



Market Weekly

Commodities, Forex, Futures and Options

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HEADLINE OF THE WEEK: "Soros paints bleak picture on commodity price 'bubble'" (Financial Times, 6/5/2008)

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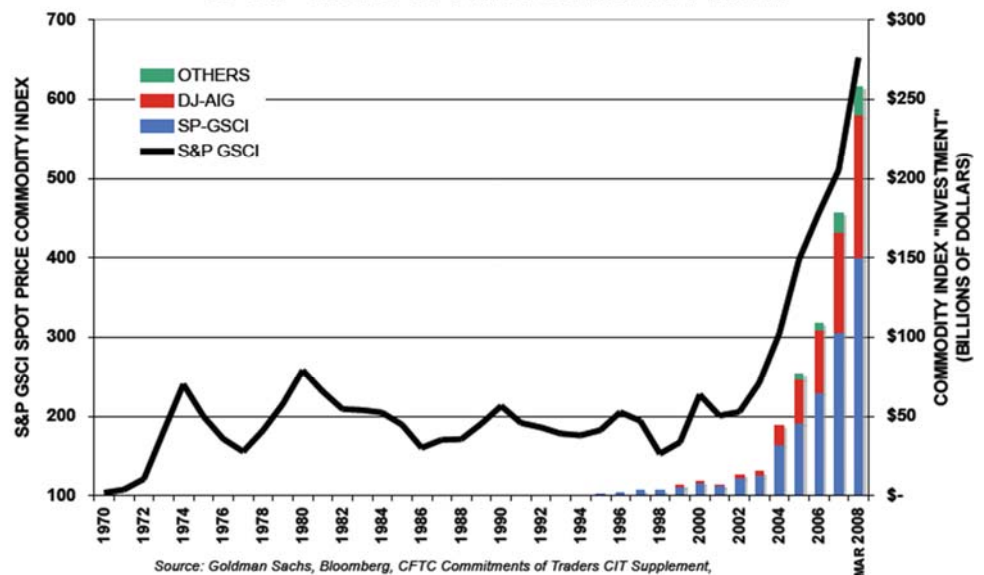
WEEKLY RECAP

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George Soros, the billionaire hedge fund legend, testified before the Senate Commerce Committee, stating that institutional investors were inflating a bubble by investing in commodity indices. According to Soros, investing in commodity indices was "intellectually unsound, potentially destabilizing and distinctly harmful in its economic consequences," and based on a "misconception." Soros testimony echoed Michael Masters' testimony just a couple weeks ago. But there are critics of this thesis. Robert Greer, who oversees the PIMCO Commodity Real Return Strategy mutual fund, argues that "coincidence is not the same thing as causality." We agree... but that also doesn't mean that there isn't causality, or that a cause and effect feedback loop between fundamentals, price and behavior hasn't occurred. With oil prices spiking over \$15 in two days on Thursday and Friday this week, there is only one certainty—this "commodity bubble" debate is going to continue to rage.

"...intellectually unsound, potentially destabilizing and distinctly harmful in its economic consequences."

COMMODITY INDEX INVESTMENT COMPARED TO S&P GSCI SPOT PRICE COMMODITY INDEX



Source: Goldman Sachs, Bloomberg, CFTC Commitments of Traders CIT Supplement,

Is there or isn't there a causality between index investment in commodities and price—that is the question.

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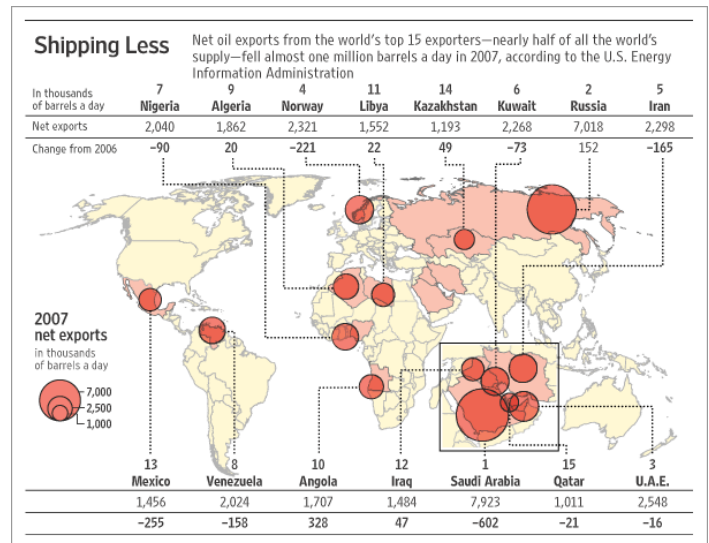
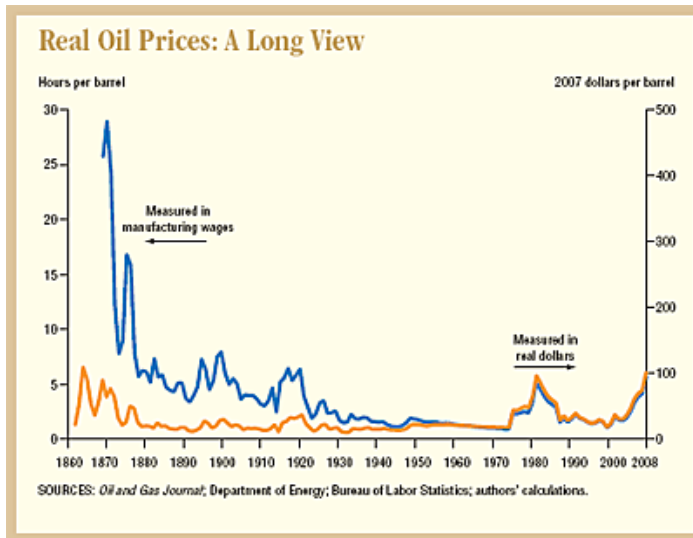
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Headlines from page 1

