

RCM

Commodities

Echo Bubble And Echo Manipulation, Crude Oil: A Further Consideration

Will The Actions Of The Authorities To Curb Commodity Speculation Inadvertently Intensify It?

To: GPC and FICO

From: Frank Veneroso

October 21, 2009

Executive Summary

- 1. Many funds, faced with the prospect of increased regulation in commodity derivatives, are now moving toward investing in the physical commodities rather than their derivatives.*
- 2. If this happens the current moves by the world's authorities to curb commodity speculation and manipulation through increased regulation may backfire in a huge way.*
- 3. If investors and speculators try to buy physical commodities instead of their futures and forwards they will create very, very severe physical shortages.*
- 4. In effect, they will unwittingly do the hiding and squeezing and cornering of the grand manipulators, and possibly on a massive scale.*
- 5. If this happens, we could have commodity markets with very large supply/demand surpluses which go to the moon because physical scarcity will drive forward curves into backwardation and that in turn will eliminate the propensity of producers and other commercials to sell forward.*
- 6. As a consequence, the whole price curve from spot to far forward could soar.*
- 7. As a consequence, the authorities could be creating, at least for some time, the worst of all possible worlds: still-unregulated commodity derivatives markets and a massive inadvertent squeezing and cornering of the overall commodity markets through speculative and investment claims on the limited physical above and beyond the needs of commerce.*

RCM

Commodities

Echo Bubble And Echo Manipulation, Crude Oil: A Further Consideration

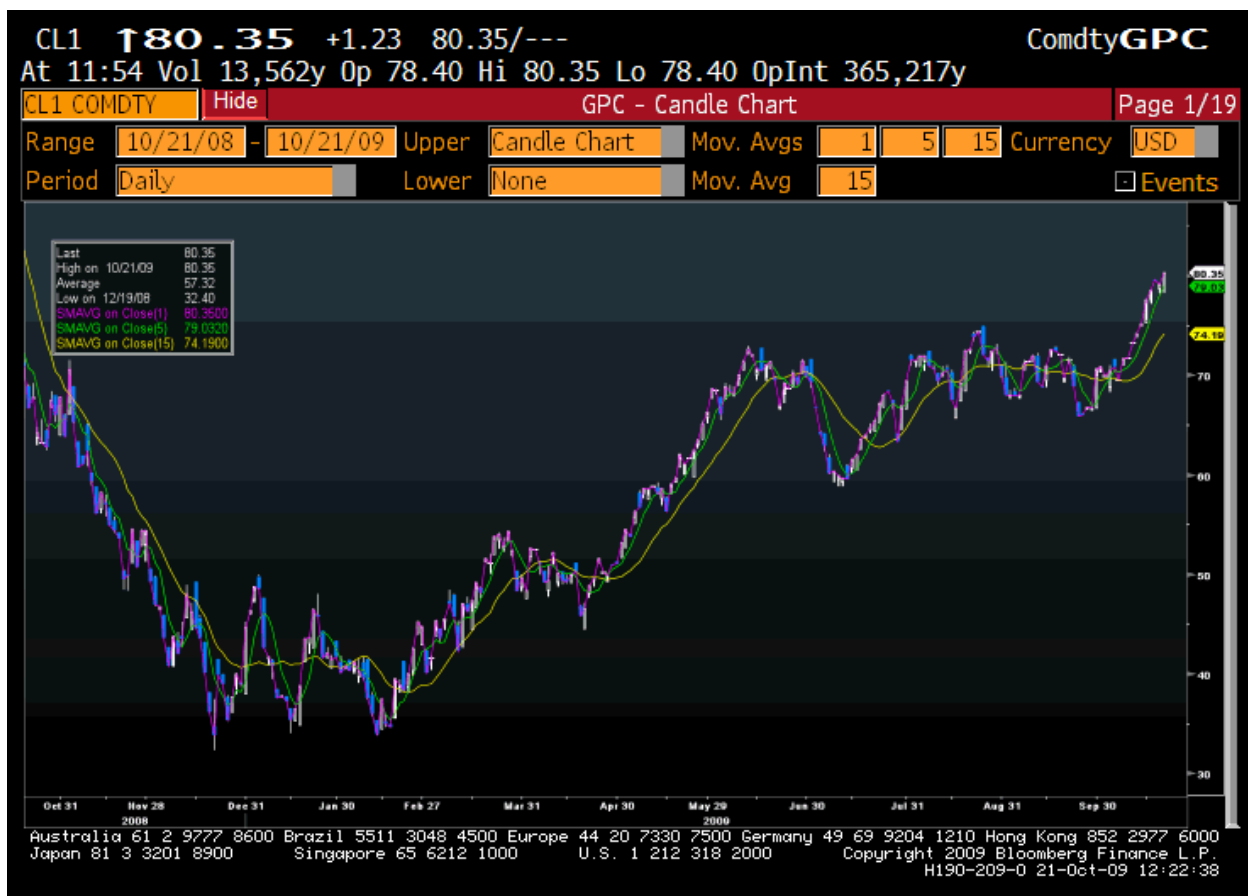
Will The Actions Of The Authorities To Curb Commodity Speculation Inadvertently Intensify It?

