Bill Gary's

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Dysfunctional Markets – Part II

In the March 15 issue of *Price Perceptions*, we discussed how grain markets had become dysfunctional. Cash and futures markets have become nearly unrelated as speculators drive up futures prices, but cash markets fail to follow. The disparity has led to country elevator bankruptcies while larger grain merchandisers and processors have been forced to meet margin calls in the billions. As a result, many grain elevators and processors will no longer contract to buy or sell grain for future shipment... Farmers are no longer able to contract crops ahead... And, foreign buyers must now pay an additional risk premium when they contract grain for future delivery. *What is causing this? Can it be fixed? What are the implications?*

Wall Street is known as a keen innovator of new financial products. Some products have been extremely beneficial to investors and the economy. Others, like sub-prime mortgages, have been very detrimental. Many recent Wall Street innovations are commodity related. These innovations can be subdivided into three categories...

- Index Funds
- Exchange Traded Funds (ETF's)
- Commodity Notes

All of these new products were designed to make commodities respectable as an "asset class." Now commodities can be purchased like stocks by mutual funds, pension funds and individual investors. Popularity has ballooned for these products with billions invested from the US, Europe and Asia. *Barclays Capital recently estimated that a record $6 billion flowed into these commodity investments during February alone.*

One problem with funds of this type is that they are "long only." In other words, when money is invested the funds buy physical commodities or futures. The only time they sell is when investors withdraw money. Therefore, commodity markets have been forced to absorb billions of dollars in new buying without an offsetting selling force. The size of this new buying has overwhelmed futures. As an example, index funds alone now own about 1 billion bushels of Chicago wheat compared to annual US production of about 500 million. Similar distortions are evident in most other commodity markets.

One extreme danger to consider is liquidation of index type funds. *If investors were to become nervous and begin withdrawing money, the mammoth size of long liquidation could be catastrophically negative to futures.*

Grain Trade Viewpoint

Because these investment vehicles are relatively new, regulators have not yet introduced rules to govern their trading. Currently, index funds are classified as hedgers because they are buying against an index, such as the Goldman Sachs Spot Index. Because hedgers have no position limits, these funds are able to buy as many futures contracts as they desire. On the other hand, speculative funds and individual traders are limited in the number of contracts they can buy or sell. Position limits were originally established to minimize market distortion and eliminate "squeeze" plays (buying more futures than can be delivered). However, *with no limits placed on index funds, markets have been distorted, similar to a "squeeze" play.*

Commodity exchanges have also contributed to dysfunctional markets. Exchanges are no longer member owned, but have become public corporations. This has shifted the function of exchanges away from a price discovery mechanism to a profit making entity. Expanding volume is the primary method of generating profits. There-

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fore, exchanges welcome these new investment innovations and work to minimize new regulations that would curb rising volume.

Some potential solutions recommended by those in the grain trade are...

- Place trading limits on funds and ETF's in both the physical and futures markets.
- Expand the number of delivery locations, including foreign countries.
- Utilize a widespread cash index for settlement prices.
- Force funds to roll positions forward at least sixty to ninety days before delivery to minimize spread distortion.

Some in the trade believe if new regulations are not forthcoming soon, it will end cash grain trading as we have known it. It could force the industry to utilize futures markets in foreign countries that have more regulation. It could also lead the government to form marketing monopolies, similar to Canada and Australia. Or, without a viable price discovery mechanism, farmers could go bankrupt and/or sell out to large corporations that are better able to manage risk with forward cash contracts.

Economic Viewpoint

Commodities have remained extremely underpriced relative to other assets for the past 25 years. Some economists believe the huge influx of money into the markets is only helping to pull commodities up to the relative value of alternative investments. In other words, commodity markets are simply undergoing a "structural" shift that is long overdue.

In addition, wealth has shifted from Western economies to Asian and Middle Eastern nations. These nations contain the world's largest populations. With their incomes rising, demand for food and other commodities is likely to continue expanding, regardless of a recession or economic downturn in Western economies.

As an example of purchasing power in Middle Eastern nations, we can look at how many bushels of corn one barrel of oil will buy. In November 1998, oil traded at $11.22 per barrel and corn was $2.19 per bushel. Therefore, one barrel of oil would buy 5.1 bushels of corn. Today, oil is $105 per barrel and corn is $5.60 per bushel. One barrel of oil will now buy 18.8 bushels of corn at today's values. In other words, the relative value of Middle Eastern oil will now buy 13.7 more bushels of corn than in 1998. *While corn prices have advanced 156% in dollar terms, it has fallen 73% in terms of Middle Eastern buying power.*

Another example is the price of wheat deflated by the Consumer Price Index (CPI). Based on a CPI index of 100 in 1982, the equivalent index was 49.7 in February 1974. At that time, wheat prices reached historic highs of $6.45 per bushel. Therefore, when deflated by the index, the equivalent price of wheat was $12.98 per bushel ($6.45/49.7). Today, the index is 173.9 and wheat prices are $10.61 per bushel. The equivalent price of wheat today, when deflated by the index, is $6.10 ($10.61/173.9). While we view prices as high in dollar terms, wheat has actually lost 53% of its value when compared to the overall price increase of consumer items.

Another measure of economic value is to index commodity prices by the value of the dollar. In August 1983, soybean prices advanced to $9.49 per bushel. The dollar index was at 1.3080 during the same period. Therefore, the equivalent cost of soybeans to foreign buyers was $12.41 per bushel ($9.49 x 1.3080). Today, soybean prices are $13.53 and the dollar index is .7144. The equivalent cost to foreign buyers now is $9.67 per bushel. Although current soybean prices are 43% above August 1983, in terms of foreign buying power they have declined 22%.

From an economic viewpoint, a strong case can be made that current high grain prices are sharply undervalued when compared to oil prices, inflation, or the value of the dollar.

Summary

Both the grain trade and economic viewpoints have strong merits. It has been obvious for years that food prices were depressed when compared to other items. One reason food prices remained undervalued for so many years was huge US subsidies paid to farmers to overproduce. However, the US has shifted from the world's largest creditor nation to the world's largest debtor. In other words, we have transferred our wealth to other nations. Therefore, foreign economies and buying power now have much greater impact on US commodity prices than 25 years ago.

Both viewpoints involve a great deal of risk. Inability to effectively maintain hedges leaves farmers and the industry without adequate risk controls. This lessens traditional overhead selling in futures and provides a pathway for index funds to push markets to extreme price levels. Conversely, if investors were to withdraw from long only funds, the marketplace would lack traditional hedge covering to counteract selling and prices could collapse. Hopefully, new ways will be found for the industry to effectively hedge and long only funds will not experience panic withdraws. Looking back at similar circumstances in the past, extreme volatility can last for an extended period. Traders who learn to adjust to the new paradigm will be offered unprecedented opportunity.