“...few observers believe China will move to raise oil prices and cut subsidies.”

India’s government raised prices at the nation’s fuel pumps, prompting a backlash and threats of street protests. The government raised retail prices of petrol, diesel and liquid petroleum gas between 8 and 17 percent to reduce the burden of fuel subsidies that are expected to grow to more than 3 percent of gross domestic product. India joins a host of other Asian countries that have been forced to take the same politically unpopular step in recent days following a near doubling of global oil prices over the past 12 months to more than \$130 per barrel. Malaysia this week also announced a 40 percent price increase to reduce a subsidy burden estimated at \$17 billion this year, while Indonesia raised prices 29 percent last month. Meanwhile, China’s main cities are beginning to face growing fuel shortages as oil companies cut supply into the fixed-price local market in response to sky-rocketing global prices. Over the past week, petrol stations in Beijing, Shanghai and Guangzhou have reported worsening supply shortages which has forced them either to ration their stocks or operate for only a few hours a day. Some Beijing petrol stations have had lines of up to 50 trucks waiting for diesel. Even so, few observers believe China will move to raise oil prices and cut subsidies.



Congress blames high oil prices on speculation in the markets, which they themselves deregulated, while failing to address policy issues relating to less production.

“Rising inflation has stoked expectations of revaluation, encouraging speculative inflows.”

So far, bets that Middle Eastern currencies will break their pegs have proven off the mark. But that doesn’t mean that Saudi Arabia and the other members of the Gulf Co-operation Council are off the hook. Policymakers—barring Kuwait, which revalued its currency last year—have struggled to defend their currencies’ pegs to the dollar. Rising inflation has stoked expectations of revaluation, encouraging speculative inflows. These, added to huge oil revenues for many states, have fed domestic liquidity. As a result bank lending to the private sector, where demand for credit is already high thanks to negative real interest rates, is up. Booming credit growth has fueled domestic demand, and thus inflation. The vicious circle has been reinforced by rate cuts in the U.S. which have forced GCC central banks to reduce domestic rates. But soaring food prices have resulted in an old-fashioned way of tackling inflation: price controls have been imposed across most of the Gulf Co-operation Council states. The gulf region governments worry that a shift away from the dollar will signal a loss of confidence in the greenback and raise the awkward question of whether oil should remain priced in dollars.

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ECONOMIC REVIEW

With commodity prices, notably oil prices, going ever higher, the terms “demand destruction” and “creative destruction” have come into vogue. Demand destruction is the economic term for what happens when the price of a commodity gets too high, and users can no longer afford the cost. They find ways to conserve and cut back on usage. This destroys demand for the commodity, and prices collapse.

Airlines have been especially hard hit. They are largely un-hedged in jet fuel, burning 500 million or more gallons, quarterly. The arithmetic of the situation is dismal. Airlines can't get ahead of the curve with incremental fuel bills rising into the billions for all carriers. Meanwhile, people in the U.S. are starting to change their driving habits with Ford Motor just owning up to falling demand for pickups and SUVs, always the most profitable models in their line. They no longer see any daylight for earnings this year. One reason why this demand destruction has not yet impacted emerging economies has been the practice of oil subsidies. India is the latest country to be added to the list of emerging countries reducing oil subsidies.

The notion of creative destruction is found in the writings of Mikhail Bakunin (1842) and in Werner Sombart's *War and Capitalism* (1913), when he wrote: “again out of destruction a new spirit of creativity arises.” The economist Joseph Schumpeter popularized and used the term to describe the process of transformation that accompanies radical innovation. In Schumpeter's vision of capitalism, innovative entry by entrepreneurs was the force that sustained long-term economic growth, even as it destroyed the value of established companies that enjoyed some degree of monopoly power.

Companies that once revolutionized and dominated new industries—for example, Xerox in copiers or Polaroid in instant photography—have seen their profits fall and their dominance vanish as rivals launched improved designs or cut manufacturing costs. It might seem foolish to expect to shift such gigantic sectors as oil and cars, but at \$150 or \$200 per barrel oil as projected by Morgan Stanley and Goldman Sachs, there is bound to be a bout of creative destruction as the economy retools.

