



Market Weekly

Commodities, Forex, Futures and Options

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HEADLINE OF THE WEEK: "Why \$120 oil is good" (CNMMoney.com, 5/8/2008)

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WEEKLY RECAP

- 1 Headline of the Week
- 2 Headlines Continued
- 3 Economic Review and Next Week's Calendar
- 4 Managed Futures News

"The possibility of \$150-\$200 per barrel seems increasingly likely over the next 6-24 months."

Crude oil rose above \$126 a barrel to a new record on May 9th, while at the same time oil and metal producers retreated on concern the surge in commodity prices will end. Last week it looked like oil prices were beginning to come back to earth as the dollar strengthened. But this began to change on Friday, May 2nd after a midday spike sent oil back up again. Another midday spike came after the release of a report from Goldman Sachs predicting that oil prices will rise to \$200 a barrel. The warning from analyst Arjun Murti carries weight as he correctly predicted in March 2005 when oil traded around \$55 that prices could suffer a "super-spike" to \$105 a barrel. "The possibility of \$150-\$200 per barrel seems increasingly likely over the next 6-24 months." The warning in 2005 was criticized as "self-serving" because Goldman Sachs is one of the largest Wall Street investment banks trading oil, and it forced the bank's chief executive at that time, Henry Paulson, to defend the bullish report. Mr. Paulson is now U.S. Treasury secretary. The crude oil futures market signaled a growing belief that \$100 a barrel is here to stay, with prices for oil to be delivered up to December 2016 trading above \$110 a barrel. Goldman said the unrelenting rise in long-dated oil prices was consistent with constrained supply driving demand rationing. So how does Goldman Sachs play the oil game?



An hourly chart of the June West Texas Intermediate oil contract shows midday spikes taking oil prices higher.

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Headlines from page 1

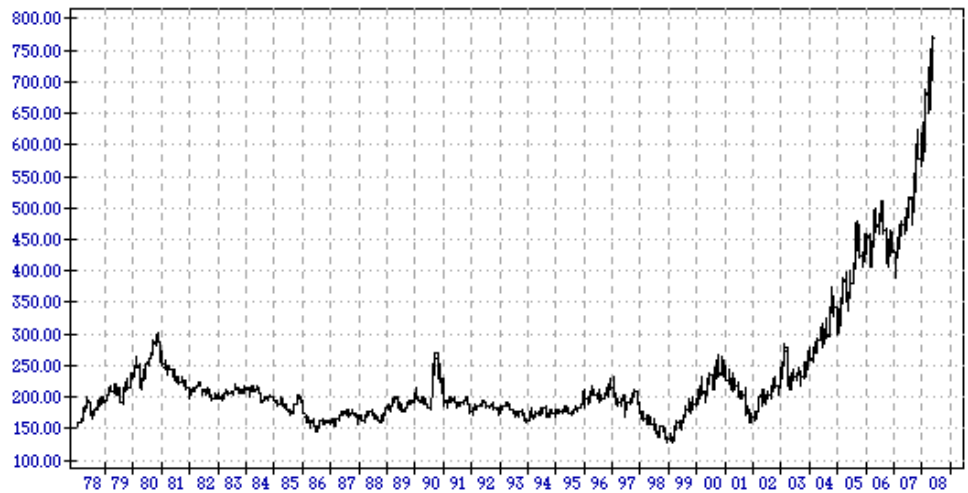
In an excellent article by Ann Davis of the Wall Street Journal from October 2007 titled, *Where Has All The Oil Gone?*, Davis explains how financial players like Goldman Sachs, Morgan Stanley, and others have gotten involved in the underlying cash commodity markets. The West Texas Intermediate oil contract which trades on the NYMEX, and which is the *de facto* benchmark for oil prices, is based on a storage and delivery point in Cushing, Oklahoma, “home to just 8,500 people if you count the 1,000 or so prison inmates.” Cushing holds 5% to 10% of the total U.S. crude inventory, and between 2003 and 2006 it became profitable to store oil rather than to sell it right away because of contango conditions. The game is to buy oil for immediate delivery and stick it in storage tanks, and then arbitrage the price by selling back-dated futures contracts at a higher price. When the delivery date on the futures contract neared, they closed out existing contracts and sold new ones for future delivery on the same oil. The maneuver is known as the oil-storage trade and the oil never budges. This is a relatively low-risk trade. However, in 2007 the situation changed and the oil markets became backwardated, which is when near-term delivery price for oil is higher than back-dated futures. Now it becomes more profitable to sell oil in the cash market and buy lower priced oil in the futures market. However, this is a somewhat more speculative proposition for players like Goldman Sachs, who also bears the name of a prominent commodity benchmark called the Goldman Sachs Commodity Index (GSCI). As reported by the New York Times on September 30, 2006, Goldman Sachs significantly readjusted in August of that year GSCI’s gasoline weighting. Index products tracking the GSCI, and representing at the time an estimated \$60 billion in institutional investor funds, were forced to rebalance their portfolios resulting in an unwinding of positions. As a result, gasoline fell 82 cent in the wholesale market over a four-week period, an unprecedented move; and crude oil, which in July 2006 traded over \$79 per barrel for August delivery—at the time an all-time record—subsequently fell to around \$56 by January 2007. Subsequently, Goldman Sachs sold its index business to Standard & Poor’s including the GSCI commodity index family. Cynical minds might point to Goldman Sachs recent report as a means to reset the oil-storage trade. While the notion of an analyst single-handedly having the power to muscle the oil market is highly questionable if not improbable, we find it interesting to understand how the “big guys” play the game.

