Commodities Suffer Worst Rout Since 2008

SPECIAL PDF REPORT

MAY 2011

A farmer removes rice grains from their stalks at a rice field at Gowa district, Indonesia's South Sulawesi province May 7, 2011. REUTERS/Yusuf Ahmad

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SPECIAL REPORT

What really triggered oil's greatest rout

By Joshua Schneyer

NEW YORK, May 9 (Reuters) - When oil prices fell below $120 a barrel in early New York trade last Thursday, a few big companies that are major oil consumers started buying around $117.

It looked like a bargain. Brent crude had been trading above $120 for a month. But the buying proved ill-timed. Crude kept on falling.

"They were down millions by the end of the day, trying to catch a falling piano," an executive at a major New York investment bank said.

Never before had crude oil plummeted so deeply during the course of a day. At one point, prices were off by nearly $13 a barrel, dipping below $110 a barrel for the first time since March.

Oil's descent followed the biggest one-day price drop in silver since 1980 on Wednesday, after hedge fund titan George Soros was reported to be selling. Exchange operators raised silver's margin requirements, making it more costly to trade the metal and sending investors out of the market. Silver plunged by 20 percent, more by week's end. The rout unnerved some commodity investors.

Oil just doesn't fall by 10 percent in the course of a normal day, though. In commodities markets, oil is king, and its daily contract turnover, typically around $200 billion, is usually able to absorb even large inflows or outflows of investment.

The rare moves of $10 a barrel usually are set off by dramatic events -- the outbreak of the first Gulf War in 1991, or the collapse in 2008 of Lehman Bros bank, which both led to recessions.

Of course, there was major news last week. But the daring Pakistan raid that killed Osama Bin Laden had done little to shift the balance of oil markets on Monday.

In interviews with more than two dozen fund managers, bankers and traders, no clear cause emerged for the plunge in price. Market players were unable to identify any single bank or fund orchestrating a massive sale to liquidate positions, not even an errant trade that triggered panic selling, as seen in the equities flash crash last May.

Rather, the picture pieced together from interviews on Thursday and Friday is one of a richly priced commodities market -- raw goods have been on a five-month winning tear over all other major investment classes -- hit by a flurry of negative factors that individually could be absorbed but cumulatively triggered a maelstrom.

Graphics on correction : (http://r.reuters.com/tyj49r)

Computerized trading kicked in when key price levels were reached, accelerating the fall.

"It was a domino effect," said Dominic Cagliotti, a New York-based oil options broker.

The negative factors -- prominent cheerleaders turning bearish, some weak economic data, cheap money from the U.S. Federal Reserve ending by July, a lessening of political risk -- merely provide a backdrop for the waves of selling.

What stands out is the way computers turned readjustment of positions in a huge and deep market into a rout.

THE COMPUTERS

Stunningly large jolts from so-called stop-loss trading amazed market traders. The automated sell orders were generated as oil crashed through price points that traders had programmed in advance into their supercomputers. In many cases, computer algorithms sold for technical reasons, as oil dropped through levels that, once breached, could trigger ever larger waves of selling yet to come.

The machine trading, based on subtly different but fundamentally similar, algorithmic models, eliminates the white-knuckles and potential human error involved in actively trading a volatile market, and increases anonymity. Instead of breeding hesitation, abrupt price drops can quickly prompt these machines to unload a bullish long position in oil, and build up a bearish short one instead.

Machine-led trading is one plausible thesis for another apparent market anomaly that occurred on Thursday. Exchange data shows that the total number of open positions in the oil market -- a number that would typically fall in a selloff -- instead rose. Normally, panicky funds selling oil en masse would cause total "open interest" numbers to shrink, as exiting investors closed out contracts. But some machines, following the market trend, may have gone further, by dumping long positions and quickly amassing sizable short positions instead.

"Computers don't care. Momentum just increases until nobody wants to stand in front of it," said Peter Donovan, a floor trader for Vantage on the New York Mercantile Exchange.

Some big Wall Street traders watched their own systems sell into the down trend but couldn't know for sure who had initiated the selling spree. They only knew that similar machines at other firms, from New York, to London, Geneva and Sao Paulo, would be automatically selling in much the same manner.

During Thursday's crash, such selling locked in profits that high-flying commodities traders have been accumulating for months. Some of Thursday's rout appears to have been more a product of the wisdom of crowd computing than of widespread human panic.

"We believe the magnitude of the correction appears in large part to have been exacerbated by algorithmic traders unwinding positions," Credit Suisse analysts wrote in a report.

High frequency trading and algorithmic trading accounts for about half of all the volume in oil markets.

BIG NAMES TURNED BEARISH

Some of the seeds for the rout were sown earlier. In April. Goldman Sachs' bullish team of commodities analysts, led by Jeff Currie in London, issued two notes to clients in rapid succession recommending they pare back positions. In one, the bank called for a nearly $20 dollar near-term correction in Brent oil, while maintaining a bullish longer-term outlook.

The closely watched money king, George Soros, who runs a macroeconomic hedge fund, had said for months that gold was pricey.

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Even online advisors to mom-and-pop investors such as The ETF Strategist had warned of a bubble in precious metals that could be ready to pop.

On Wednesday, the Wall Street Journal had reported the Soros Fund was selling commodities including silver, and four sources from other hedge funds told Reuters they believed Soros was busy selling commodities positions again on Thursday.

Silver markets already had suffered four days of carnage and ended the week down nearly 30 percent. But silver is a tiny market, much more susceptible to sharp price moves. Some traders suspect that big holders were cashing out of the least liquid commodity market first, before moving onto the big one - oil.

As crude crashed on Thursday, it dragged down every other major commodity. The Reuters Jefferies CRB index, which follows 19 major commodities, was on its way to a 9 percent weekly drop, the biggest since 2008.

Oil's selloff began in London, and accelerated as New York traders piled in.

A routine report on U.S. weekly claims for unemployment benefits spooked investors, showing the labor market in worse shape than expected. That fed a growing pessimism about the resilience of the global economy after industrial orders slumped in Germany and the massive U.S. and European service sectors slowed. Then the European Central Bank surprised with a more dovish statement on interest rates than expected, signaling its wariness about the euro zone outlook. The dollar rose sharply.

Before noon New York time, Brent crude oil prices were already trading down a jaw-dropping $8 a barrel.

Fourteen hundred miles southwest of New York's trading floors, on Texas refinery row, oil men were stunned by the drop, which played havoc with their pricing models.

"It was nuts. Our risk management guys were tearing up their spreadsheets," said a major U.S. independent refiner, who asked not to be identified.

A range of factors, both economic and political, were also at play. The recent rise in raw goods has been fueled in part by the U.S. Fed pumping cash into the markets by purchasing $600 billion in bonds. This program has pushed interest rates extraordinarily low, making borrowing essentially free once adjusted for inflation. Investors have been using the super-cheap money to buy into commodity markets. But the Fed's program is slated to end on June 30.

"Funds were likely to take profits before June when the direct (Fed) bond purchases stop. All were eyeballing each other to see who would take profits first," said a London-based oil trader. China, the world's fastest-growing consumer of commodities, also is tightening monetary policy to tamp growth rates and control inflation, raising the prospect of a slowdown in demand for oil.

The political risk premium built into oil prices also came under scrutiny last week. The unrest sweeping through the Arab world - home to over half of world oil reserves - has boosted oil this year. The only major supply disruption so far is from Libya, where war has cut off at least 1 million barrels a day.

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A labourer carries an empty oil container at a wholesale fuel market in Kolkata April 7, 2011. REUTERS/Rupak De Chowdhur

"We've been in a world thinking there's more risk, more risk, more risk," said Sarah Emerson of Energy Security Analysis Inc. "People took this week, and the news of bin Laden's death, to simply reflect. They stopped and said, maybe there's less risk."

