The Commodities Markets & Investor Narratives Today:

ALTERNATIVE PERSPECTIVES FOR MARKET PARTICIPANTS AND POLICYMAKERS

Michael Masters, Founder & Chairman of the Board for Better Markets, Inc.

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Many market participants today have investment views derived from the prior commodities investment "super cycle" during the period 2004-2014. Do these narratives hold up to scrutiny?

- ***Are there reasonable alternatives to these consensus beliefs?***
- ***What do these investor views mean for other market price formation?***
- ***Could financial market participant storylines conceal and/or conflict with underlying trends in the real economy?***

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Investor view [A]:

"Falling prices of commodities and oil futures markets are indicative of a slowdown in the broad economy, and if those same prices rise, then that indicates the real economy must be strengthening."

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Alternatively

Given today's commodities market participation, ***price formation is still largely driven by speculative flows and positioning***.

- Prices are often driven more by investment flows than by hedgers responding to individual commodity supply and demand conditions.
- Thus, commodity prices may represent an indication of broader economic demand changes, but then again they may not.
- Price changes can also be related fundamentally to greater supply just as well as to lower demand.

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Moreover

- Even if those commodities market prices could be counted on as true and consistent arbiters of economic conditions, many financial market participants look primarily at the world from the producer side, because this is the side in which they finance.
  - Importantly, shadow finance participants including hedge fund, private equity and other non-traditional financing sources have been the primary financial sponsors for this commodity cycle's recent capex binge.
- ***But commodities prices are zero sum.***
  - When prices fall, producers lose, but consumers win.
  - Recently falling commodity prices have been viewed by many in the shadow financial community as an unalloyed negative for the economy.
  - Could this "financing bias" be the reason?

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Notably

- Because of “financial innovation,” many financial products exist today that allow real-time hedging and transfer discrete credit risk into a form of broader market risk.
  - For example, shadow financial participants can “hedge” anticipated losses in their commodity credit book by shorting broad credit indices (HYG). However, the HYG is only ~15% commodities based (in 2014 it was still only ~20%). Therefore, sufficient “hedging” in the HYG creates ripple effects on the entire HYG portfolio (and the other ~85%). Enough of that kind of price formation then raises broader concerns about high yield credit (HYG), credit in general, and the overall health of the economy; even though the original intent was to hedge a unique market participant’s discrete commodity debt exposure.
  - In this way, the shadow financial system has transferred its own credit exposures to other markets.

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In fact

- If market participants from the shadow financial system are ignoring the commodity markets' zero sum math and only considering one side of the equation, then current price formation in financial markets is likely to be affected profoundly.
- Prior commodity financing done by shadow finance market participants is likely to be amplifying a negative feedback loop created by commodity futures price drops into price formation in other financial markets.
- ***This bias could show up broadly in credit spreads, cyclical company equity prices, currencies, and broad levels of interest rates.***

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Investor view [B]:

"Lower oil and/or commodity prices are very deflationary and need to be countered by monetary or fiscal stimulus to counteract these forces."

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Alternatively

- Historically, 1st order economic effects of supply or demand driven lower oil price environments (leaving aside the speculative elements) have been initially deflationary.
- However, 2nd order economic effects of sustained lower oil prices have subsequently been reflationary (see 1985-1986, 1998-2000).
- ***It seems that behaviorally folks deal with their economic pain faster than they enjoy their economic gain.*** (credit to Charles Dumas, Lombard Street Research)

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Moreover

- If market participants are primarily focusing on lower commodity price driven 1st order effects (deflationary) and not willing to consider 2nd order effects (reflationary), ***then broader financial markets may be pricing in one scenario as the real economy moves on to another scenario.***

- This may lead to a potentially rapid and/or severe adjustment in financial market prices including equities, currencies, and rates markets (especially longer duration securities).

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In conclusion

- It's possible that current shadow financial participant narratives of the present bust in commodity prices, driven from the producer / financing point of view, may conflict with important real economic trends driven by consumers, including demand and prices for goods and services.
- It's important to remember that many of the risk transference financial products today didn't exist prior to recent commodity market leadership.
- Also, it's helpful to remember that for younger market participants, commodity market leadership has been the only real investment dynamic that many have known during their investment careers.
- Additionally, investor perception today is heavily shaped by the trauma of the recent great financial crisis, which has skewed present day investor sentiment negatively.

All of these factors are worth considering by market participants and policymakers today…

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