



Market Weekly

Commodities, Forex, Futures and Options

February 16, 2008
Quarter 1, Issue 6

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HEADLINE OF THE WEEK: "Rising wheat prices flatten bakers" (Kansas City Business Journal, 2/15/2008)

Compiled by Mack Frankfurter, Chief Investment Strategist

Rising flour prices is kneading the nerves and wallets of bakers, manufacturers and others. On Monday this past week we saw an unprecedented move by the Chicago Board of Trade, Kansas City Board of Trade and Minneapolis Grain Exchange raise their daily price limits on wheat. Fortunately, this was sufficient to break the market corner that had commercial users (i.e., farmers, grain elevators) on the ropes facing margin calls. What would cause such a situation? Starting back on January 25th, and again on February 5th, the National Grain and Feed Association (NGFA) alerted the regulators and futures exchanges of "major underlying concerns over the lack of consistent convergence (narrowing) between cash and futures prices in delivery markets during the futures delivery period, and the dramatic adverse impact it is having on grain elevators, feed mills and grain processors that traditionally have used futures markets to offset price risk inherent in cash markets." Bottom line, long-only commodity funds and ETFs are helping to create an unbalanced long-biased situation, and after the NFGA's press release, speculators smelt blood and squeezed. This can be a brutal game!

WEEKLY RECAP

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"...major underlying concerns over the lack of consistent convergence between cash and futures prices..."



Going back ten years from 1998 through 2006, wheat prices stayed within a range of \$2.50-\$5.00 per bushel.

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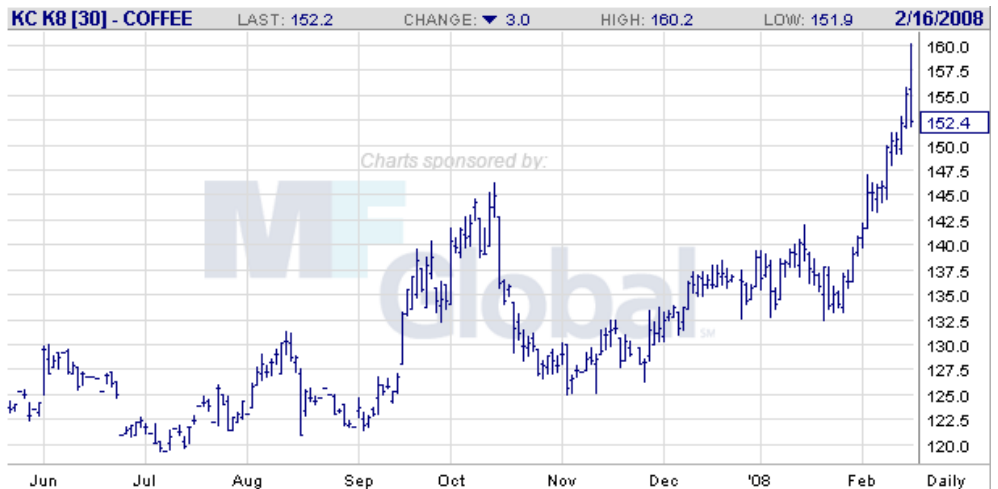
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“The power shortage in South Africa is forcing buyers to secure supplies for the metal.”

At the same time, platinum continued its record-break run, smashing through the \$2,000 level to hit a record of \$2,025 a troy ounce before easing back to \$1,997 on profit taking. There are mounting concerns about the outlook for production of metals in South Africa after Eskom, the state power company, said mining companies would not have more than 90 percent of their normal power requirements in the country until 2012. The power shortage in South Africa is forcing industrial buyers to secure supplies for the metal. Meanwhile, the news is also not so good for coffee drinkers, as coffee futures are trading close to 10-year highs. Although the supply and demand balance in the global coffee market is viewed as tight, the high levels of speculative and fund involvement is prompting talk among dealers and analysts as trade houses, and industry buyers appear to have been caught out by recent price strength. One dealer said that industry buyers had been expecting a price correction but were being forced to buy on any dips in the absence of more widespread weakness. Record agricultural prices are beginning to place a heavy financial burden on developing countries, forcing an increase in food subsidies in countries such as Egypt, Oman and Pakistan, as well as retail price freezes in Russia and China.



