Defending the Rogues

Why Speculators Were Not to Blame for High Oil Prices

By Tod Ginnis

They're destroying America's economy! We have to stop these greedy SOBs before it's too late! If you'd tuned in to a TV gabfest or Congressional hearing in the summer of 2008, you likely witnessed people with no experience in markets explaining exactly why the price of oil was so darn high. Invariably they would get around to that most vile of characters: the "speculator." Listen to Bill O'Reilly and you'd think Webster's has designated "speculator" a four-letter word. Even those who acknowledge fundamentals had been bullish for oil often seemed to accept speculation was at least partially responsible for the extent of the rally.

That July, the CEOs of 12 major U.S. airlines signed a joint letter asserting, in part, "Some market experts estimate that current prices reflect as much as $30 to $60 per barrel in unnecessary speculative costs." But were futures traders really to blame for any of the enormous run-up in energy prices? Or were they merely convenient scapegoats for politicians looking to score points with voters, and executives hoping for a taxpayer bailout?

What are commodity futures contracts?

Futures trading is a mystery to most people. A commodity futures contract represents the obligation to buy or sell a specific quantity of a specific product at a specific time. For example, one can enter a contract to sell (agree to deliver) or buy (agree to accept delivery) 100 ounces of gold that meets the standards set by the New York Mercantile Exchange. The delivery date might be late June.

While these contracts are obligations, one can escape the obligation by transferring it to another willing party before delivery. So the person who buys a gold contract can resell it on the exchange any time before delivery. Prices change constantly as traders buy and sell. The difference in price between the purchase and sale represents a trader's profit or loss. The holding period for trades ranges from seconds to years.

Who uses futures contracts?

Futures markets serve a crucial economic role. They allow large consumers and producers to hedge the risk of commodity price fluctuations that could harm their businesses. For example, General Mills knows it will need a certain amount of corn in the future to make its breakfast cereals. The company could simply buy this corn in the cash market as it needs it. But the prices of agricultural products can be quite volatile. If the next growing season is poor, prices will rise and General Mills might have to pay substantially more for its corn than it budgeted.

But if the company buys futures contracts deliverable when it needs the corn it can lock in the current price. Thus, it would avoid having to pay higher prices caused by a bad crop or unexpectedly high demand. Of course, the price of corn could go down. By hedging General Mills would lose the benefit to its bottom line of lower input costs. Most businesses will gladly give up this potential benefit in order to estimate expenses more accurately. After all, General Mills is in the business of selling cereal, not speculating on commodity prices.

344 Grove Street, #106 § Jersey City, NJ 07302 § Phone: 201.433.6630 § tginnis@comcast.net § www.TodGinnis.com

On the other side of the General Mills trade might be a farmer. She expects to grow a certain amount of corn on her land that she will harvest in July. The current price of corn will give her an acceptable profit. But what if the price drops? Rather than waiting until July to sell it, perhaps at a loss, she can lock in a price now by selling futures contracts for July delivery.

Who needs speculators?

We've seen how large-scale consumers and producers of commodities use futures markets. But why do we need speculators? They're just trying to make money, not protect against a business calamity.

The problem is the needs of producers and consumers don't always match up. At any particular time there may be far more hedgers looking to sell than to buy, or the reverse. Speculators serve a key role by creating a liquid market where hedgers can come in at any time and do their business. There may not always be a hedger willing to buy the contracts another hedger needs to sell, but there will always be a speculator looking to make a buck on either side of the market.

There's an old joke about a commodity trader's wife explaining her husband's profession: he buys things he doesn't want, and sells things he doesn't own. Speculators neither want nor own the gold, corn, or crude oil they trade. They attempt to profit by selling contracts for a higher price than they paid, or buying back contracts at a lower price than they sold them short. Speculators have no impact on the supply or demand of the underlying commodity since they nearly always liquidate their positions before delivery.

Let's take the example of a standard crude oil futures contract. Assume that in February, a contract for 1000 barrels of light sweet crude oil for May delivery is trading at $40 per barrel. If a speculator believes the price of oil will rise before the delivery date, he would buy the contract at $40. If he doesn't sell the contract by the delivery date, he must take delivery of the oil. In practical terms, delivery means he will write a big check for the oil and pay for storage until he sells it. So unless he wants the oil, he must sell the contract before the delivery date. A trader betting the price will drop must either buy back his short or purchase enough oil to fulfill his delivery commitment. (Pardon the repeated use of the male pronoun, but futures traders are overwhelmingly of the hairy-back variety).

How powerful are speculators?

