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**"The psychology that creates a bubble… feeds it."**

# The Role of "Index Speculators" In The Current "Commodity Bubble"

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## *What is the stock market's message?*

**NEWS ANALYSIS**

**By Norman F. Klopp, CFA, Partner and Elmer L. (Al) Meszaros, CFA, Partner**

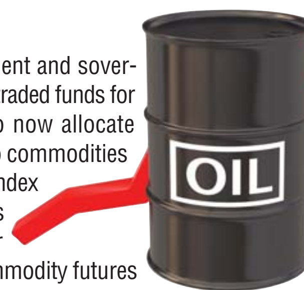
A new category of participants in the commodities future markets is helping fuel the five-year surge—a "demand shock"— in commodity prices and it's not the "usual suspects," a subcommittee of the U.S Senate Homeland Security and Governmental Affairs Committee was told in late May.

The "usual suspects" are a weak U.S. dollar; ethanol mandates; China; India; plus emerging markets in Europe and Asia.

In reality, the forces behind the "demand shock are coming from a new category of participants in the commodity futures market, namely institutional investors." said Michael Masters, managing member of Masters Capital Management LLC, a firm that manages a family of alternative assets and is based in St. Croix, USVI.

*On June 20, 2007, a barrel of light, sweet crude oil for future delivery was priced at $68.00. One year later, on June 20, 2008, the price increased to $135—a 97% increase.*

*Source: New York Mercantile Exchange (NYMEX)*




"Pension funds, endowment and sovereign wealth funds, exchange traded funds for individuals and others who now allocate 2% to 12% of their assets to commodities via the futures markets are 'index speculators'", said Masters because they distribute their allocation across 25 key commodity futures according to popular indices, mainly the S&P Goldman Sachs and the Dow Jones-AIG Commodity Indices.

These speculators control 40% of future contracts, making them the largest participant in this market. They buy commodities because, since the bear market of 2002, mainline consultants began looking at commodities as a new asset class "uncorrelated" to movements in stocks and bonds. For the first time, investors could "buy and hold" commodities futures just like stocks and bonds.

*We believe, however, that this strategy is a naïve and a flawed belief that commodity prices increase over the long run. In fact, the 100-year history of commodity prices in the U.S. shows the opposite: adjusted for inflation—except for occasional spikes—commodity prices follow a flat to declining trend, decade after decade.*

### Historical growth

In 2003, $13 billion was invested in commodity index trading strategies; today that amount stands at $250 billion, a near 20-fold increase as the 25 commodities in these indices rose 183%. The risk is that hundreds of billions more may be poised to come in, assuming a 3% allocation of $29 trillion in worldwide equities.

The behavior of index speculators is different from traditional commodity participants who are the producers and commercial hedgers. Index investors are insensitive to price; they simply buy as many future contracts as they need, at whatever price necessary, to put "money to work". Also, they rarely sell, typically buying futures and then rolling them forward, creating net one-way demand as more dollars flow-in to be invested.

### Important size comparison

Compared to the equity markets, the commodity markets are small. In 2004, the value of futures contracts was $180 billion compared to *$44 trillion* in the world securities markets, meaning traditional investing is 240 times larger. Thus, a small shift in allocation can have a big impact on commodities.

As a result, it has been recognized since the Commodities Exchange Act of 1936 that position limits are necessary in the commodities markets. However, the Commodity Futures Trading Commission (CFTC) granted exemptions to these new "institutional" investors that allow them to

*Continued on page 2*

# The Role of "Index Speculators"... (Continued from page 1)

take positions well in excess of traditional trading limits. *This is a source of the problem.*

### Possible solutions

In his Senate testimony, Masters advocated closing the position limits loophole, forcing all speculators to face position limits. Sen. Joe Lieberman, (I-CT), has convened a panel to consider closing the swaps loophole. Masters also recommended that Congress modify ERISA regulations to prohibit "index replication strategies", believing they are unsuitable investments because of damage to commodities futures markets. (In our view, however, this could be controversial and difficult to enact).