GAME OVER

Put all these factors together, and they amounted to a reason to sell. Traders and brokers who spoke with Reuters speculated that macro funds like Soros and others, which had been aggressively overweight commodities, were cutting the portion of their portfolio allocated to commodities. Because those positions had grown so large, even a small rebalancing would amount to billions and billions of dollars in contracts sold. After weeks of thin trading in Brent oil futures, Thursday's trade volume hit a record.

Early Thursday, investment advisory firm Roubini Global Economics had also joined the fray, telling clients for the first time in years to cut commodities in their macro portfolios. Many funds were merely taking months of handsome profits off the table.

Yet Thursday's rout certainly produced casualties.

By the afternoon New York time, some of the world's biggest money managers thought they smelled blood. Several banks and funds seemed to be selling oil in an orderly fashion, even if the price drop was extraordinary. But could a hedge fund be struggling for survival?

They wondered whether any major commodities funds were on the losing end of bullish oil bets, and were getting forced by margin calls from brokers into dumping massive positions.

One trader at a major bank in New York called a colleague at one of the world's largest hedge funds. During the conversation, they exchanged notes, suspicious that one or more commodities-focused hedge funds might be facing a moment of reckoning, one of the participants said.

No fund could be pinpointed. By the end of the day, the person said, they were less suspicious -- a view shared by week's end by many market participants who spoke to Reuters. No one was naming a major hedge fund in dire trouble, or a computer trading algorithm that went haywire.

And unlike last May's flash crash in equities markets -- when stocks fell by a similar 9 percent margin in just minutes -- Thursday's decline came in rolling cascades, playing out over at least 12 hours. Even after Brent fell to settle around $110 by the end of the day, crude prices were still up 38 percent from a year ago.

"Since prices have been advancing well beyond any reasonable measure of value, Thursday's declines felt more like orderly corrections than chaotic panics. There was no sense that anyone was ready to jump from the window," said oil analyst Peter Beutel of Cameron Hanover in Connecticut.

CASUALTIES

The day left some commodities-heavy funds nursing wounds - weekly losses of 10 to 20 percent, according to several fund managers who invest in other hedge funds.

Two of the sources said that London-based BlueGold, a fund known for taking aggressively bullish directional bets on oil in the past, had sizable losses. It was not immediately clear how much the fund dropped, and BlueGold declined comment.

One money manager said of BlueGold's head trader Pierre Andurand: "He's had tougher weeks so I don't think it's game over."

Fund sources also cited losses at $20 billion Winton Capital, of around 2.2 percent, on Thursday. FTC Capital, a $300 million European commodities fund, lost 4 percent in one of its larger funds, the sources said. Neither fund was available for comment.

In the space of just hours, the drop in the price of crude oil had shaved nearly $1 billion off the cost of supplying the world's daily oil needs. That could be good news for gasoline consumers. But Eric Holder, the U.S. Attorney General who has recently formed a government working group to investigate manipulation in oil markets, had a blunt warning for oil traders. He wants proof the savings are being passed on to end users.

"This working group was created to identify whether fraud or manipulation played any role in the wholesale and retail markets as prices increased. If wholesale prices continue to decrease, fraud or manipulation must not be allowed to prevent price decreases from being passed on to consumers at the pump," Holder said on Friday.

Flares burn at the Rosneft Achinsk oil refinery plant, one of the biggest Siberian fuel suppliers, near the town of Achinsk, some 188 km (117 miles) west of Krasnoyarsk, April 28, 2011. REUTERS/Ilya Naymushin

TECHNICALS

Rout not over for commodities as CRB uptrend ends

(Wang Tao is a Reuters market analyst for commodities and energy technicals. The views expressed are his own.)

SINGAPORE, May 6 (Reuters) - The Reuters-Jefferies CRB index could slump a further 14 percent following its fifth biggest one day fall ever on Thursday, a view bolstered by prospects of gains in the dollar index and near-term bearishness for oil and gold.

A long-term uptrend for the CRB index has been violated following a 5 percent fall in the previous session to 341.07, pointing to a correction to as low as 294.42, the presumed wave "B" trough.

For a CRB technical outlook graphic:

(http://graphics.thomsonreuters.com/WT1/20110605093356.jpg)

For a Brent long-term oil chart:

(http://graphics.thomsonreuters.com/WT1/20110605102037.jpg)

For a U.S. long-term oil chart:

(http://graphics.thomsonreuters.com/WT1/20110605102538.jpg)

For a long-term gold chart, please click:

(http://graphics.thomsonreuters.com/WT1/20110605103412.jpg)

For a daily comparison chart on the dollar index and CRB:

(http://graphics.thomsonreuters.com/WT1/20110605105306.jpg)

A corrective "A-B-C" wave cycle, which unfolded from the February 2009 CRB index low of 200.16 has ended, as indicated by the Elliott Wave theory -- a study on recognizable patterns with a focus on mass behavior and psychology, which usually swings from extreme pessimism to extreme optimism, or vice versa.

Based on the theory, an "A-B-C" upward move in a three-wave structure simply means the market could be extremely choppy and difficult to a forecast for a long-term primary trend, a term coined by the father of technical analysis, Charles Dow.

The 19-commodity CRB index shed 5 percent on Thursday, its fifth biggest one-day fall ever, triggered by a strong resistance at 369.37 , the 61.8 percent Fibonacci retracement on the fall from 473.97, a high hit in 2008, to a February 2009 low at 200.16. The Fibonacci ratios, such as 0.764, 0.618, 0.5 and 0.382, have formed the mathematical foundation of the wave theory, and a reversal at the 0.618 golden ratio level means a lot to Elliot Wave practitioners. However, if support holds firm at around 323.55, a recovery is possible.

BRENT, U.S. OIL, GOLD

U.S. oil accounts for a 23 percent weighting in the CRB index and a technical picture on CRB index would be incomplete without a reference.

U.S. oil's rally was exhausted early this week, and turned bearish on the short-term outlook. For Brent , the possibility of a sharp technical correction forecast earlier this week has come quickly. Cautiously, that the two oil contracts may reverse their long-term bull trends as both dropped deeply when Brent touched the 100 percent Fibonacci projection level and WTI approached its same level. But a wait-and-see approach is advised for now before confirming any rush to the bearish side. As for spot gold , it could have peaked around $1,545 per ounce - a level was pinpointed early March in a forecast based on a Fibonacci projection of its current wave "C" target.