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Monthly Goldman Sachs Nearby Index



This monthly chart of the GSCI shows how commodity prices since 1978 have mostly stayed in a range, until...

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ECONOMIC REVIEW

The sharp increase in the price of staple foods is an inconvenience for consumers in the rich world, but for those in the poorest countries it is a catastrophe. Paradoxically, rising food prices is a result of the success of globalization in reducing world poverty. As China develops, helped by its massive exports to our markets, millions of Chinese household have started to eat better. Better means more meat, but to produce a kilo of meat takes six kilos of grain. The remedy to high food prices is to increase food supply, something that is entirely feasible. The most realistic way to raise global supply is to replicate the Brazilian model of large sophisticated agro-companies supplying for the world market. Unfortunately, Africa cannot afford this approach and development agencies have oriented efforts on agricultural development to peasant-style production. As a result Africa has less large-scale commercial agriculture than it had 50 years ago. Not surprisingly,

African agriculture has fallen further and further behind the advancing productivity frontier of the globalized commercial model. Meanwhile, in the U.S., fears of climate change resulted in legislation which subsidizes inefficient production of food for biofuel. Europe has its equivalent follies, and is imitating the American bio-fuels policy while also banning genetically modified crops. America and Europe can afford bad policies, but the consequence of this reduction in productivity has rebounded on to world food markets. At the same time, certain governments in grain-exporting countries have swung prices in favor of consumers and against farmers by banning exports. These responses further politicize and fragment the global food market. Policies have increased the risks of investing in commercial-scale food production, and as a result driven up prices in food-importing countries. (Paraphrased from op-ed by *Paul Collier*, economist)

Next Week's Economic Calendar

Let's take a guess... crude oil is solidly above \$120, but the CPI will come in lower than market expectations.

Date	Time (ET)	Statistic	For Period	Briefing Forecast	Market Expects	Prior
12-May	2:00 PM	Treasury Budget	Apr	NA	\$157.5B	\$177.7B
13-May	8:30 AM	Export Prices ex-ag.	Apr	NA	NA	1.2%
13-May	8:30 AM	Import Prices ex-oil	Apr	NA	NA	1.1%
13-May	8:30 AM	Retail Sales	Apr	0.0%	0.0%	0.2%
13-May	8:30 AM	Retail Sales ex-auto	Apr	0.5%	0.2%	0.1%
13-May	10:00 AM	Business Inventories	Mar	0.3%	0.5%	0.6%
14-May	8:30 AM	Core CPI	Apr	0.2%	0.2%	0.2%
14-May	8:30 AM	CPI	Apr	0.3%	0.3%	0.3%
14-May	10:30 AM	Crude Inventories	10-May	NA	NA	5654K
15-May	8:30 AM	Initial Claims	10-May	365K	NA	365K
15-May	8:30 AM	NY Empire State Index	May	0.0	1.0	0.6
15-May	9:00 AM	Net Foreign Purchases	Mar	NA	NA	\$72.5B
15-May	9:15 AM	Capacity Utilization	Apr	80.0%	80.2%	80.3%
15-May	9:15 AM	Industrial Production	Apr	-0.4%	-0.2%	0.3%
15-May	10:00 AM	Philadelphia Fed	May	-20.0	-20.0	-24.9
16-May	8:30 AM	Building Permits	Apr	900K	912K	927K
16-May	8:30 AM	Housing Starts	Apr	940K	940K	947K
16-May	10:00 AM	Mich Sentiment-Prel.	May	65	63	NA

