COMMODITY PLAYGROUNDS- CHASING RETURNS

© Leo Haviland, 646-295-8385 February 21, 2012

"All poker is a form of social Darwinism: the fit survive, the weak go broke." A. Alvarez, "The Biggest Game in Town"

ON YOUR MARK

The Federal Reserve and other central banking all-stars around the globe have teamed up. In varying fashions, and frequently led by the Fed, they vigorously practice accommodative strategies to tackle economic weakness and to spark and sustain economic recovery.

The Fed's trusty playbook, for example, currently insists on the wisdom of keeping policy (Federal Funds) interest rates pinned to the floor. Much of the UST yield curve offers negative returns relative to inflation. The Fed thus deliberately encourages some American and other yield hunters to avoid, diversify away from, or leave US Treasury debt in search of better returns elsewhere. Many other central banks link arms with the Fed under the low interest rate banner.

Thus many players race into or cart more funds into other debt arenas. US "investment grade" (high grade) corporate debt is one corner. Those corporate bond yields recently struck a record low (Financial Times, 2/16/12, p22; citing a Barclays index which looks back to 1973). The Financial Times recently announced: "Bull run in 'toxic' subprime debt divides investors". The article notes that nowadays many investors are willing to buy into the "asset class", hoping for high returns. One advocate broadcasts: "The yield advantage of non-agency market is very attractive for a lot of investors" (2/14/12, p22). On the newspaper's front page (2/19/12), a NY Times headline shouts: "Bonds Backed by Mortgages Regain Allure". The NYT details the fascination of many "big-money investors" regarding this field. As always, other promoters scout out opportunities to capture yield (returns) in other interest rate marketplaces around the globe.

GET SET

In the film "Point of No Return", a character declares: "You can't just pout and decide you don't want to play anymore." (director, John Badham)

****

Keep focusing primarily on America for a moment. Those yearning for return trot into domains beyond the interest rate one. If US government yields are going to stay at exceptionally low levels into 2014, why not give stocks an even closer look! Besides, even though not all equities pay dividends, some do. The unending search for yield (return) inspires pilgrims to venture into (or more robustly into) stock marketplaces (use the S+P 500 as a benchmark). Also, surely people have not forgotten the anthem that US stocks are an excellent long run investment.

****

All else equal, widespread massive money printing within an economy (and across several key economies) tends to raise (support) nominal prices in general. Thus enormous quantitative easing, all else equal, tends to kick stocks, commodities, and many other "assets" higher.

Although the Federal Reserve ceased its latest round of quantitative easing (QE2) in June 2011, it did not stay on the sidelines. It unleashed Operation Twist 9/21/11. Putting more verbal chips on the table, it declared (1/25/12) that exceptionally low levels for the Federal Funds rate probably will be warranted "at least through late 2014" (even later than its previous date).

It looks like the Fed passed the money printing baton to other central banks, notably the European Central Bank. The ECB may yell that it is not engaging in money printing. However, even if their performance is not precisely quantitative easing, their artistry is a close relative to quantitative easing. Thus it very probably has similar practical marketplace consequences.

The ECB introduced its three year long term refinancing operation (LTRO) policy on 12/8/11. Taking advantage of low borrowing rates from the ECB for these three year loans, Eurozone banks borrowed E489 billion on 12/22/12. Though banks provide collateral when borrowing, and though the LTRO performs through the banking sector rather than via direct asset purchases, the LTRO nevertheless is a huge easing campaign. The ECB's mammoth loan money is still "out there" in the banking and other parts of the financial gridiron. Besides, the ECB eventually may decide to renew these three year loans. The ECB will pitch in another installment of one percent loans to banks at end February 2012. "Some analysts predict that banks will borrow as much as 1 trillion Euros, or $1.33tr, more than double what they drew in December. If so, the central bank's lending would start to approach the size of the Federal Reserve's measures to help the United States economy." (NYTimes, 2/10/12, pB5).

In addition, some other well-trained central bank referees already had been running money printing games alongside the Fed's. For example, although England and Japan have printed money for a while, why take a time out and stop now? Recently the Bank of England authorized another L50 billion in gilts purchasing (2/9/12). In addition to more definitively embracing a one percent inflation goal, Japan (2/14/12) expanded its asset purchase program by another 10 trillion Yen ($130 billion; buying Japanese government bonds).

