prices for them can affect other goods and services to some extent.

Might higher US note and bond yields to some extent indicate inflation creeping into "the economy in general" from the commodity sector? Supply/demand for interest rate securities, dollar trends, and other factors matter for yields, but still…

Is the Fed accurately monitoring current inflation? Some measures and experts see little inflation. Yet see the implicit price deflator for US GDP. It increased 2.0pc in 2Q10 and 2.2pc in 3Q10 (Bureau of Economic Analysis, seasonally adjusted, annual rate; Tables 4 and 6, 11/23/10).

ON THE EDGE OF OUR SEATS: JUST IN TIME, JUST IN CASE

The band X sings in "The Have Nots": "This is the game that moves as you play."

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Firms (and nations) obviously always need some inventory to keep their commercial and other economic wheels rolling. From the mid-1990s or thereabouts, arguably many industries reduced their desired level of inventory holdings. They fought to keep only enough supply around to satisfy expected demands "just in time". The information revolution and other productivity advances encouraged this practice of edging toward some minimum (yet hopefully safe) operating level.

Has there emerged, or is there now appearing, another shift in desired holdings of commodity inventories in days coverage terms (not merely in absolute arithmetical levels)? Has there been a change from "just in time" to somewhat of a "just in case" bias? There's no cultural bright line between "just in time" and "just in case". Yet picture the just in case perspective as one of greater fears regarding marketplace risks, with consequently higher inventory holdings.

Commodities differ, but let's focus on petroleum. In any event, one should ask to what extent the petroleum inventory orientation is mirrored in other commodity territories, especially for goods that consumers "have-to-have" like wheat and corn.

Based on Energy Information Administration (EIA) statistics of 11/26/10, US commercial (industry; in primary storage) inventory in days coverage terms for crude and products combined equaled about 58.4 days. This towers 6.3 days over the end November average of 52.1 days from 1996-2009; the end December average is 49.5 days. However, look over the very long run vista, back to 1973. For the US in the years from the early 1970s through the mid-1990s, most end-November petroleum days coverage was over sixty days. Sometimes it stretched into the low 70s or even higher.

The long run average for end November from 1973-2009 is 61.4 days (end December 57.3 days). From this perspective, current US petroleum inventories of 58.4 days don't seem excessive, do they? Suppose the petroleum uncertainties and risks of the so-called current era to some extent rival those of the pre-1996 period. Then desired levels of days coverage probably will increase relative to the 1996-2009 average. Is there a risk of a major supply interruption now? Ponder the Iran nuclear problem. And that's not the only Middle Eastern issue. Even if there are no military outbreaks, aren't many nations (or their petroleum companies) competing to buy and hold energy resources? What if the trade-weighted dollar falls beneath all-time lows?

The US days coverage pattern for petroleum is broadly true for the OECD as a whole.

Perhaps inventories in the US are high in days coverage terms relative to 1996-09 levels merely because it's taken time to work them lower after the economic crisis ended, partly because of some OPEC crude oil overproduction. Yet the American recovery, however sluggish, has been underway for a while.

And why are petroleum prices so elevated given high (relative to 1996-09) OECD inventory averages? Perhaps more and more optimists have faith the world economic recovery will continue for some time and become increasingly robust, with resulting leaps in petroleum consumption. Maybe some nations and institutions want to hold physical petroleum supplies, whether inventory or reserves in the ground. Suppose they fear worldwide crude oil reserves and production will not grow sufficiently. Dollar depreciation is part of petroleum's bullish tale. Buy and hold for the long run alternative investment is bullish for prices in petroleum and other widely-traded commodities. In any event, observers should not rule out an inventory holding shift in the US and the rest of the OECD, from a strong just in time bias to somewhat more of a just in case one.

In addition, as non-OECD nations such as China grow (industrialize, consumers drive more vehicles, etc.), they will add to their petroleum inventory holdings in arithmetic terms. In many such nations, the division between the government and the private sector is not always or everywhere definite. To the extent that these nations need more inventory to run "just in time", they need more arithmetic inventory. Hence there's an upward push on petroleum prices from this direction. To the extent their desired levels seek to match those of the OECD in days coverage terms, (including strategic stocks akin to the US Strategic Petroleum Reserve), the increasing desire for just in case supplies bolsters petroleum prices.