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MANAGED FUTURES NEWS

ELX Liquidity Exchange, the startup that plans to challenge CME Group Inc.'s dominance in financial futures, is in final negotiations with Chicago-based Clearing Corp. for the critical job of guaranteeing its contracts. The impending clearinghouse agreement is the first concrete sign after months of silence that ELX, whose owners include Wall Street banks such as Citigroup Inc. and Chicago hedge fund Citadel Investment Group LLC, is nearing a launch.

On Wednesday, May 7th, they finally took Bear Stearns out behind the woodshed and ended its lingering misery. On that day, the plaintiffs' attorneys in the last remaining viable lawsuit in New York against JPMorgan Chase and Bear withdrew their motion for a preliminary injunction to halt the JPMorgan acquisition. Instead, the lawyers stated that they will pursue monetary damages. There is one more suit pending in federal court but it does not look significant.

Soaring prices for oil, gasoline, grains and other commodities are not the result of market manipulation, the top U.S. futures market regulator told Congress on Wednesday. "Broadly speaking, the falling dollar, strong demand from the emerging world economies, Mideast political unrest, detrimental weather and ethanol mandates have driven up commodity futures prices across-the-board," said Walter Lukken, chairman of CFTC. "To date, CFTC staff analysis indicates that the current higher futures prices are generally not a result of manipulative forces." However, a review of comments by the agricultural community show that many do not agree: http://www.cftc.gov/newsroom/cftcevents/2008/event042208_comments.html

NYSE Euronext (NYX), the international exchange operator, said that it hoped to secure a license to operate a U.S. futures platform by the third quarter of this year. The company operates equities exchanges in Europe and the U.S. and is looking to leverage the position of its London-based Liffe derivatives business in North America. In March, NYSE Euronext acquired the gold and silver futures complex from CME Group Inc. (CME), providing a launch pad for a U.S. futures operation.

When it comes to investing, hedge funds can do almost anything. They just can't talk about it. In return for the right to rely on trading techniques that are largely off limits at mutual funds, hedge funds have for decades been prohibited from marketing or advertising broadly. Now some managers in the \$1.8 trillion industry are pushing for new leniency -- not to sell themselves but at least to tell a little bit more about themselves. Fund manager Philip Goldstein, best known for a landmark lawsuit that rolled back U.S. financial regulators' rights to watch hedge funds more closely, is leading the charge.

The CME Group Inc. (CME) said Monday it's investigating a "data issue" that fueled wild volatility in its futures markets overnight. The issue led to wider-than-normal trading ranges in a host of markets, including Chicago Board of Trade grains, traders said. It also affected the futures markets for CME equities, CBOT bonds, Comex gold and CME Eurodollars, market participants said. A CME spokeswoman confirmed there was an issue in "multiple markets" but wouldn't specify which markets were affected, outside of the grains. "There was a data issue," Haffenberg said. "No trades were busted. We're still investigating it. It was not a CME data issue." The CME is investigating "the entire incident," she said. "It's difficult to comment on an ongoing investigation until we have all of the information." Traders watching the markets Sunday night said they were surprised to see sharp moves in prices. A CBOT floor trader said he was watching the soy meal market and saw prices swing suddenly. The volatile activity occurred around 9:20 p.m. EDT Sunday and lasted about a minute. For example, in July CBOT wheat, the range was about 40 cents within one minute. Questions about the source of the data issue remained even after Monday's day session ended.

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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