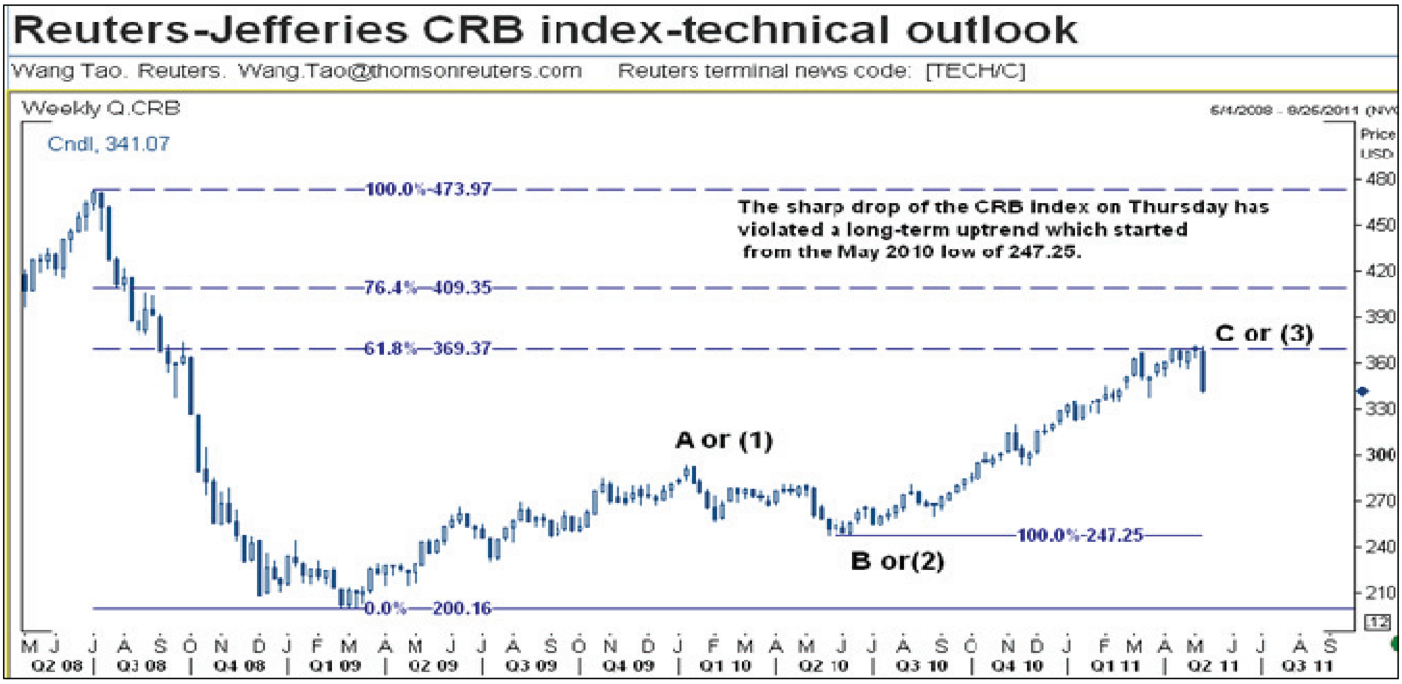
DOLLAR INDEX

Falling commodity prices often present a good excuse for the market to buy the dollar and that appears to be the case this time, as illustrated by the dollar index.

The dollar index rebounded sharply after it touched a strong support at 73.231, the 61.8 percent Fibonacci projection level of the current wave "C", based on a length of a wave "A".

Over the next few weeks, the index may rebound to a high at 77, confirming a further fall in commodity prices.

** No information in this analysis should be considered as being business, financial or legal advice. Each reader should consult his or her own professional or other advisers for business, financial or legal advice regarding the products mentioned in the analyses. **



ANALYSIS

Time to move some money to stocks from commodities

By Walter Brandimarte

NEW YORK, May 12 (Reuters) - Commodities have lost their luster for leading investment strategists on fears that global economic growth, particularly Chinese demand, may be lower than previously expected.

Instead, they are recommending investing in large-cap U.S. companies whose earnings have historically varied less through economic cycles. That includes defensive areas such as household products and utilities but also some technology and industrial companies.

Investors became more cautious about commodities after last week's vicious unwind of oil, copper and precious metals -- which some dubbed a mini "flash crash" similar to the one seen in U.S. equity markets a year earlier.

Even as strategists recommend steering away from commodities, they agree that the long-term outlook is positive. But over the near term they do not rule out another downleg in prices -- especially if China, the world's largest consumer of raw materials, continues to tighten monetary policy.

"Chinese policy makers made it very clear that there is 'no absolute limit' to what they will do to control inflation, which raised concerns around the impact of their actions on demand growth" for commodities, Jan Loeys, head of asset allocation at JPMorgan, wrote in a research note this week.

Economic activity has been moderating in China, and prospects for future growth seem less certain after the government signaled no end in its fight to curb inflation.

China raised bank reserve requirements by 50 basis points on Thursday, surprising analysts who had expected it to use monetary brakes less aggressively after a series of weaker-than-expected economic data for April.

For its part, the United States saw growth domestic product of only 1.8 percent in the first quarter, down from 3.1 percent in the last three months of 2010.

Last week's sell-off drove the price of U.S. crude oil below $100 from an April peak of more than $113. Prices have been volatile since then, and further weakness is possible.

"What happened in commodity markets last week was not surprising at all, and more weakness in the near term wouldn't be that surprising either," Jim O'Neill, chairman of Goldman Sachs Asset Management, said in a recent research note.

U.S. A BRIGHT SPOT FOR NOW

As commodities lose appeal, the outlook for U.S. stocks remains bright in the short term -- at least as long as the U.S. Federal Reserve continues to provide easy money with its quantitative easing policy.

Merrill Lynch argues that the three main drivers of stocks performance -- investor positioning, monetary policy and company profits -- remain in place, albeit less so than two years ago.

"While we would wait for a better entry point, we believe the cyclical bull market in equities is not over and would buy any summer weakness in stocks, Michael Hartnett, Merrill Lynch's chief global equity strategist, wrote in a report, in which he favors U.S. and emerging markets over Europe and Japan.

Defensive stocks are preferred to cyclical ones, JP Morgan said, arguing that the economic indicators show the global manufacturing sector is experiencing an inventory correction similar to the one seen around the middle of last year.

Defensive stocks are not the only ones that should perform well this year, according to Merrill Lynch. Companies with strong and stable profit growth are also expected to thrive as corporate earnings decelerate in general and the Federal Reserve prepares to reduce monetary stimulus, it said.

"The list of stocks (with the lowest earnings variability) comprises a surprisingly diverse group, with almost equal representation from cyclical sectors as well as defensive sectors," Savita Subramanian, Merrill Lynch's quantitative analyst, said in a research note,

Technology stocks, Subramanian added, are well represented in that list.

Other strategists favored U.S. equities over commodities-rich emerging markets because of the opposite impact of lower energy prices.

"Lower energy prices are positive for the U.S. as it allows consumer demand to sustain itself and thereby the economic recovery," said Alberto Bernal, head of research at BullTick Capital Markets.

"A correction in commodities, however, is negative for the emerging markets exporters, consistent with our call for overweight U.S. and developed market equities versus those of emerging markets this year."

COMMODITIES IN FAVOR LONG TERM

But even as worries about demand from China cloud the near-term picture for commodities, views on the global economy lend support for longer term gains.

Bank of America Merrill Lynch economists forecast the global economy to expand 4.2 percent this year, led by strong 6.5 percent growth in emerging markets. In the United States, they expect corporate spending to accelerate throughout the year and help the economy grow about 2.5 percent in 2011.

The outlook for strong growth in emerging markets and a recovery in the developed world should translate into long-term gains in commodity prices, with rises seen beginning later this year, according to strategists.

The conflicting near-term and longer term outlooks is driving caution for now.

"We expect higher prices from here but we wait for more clarity on the impact of the economic soft patch on final demand before going long," JPMorgan said, adding that the recent rout in commodities may have no significance.

"Our reading is that the outlook for commodities may be as little affected by this flash crash as was the outlook for the equities markets after the events in May of 2010," said Kevin Gardiner, head of investment strategy at Barclays Wealth.

While last year's flash crash hammered the Dow Jones industrial by as much as 9.2 percent in its worst moment, the index quickly regained those losses and has since climbed more than 20 percent.

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Barclays Wealth is advising its affluent clients to go neutral on commodities, as they look "very expensive" at the moment despite recent falls.

Prices are unlikely to go much higher, Gardiner says, but "simply keeping pace with inflation over the next year or two will make them a better investment than bonds."

Wild swings in oil prices likely to persist

By Claire Milhench and Christopher Johnson

LONDON, May 12 (Reuters) - Wild swings in oil prices will continue for months to come, after volatility hit a two-year high this week, as trading is increasingly dominated by relative newcomers to the market.

Oil and other commodities markets have gone on a rollercoaster ride since May 5, reacting wildly to economic, currency and inventory data.