*Masters would like the CFTC to assert regulatory control over all commodity platforms operating in the U.S. as a first step to reclassify physical hedgers from speculators who would be subject to margin requirements.*

### How will it end?

Commodity bubbles tend to feed on the emotions of their existence. Therefore, timing their end is difficult. But, we know with certainty that they do end. Here are three possible scenarios:

### Scenario I—The Bubble Bursts

This would likely result from a combination of economic and regulatory factors impacting supply and demand in the global cash commodity markets and the structure of the futures trading markets. On the economic side this would include:

- Further slowing of economic growth rates in the developing countries, particularly China and India.
- Accelerating weakness in the economies of the U.S. and Europe.
- Revision of excessive Russian taxes that are limiting oil production.
- Higher global agricultural production as a result of higher prices.
- Accelerating strength in the dollar

On the regulatory side we could see:

- The CFTC enforce the position limit regulation for all investors, to limit the impact of currently exempt investors.
- Margin requirements in the commodity futures markets increased significantly.
- The current moves by some foreign governments to limit speculative trading expanded.
- The U.S. government change various subsidies and tariffs surrounding ethanol production and importing.

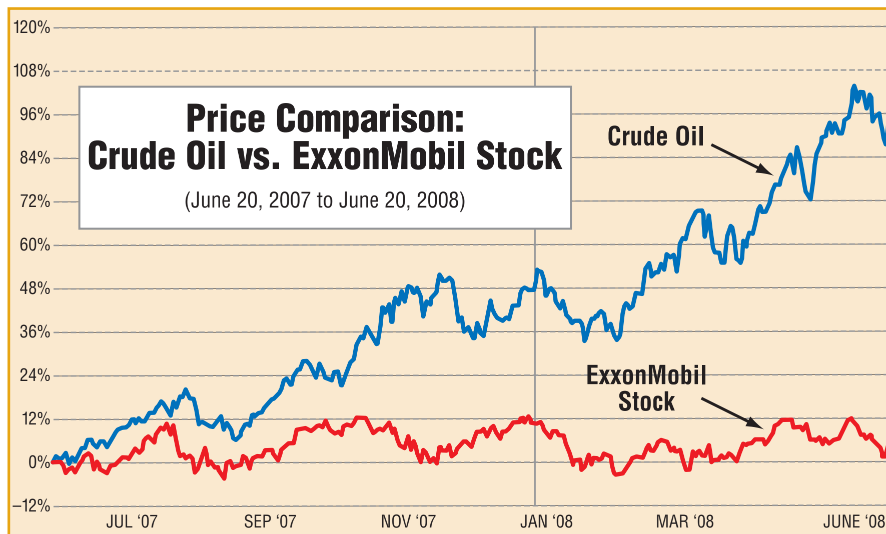
Each of these factors would put some pressure on commodity prices that, collectively, could be significant. In addition, it's likely the market psychology that caused the bubble would reverse quickly as "investors" sensed a risk, or collection of risks, that were ignored previously. *In this environment, prices declines of 30% to 50% would be possible.*

### Scenario II—The Bubble Continues

Because it's difficult to call the end of a bubble, it's possible we are only part way through this one. We may have 20% to 30% further to go. The psychology that creates a bubble by definition feeds it. Frequently, the entrance of new pools of capital, new types of investors, and new investment vehicles *drive bubbles well beyond even unreasonable expectations.*

The result would be even higher commodity prices which could:

- Accelerate negative impact on global economies and set the stage for serious economic recessions worldwide;
- Precipitate significant declines in the demand for commodities and bring a self-fulfilling and chaotic end to the bubble.
- Produce additional draconian regulatory actions by governments to "prevent this kind of thing from ever happening again", (but which they don't actually accomplish).




***From June 20, 2007 to June 20, 2008, the cost of a barrel of crude oil increased by 97%. By comparison, a share of ExxonMobil Corporation stock increased only 3%. Source: Baseline***

### Scenario III—The Bubble Deflates

Bubbles don't have to end with a bang. They can deflate in a somewhat orderly fashion. Commodities represent a broadly diverse set of individual investments, from agricultural, to industrials, to precious metals, to energy. Each of these groups has different economic drivers of supply and demand. As a result, certain markets can "unwind" while others continue to spiral upward or crash.

