BLAME WALL STREET FOR THE PRICE OF GASOLINE

By John Lohr

"Driving from bank to bank, a man has got to be careful nowadays, for at the price of gas he will burn up more gasoline trying to get a loan than the loan is worth."
Will Rogers (May 17, 1931)

The supply and consumer demand of oil is just fine. There is no shortage of oil, no lines at the gas pumps.

The world-wide production of oil has averaged about 85 million barrels in each of the past three years. Demand now is in the vicinity of 86-87 million barrels. It is expanding steadily in the emerging economies like India and China, pretty much offsetting demand decline in the major economies like ours. However, India and China cannot afford higher oil prices. (Neither can I, Can you?)

So is Big Oil lining its own pockets gouging consumers? O.K, well maybe they are, but that's NOT what's driving up the price of oil.

There is an artificial profit-generator that Wall Street has created that is responsible. It is the massive buying of oil futures by a new category of buyer—Institutional Investors—the giant Pension funds and University endowments in search of more profits. Some call them index speculators, but actually they are institutional commodity indexers, and they are HUGE buyers of commodity futures. They are creating "demand shock" market factors using new investment techniques with consequences unforeseen by Congress.

SO? Explain.

In 1936 the commodities market (CFTC) was created to provide consumers of commodities (ie: buyers of actual barrels of oil like Rocky Mountain Power) with a mechanism to hedge the prices they may be expected to pay for the commodity in the future. There were limits imposed which did not allow speculators to dominate the market. For decades, futures contracts were mostly traded by commodity consumers, agreeing to a price today for a commodity to be delivered in, say, two months as a way to smooth out price fluctuations for those supplies.

Since becoming a for-profit entity the CFTC now allows virtually

UNLIMITED access to institutional speculators. Speculation has always been a force behind commodity prices, but traditional consumer speculators buy and sell to hedge their commodity purchases. Institutional buyers are driving demand in an unprecedented manner. This new breed treats commodity futures as an asset class. Their buying and holding for investment purposes means they consume liquidity and hoard it while providing no benefit to the futures market.

Let's look closer:

Institutions allocate Billions of dollars to this "Asset class" and they buy to their limit, insensitive to the actual price. They're not making an investment decision; they're making an asset allocation decision. Since the commodity futures markets are much smaller than the capital markets, when the Billions pour in, the impact is higher. In the first 52 trading days of 2008, $55 Billion poured into commodity futures. In 2003, Institutional investors put $13 Billion in commodity futures. In the first 3 months of 2008, they put in $260 Billion. Commodity prices rose 183% in those 5 years.

Institutional investors now compose a larger share of outstanding futures contracts than ANY OTHER market participant. When they place 1 or 2 percent of their huge portfolios in commodities futures, they drive the spot price of the commodity UP. Period.

And it gets worse. Index speculation increases the more the prices increase as more and more speculators are attracted. It's the herd mentality—"Have you seen CALPERS (California public employees) is up 137,000%? We need to be there." Their financial advisor helpers tell them they need to be there.

Speculators put money into commodity markets simply to make money on their investments - unlike the consumer investors, who are actually buying or selling orders for physical goods. So, instead of a hedge for physical commodity buyers, oil futures have become a Buy and Hold asset allocation strategy for the biggest institutions. Following their financial helpers' advice they hoard assets while the price has to go up as a self-fulfilling prophecy.

Think of it this way--Institutional buyers hold a 1.1 Billion oil barrel market stockpile-- 8 times the amount the USA added to the Strategic Petroleum Reserve in the last 5 years.

With hundreds of Billions of new dollars poised to enter this market, Congress has to act now to close the legislative and regulatory loopholes that allow the institutional phenomenon to continue to dominate prices.

There are more than a dozen proposals to rein in commodity trading, including limiting how many contracts speculators can hold and closing loopholes that allow them to skirt regulations. Fuel consumers like airlines are writing their customers to lobby their congresspersons. There needs to be immediate reform. Congress says maybe something in August. Sometimes Congress surprises us and passes timely legislation that makes sense, is adequate and actually works. Mostly they do not.

Pension funds say the risk is that if the remarkable run-up in oil and other futures markets reverses course, billions of dollars of retirement benefits could be wiped out. The worry is that if the market does not continue to go up artificially, then pension funds will be in a freefall when there's a downturn. All those of you who have a real pension fund—a defined benefit from your company—not a 401k, or IRA raise your hands. That's what I thought. Much of the USA pension money is held by Public employees—like government workers and teachers. As far as I'm concerned, let the teachers keep what they got and stiff the rest.

Driving the price of commodities by buying and holding futures for investment purposes is a great idea—let's ALL do it. The commodities markets were up 19% the past 5 years, compared to 9% for stocks. That way we can all be there for the crash. Every market fluctuates—it goes up and down. What do you think will happen? The real question is when; the why is somewhat unimportant.

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