"It will persist until the end of the year, and there will be more violent swings in both directions," said Angelos Damaskos, chief executive officer of Sector Investment Managers, which manages the Junior Oils Trust and the Junior Gold Trust. "It will be the fourth quarter before we see more stability."

Close-to-close volatility for the world's two crude oil benchmarks, North Sea Brent and U.S. light crude , known as West Texas Intermediate or WTI, has rocketed to well over 60 percent after two years of declining price moves.

Fund managers and analysts say the heightened volatility reflects increased levels of retail investment and speculation in the commodities markets as exchange-traded products provide easy access for investors with little experience.

"We are seeing a lot of less skilled commodity investors who come in and will hop on a trend," said a UK-based commodity hedge fund manager who asked not to be named.

"When there is a small news event that triggers a correction, either they'll misinterpret it or the trend will temporarily change, there will be a bit of a dip, and they will quickly sell out on that."

"ON THE SIDELINES"

Michael Korn, president of Princeton, New Jersey-based over-the-counter broking house Skokie Energy, said volatility was being encouraged by very large sums of money being deployed by fund managers and non-professional investors.

"The funds being wielded have been growing," Korn said. "It seems like every two to three months we have a new record in speculative open length."

Carl Larry, director of derivatives trading and research at Blue Ocean Brokerage, said there were huge sums of money moving around very quickly, some being invested by people with little experience, and that this was prompting physical traders to sit out during very rapid price moves.

"Physical traders are definitely on the sidelines until the volatility stops," Larry said.

"We're losing any participation from commercial traders trying to get caught in these over-extended moves. When you take that stop gap out of the market, all you are left with is a bunch of funds dictating direction," he said.

Increased futures volatility is also keeping traditional players such as physical traders on the sidelines, making it difficult for them to hedge their supply and demand requirements.

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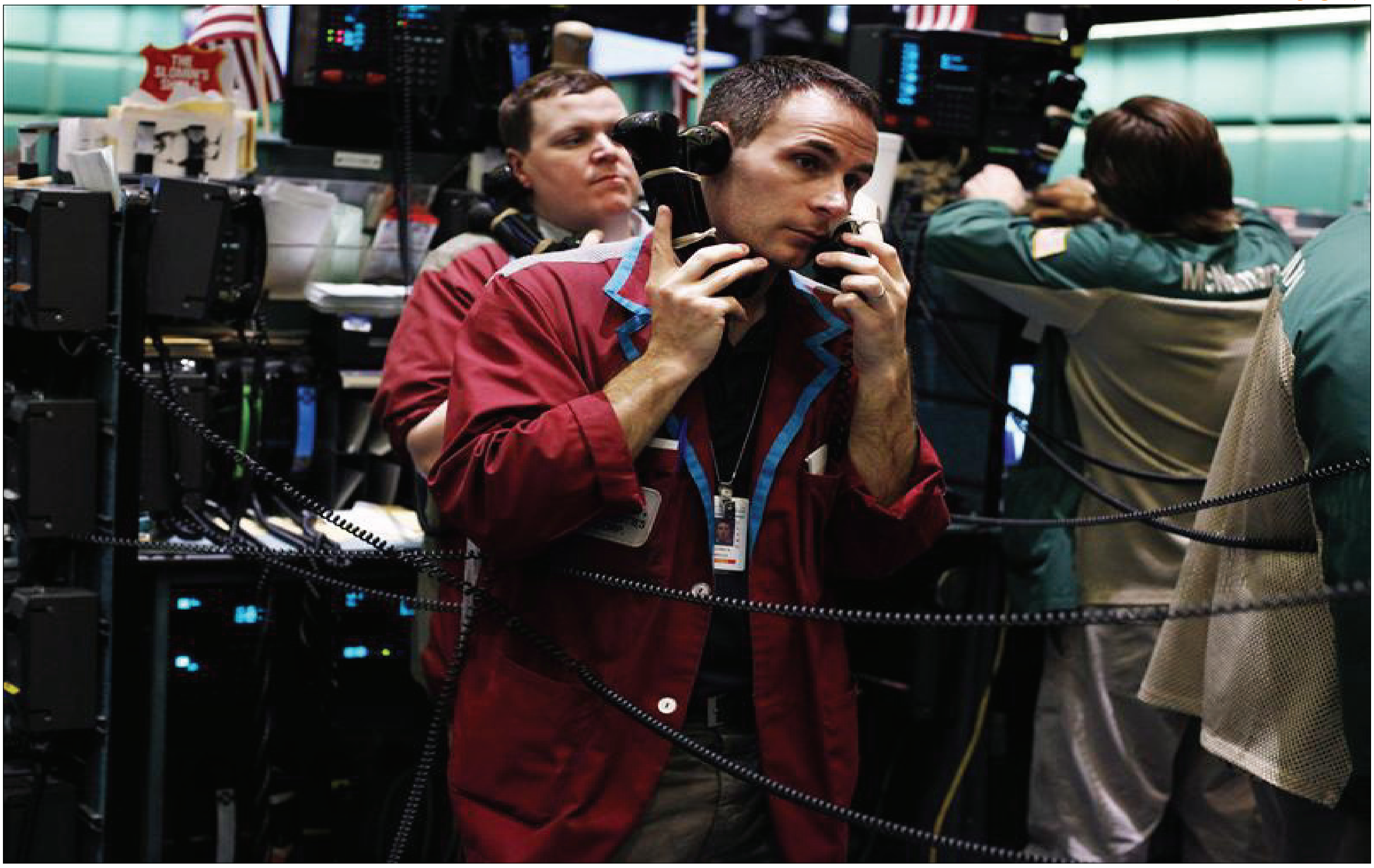

Traders work in the crude oil and natural gas options pit on the floor of the New York Mercantile Exchange in New York May 13, 2011. REUTERS/Shannon Stapleton

Last week investor sentiment changed due to doubts about global growth as China raised interest rates. That followed several months of worries over the loss of oil supply from the Middle East and North Africa as civil war in Libya shut down exports.

Crude oil fell more than $20 per barrel last week, with North Sea Brent tumbling to a low of almost $105 before a partial recovery, but prices have continued slide this week with total daily price moves of up to 8.5 percent.

SYSTEMATIC TRADING

Higher margin requirements for oil and silver on the CME futures exchange have also forced speculators to adjust their positions, adding to choppiness. Fund managers also pointed the finger at systematic trading, which triggers stop-losses when technical levels are breached.

Nigol Koulajian, chief investment officer of commodity trading adviser Quest Partners, said market reversals are getting faster in oil and grains, a by-product of too many people trading the same type of strategy.

"When the market is going up, you get a positive feedback loop, so the price gets reinforced as people add to their positions. But when the market corrects, everyone is running out the door at the same time," he said.

Koulajian said this was much stronger than it used to be as there are more people trading on the technicals.

Investors see no reason why the extraordinary volatility should not continue as worries about the end of quantitative easing, the euro zone debt crisis and inflation combine. Koulajian said quantitative easing had encouraged investors to buy commodities in order to preserve their savings.

"The liquidity in commodity markets is minute compared to financial markets," said Koulajian. Even a small shift in assets from financial to commodity markets will therefore result in substantial swings in commodity prices, he said.

"We are only in the beginning stages of this shift and we expect much more volatility and price increases ahead."

Faint signs show sugar longs may be regrouping

By David Brough and Rene Pastor

LONDON/NEW YORK, May 12 (Reuters) - Investor holdings in sugar have slumped to a two-year low on prospects of increased supplies, but signals are now emerging that investors and funds will pile back in as prices hold above costs of production.

Following a slide of more than 40 percent in ICE raw sugar futures from a 30-year high to stubborn support above 20 cents a lb, some analysts believe that investors and funds could be rebuilding net long positions.

James Dailey, chief investment officer of TEAM Financial Asset Management in Harrisburg, Pennsylvania, said he does not believe sugar's appeal has diminished.