*As we wrote this report, data from the previous three months showed that crude oil prices were up about 31%, and corn was up 44%. Meanwhile, gold was down 2% and wheat was down 18%. That is not to say that certain commodities, such as oil, won't experience their own bubbles bursting in a chaotic fashion while other markets deflate.*

There are other factors that could cause this deflation scenario to develop. The huge influx of "new" investors into these markets could moderate. The government regulatory agencies could move slowly or not at all. And finally, individual commodity corrections could continue and reduce the aggregate speculative excess in these markets.

### What's ahead?

We believe the third possible scenario ("The Bubble Deflates") is the most likely. It is, perhaps, already underway as is evident in some of the price declines discussed earlier. Overall, this would be the "best case" scenario. The price corrections would be more orderly and less panic filled. As we pointed out, however, that does not exclude the fact that a broadly traded commodity such as oil might experience a period of true "panic selling". The oil bubble could "burst" while other commodities are "deflating".

In summary, the 5-year-long surge in commodity prices is unprecedented in U.S. history. A correction is long overdue and some of those corrections could be very significant. On the positive side, the stock market will likely turn to undervalued equity sectors such as technology, certain industrials and health care that are unrelated or less related to commodity cycles. A broad commodity price decline would also set the stage for accelerated economic and profit growth.

### The market's message

The chart at left is the stock market's message on the current price of oil. Over the past 12 months, the price of oil was up 97% while ExxonMobil stock was up 3%. The market is saying:

- There is very little economic justification for oil's price increase;
- There has been little impact on ExxonMobil's stock price.
- *This is speculation... a bubble.*

# Exports Help NE Ohio Manufacturers Weather U.S. Business Downturn

**By J. Mark Wipper, Managing Partner**

Our firm maintains an ongoing policy of meeting with corporate executives and board members, as a way to evaluate economic trends and investment opportunities for our clients. The Partners of Midwest Investment Management visited various corporations this past spring. Their key visits are summarized below.

SHERWIN WILLIAMS – The retail store division of this corporation has reported lower sales primarily due to the "housing bubble"—notably in Las Vegas, California, and Florida. This weakness, coupled with continued cost pressures for materials, has caused management to project an earnings decline in 2008. Aggressive price increases for paint have been implemented in an attempt to offset the increased costs of raw materials.

EATON CORPORATION – Fundamentals at Eaton are currently very good, Midwest Investment Management Partners Robert J. Yaroma and Norman F. Klopp report. "CEO Sandy Cutler has done an excellent job," said Yaroma, "Eaton's management team is also excellent." Approximately 50% of Eaton's revenue is generated outside the U.S.

"Fundamentals at Eaton are currently very good..."

"Global demand in Eaton's important electrical controls business remains strong and is an important driver of growth right now," said Klopp.

Earnings for 2008 are expected to increase over 2007, even though Eaton's heavy duty truck business remains weak. Despite some price increases, commodity prices (notably metals) are putting pressure on profit margins for some of Eaton's operations, said Klopp.

*"We view our meetings with corporate CEOs and board members as important components of our disciplined investment management process," says J. Mark Wipper.*

FERRO. CORPORATION – CEO James Kirsch appears to have the corporation headed in the right direction, and the earnings outlook for 2008 is positive. One area of strength is its exports. Kirsch has "repaired employee morale, and has recruited a number of operations personnel he has known and respects from Dow Chemical," said Partner Robert J. Yaroma.

OMG OM GROUP – At a recent meeting, Chairman and CEO Joe Scaminace reported a bright earnings outlook and predicted a positive future for this corporation, a leading producer and marketer of value-added specialty chemicals and related materials.

The company "continues to execute its strategy of moving further away from a commodity producer to a value-added product producer," reports Midwest Investment Management Partner Norman F. Klopp. "I remain convinced that additional technology breakthroughs in the electric battery industry will accelerate the development of practical electric vehicles."