Speculators sometimes push stocks higher for no fundamental reason. The "Greater Fool" theory can take hold and send equities to levels that in hindsight seem ridiculous. This may happen to one stock or an entire industry, or in extreme cases to a large segment of the market (recall the technology bubble that burst in 2000).

But physical commodities are different than stocks. They add the elements of time and deliverability. This makes sustaining unrealistic prices much more difficult. Futures contracts have a fixed expiration date. Once this date arrives, anyone long the contract must either sell it or take delivery of the commodity. And anyone short must either buy back the contract or deliver the commodity. Since most speculators don't participate in the delivery process, they liquidate their contracts before delivery.

If you believe the politicians and pundits, during the 18 months through July, 2008 speculators must have held large long positions. What do they do with the contracts their contracts as the delivery date approached? Perhaps they sold them. Can you imagine what would happen to the price of oil if there were a sudden rush of speculators selling huge positions? Once a month the expiring contract would plunge. This didn't happen.

If traders reestablished their long positions in contracts for more distant delivery, those contracts would jump in price and volume. This didn't happen either. The overwhelming amount of volume and open interest is always in the contracts for nearby delivery. Distant contracts barely trade at all.

Alternatively, a trader unwilling to sell his longs can accept delivery. Since large numbers of traders immediately turning around and selling all of this oil in the cash market would send cash oil sharply lower once a month. This didn't happen.

So they must have taken it off the market and put it in storage. Each speculator would have written a big check to pay for the oil ($140,000 per contract when the prices was $140 per barrel), and then assumed the cost of storage. Their plan would be to sell their oil in the future at a higher price. If traders were taking oil off the market on a large enough scale it could send prices sharply higher.

Where was the oil?

Anyone who believes speculators were to blame for high prices must answer this simple question: where did they store the oil?

According to the July, 2008 Interim Report on Commodity Markets issued by the CFTC's Interagency Task Force, "Preliminary OECD (a group of 30 industrialized nations) inventory data for the first part of 2008 shows that OECD stocks have again fallen below levels seen in 1996-2002. Because oil use has been growing over time, inventories are even tighter when considered on a 'days of supply' basis (defined as dividing inventories by the level of consumption). In addition, U.S. inventories for crude oil and key petroleum products are relatively low. After remaining relatively high for much of 2006 and the first half of 2007, U.S. crude oil inventories have fallen toward the bottom end of the average range. Crude oil and

petroleum product stocks in other OECD regions exhibit the same declining trend." Tight inventories amid increased demand are a recipe for higher prices.

Some anti-speculator activists, such as the web site StopOilSpeculators.com, warned of "Dark Exchanges" overseas that are not subject to U.S. regulatory oversight. But regardless of who trades it there are only two things you can do with oil: refine it or store it. Perhaps one day someone will stumble upon a "Dark" storage facility holding 100 million barrels of oil. Given the near impossibility of keeping such a plot secret, this hidden storage theory is extremely dubious. If it were true, eventually this oil would hit the market and cause a spectacular plunge in prices. But we have seen no jump in supply. The steep decline from the highs is due to lower demand amid a global recession.

Could well-financed speculators acting in concert (intentionally or not) cause oil futures to rise for a day or a week? Absolutely. But the view that they had anything to do with the jump from $50 to $145 during the 18 months ended July, 2008 is not credible.

It's probably not a coincidence that commodity prices in general rose along with oil. Some may finger speculators for raging bull markets in corn, gold, and copper, but you can't blame them for corresponding spikes in iron ore and onions, which don't even trade on futures markets. Obviously, something else was at play.

So what happened?

Why did oil and other commodities rise so spectacularly? Maybe it was largely due to demand growth in developing economies.

Or perhaps it was the result of supply and demand curves that are inelastic over the medium term. In other words, both supply and demand take a long time to change significantly. For example, a steep rise in gasoline prices won't cause people to change their driving habits immediately. But over time there can be a significant impact once prices reach a certain level.

Were environmental restrictions against drilling in the U.S. a factor? One thing is certain: if our politicians focus on the speculator bogeyman, they will avoid having an honest debate that uncovers the underlying causes of the commodity run-up. And they may pass laws aimed at reigning in speculators that has the unintended consequence of increasing the cost of hedging. To borrow the rhetoric of Bill O'Reilly and Keith Olbermann, if that happens your aunt on Long Island may have to sell her body for medical research just to pay for heating oil one winter.

Tod Ginnis is a freelance writer and financial consultant "Helping Wall Street Speak to Main Street." Feel free to drop him a line at (201) 433 – 6630 or tginnis@comcast.net to discuss how he might support your communications efforts. Tod's web site is www.TodGinnis.com.

