Financial flows in commodity markets

There is a difference between

1. Informed speculation
2. Cornering the market
3. Creating rents
Accusations against speculation are not new – the Agrarian Movement, some quotes
from "The Chicago Board of Trade 1859-1905", Jonathan Lurie, Univ of Illinois Press, 1979

"We are profoundly impressed with the conviction that the gigantic gambling device known as short selling, in which one party agrees to sell what never did and never will exist, and the other agrees to buy what he knows is never to be delivered to him, has been a potent cause in producing the ruinous agricultural depression from which the country has suffered", from a print 1892

"By the combined action of certain persons… organised into… Boards of Trade, the prices of all kinds of farm products are so manipulated and depressed that they cannot be produced except at a loss to the farmer", the Hurricane Grange No. 359.

Butterworth Bill of 1890: a dealer pays $1000 pa for the privilege to trade in futures and options, 5 cents / lb of cotton, 20 cents / bu of grain bought or sold.
Hatch Bill of 1892: $2000 pa + 20 cents / bu of grain. (passed the House easily. Was sent back from Congress with amendments), failed to get 2/3 majority with a small margin in 1893.

Why did it not pass?

CBOT: Produce gambling "bears about the same relation to legitimate commerce and speculation… that the froth and foam of the Niagara do to the almighty volume of water underneath. It is the bubble and fuss and fury, the froth and foam upon the surface that offends, not commerce itself", DP April 29, 1890.

"How in the world a farmer can be benefited by the passage of such a measure… is beyond us", Northwestern Miller, January 22, 1892

Farmers were quite active speculators, Prairie Farmer wrote on Dec 27, 1884: "What is wanted now, is for farmers to hold back all the grain they possibly can, and hold on to it".

The reason most cited for not interfering in the commodities markets was that "the ethical distinctions involved between legitimate and illegitimate speculation are not easily reducible to exact legal definition", Newman Smyth, Forum 19, 1895.
Assets under management

USD bn

Index AUM
Total Commodity AUM
ETP AUM

Source: SEB, Barclays

AUM for the largest ETPs

Basemeats
Other Precious
Gold
Energy
Agri
Index

Source: SEB, Bloomberg
Flow Energy ETPs

Energy ETPs and price change

Flow

\[ y = -684.54x - 96.964 \]

\[ R^2 = 0.0089 \]
Powershares DB Agriculture, the largest Agri ETP in the world, weekly data from 2007

Granger causality goes from price change in wheat to ETP flow. ETP flow statistically has the *opposite* price causation!

Flow actually causes price to go down!

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Price change causes flow

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Weekly data from 2007
What about non-commercials in CFTC data?

Share of open interest held by "Swap dealers" in the latest COT report
Correlations between price change and change in (# of) contracts held by non-commercials (weekly data) for corn

Since 1994

Dito 2008-2009 (an unusual credit crunch as common factor affecting all things)
Dito for corn since 2010
Price change causes change in speculative position

Is there some other common factor behind commodity waves?
Share of global population with GDP per capita between 2000 and 13000 dollars

The sum of GDP for countries in the growth zone for GDP/capita as explanatory variable
Crude oil (black) explained by the "Emerging market GDP indicator" and US CPI

10 year rolling correlations between the "emerging market" indicator and the volatility of Chicago wheat prices
Conclusion

The importance of financial flows is greatly exaggerated.

The fundamental and powerful demand force caused by the modernisation of half the world’s population does not get the attention it should.

If you want to read more on this, there is for example:

Scott H. Irwin and Dwight R. Sanders, “The Financialization of Commodity Futures Markets or: How I Learned to Stop Worrying and Love the Index Funds”, October 2010 (http://ssrn.com/abstract=1699793)