National City – Loud outbursts from angry shareholders punctured a generally somber mood at National City Corporation's recent annual meeting. On Feb. 26, 2007, NCC shares closed at $38.94. In late-May of this year, shares were hovering below $6, due largely to NCC's deep involvement in sub-prime mortgage lending.

After NCC's attempts to find a merger partner failed, Corsair Partners LLC, a New York City private equity firm, provided National City with a $7 billion cash infusion—in return for a 70% ownership stake—on April 20. That action, however, helped ensure that NCC would retain its headquarters in Cleveland. "We expect it will take two to three years for NCC to rebuild to profitability," said Midwest Investment Management Partner Elmer L. (Al) Meszaros.

"...it will take two to three years for NCC to rebuild..."

DIEBOLD – This Canton-based manufacturer of automated teller machines (ATMs) reports that equipment sales to U.S.-based banks has been better than expected, considering the current turmoil in the banking industry, said Partner Norman F. Klopp.

Diebold's sales have been helped significantly by strong ATM orders from overseas, highlighted by a recent 9,600-unit order from a Brazilian bank, said Klopp.

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You may contact our partners or staff by phone or e-mail. Here is a complete listing for your convenience.

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***2nd Quarter Economic Review***

# As market volatility continues, what should a prudent investor do?

**By: Norman F. Klopp, Jr., CFA, Partner**

Once again, volatility was the dominant characteristic of the stock market in the second quarter.

From Mar. 31 to May 19, the market was up 7.9%. But subsequent declines saw it down 2.5% by June 26th. The volatility continued as the market dealt with the "wall of worry" related to a slowdown of the economy, the continued workout of the financial turmoil, and the apparent "bubble" developing in some commodity markets. The commodity "bubble" could be the next significant economic event.

### Federal Reserve

Meanwhile, recent statements by Federal Reserve Chairman Ben Bernanke have lowered expectations of further interest rate cuts unless a more serious economic slowdown or recession become apparent. The Fed's focus is turning back to potentials for inflation.

Individuals, companies, and government agencies are starting to take a serious approach to reducing energy consumption. Some examples:

- The first decline in miles driven during the month of March since 1978—a decline of 4.3%;
- A glut of large SUV's and a growing shortage of small car inventory at dealers;
- Discussions by some government agencies about moving to a 4-day, 10-hour-per-day work week in order to reduce commuting by 20%.
- Increased public transportation ridership—already up more than 10% year-to-date.
- Gasoline consumption is down 1.9% year-to-date and more than 3% in the latest reporting periods.

*In short, people are finding ways to cut energy consumption; it's happening quickly, and we expect it to accelerate.*

### Second-half '08

Stock market volatility is likely to continue as it deals with diverging economic reports and the negative focus that is typical of an intense American presidential campaign.

As we move through the second half of 2008 we now anticipate the following:

- Continued resolution of the housing/mortgage "crisis";
- A clearer picture of the magnitude of the economic slowdown;
- A period of stable interest rates;
- Perhaps the beginning of some relief from the sharp advances in commodity prices.

These clarifications should set the stage for a less volatile and a more sustained, positive stock market performance. We continue to believe that a portfolio of stocks of high quality, large, highly profitable, globally exposed companies can be the best and most prudent way to participate in the market we envision.

# Joseph Harrison Elected President of Cleveland Assn. of Business Economics

*Harrison*

Midwest Investment Management Senior Advisor Joseph A. Harrison has been elected president of the Cleveland Association of Business Economics (CABE) for the 2008-2009 year.

CABE is a chapter of the National Association of Business Economics, whose members include business leaders from more than 1,500 businesses and government organizations throughout the United States, including the Federal Reserve System.

"We congratulate Joe on his recent election to the presidency of a very important organization in the Cleveland business community," said J. Mark Wipper, managing partner of Midwest Investment Management.

We hope you enjoy reading our quarterly newsletter, which contains news about our firm, its investment philosophy, the economy and market trends. We suggest you retain these newsletters for future reference.

*Perspective* is published quarterly by Midwest Investment Management LLC, Cleveland, Ohio for its clients, friends and members of the business community. All information contained herein reflects the opinions of the authors and does not necessarily constitute investment advice. Past results are no guarantee of future performance.

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