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Agricultural Outlook Forum  
U.S. Department of Agriculture

Presented: February 24-25, 2011

## Triumph, Tribulation, and Collateral Damage

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## Triumph, Tribulation, and Collateral Damage

Of all the changes that have come to our market over the past ten years, if you can forget about the near non-stop trading on our electronic exchange, and I would rather that you did, surely the biggest is the emergence of large pools of investment funds into our small world. A generation ago, the notion that private investors and, horror of all horrors, retirement and pension funds. place some of their money into our universe could not be discussed with a straight face. But that is exactly what has happened, and to now what seems like an unimaginable figure of about \$350 billion and counting, if you can believe the best efforts of Barclays Bank to keep score.

The analysis that opened the door for this was work that determined that commodities as a group had a negative correlation with equities. In other words, if the stock market was going down, it was more than likely that commodities would not move in the same direction, and that by including the group, overall negative performance might be improved. Since about 2000, commodities have had a correlation of about .6, suggesting that their movement would be more or less positively correlated with equities, but the move was on, and Wall Street had built up the momentum to deliver its

capital into our world. It was all framed in nice, polite language, with the suggestion, hard to deny, that commodities, as an asset class—note the highfaluting language—belonged in a portfolio, whether it be that of the common garden variety rich (we now call them “high net worth”) investor or the holy of holies, CALPERS, the California Public Employees Retirement System, with its 1.6 million investors and its portfolio of over \$200 billion. It’s easy to see that if a fund of that size sticks its toe in the water with, say, at the most, 1%, and who could challenge such a tiny bit of diversification, it doesn’t take long for the investment pools of money to reach the \$350 billion mark, and surely it will continue to grow and grow.

Naturally the wise people in our market, including the CFTC, would like to measure the extent of this investment, doing their own work rather than trusting banks. And since the CFTC has long kept score on market participants, providing us with a transparency unheard of in the securities markets, the agency finally got around, after much clamor for additional data, to setting up new category for swaps, for managed money, and for index funds. Those classifications could not be expected to embrace the entire \$350 billion of new investments, but this was a good start.

And the minute the numbers were released, a witch hunt got underway for the new villains out there. Speculation has always been the dirty word in our business, as much as the academics continue to reassure us that it is needed, but now that has been supplanted by investment funds, traditionally a force for the good, as I have been raised to believe, but now turned into pure evil. And once we could see the size of the index funds, for they were the easiest to measure, the hunt really heated up.

The first salvo in the attack was launched by an investment fund manager who just so happened to be long airline stocks and was severely chastened by their plunge, all in response to sharply higher fuel costs. The futures industry, instead of being buoyed by stories of how Southwest Airlines, in particular, hedged itself against the possibility of higher costs by the use of various derivatives, was immediately on the defensive. That salvo was rejected by the wise economists at the CFTC, and in the face of renewed attacks from other segments of the market, as you can well imagine in these days of \$2 cotton, the efforts to destroy the market will be deflected. Let's look at some numbers as they apply to cotton and this recent market. When the data was initially collected, at the start of 2006, index fund traders, long only, never mind the small amount of shorts, held 51,300 contracts, or 35%

of the total open interest. When cotton exploded in the first week of March 2008, trading over \$1, the index fund participation had risen to 123,000 contracts, though that was only 22.5% of the open interest. The increase was significant enough to suggest that funds were the culprit in the unforeseen price explosion, though I believe that it only reflected a continued passive flow of funds into all the markets, and that the cause of that explosion was, to a large part, the fault of excessive speculation on the part of the merchant community.

Now fast-forward to the first week of August last year, when the market first poked its head above the 80¢ level for keeps, never looking back. Index funds at that time had reduced their stake in the market from 123,000 contracts to just shy of 78,000 contracts, 31% of the open interest. During the subsequent run-up to the \$2 level, those funds, using data only a week old, slowly reduced their position to just over 64,000 contracts, less than 20% of the open interest. It hardly seems as if they were the bad guys.