Next Week's Economic Calendar

The headline CPI should be an interesting number to watch as higher oil prices begin to permeate into the economy.

Date	Time (ET)	Statistic	For Period	Briefing Forecast	Market Expects	Prior
9-Jun	10:00 AM	Pending Home Sales	Apr	-	-1.0%	-1.0%
10-Jun	8:30 AM	Trade Balance	Apr	NA	-\$59.5B	-\$58.2B
11-Jun	10:30 AM	Crude Inventories	7-Jun	NA	NA	-4802K
11-Jun	2:00 PM	Fed's Beige Book	-	-	-	-
11-Jun	2:00 PM	Treasury Budget	May	NA	NA	NA
12-Jun	8:30 AM	Export Prices ex-ag.	May	NA	NA	0.6%
12-Jun	8:30 AM	Import Prices ex-oil	May	NA	NA	1.1%
12-Jun	8:30 AM	Initial Claims	7-Jun	NA	NA	357K
12-Jun	8:30 AM	Retail Sales	May	NA	0.6%	-0.2%
12-Jun	8:30 AM	Retail Sales ex-auto	May	NA	0.7%	0.5%
12-Jun	10:00 AM	Business Inventories	Apr	NA	0.4%	0.1%
13-Jun	8:30 AM	Core CPI	May	NA	0.2%	0.1%
13-Jun	8:30 AM	CPI	May	NA	0.5%	0.2%
13-Jun	10:00 AM	Mich Sentiment-Prel.	Jun	NA	57.5	NA

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MANAGED FUTURES NEWS

The chairman of a Congressional energy panel said this week that oil and products markets were being "manipulated" by the biggest trading houses in the futures markets, though he said a probe hasn't uncovered illegal activity. Bart Stupak, D-Mich., named Goldman Sachs (GS) and Morgan Stanley (MS) as two of the trading houses. He said the U.S. House Energy Oversight Committee hasn't subpoenaed the banks and is basing its findings on data from the Commodity Futures Trading Commission. Stupak said initial results of his committee's investigation into skyrocketing oil and product prices had found loopholes in current laws were allowing the biggest traders in the futures market to "game the system." He said the committee would hold a hearing to announce full results of the investigation on June 23.

CME Group Inc. has resubmitted its pre-merger filing for its proposed acquisition of NYMEX Holdings Inc. to give the Department of Justice more time to review the transaction. The new waiting period will expire at the end of June 18. The exchange said it believes it has made progress with the merger review process. But some shareholders of NYMEX, a major energy derivatives exchange, are threatening to block the \$9 billion deal reached in March, accusing the exchange's management of underselling the exchange. Holder of trading seats on the NYMEX are also upset about the price CME is offering for their seats. A NYMEX meeting with members is set for June 19 to address their concerns.

Hedge funds and big Wall Street banks are taking advantage of loopholes in federal trading limits to buy massive amounts of oil contracts, according to a growing number of lawmakers and prominent investors, who blame the practice for helping to push oil prices to record highs. The federal agency that oversees oil trading, the Commodity Futures Trading Commission, has exempted these firms from rules that limit speculative buying, a prerogative traditionally reserved for airlines and trucking companies that need to lock in future fuel costs. The CFTC has also waived regulations over the past decade on U.S. investors who trade commodities on some overseas markets, freeing those investors to accumulate large quantities of the future oil supply by making purchases on lightly regulated foreign exchanges.

Unprecedented growth in electronic and worldwide trading may be overwhelming commodities markets and raising prices, said Walter Lukken, the acting head of the U.S. commodity trading watchdog. Lukken, the acting Commodity Futures Trading Commission chairman, said he believes prices aren't being systematically driven up by manipulation, and that the commission is looking into whether prices are rising because of a massive influx of legal trading. The commission faces congressional scrutiny over record commodities prices and yesterday announced new requirements that investors and index funds disclose more information about their holdings in agricultural markets.

The Senate Agriculture Committee by a voice vote Wednesday approved the nominations of Walter Lukken, Bart Chilton and Scott O'Malia to serve as commissioners of the CFTC. Lukken has served as the acting CFTC chairman for the past year, and if confirmed by the full Senate, will drop the "acting" qualifier from his title. During his confirmation hearing, Lukken pointed out to lawmakers that the CFTC's work had dramatically expanded since its inception in 1975. "Since the CFTC opened its doors 33 years ago, the volume on futures exchanges has grown 8,000% while the CFTC staffing numbers have declined 12%," Lukken said. Chilton, in his testimony, noted CFTC staffing has fallen from just under 600 employees in 1992 to just below 450 currently. Senate Ag Committee Chairman Tom Harkin asked if, given those figures, the CFTC needed more funding. Lukken told Harkin the Bush administration had asked Congress for \$130 million for fiscal year 2009 and said he'd certainly be willing to talk about getting more than that.

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