"I believe the time to consider buying something like sugar is when it is experiencing a significant price decline," he said.

"I don't think the long term bull market is over and also believe the current 'bust' is close to being, if not already, concluded."

Dailey added, "However, the extreme swings make a long term buy and hold position undesirable to us, so we are just now getting interested in a potential position in sugar."

Signs of a recovery in sugar holdings have emerged, as investors raised their net long position in ICE raw sugar futures and options by 9 percent in the week ended May 3, according to U.S. Commodity Futures Trading Commission data.

For sugar, this brought speculators' net long position to 56,915 lots, up 4,842 lots from the previous week.

Sugar prices are not likely to fall below the Brazilian cost of production -- estimated at around 18-20 cents a lb -- for long, otherwise supply of the staple would dry up. Brazil is the world's top sugar producer and exporter.

Keith Flury, senior commodity analyst with Rabobank, said he believed 20.00 cents a lb represented strong support for ICE raw sugar futures.

The market fell as low as 20.40 cents a lb, an eight-month trough -- just above the Brazilian production cost -- on May 6.

ICE front-month July raw sugar futures were down 0.04 cent or 0.19 percent to 20.90 cents a lb on Thursday.

OUTSIDE SHOCKS

Analysts said any return by investors and funds into sugar would be hostage to unexpected macroeconomic events and adverse weather.

A macroeconomic shock, such as a heightened sovereign debt crisis, could spur a flight from risky assets like commodities, including sugar, even if the fundamental picture for the sweetener was turning more positive, Flury said.

"If there was some kind of unexpected macro event, then we could see a sell-off," he said.

Mike McDougall, senior vice-president of brokerage Newedge USA, said that for hedge funds and long-only funds to return to sugar, weather problems in Brazil or number 2 producer India could again spur a rally. Investment funds which had bailed out of sugar would need to look at how the supply/demand situation evolves in 2011/12 before deciding whether to get back into the market.

"I think you saw some fund liquidation. I think you had some general lightening up of positions," McDougall said, referring to the sell-off from the 30-year high. Sugar was caught up in the latest commodities market sell-off, but has fallen less than oil as the sweetener's cost of production point approaches.

PYSCHOLOGY

The general market psychology was that supply was better than expected and prices could only fall, Rabobank said earlier this month in a report entitled "Speculators Soured on Sugar?"

"The falling net long position and recent downward price movement correspond very closely to what occurred last season when levels reached nadirs in early May and then increased significantly to the end of the year," Rabobank said.

ICE raw sugar dropped to a low of 13.00 cents a lb on May 7, 2010, before surging 178 percent to its 30-year peak on Feb. 2., 2011, as sentiment turned bullish due to tight supplies.

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After hitting the high, futures collapsed by 43 percent, as speculators cut their net long position by a quarter with market fundamentals shifting from a global deficit to a surplus.

The market fell on expectations of huge supplies from the current harvest in the centre-south of Brazil and bigger-than-expected Thai output. "It (net long position) can only go so low," Keith Flury, a senior commodity analyst with Rabobank, told Reuters. "Once the quick-to-leave speculators have sold, we're left with some who are still in with expectations of a tight supply next season (2012/13)."

Low prices will stoke physical demand, potentially reducing availability of the sweetener and driving the market upwards.

"In the long run there is a need for sugar prices to stay high to encourage growers to plant sugar," Flury said.

Commodities margins: art, science or politics?

By Jonathan Leff and Robert Gibbons

NEW YORK, May 12 (Reuters) - Recent nerve-shattering hikes in the amount of money exchanges require to trade commodities have stoked concerns over an often overlooked cornerstone of managing risk in futures markets: setting effective margins.

The CME , which operates the world's leading energy, grain and precious metal markets, portrayed a series of five increases in silver margins, and this week's 25 percent rise in escrow requirements for oil, as prudent responses to unusual volatility as prices surged to historic levels, then swooned.

But a close examination of the relationship between price volatility and margins, and of ways exchanges apply margins to similar products, shows these decisions are not automatic. And as the past three weeks have shown, decisions whether or not to change them can become the subject of intense speculation.

While the CME says its policies are largely predictable, mitigating the chances of them triggering anything like the crash in silver prices, they also say it's a judgment call.

"It's not a science, not a black box. Judgment and experience definitely come into play," Kim Taylor, President of CME Clearing, told Reuters this week. With some 40 experts monitoring both realized and implied volatility around the clock, "we have flexibility around the margin levels."

After last week, some wonder whether the exchange was factoring a new variable into its considerations -- political risk or, at its most extreme, political interference.

Taylor dismisses the suggestion that anything other than market factors are used to set margins, a critical task that safeguards the ability of an exchange to keep functioning in the event that one of its members fails to pay up.

But some industry experts and traders say it would be logical for exchange executives to take a more proactive approach to managing systemic risk. With high food and fuel prices topping political agendas, exchanges would be wise to head off potential criticism that they stood by while markets got overcooked and then melted down.

If this was a change dictated by the exchange's risk models and algorithms then "that's fine," said Jerry W. Markham, a professor of law at the Florida International University at Miami and an expert on commodity market regulation.

"But these changes were large enough and rampant enough that it looks like to me, sitting outside the process, they may have been designed to discourage speculation."

There's no question pressure from Washington is growing.

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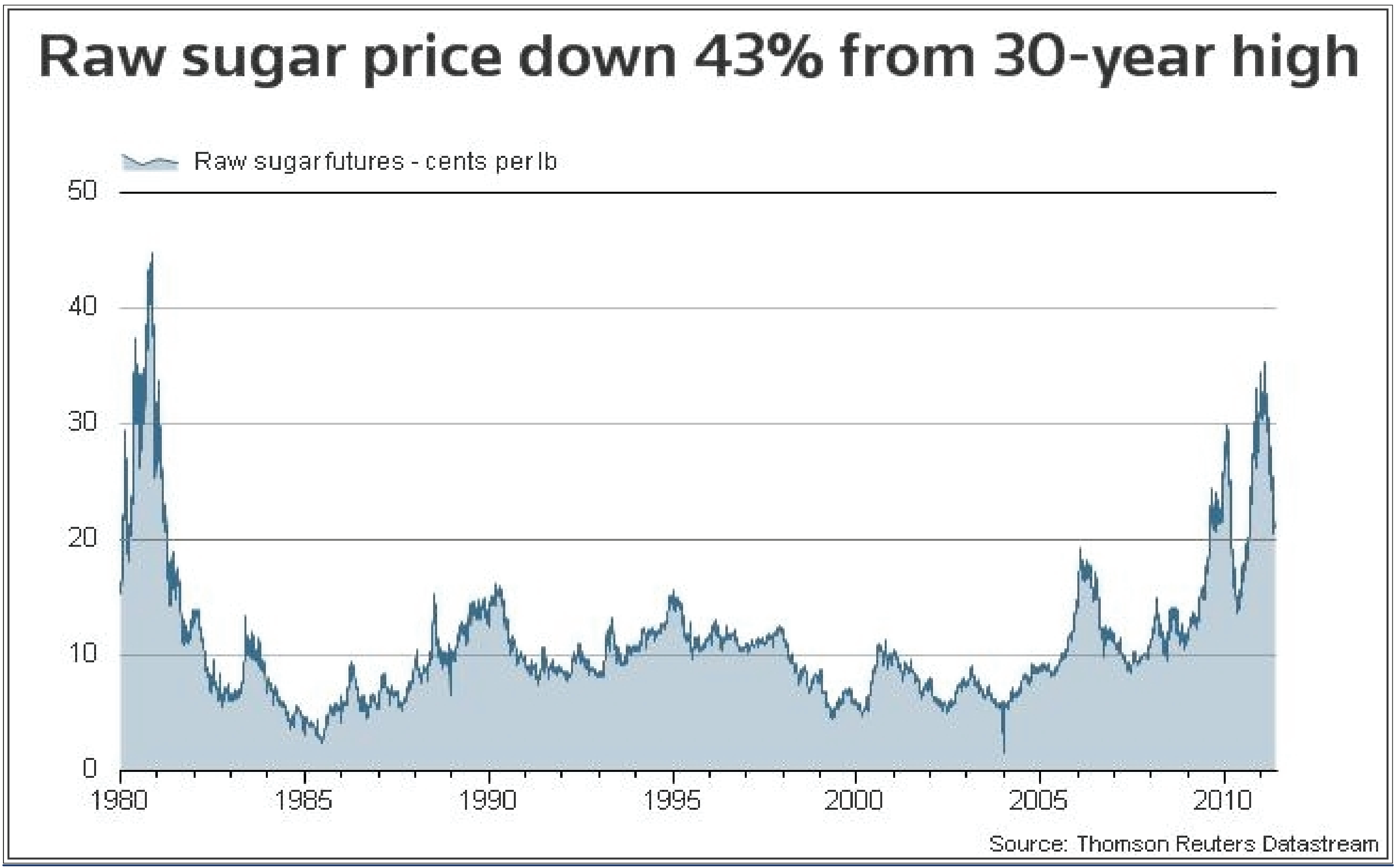