Continuing the line of discourse that says that speculators are responsible for this blow-up in prices, we should test that theory with the traditional CFTC category for large specs, the so-called non-commercial longs. A few weeks

after the break-out of prices in early August this year, that category had swollen to almost 80,000 contracts, up a full-third in just a few weeks. No doubt that specs were entering the market in large numbers, though they never reached the levels from early 2008. The high-water mark in spec participation came when cotton reach \$1 in the middle of September. Since that time, the size of the spec involvement in our futures market has slowly unwound from the near-80,000 contract level to the high-40's, and stood at 48,472 contracts on last Friday's report. We could do the same analysis with the category for managed futures and still come up with the same conclusion. This advance in price should not be hung around the necks of speculative, much less investment capital...and in fact, perhaps they did not take as much advantage of it as they could have.

The same evidence waits for us in the other markets. Just to use an easy one, our biggest ag market, let's look quickly at corn. Prices crossed the \$4 level for March futures in early July, with index fund positions at 490,000 contracts, 34% of the open interest. With prices making a new high of over \$7 at the end of last week, index funds held 493,000 contracts, almost exactly the position they had when the advance started, but now only 16.5% of the open interest. This new breed of investor is a passive one, content to

stay with its commitment for the long term, much as it had done with blue chip equities over the years, for better or worse.

Well, we have to blame somebody for what happened, don't we? After all, we'll be paying a good bit more for T-shirts in a few months, and you'll be paying a good bit more for blue jeans. And not to make light of the problems, the world will be paying a good bit more to feed itself.

Of course, as every one knows, these markets have been demand driven, China being the biggest factor, with its enlarging appetite coming at a time when supply has been impacted by weather. At the same time, we should know that world cotton production for the current season of 115¼ million bales compares to the USDA initial estimate last May of almost 114 million, crops coming in slightly larger than the initial estimate despite weather issues. And similarly, this season's consumption of 116½ million bales compares to the 119 million bales in the May estimate. I would be hard-pressed to find a year in which the USDA work held up so well. So, consumption is less and production greater than originally estimated, yet prices rose from 80¢ to \$2 in that time. What in the world happened?

The big statistical change is in the season=ending stocks number, which now stands at about  $7\frac{1}{4}$  million bales less than originally estimated, with almost  $\frac{2}{3}$  of that reduction coming in China.

But that doesn't answer the question of why we are up here. There must be some culprit, someone to blame for all this. Even the ICAC, with its well-constructed and difficult-to-explain formula for predicting prices, didn't see it coming, plugging in 85¢ in May and staying with that for a full third of the year, barely keeping in step with the futures market.

The most extraordinary characteristic of this market, at least in my opinion, is that it advanced from \$1 at Thanksgiving time, basis the March contract, all the way to \$2 without a single piece of news. No weather calamities. No explosion in crude oil or gold, no destruction of the dollar. The dollar is down less than 3% in this time, gold up less than 2%.

We have to blame this advance on someone....after all, someone is always at fault. And who could be that culprit if it is not the specs. And it is particularly not the specs as we know them, since almost every serious

economist whose work I have seen calls this advance a reflection of fundamentals, and never uses the word “speculation.”

Could it possibly be the textiles industry itself? How much blame should they be assigned for what has happened.

You be the judge. Let's look at the CFTC cotton on-call report, which has faithfully collected data of on-call purchases by mills and on-call sales by growers for longer than any of us can remember. (Parenthically, let's suggest it dates from the 1930's. All the old records were kept in the New York office of the CFTC and were destroyed on 9/11.) For the second week of August, when this price advance started, mills had 80,161 contracts of mostly current crop cotton to fix. That's eight million bales. It compares to an average of slightly over five million bales for the same weekly period during the prior five years. That average of just over five million bales was only 2.7 times the amount of on-call farmer sales to be fixed for that period, but the current on-call purchase data was 6.7 times the amount of on-call sales. Of all the numbers we had never seen before, this is the most shocking one. There has never been such a huge amount of cotton that had

to be fixed by buying futures, and such an over-whelming preponderance over what needed to be sold.