GO! COMMODITY GAMES

"It is not unusual for a quiet country gentleman to be more taken with such a venture than a speculator who has had more experience in its uncertainty. It was astonishing how many New England clergymen, in the time of the petroleum excitement, took chances on oil. The Wall Street brokers are said to do a good deal of small business for country clergymen, who are moved no doubt with the laudable desire of purifying the New York stock board." "The Gilded Age", by Mark Twain and Charles Dudley Warner

****

In recent years, major trends in the S+P 500 and commodity signposts such as the broad Goldman Sachs Commodity Index (GSCI) have roughly tracked each other. Review the scorecard. Note the final high in the S+P 500 on 5/19/08 at 1440; GSCI 7/3/08 around 894. S+P 500 major low 3/6/09 at 667, GSCI slumped to a bottom on 2/19/09 at 306. The S+P 500 jumped to a 4/26/10 high at 1220; the GSCI high was shortly thereafter, at 556 on 5/3/10. The stock weathervane and the commodity one subsequently made key lows in late August 2010. The S+P 500's was on 8/27/10 at 1040 (as QE2 unveiled; initial low 7/1/10 at 1011). The GSCI take-off point was 8/25/10 at 490 (though it touched 459 on 5/25/10). The S+P 500's spring peak was 5/2/11 at 1371; GSCI attained its 762 high on that day as well as on 4/11/11. Recall the S+P 500's fierce charge from its low at 1075 on 10/4/11; a GSCI trough likewise was on that day, at 573.

Of course not all commodities perform alike. The Goldman Sachs US Agriculture Commodity Index made a low on 10/3/11 at about 416, yet a lower one on 12/15/11 at 398. It has rallied since then, but not as sharply as petroleum.

US dollar and other currency and interest rate trends of course intertwine with the equity and commodity story. The US broad real trade weighted dollar averaged about 84.4 for January 2012. Though it hovers a bit above the record low of July 2011 (80.5; June 2011 80.9), that January level still remains rather low.

****

Everyone knows that various commodities have diverse supply/demand pictures. In commodities, the petroleum league is particularly large and important (including in many commodity indices). Not only does petroleum have numerous players competing for money and glory. Many money managers in other marketplaces, financial media, Main Street, and politicians and regulators watch it rather closely.

Numerous grandstanders readily promote a bullish worldwide petroleum picture these days. Some believe supplies are or may become tight in days supply terms. At present, this is perhaps true for some regions, and perhaps some grades of oil (think of sweet low sulfur crude). Suppose the economic recovery strengthens. Isn't non-OECD growth going to remain powerful? Look at politics. The Iranian nuclear crisis has persisted. Nigerian politics simmer. The Iraqi political (religious) situation remains volatile. Look at supply issues in Libya, Sudan, Syria, and elsewhere. The Israel/Palestine situation has not progressed. Looking to the horizon, how much spare production capacity will there be?

However, at least in the OECD, industry stocks may not be that tight. The International Energy Agency says industry stocks were 57.2 days relative to forward demand. They indeed are far beneath the 61.0 days of 1Q09, yet they look comfortably above 4Q07's low level of 53.0 days. Admittedly, if many industry players have shifted from a just-in-time bias in their inventory management to a just-in-case one, then perceptions regarding sufficient days coverage levels climb higher. Maybe European stocks have tightened since December due to cold weather and production problems in Libya and elsewhere.

However, United States petroleum industry inventories as of 2/10/12 (crude and products combined) at 57.7 days of coverage versus recent demand exceed by more than five days the 1996-2011 average for end February. They have increased from a low of 54.2 days three months ago (11/11/11). Also, US petroleum demand has slumped. The most recent four weeks average for total products supplied (EIA, 2/10/12) dove 4.6pc year-on-year versus the comparable year earlier period. This is not merely a matter of a warm winter. Gasoline consumption cratered 6.4pc year-on-year, and jet fuel slipped 2.1pc lower.

****

Let's focus for a while on another aspect of the petroleum game, that of noncommercial participants.

Although Brent North Sea crude oil is a major petroleum benchmark, the NYMEX petroleum complex is too. Moreover, for well over a decade, the CFTC has published open interest statistics (Commitments of Traders) on noncommercial and commercial participation for the key NYMEX petroleum contracts (crude oil, heating oil, and RBOB/gasoline). Assorted viewpoints may label these noncommercial adventurers as investors, speculators, or otherwise. However, the CFTC's noncommercial category is merely a general one, distinct from the commercial one. For recent years, what does analysis of noncommercial participation in the NYMEX petroleum complex (futures and options combined) reveal in the context of the broad GSCI and the S+P 500?

“High” levels of noncommercial longs often are associated with important highs in the broad GSCI and the S+P 500. The net noncommercial long (NCL) total as well as the net NCL position as a percentage of total open interest are especially significant. However, one also should monitor the gross NCL total. The overall NYMEX petroleum complex noncommercial category in recent years has stayed net long. Thus what is a “low” net NCL position and net NCL percentage should be considered not only with thoughts of “high” plateaus, but also with this consideration in mind. Relatively depressed net NCL positions roughly connect to price bottoms in the broad GSCI and stocks.