A group of 17 U.S. senators on Wednesday called on the Commodity Futures Trading Commission to crack down immediately on excessive speculation in crude oil markets, demanding the agency's plan to impose position limits within weeks.

"The wild fluctuation could only be the result of rampant oil speculation, plain and simple," said Senator Ron Wyden, one of the lawmakers who wrote to the CFTC demanding action.

Silver volatility and margins: (http://r.reuters.com/duv49r)

Oil volatility and margins: (http://r.reuters.com/zav49r)

Free from regulation, exchanges must walk a tightrope in setting margins high enough to protect themselves from default, but not so high that they choke off liquidity and trading volume, their primary source of revenue. Futures commission merchants also set their own margins for customers.

Many traders tied silver's 25 percent nosedive last week to the CME's 84 percent increase in silver trading margins over two weeks. Yet such a massive collapse resulting from an increase in margin is rare if not unprecedented.

CME officials say margin adjustments do not move prices very much. Typically, market reaction is transitory and brief.

But a sharp increase in trading costs will often force many smaller speculators to close positions rather than pay up to maintain them. As a result, prices can fall, at least briefly. Market talk of a margin call by a major brokerage, though not an exchange, was mooted on Wednesday as a possible cause for the second sharp fall in commodity prices in a week.

"The CME raised (silver) margin requirements four or five times in a dramatic and draconian fashion. Whenever that happens, there is a big correction," commodities guru Jim Rogers told Reuters Insider in an interview on Tuesday. Meanwhile, the potential for short-term volatility caused by uncertainty over margins is real, experts argue. The stakes are set to rise massively as regulators force more of the $600 billion global over-the-counter derivatives market through clearing houses.

"Think of silver as being a scale model of what could happen when OTC swaps are cleared in a big way," says Craig Pirrong, a finance professor and regulatory expert at the University of Houston who argues that margins affect prices.

"Changes in initial and maintenance margins adopted in response to big price moves can destabilize things." he wrote this week on his blog streetwiseprofessor.com. Smaller markets can recover quickly. But for bigger markets like the OTC swaps, it may rattle them "by more than they can withstand."

THE MAN AND THE MODEL

In their simplest form, margins are cut and dried: they are the "prepayment of potential losses", explains Taylor, cash deposits paid by investors to a clearing house to cover the risk of default. They are meant to cover either 95 or 99 percent of all anticipated losses, depending on the market.

Unlike equity markets, where margins are dictated by the Federal Reserve and used more or less explicitly to limit speculation and thus prices, commodity markets establish their own, having successfully argued against repeated efforts to impose more government controls over the past century.

In that period it has an unblemished record, having never experienced a default. The margin-call model also helped exchanges emerge largely unscathed from the Lehman Brothers debacle and ensuing financial crisis.

The CME has 35 to 40 risk professionals in Chicago, New York and London monitoring markets around the clock. If any of them see unusual volatility, they can set the wheels in motion for a possible adjustment in the margin, Taylor said.

The CME Clearing management team would approve those changes, usually after a market closes.

The two most basic metrics for assessing volatility are fairly clear and understood: the actual volatility in futures prices; and implied volatility derived from options trade.

But the team can also look at other "less quantitative market conditions", including news or macro-economic events. It can even hike margins ahead of events, as it did when Hurricane Katrina was bearing down on the U.S. oil patch in 2005.

Taylor said her team would take note of the total number of speculators in the market, but that figure wasn't as important as the potential risk of concentrating too much of the market with a single counterparty.

"The type of market player doesn't matter as much as the diversity of market players," she added.

The CME can then test the extent to which a margin increase or cut would cover anticipated losses using the Standard Portfolio Analysis of Risk (SPAN) quantitative model. Developed by the exchange in 1988, it has become the industry standard used by some 50 exchanges globally.

The degree of discretion can be plain to see.

The New York Mercantile Exchange quickly raised its benchmark U.S. crude oil contract margins in response to last week's abrupt and unexpected fall that caused volatility to spike. It did not boost margins following a similar pick-up in volatility last May, amid heightened European debt concerns.

It also waited until two days after the big fall to raise crude markets; on Wednesday, it hiked gasoline margins by 21 percent on the same afternoon that price fell limit down.

The CME also administers margins differently than archrival IntercontinentalExchange and its Brent crude contract. The CME has raised WTI margins four times for a cumulative 67 percent increase since February, while the ICE has raised margins 9 times totaling 47 percent. Its latest rise on Wednesday increased margins by just 9 percent.

While a record gap has emerged in the prices of WTI and Brent, their volatility remains similar.

"ICE seems to be far more model-driven than the CME," says Dennis Gartman, a long-time commodity trader who also sits on the board that makes decisions on margin changes at the Kansas City Board of Trade.

POLITICAL RISK

The last time margins became a political issue was following the stock market crash of 1987, when rumors about the integrity of the clearing houses caused a surge in calls. The presidential Brady Commission that investigated the crash recommended that margins be set equivalent in futures and stocks, and that both be regulated by the Federal Reserve.

The CFTC demurred, arguing that margins too high would diminish liquidity and undermine the market's function.

(Continued on page 11)

It allowed exchanges to continue setting their own margins, although it retained the right to set "temporary" margins in the event of an emergency, part of the Commodity Exchange Act.

The CFTC is usually informed of margin changes as a "courtesy", but not always, Chairman Gary Gensler said on Wednesday. He said there is "close dialogue" on levels and the CFTC does its own modelling and stress-testing.

But while the Dodd-Frank regulations gave the CFTC more authority to write policy and procedure rules, he said, "the responsibility is clearly the clearinghouse's."

Still, some say Washington's role is substantial.

David Greenberg, a member of the NYMEX board from 2000 to 2007 and founder of one of the biggest local clearing houses on the now CME-owned NYMEX, put it bluntly: "It was window dressing to get the government off their back after the recent remarks by President Obama and Attorney General Holder."

Exodus from silver set to take prices below $30/oz

By Jan Harvey

LONDON, May 12 (Reuters) - Silver's rout this month after its bullish run this year could take the metal to three-month lows below $30 an ounce, as speculators, shaken by its 30 percent plunge of the last two weeks, rush for the exits.

A wave of hot money from funds fuelled a rally that saw the price nearly double in the space of four months, overwhelming fundamentals in an illiquid market, touching a record near $50 an ounce last month. "Silver is looking more and more like a bubble," said Saxo Bank senior manager Ole Hansen.

