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STRUCTURAL CHANGE IN THE AGRICULTURAL FUTURES MARKETS?

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(The views expressed herein do not necessarily reflect the official opinion of AMIS)

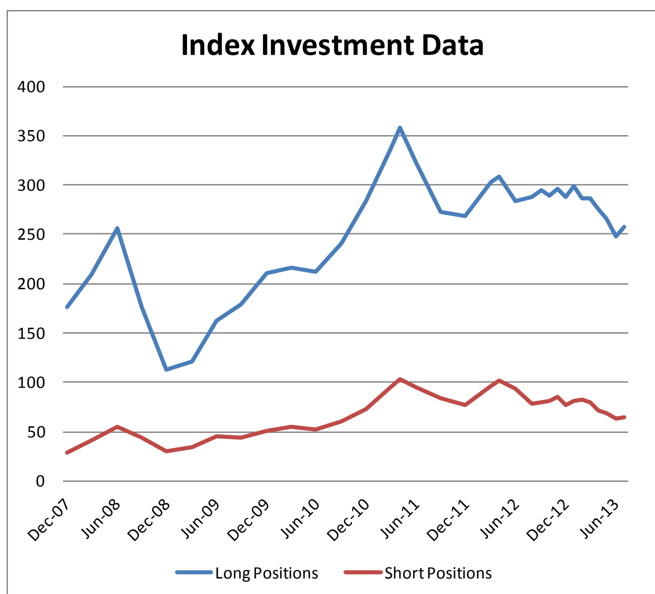
1. The tide of financial flows into commodities markets, seemingly unstoppable over the past decade, appears to be ebbing. The simplest explanation for the cooling commodities enthusiasm is a significant price decline across several sectors. However, the reality involves many complex variables, including federal regulators' re-examination of the banking sector's commodities activities, allegations of commodity price manipulation in the energy and metals markets, a review of high speed computerized trading and rising interest rates following a signaled change in monetary policy by the US Federal Reserve. Also, unusually high prices and price volatility between 2007 and 2012, particularly in the agricultural sector, launched a public debate over the effects of speculation, helping influence policy makers in both the US and European Union to reverse the deregulatory trend present throughout the 2000s.

2. Although the published figures related to commodities trading activity, such as over-the-counter (OTC) markets, bilateral cash markets and futures and other derivatives markets are incomplete, current information available – both public and private – indicates that commodities trading by non-commercial entities is in a downtrend. Because several types of traders comprise the non-commercial participants in commodities trading, including index fund investors, hedge funds, commodity trading advisors (CTAs), bank proprietary trading desks, and small speculators (not addressed here), each type can be viewed separately.

3. Index investors are relatively new participants which have poured money into commodity index funds over the last decade. Index funds track the movements of various commodities prices, and are marketed as an attractive alternative to bonds or equities. Similar to mutual funds, index funds are based on a basket of commodity futures contracts traded on US futures exchanges. Securities firms and investment banks which select the basket components then transform them into marketable securities, usually investment trusts, basing the fund share price on a formula of the weighted futures prices in the basket.[1] A fund manager is responsible for replicating the futures positions comprising the basket. Other securities tracking commodity prices developed over the past few years are exchange traded funds (ETFs) or exchange traded notes (ETNs). Most of the newer funds are commodity sector specific, allowing customers more product choices. Graph 1 shows that investments in commodity index funds, ETFs and ETNs peaked in April 2011. It has declined gradually for two years –experiencing an outflow of 33% as of June 2013. The overall decline of commodity prices

[1] The Stand and Poors Goldman Sachs Commodity Index Fund (S&P GSCI) is the most widely recognized of this type of investment.

Graph 1 – CFTC index investment data - Dec 2007– July 2013.



has been the most important factor in this trend, particularly during in the first half of 2013, when the highly subscribed gold ETFS experienced the largest outflows and price declines in over 8 years. Other commodities such as aluminum and copper, cocoa, sugar and coffee hover around multi-year lows. In grains, the maize market has declined the most – and as of September 2013, has lost about 40% of its value since mid-2012.[2]

4. The commodities sphere of managed money which had its beginnings in 1980 includes hedge funds, CTAs, and bank proprietary trading desks. Although the reporting requirements and operating protocols differ among them, essentially their aim is to generate profits by trading futures contracts using long, short or spread strategies.[3] As reported in FAO Food Outlook (June 2013), commodity hedge funds and CTAs have performed poorly for 2011, 2012 and the first half of 2013, although some private services report that pure agricultural funds, which are dwarfed by the diversified commodity funds in terms of assets under management, have returned a small profit during the same time period. Significantly, the CFTC has recently announced that it is developing a roadmap to rein in high frequency trading (HFT), which it views as potentially disruptive to markets. HFT is estimated to account for half of all futures trades on US exchanges, its largest users being hedge funds and banks. European regulators addressed HFT and other computerized trade programs in 2012 by issuing guidelines on the issue.