Since the broad GSCI and the S+P 500 have marched higher since early October, first focus on the recent past. As of 2/14/12, the gross noncommercial long position of the NYMEX petroleum complex was about 536,000 contracts. The net NCL was around 390,000 contracts. The net NCL position was 12.36 percent of total open interest. Lows in these categories occurred in early October 2011. The gross NCL low was about 427m (10/11/11), with that for net NCL 225m (10/4/11) and net NCL as a percentage of open interest 6.48pc (10/4/11).

The prior noteworthy highs in the NCL categories were around the spring 2011 stock and broad GSCI ones. Gross NCL sagged from 4/26/11’s 570m contract level (575m high 4/5/11), net NCL from around 422m on 4/26/11 (427m on 3/8/11, 426m 4/5/11). The net NCL level peaked at 11.57pc on 3/29/11; it then fell sharply from 4/26/11’s 11.49pc.

The spring 2010 net NCL highs were about 334m contracts on 4/6/10, with net NCL at 9.60pc. These totals declined rather quickly from 5/4/10’s 306m and 8.52pc. Again recall the timing of the Fed’s thrilling second round of quantitative easing. The trading game never ends. The net NCL low was 8/31/10 at 116m contracts, a subdued 3.48pc of total open interest. .

During the agonizing acceleration of the worldwide economic crisis in autumn 2008, the petroleum complex touched its net NCL at 73m on 10/7/08. The net NCL percentage likewise bottomed then, at 2.15pc. Although the S+P 500 did not tumble to its depth until March 2009 (preceded slightly by the GSCI), some other key equity marketplaces reached major lows around October 2008. For example, China’s Shanghai Composite’s low was 1665 on 10/28/08. Yet though the net NCL jumped to 199m on 1/6/09, it then slid. When did the final low net NCL occur? Right around the time of the S+P 500’s major low, at 131m contracts on 3/10/09; the net NCL percentage low also was that week.

Let’s take the clock further backward to the time of the 2007 and 2008 S+P 500 pinnacles. The initial peak in the net NCL around 236m contracts was 9/18/07 (8.08pc net NCL), only a few weeks before the October S+P 500 high. The net NCL’s final peak was about 238m contracts on 4/22/08 (and 6.95pc), close to the S+P 500’s final high in May 2008, though admittedly only fairly close in time to the broad GSCI’s several weeks later.

The current week’s Olympian net NCL percentage of open interest is the highest for almost seven years, since it reached 13.11pc in May 2004. Going back to 1995, the current week’s lofty net NCL total of around 390m contracts is in second place overall relative to prior heights. Present net NCL stands beneath only the mountainous record highs of March/April 2011.

There of course are other important petroleum playgrounds, both exchange-traded and over-the-counter. And petroleum is not the only commodity game around. However, this evidence from the NYMEX petroleum complex Commitments of Traders indicates that noncommercial petroleum activity substantially can influence (reflect) trends in the S+P 500 and broad GSCI (commodities in general). Significant noncommercial buying probably has played a substantial role in the rally in the broad GSCI since autumn 2011.

Some financial coaches in recent years have advertised commodities as a fine place in which one reasonably can try to seek (or improve) returns. Since the Federal Reserve and many other central banks have made their government interest rate yields rather unattractive- and again note the Fed's recent warning of low rates lasting out into 2014- they help to push some profit-seekers into commodities.

Central bank gatekeepers probably prefer that people (especially noncommercials) are substantial net purchasers of stocks rather than of commodities. However, since major commodity trends have been bound up with those in equities (and are part of the worldwide growth story, including its China chapter), the recent spike in the S+P 500 has encouraged and intertwined with that in commodity playgrounds in general (and especially in petroleum).

COMMODITY "INVESTMENT" POSITIONS

What are investment, speculation, and gambling? In stocks, interest rates, real estate, and elsewhere, investment rhetoric encourages and often persuades people to embrace a given investment perspective and to act accordingly. Since investment generally is associated with notions such as reasonableness, prudence, and goodness, many people race to be investors (join some investment team) and wear the honored investment crown. And those promoting particular financial instruments compete fiercely to attach an investment label of some sort on what they want others to buy and hold. Thus in recent years, the commodity world has found numerous cheerleaders for concepts that commodities ("in general") are (can be) an investment, an alternative investment, or an asset class. Think also of the potential diversification benefits for your portfolio of stocks and interest rate holdings. In any event, various assorted commodity investment advocates have won quite a few victories for their ownership cause.

Suppose groundskeeping central bankers mow down the yields of government securities to very low nominal levels (and especially suppose those returns are negative relative to inflation). Those central bankers thereby encourage "investors" in government debt (and those with deposits at bank and money market funds) to seek "investment" returns elsewhere. So why not entertain commodities as a marvelous investment buying opportunity?

Since end 2006, the CFTC has provided Index Trader (IT) data for 12 US agricultural commodities. The net Index Trader position (which has always been net long) is a proxy for the buy and hold crew in this territory, many of whom call themselves or are designated by others as investors or alternative investors.

