



Market Weekly

Commodities, Forex, Futures and Options

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HEADLINE OF THE WEEK: "China raises energy prices" (Financial Times, 6/20/2008)

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At talks which started June 17th, the U.S. urged China to be more transparent about its oil stockpiles and the policies governing its strategic petroleum reserve. Those talks are aimed at working out a 10-year plan for co-operation on energy and included discussions on steps that could be made to make the oil markets less volatile in the near term. Saudi Arabia, meanwhile, held a meeting with some of the biggest international energy groups while acknowledging that oil prices have risen to unreasonable levels. The potential for permanent demand destruction is worrying Riyadh, which gave indications that it would boost oil production to its highest level in more than 25 years. But the most significant oil-related news this week was China's decision to raise energy prices across the board in a policy shift that risks stoking the country's already high inflation. The Group of Eight finance ministers said last weekend that "reducing subsidies" was important for lowering oil prices. Analysts had expected Chinese authorities to hold off price increases until at least after the August Olympics. However, it looks like China buckled to growing international pressure to reduce its oil subsidies, which in the form of price caps artificially stimulate demand. International oil prices fell immediately on Thursday, only to bounce back up Friday morning.

WEEKLY RECAP

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"China buckled to growing international pressure to reduce its oil subsidies, which in the form of price caps artificially stimulate demand."



Oil has been stuck in a range centered around \$135/barrel. Could this be the new equilibrium price?

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The fixed exchange rate policy, which ties Saudi Arabia to a dollar peg, is becoming a headache for the kingdom as double-digit inflation is depressing real incomes of millions of low-income workers. The peg to the dollar contributes to Saudi inflation in two ways. First, the dollar link forces the Saudi central bank to match U.S. interest rates. Second, the dollar peg also raises the cost of imports as the dollar declines relative to the euro, yen and other currencies. The U.S. is the source for only about 12 percent of Saudi imports. Meanwhile, inflation has proved to be the biggest external shock for Asian economies with fears that Asian governments lack the ability or political will to stop higher domestic and imported prices which could devastate their economies. Asia's inflation troubles are not taking place in a vacuum—they're now paying the price for years of unsustainable exchange rate and monetary policies. No country can simultaneously have freely flowing capital and control of both the exchange rate and monetary policy; only two of these three are possible, as theorized by Nobel prize-winning economist, Robert Mundell. For Asian central bankers, any mismanagement of inflation could erode much of the credibility that they have regained since the 1997 Pacific rim crisis.

“No country can simultaneously have freely flowing capital and control of both the exchange rate and monetary policy...”



Devastating flooding along the Mississippi River is reigniting soybeans back to their previous highs in May.

The impact of severe weather in the U.S. agricultural heartland is likely to cause even sharper increases in global food prices. Some of the best farmland is facing the worst flooding in 15 years as at least 18 more levees on the already flooded Mississippi River are at high risk of being overwhelmed this weekend, endangering small communities and farmland where decades-old flood protections are far below modern-day guidelines. Local farmers in Illinois said that the bad weather had delayed planting by up to five weeks, which would result in a much reduced crop of corn and soybeans. Some farmers expected their corn production to be down by as much as 50 percent from last year's level. Meanwhile, the airline industry's fight for survival in the face of soaring oil prices has triggered a massive jump in the price of a number of obscure and scarce metals that are used to improve the fuel economy of jet engines. Demand for metals such as rhenium, chromium, cobalt and titanium is booming. At current rates, metals such as rhenium are a boon to Chile and Kazakhstan, the largest miners of the metal.

“...at least 18 more levees on the already flooded Mississippi River are at high risk of being overwhelmed...”

ECONOMIC REVIEW

As gas prices skyrocket, attention has increasingly turned to speculators in the oil futures pits at the NYMEX. But far away from open outcry trading, hundreds of millions of barrels of oil futures contracts are traded electronically every day. More than 30 percent, experts say, exchanged in so-called “dark markets,” the exact size and scope unknown to U.S. regulators. “If you can trade out of the sight of U.S. regulators, you can manipulate these markets,” said Michael Greenberger, a former top staffer at the Commodities Futures Trading Commission, or CFTC, which regulates the trading of commodities like oil in this country. Greenberger recently told Congress that speculation is placing a huge premium on the price of oil. “There have been various estimates - anywhere from 25 percent to 50 percent,” Greenberger said. “People can actually corner the market and drive up the price,” said Sen. Maria Cantwell, D-Wash. “When there is no policeman on the beat, you know that crime can go up.”

More and more fingers are pointing at one of the least-known but most powerful foreign exchanges - the InterContinental Exchange, or ICE. By the end of 2007, the all-electronic exchange accounted for nearly a 50 percent market share of all global oil futures contracts, a total of 138.5 million contracts - up 49 percent from 2006. Today it boasts more than 2,100 individual traders representing virtually all of the major players in oil - banks, hedge funds, energy companies, investment giants.

According to a securities filing, two of those giants, Goldman Sachs and Morgan Stanley, were founding partners of ICE. “The fact that they started this shows the intent of where they wanted to go,” Greenberger said. “Which was to trade crude oil and energy products without any police in the United States supervising it.” That’s because it’s considered a foreign exchange. Taking advantage of a loophole created by the CFTC, the company says its energy futures business is conducted in London, it is not subject to U.S. laws. Over strong criticism, the CFTC agreed. All this despite the fact ICE headquarters are on the fifth floor of a building in Atlanta, it’s primary data center in Chicago, and nearly all its trades settled in U.S. dollars. “It is a charade, and ... it defies explanation,” Greenberger said.