5. Among all of the entities that manage money by trading futures, banks have come under the greatest scrutiny of regulators and policy makers. A series of enactments and rulings in the US in the early 2000s allowed banks to trade commodity futures and later enter the actual physical business of storing, handling and transporting commodities. According to the filings with US Securities Exchange Commission (SEC) by the top 10 banks, these activities have been profitable year on year although

[2] As of September 2013

[3] The simultaneous purchase and sale of two different contract months within the same futures product, e.g. buy July wheat and sell December Wheat in equal quantities.

banks reported a 25% drop in revenues from commodity related activity for the first half of 2013 from the same period a year ago. More significantly, multiple regulatory agencies are investigating banks on a variety of market pricing issues that involve basic commodities. In April this year, the US Federal Energy Regulatory Commission charged 2 major banks with electricity price manipulation. One bank settled the charges for a record enforcement fine of $425m.

6. More recently, a scandal has engulfed some of the banks over their ownership of aluminum warehouses situated in the US that are registered as delivery houses for aluminum futures contracts under the London Metals Exchange.[4] Complaining of a 12-16 month wait time for accessing their aluminum from the warehouses, aluminum end-users allege that several banks (along with other trading companies) are manipulating the metal's price by deliberately restraining the amounts loaded out in order to maximize revenues from storage. These allegations have prompted a US Senate hearing, multiple class action suits, investigations by the US Department of Justice and the UK Financial Conduct Authority and a series of subpoenas from the Commodity Futures Trading Commission (CFTC) ordering document preservation. Not surprisingly, two of the largest banks in the commodity space – JPMorgan and Morgan Stanley have announced that they are exiting the physical commodities business and closing their proprietary trading desks, although they will likely maintain their sizable commodity futures brokerage businesses. In the meantime, the Federal Reserve is reviewing its 2003 ruling allowing banks to own commodity infrastructure, such as warehouses, pipelines or power plants and the SEC appears to be pushing to implement the "Volcker rule" which would disallow proprietary trading in all sectors by banks. Although statistics on the yearly trade volume levels by banks are not available, most experts expect that banks' commodities departure will likely depress volumes. In the agricultural markets, despite a hefty rebound in production and corresponding need for more producer and end-user hedging, year-to-date trade volumes 2013 vs. 2012 have declined by 10

Graph 2: Volumes (Jan-Aug 2012 vs Jan-Aug 2013)

[4] The LME was acquired by the Hong Kong Exchange in 2012

– 20 %, indicating a drop in speculative trading by banks, hedge funds and other non-commercial traders.[5]

7. Finally, higher interest rates first signaled in May 2013 by the US Federal Reserve have reverberated globally, sharply reversing the decade long period of investment flows into emerging markets, pressuring their currencies and equities markets. This phenomenon has the potential to dampen further the commodity "super-cycle." Because commodities are denominated in US dollars, weakening currencies in emerging markets that are large importers make commodities procurement more expensive. Although most commodities have declined, oil prices remain stubbornly high in terms of US dollars per barrel, potentially slowing GDP growth in energy deficit regions.

8. Commodity cycles occur with frequent regularity. Although history will judge whether the current cycle is ending, the unprecedented breadth of participation from small retail investors and large pension funds to vast banking enterprises appears to be receding. Low profitability and expectations of higher interest rates are partly responsible. A broad-based inquiry by multiple US and European Union regulators into commodities trade practices and participants is a new development, and depending upon the outcome of forthcoming rulings, may substantially alter the whole commodities business that has extended over the last decade. Markets, particularly agricultural markets, which enjoy greater levels of small producer participation than metals and energy markets, may revert back to a more customary balance between bona fide hedgers and speculators that has traditionally helped price discovery.

[5] Rice futures volumes, too small to be included in the graph, also declined by 26%.