One can link the IT statistics to the S+P 500 and broad commodity price trends (not just those in the agricultural complex via the Goldman Sachs Agricultural Index) and other variables. The linkage of the net IT position to the S+P 500 (or the broad GSCI) may not always be tight. But it sometimes is. For example, the net IT long position reached its low of about 923,000 contracts on 3/10/09, around the day of the major low in the S+P 500. The 1.78 million contract net IT peak on 5/13/08 was quite close in time to the S+P 500's final high that month.

In 2010, net IT highs were 1.62mm on 5/4/11; recall the S+P 500 and broad GSCI tops. However, just before QE2 commenced in August 2010, they were a bit higher rather than lower, at 1.63mm (8/10/10).

What about 2011? The high in net IT length around 1.53mm contracts on 4/26/11 fits in from a timing perspective with the peaks in the S+P 500 and the broad GSCI. Then the net IT level drifted down. Interestingly, its low was 10/4/11, at about 1.3 million contracts. Since then, as stocks and commodities in general have rallied, this total has increased to a high this week (2/14/121) of 1.45 million contracts.

The average net IT long position percentage relative to total contract open interest, going back to the start of the statistics, is just over twenty-five percent. It is about 24.9pc for 2/14/12. The percentage level varies between the individual agricultural commodities. For 2/14/12, the net IT length for CBT wheat as a percentage of total CBT wheat open interest was 39.9pc, that for corn 19.6pc. Sugar net IT longs were 25.6pc of sugar total open interest, while those for coffee were 21.7pc.

In any event, twenty-five percent net IT length hints that this segment of the overall noncommercial buying crew, whether one calls them investors or something else, probably plays an important role in helping to rally (support) commodity prices. If and when IT players liquidate a substantial portion of their holdings, they can be a notable bear factor. Commodity investment rhetoric often suggests the wisdom of owning a wide-ranging basket of commodities. Thus on the basis of this agricultural IT data, commodity "investors" outside of the agricultural playing field probably are a substantial group, whether twenty-five percent or a roughly similar level.

RUNNING THE BASES

What are important levels to monitor in the broad GSCI and the S+P 500?

For the broad GSCI:

894 (7/3/08 pinnacle)
800 (10pc fall from 894 is about 805; a five pc rally above 762 gives 800)
762 (4/11 and 5/2/11 peaks)
732 (3/7/11 high; 50pc rally from 8/25/10's 490 low is 735)
705 (7/26/11 elevation) to 715 (712 the 6/9/11 high; 715 is 20pc drop from 894)
668 (3/16/11 low) to 677 (8/31/11 high)
610 (613 12/19/11 low; 20 percent fall from 762 is 610; twice the 306 valley on 2/19/09 is 612)
556 (11/23/10 low and 5/3/10 top) to 573 (10/4/11 low)
459 (5/25/10 low) to 490 (8/25/10 trough).

For the S+P 500:

1576 (10/11/07 pinnacle)
1510 (a five percent move over 1440 is 1512)
1440 (5/19/08 final high; 10pc fall from 1576 is 1418; a five pc rally over 1371 gives 1440)
1371 5/2/11 peak (twice 3/6/09's 667 major bottom is 1334; 1368 equals a 5pc fall from 1440)
1293 (10/27/11 elevation)
1220 (4/26/10 summit) to 1231 (8/31/11 high); 1249 (3/16/11 low) to 1258 (6/16/11 low)
1159 (11/25/11 trough) to 1174 (11/30/11 low)

1075 (10/4/11 low)
1011 to 1040 (1011 the 7/1/10 low; 50pc rally from 667 valley is 1000; 1040 the 8/27/10 low).

The current race for return in commodities and stocks and elsewhere (including some interest rate domains) should evoke memories of the later stages of the Goldilocks Era in 2007/08. Such chases for return can go on for quite some time (and distance).

Marketplace history is not marketplace destiny. However, if the current rally persists for commodities and US (and related) stocks, for calendar timing purposes in regard to a peak (for both marketplaces, either individually or together), keep in mind the S+P 500's 3/6/09 major low and its 5/19/08 height as well as the broad GSCI's 7/3/08 plateau.

****

In regard to the financial scene of a few years ago, why not glance at art? Is "art" an asset, an investment vehicle, a commodity, or something else? Opinions differ. Anyway, some current comments from the art universe make one think of issues related to central bank policy, UST yields, and notions of return.

The Financial Times notes (2/16/12, p6) that Christie's contemporary art sale hit a post-2008 high. It quotes the head of art and private clients at Hiscox, a specialist art insurer. "'There is a lot of cash around at the moment and not many places to put it. The financial crisis is not really having an effect on the super rich who are buying these works.'"