What is really catching the attention of Goldman Sachs now is the outlook for agricultural prices.

“Changes in the Average are supervised by The Wall Street Journal’s editorial board.”

In other market news, the Dow Jones Industrial Average (DJIA) stock index, the oldest and most recognizable U.S. equity benchmark for investors, was “traded” again this past week. Bank of America and Chevron became the latest companies to be selected as constituents for the index in the first change to the share market barometer since 2004. The newest members to the benchmark, which dates back its inception to 1896, replaced the shares of Altria and Honeywell. Changes in the Average are supervised by The Wall Street Journal’s editorial board. The Dow is a narrow market benchmark with the average calculated on the price of its 30 constituents and not their market capitalization. This means Dow stocks with high share prices carry more weight in calculating the average. The futures contract for the DJIA trades on the Chicago Board of Trade (now part of the CME Group). The “BIG Dow Jones” contract is equal to \$25 times the index, and the regular and mini-sized contracts are equal to \$10 and \$5 times the index, respectively.

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ECONOMIC REVIEW

Forget for one moment all the gloom and doom—from the banking sector write-downs to the monolines being given five days by Spitzer to find funds, to the SocGen rogue trader debacle, etc., etc., etc. Consider, instead, the encouraging comments from multinationals like General Electric and Kraft, and entrepreneurs from the Midwest who have been receiving record orders from Conagra and Cargill. It would appear that economists are from Venus and business is from Mars. Even European manufacturers such as the German chemicals conglomerate BASF, or car company Peugeot-Citroën, or other members of the European Who's Who of manufacturing, ArcelorMittal, Diageo, Lafarge, Total and so on, have been trotting out good numbers and showing relative confidence for the future.

All this is a striking contrast with what is happening in the financial sector. In some cases, governments are stepping in to bail out troubled banks—directly in Germany and by the back door in the U.K. In other cases, sovereign wealth funds from emerging countries are coming to the rescue.

But financials have traditionally led a downturn in the economic cycle, with the manufacturing sector lagging behind. Many are thus warning that the apparent resilience of manufacturing companies could be short-lived and the turbulence in the financial markets will

eventually catch up with them. Corporations concede the risk, but they also argue that the world economy is still growing at an extraordinary pace, driven by emerging countries such as China and India.

However, to many economists, the confident statements coming from boardrooms ring increasingly hollow. The prospects of a U.S. recession have grown significantly as key indicators on employment and business sentiment have disappointed. Bad news first came from the Labor Department statistics which showed that the U.S. had lost 17,000 jobs in January, the first decline since March 2003. The second bombshell came on February 5th when the Institute for Supply Management's monthly report showed that the U.S. was moving from expansion mode to contraction for the first time also since March 2003.

If we do end up in a recession, chances are that people who lose their jobs in the current downturn will behave differently than in 1991 and 2001. Some are talking about changing habits altering the performance of traditional “recession-proof” sectors. For example, people may be more inclined to disconnect landlines and hang on to their mobile phones while waiting for a call for a job offer, as they hang out in Starbucks working on their laptop surfing the internet.

Next Week's Economic Calendar

Focus will be on the CPI as a Merrill Lynch survey revealed stagflation fears while risk aversion hits 7-year high.

Date	Time (ET)	Statistic	For	Briefing Forecast	Market Expects	Prior
20-Feb	8:30 AM	Building Permits	Jan	NA	NA	1068K
20-Feb	8:30 AM	Core CPI	Jan	NA	NA	0.2%
20-Feb	8:30 AM	CPI	Jan	0.3%	0.3%	0.4%
20-Feb	8:30 AM	Housing Starts	Jan	NA	NA	1006K
20-Feb	8:30 AM	Core CPI	Jan	0.2%	0.2%	0.2%
20-Feb	8:30 AM	Housing Starts	Jan	1020K	1000K	1006K
20-Feb	8:30 AM	Building Permits	Jan	1005K	1035K	1068K
20-Feb	10:30 AM	Crude Inventories	16-Feb	NA	NA	1066K
20-Feb	2:00 PM	FOMC Minutes	30-Jan	-	-	-
21-Feb	8:30 AM	Initial Claims	16-Feb	355K	NA	348K
21-Feb	10:00 AM	Leading Indicators	Jan	-0.1%	-0.1%	-0.2%
21-Feb	10:00 AM	Philadelphia Fed	Feb	-10.0	-10.0	-20.9

Data is provided for informational purposes only, and is not intended for trading purposes.

