The Role of Financial Investment in Commodity Markets

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In early 2011, the IIF was asked by the French G-20 Chair to bring together senior market practitioners to add their perspectives to the debate on the potential role of financial investment in driving trends in commodity markets.

The IIF Commodities Task Force, including market professionals, academics and other researchers, was convened in February 2011, and a CTF Workshop was held in Paris in July 2011.

The Task Force submitted its report to the G-20 in September 2011.
IIF Commodities Task Force Report: Key Messages

A review of the academic literature and studies by official sector bodies suggests that despite periods of correlation, there is little robust evidence of a causal link between financial investment in commodities and trends in commodity prices and volatility.

In recent years, rising demand from emerging markets has contributed to the trajectory of commodity prices and volatility, exacerbated by periodic or structural supply constraints.

Financial investment is an integral part of commodities trading; excessive regulatory constraints on investment could dampen price signals, impair market liquidity and efficiency.
Concern about the link between commodity prices and inflation…

World Inflation vs. Commodity Prices

percent change, yoy

-60 -40 -20 0 20 40 60 80 100

-60 -40 -20 0 20 40 60

-1 0 1 2 3 4 5 6

'00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12

Inflation
Commodity prices (rhs)
...contributes to fears that financial investment drives trends in commodity prices and volatility.

Commodity Assets Under Management

*USD billions*

- Exchange-traded products
- Medium-term notes
- Indices

Source: Bloomberg, MTN-I, ETP issuer data, Barclays Capital
However, correlation between flows to commodity funds and commodity prices is not consistent…

Total Commodity Investment Inflows

Source: Bloomberg, MTN-I, ETP issuer data, Barclays Capital
...and periods of higher volatility are not always associated with high financial investment

Commodity Price Volatility, 1992-present
*Goldman Sachs Commodity Index, 60-days*
Those who believe financial investment drives prices point to correlation between futures prices and open interest in some commodities…

Soybeans: Open Interest & Price

000s of contracts

US cents per bushel

- Open Interest
- Front month futures contract price (rhs)
...and more correlation between previously uncorrelated asset classes ("financialization" of commodities markets).

Correlation between Commodities and Equity Prices
GSCI index and S&P500, 30-day rolling correlation, 90-day mav

'70 '73 '76 '79 '82 '85 '88 '91 '94 '97 '00 '03 '06 '09 '12
Periods of divergence between cash & futures prices have triggered concern about “mispricing.” These arguments have been used to justify position limits.

Copper Prices: Daily Difference Between Futures and Cash Prices

USD/MT, 20-day mav
Another fear is that long-only index traders create “new demand” for commodities, outweighing the market-stabilization effect of financial investment.

Commodity Index Traders' Long Positions vs. Price: Wheat, Corn, Cotton, Cocoa, Soybeans

000s of contracts vs. weighted average futures price

- Total long positions
- Total weighted futures price (rhs)
However, correlation between price and financial investment varies greatly among different commodities over time. For some, correlation is low.
During specific periods, correlation between financial investment and price has been low or even negative; moreover, evidence of *causality* is limited.

**Correlation: Non-Commercial Positions vs. Futures Price**

*selected commodities, net non-commercial positions*

- **2007-08**
- **2009-12**

- Corn
- Platinum
- Wheat
- Milk
- Oil
- Live cattle
- Natural gas

<table>
<thead>
<tr>
<th>Commodity</th>
<th>2007-08</th>
<th>2009-12</th>
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<tbody>
<tr>
<td>Correlation</td>
<td></td>
<td></td>
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<tr>
<td><strong>Corn</strong></td>
<td>0.9</td>
<td>0.7</td>
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<tr>
<td><strong>Platinum</strong></td>
<td>0.4</td>
<td>0.8</td>
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<td><strong>Wheat</strong></td>
<td>0.6</td>
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<td><strong>Milk</strong></td>
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<td><strong>Oil</strong></td>
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<td>0.5</td>
</tr>
<tr>
<td><strong>Live cattle</strong></td>
<td>-0.2</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Natural gas</strong></td>
<td>-0.4</td>
<td>0.5</td>
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While index traders are often blamed for “new demand,” driving up prices, for many commodities their share of financial investment is relatively low.
For many commodities, the level of long positions relative to short hedging—the “Working’s T” ratio—has tended to be appropriate and stable over time.
Prices of non-traded commodities, which reflect industrial demand, tend to move in synch with traded commodities (which attract financial investment)—another indication that fundamentals are dominant.
Financial investment provides **valuable and necessary information about projected changes in fundamentals** to the market.

Financial investment is an essential part of spot and futures markets, as it helps equilibrate price differentials between the two markets.

Financial investment thus has a vital role in **enhancing market liquidity and mitigating price risk** for commercial market participants (hedgers).
Industry Concerns about Further Regulation

Tighter regulation has not been backed by convincing impact analyses or evidence that financial investment is a significant driver of higher prices/volatility.

No robust definition of financial investment has been put forward to adequately separate this activity from hedging and other commercial trading activity.

Measures to enhance transparency are broadly welcomed; however, position limits and other regulatory measures could have unintended and damaging consequences.
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