As the market advanced in August from 80¢ to the \$1 level basis March seven weeks later, that number has swollen to 10 million bales, and didn't stop growing until it reached 12 million bales the first week of November, by which time the price of March futures had sailed over the \$1.50 mark. At that point, the unfixed sales to mills were 17.5 times the unfixed call purchases from growers. Of all the record-breaking numbers we've had this seen, that is perhaps the most astonishing. The textiles industry was engaged in a death wish, hoping that prices would go back to earlier levels and ignoring all evidence that the fundamentals of supply and demand were screaming for higher prices. In effect, they were digging themselves deeper into a hole as the market advanced rather than making an effort to climb out of it.

In truth, when the USDA first published its projection of US ending stocks for 1.9 million bales in early December, that should have been the biggest alarm that had ever gone off in the market. The textiles trade just ignored the truth and their minds went on strike. The 8.3 million bales remaining to

be fixed when that December report was issued was reduced by only 25% over the next two months and the next 50¢. Talk about tribulations. Talk about collateral damage. Talk about tears.

So you at least know what I think about the role of the speculator in this market. I may be all wrong, but I don't think so. The price went up to \$2 because of fundamentals. The speculators played a role in that price rise, but not traditional speculators like my old friends. The speculators were all in the textiles trade, and they missed the biggest move in the history of the market, and by missing it, helped bring it about.

But it's all so clear looking back. How about looking forward? Where are we going to be, not later this spring or next year, but way down the road?

In a presentation made to the ICAC seminar on price volatility a few weeks ago, John Baffes, an senior economist at the World Bank with the Development Prospects Group, presented a number of charts that showed ag and cotton correlation with other markets. Perhaps the most interesting one to me was the one that showed a positive correlation of cotton to crude oil.

In that vein, a well-argued paper that appeared in a financial periodical just this past week suggested that crude oil prices could go the \$300 a barrel by the end of this decade. That's a long time from now, but does that suggest that cotton could find a home at around the \$2 mark down the road? Or to paraphrase a friend's new book asking if 50 (her age, of course) were the new 30, will \$2 be the new 70¢?

For years, a good average price for cotton futures was 70¢. After trading up to 99¢ in 1973 and then back down into the 30's in a year-and-a-half, then up to \$1.17 in 1995 and all the way back to 50¢ in 1999, it traded on either side of 50¢ until blowing up to \$1 in 2008, came back to 40¢ in '08 and '09, and now look at it.

If 60-70¢ was the norm for cotton, then \$2.50 was the norm for corn, if you'll forgive a blow-up to \$5.50 in 1995, then a return to under \$2.00, an explosion to \$8.00 in 2008, a return to less than half of that, and now this.

The norm for soybeans was more or less \$4.50-5.50 until it exploded to \$9.00 in 1995, came back to almost \$4.00, finally traded into the teens in

2008 when it topped \$16.00, then returned to half that in less than a half year.

If there is some relationship to crude oil, what can we make of the suggestion that oil will trade at \$300 a barrel by the end of the decade? Does that equate to \$2 cotton for real, to \$20 beans, to \$8 corn? That's the challenge, of course. There are those who say that our markets will absolutely never ever return to familiar prices, that the cost of production, thanks to high energy prices, will not let that happen. At the same time, we have to remember what has happened when our own pipelines get replenished, when there is a break in the weather and a softening of demand. It happens, you know, it always has, and it happens so fast. The consensus in the industry is that we will never go back to the old-time price levels. Never say never. It comes back to haunt you. And who can forget the old adage in this trade, that the best cure for high prices is high prices?

In short, referring to Carol's title, the triumph of the market was the triumph of demand and the triumph of fundamentals. We all shared in the tribulations. The damage, more than collateral, I fear, was to the speculators

who paid no attention to the facts of the matter and were left holding the bag. A cotton bag, perhaps, but there is very little left in it.