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To the extent nations fear having inadequate food (or any other commodity) supply, might they engage in hoarding? China, Russia, and India, like many other nations, do not want political and social unrest.

"INVESTMENT" IDEOLOGIES

In "Gulliver's Travels", Jonathan Swift remarks: "And, he gave it for his Opinion; that whoever could make two Ears of Corn, or two blades of Grass to grow upon a Spot of Ground where only one grew before; would deserve better of Mankind, and do more essential Service to his Country, than the whole Race of Politicians put together." (Part II, chapter vii)

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Although individual circumstances differ for many consumers and between nations, many "commodities" also are "necessities". It's a truism that there are a lot more commodities than gold and other precious metals. Some of them like wheat sure appear more necessary than others. Think also of corn and other coarse grains and the oilseed complex. Don't forget the energy universe, with petroleum, coal, natural gas, and electricity. Think of base metals like copper and aluminum and iron ore. Remember ones that only seldom grab headlines like rubber and potash. Even if most consumers can get by without softs (coffee, sugar, cocoa), these are pleasant indulgences. Yet consider fresh water. Should water be considered a "commodity"?

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Consumers (and governments) for centuries have bought gold to hold for some version of the long run, regardless of whether they or pundits labeled such acquisitions as investment, speculation, collecting, hoarding, a financial or monetary asset, or otherwise. In the famed epic poem, heroic Beowulf slays the fierce dragon hoarding and guarding a great golden treasure. But let's glance at commodities other than gold.

The revered "investment" label is not a scientific word. Besides, owners can be speculators (or excessive speculators), collectors, hoarders, and so on.

In recent years, buy and hold alternative "investment" in commodities by noncommercial marketplace participants has become increasingly popular and substantial. Diversification doctrines often encourage and justify such activity. Some consumers may place their funds in institutions investing in commodities. They enjoy whatever blessings may result from such holdings. Admittedly profits are not guaranteed. Think not only of price trends, but also of potential costs of rolling positions forward.

However, most individuals around the world do not invest in such vehicles. Since alternative investment in commodities acts to move commodity prices higher, consumers in general pay a

price for such noncommercial behavior. One can debate how big a cost that is. But noteworthy buying and holding reduces "free supply". Therefore it is nonsense to say that the flat (outright, cash) consequences of significant noncommercial ownership (whether designated as investment or otherwise) is nonexistent.

Investment demand may enter the commodity corner of the financial pasture in various ways. People not only acquire physical commodities (or in instruments backed by actual physical inventory; ETFs). They may engage in buy and hold strategies in derivatives, whether on exchanges (futures) or over-the-counter. Because derivatives are not separate islands from underlying cash marketplaces (including those linked via basis relationships), net buying in them is a bullish factor in both domains. Since the net investment buying almost certainly is not matched entirely (or close to it) by net "real world" producer selling; the noncommercial shorts (or their agents) selling to the buy and hold for the long run choir eventually must cover their positions. Suppose those who sold to the investment buyers, say in a forward or futures arena, were dealers. Most of these market-makers run a balanced book. They consequently usually will buy an instrument to balance their short position around the time they establish their short. That buying (hedging its short position), whether in cash or derivative marketplaces, thereby intertwines with the investor's acquisition, and thus influences free supply.

The actual degree of leverage employed around the world in commodity investments is unknown.

In any event, many commentators speak of the billions of dollars invested in commodity marketplaces, whether in individual commodity fields or via indices. Let's also dig into the CFTC's CIT Report (futures and options combined) for 12 US agricultural commodities. The Index Traders in this report represent the buy and hold for the long run alternative investment category. Look at the size of the net Index Trader length for 11/30/10. It was about 1.48 million contracts, or about 23.2 percent of total open interest. That is not small potatoes, is it? Suppose the owners wanted to liquidate a substantial amount of their investments fast. All else equal, wouldn't that selling probably have a dramatic bearish price effect? The net Index Trader percentage relative to total open interest for each of the dozen commodities varies. The CBT wheat index trading net long position equals about 40.1pc of its open interest. For corn, the net IT length is 21.4pc, with that for soybeans 20.8pc, lean hogs 39.7pc, coffee about 28.0pc, and sugar 15.1pc. For all 12 commodities combined from 2007 to the present, what is the average net long Index Trader open interest position as a percent of total open interest? It has averaged a bit over twenty-five percent of total open interest.