To: GPC and FICO

From: Frank Veneroso

October 21, 2009

The price of oil has broken out to the upside on the generic chart, despite a widespread acknowledgement that there is plenty of oil around.



Bloomberg, October 21, 2009

What is happening? In a parallel piece (*Commodities, Crude Oil, Basic Considerations*, October 21, 2009) I have set out what I believe are the basic dynamics governing the oil price. But there is now a new possible concern about commodity speculation and manipulation on the horizon.

The governments of the G10 countries now know what happened in the oil and commodity markets last year. They know that in the first half of the year, amidst an unfolding recession, the prices of commodities soared in an unprecedented fashion because of swirling speculation and manipulation. Belatedly, they are now pushing for stricter regulation of commodity markets.

The focus has been first on increasing regulation of commodity futures markets, in part because registered futures exchanges are the easiest part of the market to regulate. A high priority has also been put on regulating OTC commodity derivatives markets. However these markets are far more difficult to regulate. Nonetheless, it appears that much greater regulation will eventually descend on all commodity derivatives markets.

The threat of such increased regulation may create a more damaging and more dangerous form of commodity speculation. Many funds, faced with the prospect of increased regulation in commodity derivatives, are now moving toward investing in the physical commodities rather than their derivatives. Investment banks are beginning to push physical commodity products. Scotia Bank is launching an ETF that invests in physical copper. Credit Suisse and Glencore are launching an ETF that invests in physical aluminum. I hear that the investment banks are advising hedge funds, pensions and endowments to invest in physical commodities rather than commodity derivatives.

(It may be that for some physical commodity investment products physical holdings are then lent out. If so, there will be no physical shortage. I am considering only those investments where physical commodities are removed from circulation.)

If this happens the current moves by the world's authorities to curb commodity speculation and manipulation through increased regulation may backfire in a huge way. The futures and forward markets in commodities are far larger than the physical markets. Typically the physical stocks of a commodity above the minimum necessary for commerce are very small relative to the overall commodity derivatives market. If investors and speculators try to buy physical commodities instead of their futures and forwards they will create very, very severe physical shortages.

How does commodity manipulation work? Manipulators know that the surplus of physical commodity stocks above those needed for day-to-day commerce is rather small. They secretly purchase this physical surplus and remove it from the marketplace, thereby deliberately creating a physical shortage. Such a physical shortage drives the spot price higher. It also drives the spot price above the forward price. The resulting backwardation makes it extremely expensive to roll shorts in futures and forwards, thereby reducing supply in those markets. With an induced physical shortage and less forward supply prices skyrocket. Given the high cost of maintaining short positions and the possibility of unlimited losses on shorts, the manipulators holding and

hiding the physical commodity scare the shorts into covering. When the shorts cover the manipulating longs can offload their long positions into a soaring market.

What will happen if investors and speculators with no intention to squeeze or corner a market collectively decide to buy physical commodities on a large scale? They, too, will create severe physical shortages. In effect, they will unwittingly do the hiding and squeezing and cornering of the grand manipulators, and possibly on a massive scale. If this happens, we could have commodity markets with very large supply/demand surpluses which go to the moon because physical scarcity will drive forward curves into backwardation and that in turn will eliminate the propensity of producers and other commercials to sell forward. It is this propensity to sell forward that balances commodity futures and forward markets and keeps the overall price structure somewhat in check. As a consequence, the whole price curve from spot to far forward could soar.

The world's authorities have been beating the drum about curbing commodity manipulation and speculation through regulation. They have made much noise, but so far there has been little effective action. In response to this loud drum beating, investors and speculators may be moving into the physical. If they keep moving into the physical they could create dangerous physical shortages, and before any effective curbs have been placed on the futures and forward markets. As a consequence, the authorities could be creating, at least for some time, the worst of all possible worlds: still-unregulated commodity derivatives markets and a massive inadvertent squeezing and cornering of the overall commodity markets through speculative and investment claims on the limited physical above and beyond the needs of commerce.