Spot prices fell another 7 percent so far on Thursday after a 9 percent drop in the last session, extending losses after their largest weekly fall on record last week.

"Many have been trapped over the last week on the bounce. $30 cannot be ruled out, and to the extreme $25, which would be the 50 percent correction," Hansen added. Investors have sold the metal heavily after exchange operators in Shanghai and New York increased the amount of money they require to trade silver futures.

The Shanghai Gold Exchange's announcement of another hike in margin requirements on Thursday helped push prices below $33 an ounce for the first time since February. Analysts said the metal has found good chart support around current lows, but remains vulnerable.

Silver's fall was long predicted by precious metals traders, who said its rally to a record $49.51 an ounce on April 28 was unjustified by fundamentals. As a small and relatively illiquid market, silver tends to be more volatile than gold.

Analysts said its strong price performance attracted more speculators to the market, who were easily scared off when the metal's correction first started gathering steam.

(Continued on page 12)

A man looks at an electronic board displaying various market indices from around the world outside a brokerage in Tokyo May 16, 2011. REUTERS/Toru Hanai

"The price increase we have seen over the last few months has been exaggerated by speculative interest, and the shaky hands now need to be pushed out of the market," said Commerzbank analyst Daniel Briesemann.

With some less committed investors still present in the market, prices have further to fall, he predicted.

ETF INVESTORS HEAD FOR THE EXITS

Investors have also been pulling out of the world's largest silver-backed exchange-traded fund, New York's iShares Silver Trust . The trust's holdings have dropped by more than 480 tonnes since the beginning of May, already approaching its biggest monthly outflow ever of 495 tonnes, recorded in January.

The popularity of the silver ETF, which added nearly 1,500 tonnes of metal to its holdings last year, was a key factor pushing prices towards $50 an ounce. A return of significant quantities of that metal to the market could hit prices hard.

"Investor interest in silver has declined dramatically since the start of the correction, epitomised by the large ETF outflows," said Anne-Laure Tremblay, an analyst at BNP Paribas.

"So far we haven't seen any outflows of this magnitude in gold ETFs. This may be linked to the different risk/reward profiles of gold and silver. Silver is often considered as a geared play on gold, so it would be logical to see more pronounced shifts in investor sentiment."

Traders were also spooked in recent weeks by silver's increasing expensiveness compared to gold. The gold:silver ratio -- the number of silver ounces needed to buy an ounce of gold -- fell to its lowest in nearly 30 years near 31 as the grey metal rose towards $50 an ounce, but has since rebounded to around 44.

"It is in much more comfortable territory now," said Mitsubishi precious metals analyst Matthew Turner.

But while silver is expected to correct further in the short term, in the longer run it remains supported by the same factors that took both gold and silver to record highs this year -- concerns over the outlook for the dollar, the low interest rate environment, and the impact of the euro zone debt crisis.

Demand for the metal from industrial users, chiefly electronics manufacturers, is also likely to put a floor in prices, though it is unclear where this will be.

And overall, silver investors are still in the black this year, albeit to a lesser extent than in previous years. Spot prices are up nearly 7 percent so far in 2011, meaning the metal is still comfortably outperforming gold, platinum and palladium.

Too early to call a bear market for copper

By Pratima Desai and Polly Yam

LONDON/HONG KONG, May 10 (Reuters) - An exodus of investors from the copper market could see prices slip to the $8,000 a tonne mark before heading back towards record highs later this year as stronger demand from China and Japan becomes visible.

Copper prices tumbled with other commodities last week as the dollar strengthened and investors fretted about consumption after disappointing surveys of manufacturing in top consumers China and United States.

LME copper fell to $8,657.50 a tonne last week, its lowest in more than 5 months and a 15-percent drop since the all-time high. It was trading around $8,950 a tonne on Tuesday.

China's absence from the market for some months now has also taken its toll on sentiment. It accounts for about 40 percent of global demand for the metal used widely in power and construction.

But as Chinese consumers are expected to return later this year, Japan rebuilds its infrastructure after the earthquake in March and inventories fall, confidence in the metal's price prospects will grow.

For now though a lacklustre performance is on the cards.

"It could go to $8,500 a tonne or perhaps even as low as $8,000 as investors unwind positions," said Stefan Graber, commodities analyst at Credit Suisse Private Banking.

"But copper price weakness will be used by physical consumers who have been waiting to step up their purchases and replenish their inventories ... We expect reconstruction efforts in Japan to boost consumption in the second half of the year."

Analysts reckon Japan normally consumes about 5 percent of global copper supply -- estimated at around 19 million tonnes last year. It's consumption in 2011 could jump to 10 percent of the total estimated at around 21 million tonnes this year.

The second half of the year is when many fund managers and analysts think copper on the London Metal Exchange will tackle the record high of $10,190 a tonne hit on February 15.

Jing Chuan, chief researcher at Hua Tai Great Wall in Shanghai said demand could pick up quickly as credit became more easily available.

"It's too early to say the bear is coming," he said.

Monetary tightening to restrain inflationary pressures in China have curbed demand and the country's copper imports, which in the first three months of this year fell 21 percent from a year earlier to 595,963 tonnes.

BEFORE TOO LONG

The spotlight is also on bonded stocks in Shanghai, which analysts and traders last month estimated at between 500,000 and 700,000 tonnes, about double the levels seen last December.

These stocks are not monitored by the Shanghai Futures Exchange (SHFE) and so are only estimates, but they are used as collateral for loans, for higher-yielding investments elsewhere.

"Any move back to the $10,000 mark in the next few months would again shake loose stocks held by speculators in China," said David Thurtell, analyst at Citi.

"We believe the tight market should sustain the copper price in an $8,000-10,000 range over the next year or so."

A purchasing manager for a large Chinese copper tube producer said it will not be easy for copper prices to fall below $8,000 a tonne and that demand for the company's products had been strong since April.

(Continued on page 13)

Analysts say other consumers in China have reported better demand for their products -- possibly a reason why stocks in warehouses monitored by (SHFE) have since April 1 fallen nearly a quarter to 123,043 tonnes.

However, stocks of copper in LME warehouses have climbed more than 30 percent to above 468,000 tonnes since December 9. "We think LME warehouse stocks will follow (Shanghai stocks) before too long," Graber said.

DRIVERS

"To see copper back at its peak we would need to see China finished with monetary tightening," said Sean Corrigan, chief investment officer at Diapason Commodities, who thinks there is potential for copper to see $8,000 a tonne.

"Conversely we need another set of drivers for speculative activity to push prices higher ... One thing we need to think about is how much more money could the Bank of Japan print for the reconstruction process."

Investors have in recent months and years borrowed and sold cheap dollars to finance potentially higher-earning assets such as equities, corporate debt and commodities.

Those trades have been reinforced by an abundance of liquidity, or dollars pumped into the global financial system by the U.S. Federal Reserve.

"But people could start using the yen again if the Bank of Japan is led into helping to provide extra credit and if that happens all bets are off," Corrigan said.

If people start using yen to finance trades then they will not use dollars, which may mean a higher U.S. currency and more expensive commodities for investors who use other currencies.

A weaker dollar has been a key factor behind commodity price strength since 2002/2003.

An employee works in a ferronickel smelter owned by state miner Aneka Tambang Tbk at Pomala district in Indonesia's southeast Sulawesi province March 30, 2011. REUTERS/Yusuf Ahmad

Dollar vs commodities play strong on end of QE2

By Pratima Desai

LONDON, May 10 (Reuters) - Prospects of an end to liquidity provided by the U.S. Federal Reserve have sent the inverse correlation between commodities and the dollar into overdrive and to many investors that means time to sell.

The inverse relationship has surged in recent days to levels not seen since early November when the U.S. central bank announced further liquidity boosting measures.