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MANAGED FUTURES NEWS

Moore Capital, a \$15 billion hedge fund founded by renowned commodity trader Louis Bacon who started out in managed futures back in 1989, spun out one of its best traders into a new \$2.5 billion fund. Tim Leslie will take 30 people while Moore Capital will retain a stake in the new business, reflecting a growing trend towards the creation of second-generation funds started by experienced hedge fund managers rather than bank proprietary desk traders.

Fungibility is the ability of traders to open a position at one exchange and close it at another. Central to this ability is either that both exchanges use the same clearing house, or that there are links between the two clearing houses. Fungibility has been a feature of the stock and option markets for years, but not for futures. However, last week the Department of Justice signaled it was unhappy with this model in a letter to the U.S. Treasury, throwing its weight behind the idea that clearing houses should be separated from the futures exchanges that own them.

The Commodity Futures Trading Commission (CFTC) announced the establishment of an advisory committee that will provide a public forum to examine emerging issues related to the energy markets and the CFTC's role in these markets under the Commodity Exchange Act.

January offered something of a case study for those arguing that an allocation to commodities can reduce risk and lower portfolio correlation in times of market turmoil—at least as far as the Dow Jones-AIG Commodity Index is concerned. In a month when the S&P's 500 stock index fell 6.1% and the Dow Jones Industrial Average lost 4.6%, the DJ-AIG index rose 4%, with energy, grains and base metals driving the largest increases.

The National Grain and Feed Association (NGFA) said it told the CFTC it opposed proposals to establish a new “risk-management exemption” on the size of speculative positions that index and pension fund traders can control in grain futures or options contracts. “Such traditional hedgers have seen a dramatic increase in recent months in the amount of money needed to finance margin requirements on outstanding futures contracts,” NGFA said in a statement. “In this environment, the marketplace is ill-equipped to efficiently absorb more investment capital and perform its core function of serving as an efficient tool for businesses hedging physical grain purchases, particularly when virtually all of that investment capital is long-only and a large share of open interest essentially is 'not for sale' for long periods of time.”

PGGM, which now manages the assets of Pensioenfond Zorg en Welzijn, has shaken up its €484m (US\$706m) commodities allocation. The asset class will continue to make up 5.5% of the €88bn (US\$127bn) Dutch portfolio but there have been changes to the make up. PGGM has taken natural gas out of the energy holding which now makes up 80% of the commodities allocation, and removed precious metals, but now hold 10% of the allocation in industrial metals instead. PGGM has added a 5% stake in livestock to its commodities holding and retained 5% in agriculture. The changes were a result of PGGM adjusting the benchmark of the commodities portfolio.

National Futures Association (NFA) has ordered Black Flag Capital Partners LLC (Black Flag) and its principal, Jason Black, to withdraw from NFA membership and associate membership, respectively, for a period of thirty months. Black Flag is a Commodity Trading Advisor and Commodity Pool Operator. The Complaint charged that Black Flag failed to maintain their correct business address with NFA, failed to properly prepare pool financial statements, and failed to provide accurate disclosure documents to its pool participants.

Craig Donohue, chief executive of the CME Group, launched an attack on investment banks. He said the subprime mortgage crisis and the trading scandal at Société Générale had happened because Wall Street had resisted centralized clearing such as that offered by the CME.

Market Weekly is a newsletter publication of Managed Account Research, Inc. Its purpose is to provide weekly commentary on the commodity, forex, futures and options markets, as well as economic news impacting your managed futures investments. To subscribe or unsubscribe, contact us at 800.308.1495 or email: research@ma-research.com.

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