In a statement, ICE CEO Jeffrey Sprecher said that ICE is committed to providing “the same visibility in our oil markets that exists for U.S. Exchanges,” and that ICE Europe is “fully regulated” by the British government. But British financial authorities are notoriously lax. Now Congress and others are asking just how much of the crude oil futures market is being manipulated by either excessive buying designed to drive up the price, or phony transactions that imply a supply problem that does not exist. Today, under pressure, ICE finally agreed to impose stricter limits on certain trading, shedding some much needed light on the dark side of oil.

Next Week’s Economic Calendar

U.S. consumer confidence by one measure is now at lows last seen in 1980, when inflation raged at double digits.

Date	Time (ET)	Statistic	For Period	Briefing Forecast	Market Expects	Prior
24-Jun	10:00 AM	Consumer Confidence	Jun	57.0	57.0	57.2
25-Jun	8:30 AM	Durable Orders	May	0.3%	0.0%	-0.5%
25-Jun	10:00 AM	New Home Sales	May	520K	510K	526K
25-Jun	10:30 AM	Crude Inventories	21-Jun	NA	NA	-1242K
25-Jun	2:15 PM	FOMC Policy Statement	-	-	-	-
26-Jun	8:30 AM	Chain Deflator-Final	Q1	2.6%	2.6%	2.6%
26-Jun	8:30 AM	GDP-Final	Q1	1.0%	1.0%	0.9%
26-Jun	8:30 AM	Initial Claims	21-Jun	NA	NA	381K
26-Jun	10:00 AM	Existing Home Sales	May	5.05M	4.96M	4.89M
27-Jun	8:30 AM	Personal Income	May	0.4%	0.4%	0.2%
27-Jun	8:30 AM	Personal Spending	May	0.7%	0.7%	0.2%
27-Jun	8:30 AM	PCE Core Inflation	May	0.2%	0.2%	0.1%

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MANAGED FUTURES NEWS

Sen. Joseph Lieberman on Wednesday unveiled three draft legislative proposals aimed at limiting speculation in crude oil futures markets, including one that would ban participation by big institutional investors. That proposal included the following prohibitions: Prohibit private and public pension funds with more than \$500 million in assets from investing in agricultural and energy commodities, whether traded on a U.S. futures exchange, a foreign exchange, or over-the-counter. Prohibit U.S. or foreign governmental entities or instrumentalities (such as public university endowments or sovereign wealth funds) with more than \$500 million in assets from investing in agricultural and energy commodities, unless the governmental investor is engaging in a bona fide hedging activity. A bona fide hedging activity by a governmental entity could include, for example, purchasing an oil futures contract to reduce the price risk associated with a government fleet's fuel consumption. Prohibit institutional investors, broadly defined, with more than \$500 million in assets, from investing in the commodity markets through a passively managed and broadly diversified index fund tied to physical commodities.

Six trade associations have issued a joint letter warning members of Congress that "hastily enacted initiatives" to limit speculation in commodity futures markets could lead to several harmful consequences, including the "exodus" of speculators to other markets. The six associations, which represent investment companies and pension funds as well as banks and brokers, endorsed efforts to increase funding for the Commodity Futures Trading Commission, and urged Congress to recognize the "critical role" of speculation in the commodity markets. The six associations consist of the Financial Services Roundtable, the Futures Industry Association, the International Swaps and Derivatives Association, the Investment Company Association, the Managed Funds Association, and the Securities Industry and Financial Markets Association.

In a pair of lengthy and sometimes testy closed-door sessions in the Senate last week, executives from Goldman Sachs and Morgan Stanley, two of Wall Street's largest investment banks, made the case that their multibillion-dollar investments in energy contracts have not led to higher oil prices. But the executives were met with skepticism and occasional hostility. "Spare us your lecture about supply and demand," one of the Democratic aides said, abruptly cutting off one of the executives, according to a staff member in the room.

Oil futures regulators in Britain and the United States have reached an agreement to impose the first trading limits on oil contracts changing hands on a London electronic exchange. The U.S. Commodity Futures Trading Commission and its British counterpart reached a deal with ICE Futures Europe to impose regulations on West Texas Intermediate oil contracts that trade on the London-based electronic exchange within 120 days, the CFTC's chairman told U.S. politicians Tuesday. The move will place more limits on trading of the U.S. benchmark WTI contract on the London exchange, which hosts up to 30 percent of total volumes. The New York Mercantile Exchange, which the CFTC regulates, has the rest.

It looks like it will take more than tighter regulation of oil trading in London to cool the fever for black gold. Oil-watchers were skeptical on Wednesday that a move by the United States Commodity Futures Trading Commission (CFTC) to close the so-called "London loophole" would take a decisive swipe at speculators. The CFTC wants to limit the amount of U.S. oil contracts held by investors on the InterContinental Exchange's London subsidiary--which is largely exempt from U.S.-style regulations--but its proposal crucially does not extend to European Brent crude contracts.

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