The Economist

Commodity speculators

Dr Evil, or drivel?

The charge-sheet against commodity speculators is flimsy

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I'll bet one million dollars

ONIONS are an important ingredient in the history of commodity speculation. In 1958, after American growers moaned that speculators were behind see-sawing prices, legislation banned trading in onion futures. Now critics are stewing over speculators again, thanks to rising prices in everything from oil to metals and grains. Such is the turmoil speculators are believed to cause that Nicolas Sarkozy may use France's presidency of the G20 to push for rules to curb their activities.

Investors have certainly acquired more of a taste for commodities over the past few years. According to Barclays Capital, around $320 billion of institutional and retail money is now devoted to commodities, compared with just $6 billion a decade ago. That sum does not include hedge funds, whose involvement is significant but difficult to quantify.

Fund managers, who allocated a pittance to commodities a few years ago, now put up to 5% of their cash into them. Commodities diversify portfolios: in theory, at least, price moves are uncorrelated to shares and bonds. They act as a hedge against a depreciating greenback. And since 2005, when China began importing huge volumes of raw materials, commodities have also offered exposure to its rise.

As the sums devoted to commodities have grown, so have complaints about the damage that speculative cash causes. Investors came under heavy fire in 2008 as the price of oil and food raced upward. More recently they have been knocked for rises in wheat and corn prices. Yet the benefits that investors bring—the liquidity and price information that make for efficient markets—barely get a hearing.

In fact there is little empirical evidence that investors cause more than fleeting distortions to commodity prices. The most persuasive explanation for the rises and falls of commodities is demand and supply. In 2008 a still-growing rich world and a boom in developing countries pushed demand for oil and food up against the limits of supply. Wheat prices spiked this August after a drought and fires in Russia, an important supplier, prompted an export ban. The recent surge in sugar prices comes after a bad harvest, that of corn after official warnings of a lower-than-expected crop.

Investors still make up only a small part of the commodities market. The global oil market alone is worth some $1.8 trillion annually, compared with the $320 billion invested by institutions in all commodities. John Stephenson of First Asset Investment Management, a Canadian fund manager, reckons the idea that speculators swamp every other price signal is odd.

Commodities markets have always been volatile. Harvests are dependent on the weather, and short-term changes in demand are out of kilter with the long-term investments needed to boost supplies of metals and oil. Research published in June by the OECD shows no difference in volatility between agricultural commodities traded on exchanges and those (like onions) that are not. Indeed, the OECD found a "consistent tendency" for greater volumes of index-fund trading to sit alongside declining volatility.

According to Michael Widmer of Bank of America Merrill Lynch, metals traded on exchanges show less price volatility than the non-traded sort. That may be because managers set limits on the proportion of assets accounted for by commodities. So they will sell as prices rise to keep their holdings below that limit, which tends to stabilise prices.

Sceptics point to the behaviour of copper prices in the latter part of last year. Normally prices and inventories should not rise at the same time, since higher stocks ought to bring down prices. The fact that both were rising simultaneously in the copper market had many worried that speculators were buying and hoarding the metal. Speculators were indeed at work but there is no evidence of hoarding. According to Kevin Norrish of Barclays Capital, the rapid price crash of 2008, when prices fell as far as during the Depression (but over five months rather than five years), was an overreaction. As buyers subsequently priced in a recession rather than a depression, prices recovered even as stocks were rising. The steep increase in copper prices since then has proved that the bet was a good one.

Investors do have an effect on prices. Research by Goldman Sachs suggests that speculators exacerbated the oil-price spike in 2008, contributing perhaps $9.50 to the price of a barrel of oil on average. As oil prices recovered from a low of $33 a barrel in 2009, hedge funds that were short-selling oil on doubts about the American recovery surely acted as a drag on prices. But other, more optimistic investors soon started buying. Speculators often lose huge sums on commodity bets, rather denting their reputation for moving markets. The collapse of the commodities market in 2008 battered many hedge funds.

That said, a new version of a fashionable financial instrument may be a step too far. American regulators are on the verge of approving physically backed copper exchange-traded funds, listed investment vehicles that have become hugely popular. Several institutions are planning to offer them. ETFs for other base metals could follow.

Almost all current investor activity is in futures markets. It is rare for investors to take physical delivery of commodities, so no raw materials are removed from the supply chain (another reason why investors are unlikely to affect spot prices). Yet the express purpose of the new ETFs is to take copper off a market that is already tight, bringing investors and industrial consumers into direct competition for supplies. Not everyone agrees this is a problem; some say it is just another price signal. But it has the potential to cause price swings that would make the row over onions look like small potatoes.