Petroleum has been called "black gold". Suppose a similar percentage ranges across the exchange-traded commodity landscape. Buy and hold investment of at least 20 percent in petroleum and base metals would be noteworthy.

At what point should marketplace buying and holding of commodities by noncommercials (including investors) be declared excessive? People will disagree. Should politicians and regulators await or tolerate very high prices (however defined) before acting? What about buying and holding by commercials? People will debate this too, with those enamored of free market dogmas being especially reluctant to restrict commercial ownership. What about by sovereign nations?

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Not all fears regarding noncommercial commodity trading deal with exchange-traded marketplaces, or even with investors. "OPEC calls for tighter controls on OTC trading" (Financial Times, 11/24/10, p4). OPEC's Secretary General speaks of risks of "chaos" and

disruption of global supplies unless authorities impose tighter regulation on oil-based financial instruments (derivatives). These, he says, often exert greater power than physical supply/demand realities. OPEC meets 12/11/10, but they don't regulate OTCs.

Plus many OPEC members want high prices, just not too high ones. What many consumers deem reasonable or fair may not be OPEC's viewpoint. What's a fair (supposedly reasonable) price for commodities? Though it's inevitably a matter of opinion, the answer is important to both producers and consumers, as well as to commodity merchants in the middle.

What constitutes a commodity "bubble" likewise is an opinion.

It will be interesting to see whether any new American position limit rules will significantly influence (reduce) noncommercial commodity positions, including those of index traders. To what extent will legislation and regulation affect over-the-counter investment? Many commodity OTC products may be forced onto exchanges. Yet the US is not the only jurisdiction, right?

There has been some pressure in addition to that from politicians and regulators to seek limits on or reduce passive commodity investment. Some of this effort probably derives from concerns about how such investment affects consumer prices. California State Teachers' Retirement System allocated $150mm to commodities, much less than its staff recommendation of $2.5 billion (Financial Times, 11/12/10, p20). But that $150 million total is not small, and this institution is not alone.

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How much new money could cascade into the commodity landscape? One can only conjecture. However, the commodity universe appears relatively small in comparison to the securities universe. Note the International Monetary Fund's "Global Financial Stability Report" ("Statistical Appendix", October 2010, Table 3, p19). It estimates the size of worldwide capital marketplaces at end 2009. World stock marketplace capitalization was about $47.2 trillion (the US is about $15.1tr of that). Debt securities (public and private combined) equal around $92.1 trillion (the US segment is $31.7tr). Suppose one percent of the combined $139.3 trillion total for stocks and interest rate instruments ventures in some fashion into the commodities space. That equals about $1.4 trillion.

All the petroleum in US industry primary storage as of 11/26/10 adds up to around 1,106 million barrels (EIA). At $100 barrel, that has a value of over $100 billion. Compare that with the $1.4 trillion of the preceding paragraph. Total US crude oil stocks are about 360 million, with those in Cushing, Oklahoma (the NYMEX delivery point) 34.5mm barrels.

For some commodity marketplace players- whether sovereign nations, commercials active in the actual trade or business of the commodity, or noncommercial participants- exchange as well as OTC marketplaces may be too small. Or, such players may want to hold the actual physical commodity (including reserves of it; or, agricultural land) or the means of processing (refining) or distributing it. That commodity acquisition also could involve the acquisition of equities (buying actual corporations). Or, they may not want to deal with legislative or regulatory efforts to control their behavior. Also, for some nations, commodities perhaps have currency (financial store of value) implications. See "China: Currencies, Commodities, and US Treasuries (11/22/10).

For December 2010, to what extent will commodity forums see end of month, quarter, and year new buying? What net new funds, if any, will investors allocate to commodities in general and derivatives in particular?