

Enter the Dragon – New Dynamics in the Oil Market

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Traditionally, the hedgers and speculators have ruled the commodity markets. But now a new behemoth has stepped in- the institutional 'long only,' 'real money,' fund manager, who has incorporated indirect ownership of raw commodities as an 'asset class.' Yes, there are very large commercial hedgers, and there are very large hedge funds who are speculators, but this new entrant with \$ trillions of assets under management is changing the landscape.

In a recent Dow Jones Newswires article by Spencer Jakab, entitled "US Pension Funds Dip Toe into Commodities, Roil Waters" the author presents his research into the prospective impact of direct investor involvement in commodities:

"...the advent of new funds that have allowed pension trustees to buy a basket of commodities without dabbling in futures themselves, has unleashed a torrent of money -- an estimated \$50 billion of flows into index-tracking funds in the last two years alone, with estimates of another \$50 billion on the way in 2005."

What makes these funds qualitatively different is that they buy and, for all practical purposes, never sell. In fact, most of them continue to net buy an asset class as a percent of their total assets, which means as their financial assets grow over time they buy and hold more and more commodities. And this is exactly what the crude oil markets are telling us. Even as inventories continue to grow well beyond commercial demand, the price continues to rise, as pension funds continue to buy and hoard inventory. And, if allowed to continue, this building inventory will grow indefinitely and NEVER be used! Yes, price is still a matter of 'supply and demand,' but in this case the demand is to hoard- continuously buy and store, and NEVER sell.

At the macro level, our own pension funds are buying crude oil to put away forever, by bidding up the price and depriving us FOREVER from

using the crude oil they purchase. This is truly a bizarre set of circumstances at the macro level, while it makes perfect sense at the micro level. It is a classic and colossal case of failure of institutional structure to serve a viable public purpose.

To make matters worse, this monster has staggering geopolitical consequences that are currently being played out. Hopefully essays on this developing story will trigger more of the same that will enlighten our leadership to these new forces in motion. But be prepared for things to get much worse before they get better.

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