(http://r.reuters.com/wex39r)

The Fed in November launched a second programme of bond purchases or quantitative easing, known as QE2. Due to end in June, it has pumped $600 billion into the financial system.

"What we are seeing is a little bit of de-risking -- taking profit on commodity investments -- on concerns about what a post QE2 environment looks like," said Andrew Cole, a fund manager at Baring Asset Management.

"Periods of de-risking tend to be dollar supportive ... the market will be nervous until the moment QE2 ends."

Without another bond-buying programme, thoughts have inevitably turned to interest rate hikes in the United States, which is one reason why the dollar last week rallied as commodity prices plunged.

"If the Fed deems there to be no need for QE3 then presumably at some point short-term interest rates will normalise," Cole said.

"That will feed through to the cost of carry (cost of borrowing dollars to sell for commodities), which is one reason why you would be less inclined to own assets that don't pay anything (such as commodity futures)."

SPECULATIVE FROTH

The 20-day rolling inverse correlation between the dollar and the CRB index of 19 commodities is now around 70 percent compared with 10 percent in the middle of April.

Last October, in the run-up to QE2, the inverse correlation between the dollar and the CRB stood at 74 percent, while versus crude oil it was a 77 percent.

The dollar's negative correlation against crude oil is now about 73 percent from 3 percent on April 15.

"If there is no QE3 the dollar will get stronger which means it will be risk-off, which certainly, means more speculative froth coming off commodities," said Lars Steffenson, managing director at Ebullio Capital Management.

"We've taken a good 10 percent out of commodities, which is probably about half the speculative froth. Whether the other half gets lifted depends entirely on the dollar."

Spot silver plunged 25 percent last week and copper on the London Metal Exchange lost 5 percent.

U.S. crude oil futures fell $16.75 a barrel last week, the biggest weekly loss in dollar terms since oil trading began on the New York Mercantile Exchange in 1983.

(Continued on page 14)

"The biggest trade out there has been the short dollar, long macro trade, a lot of people have been playing that aggressively via commodities," said Michael Lewis, head of commodities research at Deutsche Bank.

"We are seeing renewed inflows into U.S. Treasuries ... the end of QE2 could see a big impact on commodities, particularly oil, there are some huge positions out there."

One trigger for dollar strength and the commodities rout last Thursday was European Central Bank President Jean-Claude Trichet, who signalled that euro zone interest rates are unlikely to rise next month, as some had been expecting.

That leaves the euro's interest rate differential against the dollar unchanged and markets used the news to drive up the U.S. currency to its highest in more than two weeks.

"The primary driver of currencies is going to continue to be the divergent interest rate policies between the Fed and the ECB and the debt situation in the euro zone peripheral economies," said Omer Esiner, chief market analyst at Commonwealth Foreign Exchange in Washington.

"If we do see another move similar to what we saw last week in commodities, certainly that can't be ignored, but that will probably take a back seat to interest rates and debt problems in Europe."

Debt problems in Greece and Ireland are weighing again on the euro against the dollar.

Commodity correlations with dollar :

(http://r.reuters.com/wex39r)

Commodities performance :(http://r.reuters.com/nab49r)

Is the global economy slowing?(http://r.reuters.com/kej49r)

Oil daily price changes :(http://link.reuters.com/qaj49r)

Commodity storm leaves food concerns intact

By Marie Maitre and Gus Trompiz

PARIS, May 6 (Reuters) - This week's commodities plunge has done little to dent concerns of continuing food price inflation, as grain prices held up better than most and fundamentals for the highly weather-sensitive sector are unchanged.

Grain traders have had their eyes glued to weather forecasts rather than economic data, as heavy rainfall slows planting in the U.S. Corn Belt and a drought in parts of the United States and western Europe threaten wheat crops.

Oil dived 10 percent on Thursday as weak U.S. and German data stoked worries about slowing global growth but any new rush out of top commodities would pinch, not hammer, agricultural goods, says fund manager Gertjan van der Geer.

"If investors get out of commodities as a whole it will also put some pressure on agriculturals, but fundamental investors may start looking at agriculture as the odd one out, the attractive one in the bunch," said Van der Geer, who manages agricultural funds at private Swiss bank Pictet.

Most commodity markets remained jittery on Friday, with oil seesawing before rising on a stronger-than-expected U.S. jobs report, which helped ease some economic worries. But gold, copper, iron, sugar or coffee showed no sign of regaining substantial ground after the previous session's brutal losses.

European wheat futures were up 2 percent at about 214 euros a tonne, after adding 0.5 percent on Thursday, apparently immune to the brutal losses in commodities that stunned many traders around the world. Chicago wheat was 1.39 percent higher at $7.64 per bushel.

"The (agricultural) fundamentals are less dependent on economic activity. Soft commodities are more dependent on the weather," Van der Geer said.

CLINTON ACTION CALL

Earlier on Friday U.S. Secretary of State Hillary Clinton said the world has to take swift action to arrest steadily rising food prices and step up its commitment to sustainable agriculture, even as commodities prices were sliding.

Food prices, which hit record highs in February, have been a long running concern for the U.N.'s Food and Agriculture Organisation which said on Thursday its world food index rose slightly in April, boosted by worry about the U.S. grain crop.

FAO Director General Jacques Diouf told Reuters Insider on Tuesday a weak trend in world food prices had already begun to reverse and prices were set to rise again as concerns persist over Chinese and U.S. winter crops.

Grains and oilseeds were tied to some extent to fluctuations in oil and other commodities due to their use in biofuels and with commodity-wide strategies used by some investors.

U.S. corn futures bounced in early Chicago trade in Friday with help from firmer crude oil as the U.S. jobs data encouraged renewed buying.

But weather and production issues continued to haunt the market and operators said slow U.S. corn plantings and the tightest stocks since the 1930s have helped soften the blow of the commodity selloff.

Wheat has also been underpinned by adverse weather. Severe drought in Texas and the U.S. Plains threatens to cause significant crop losses, while persistent dry weather in France, Germany and Britain could harm crops in Europe's bread basket.

COMMODITY PICKING

"There are such low inventories that if the U.S. Corn Belt stays too wet too long it may push farmers to switch crops. That could mean even less corn and we would see new inflationary pressures," Van der Geer said.

Philippe Chalmin, an academic who advises the French government on food issues, said a commodity selloff had been long overdue as prices "were nearing the sky" but he believes investors will do some "commodity picking."

"Agriculturals appear best placed to do well. Not all of them will (do well), but there are some where we have real issues underpinning prices. This is the case for corn," added Chalmin, who said the weaker dollar and Goldman Sachs were the double trigger of Thursday's rout in commodity markets.

The U.S. bank advised customers to take profits from major commodity markets three times in early April, saying prices had moved too far, too fast, and that speculators had pushed prices ahead of fundamentals.

(Continued on page 15)

Also lurking behind the most immediate weather concern was a longer-term belief among market players that the production of agricultural commodities is struggling to cope with the ever rising needs of a growing world population.

"We have neglected as a population the food complex for the past 40 years. The problem is that we haven't invested enough," Ralf Oberbannscheidt, manager of the DWS Invest Global Agribusiness fund, said at a presentation in Paris on Friday.

"Today you have higher inventories in copper and iron ore but not in food," he said, arguing this imbalance "absolutely justified" higher food prices.

Is the global economy slowing?:(http://r.reuters.com/kej49r)
Correlations with the dollar:(http://r.reuters.com/wex39r)
Commodities performance: (http://r.reuters.com/nab49r)

Commodity scare may reinforce, not reflect growth

By Mike Dolan

LONDON, May 6 (Reuters) - This week's commodity market fright at the cresting of world economic growth looks oddly panicky and easier oil and raw materials prices may themselves reinforce a more benign outlook than the market scare suggests.

For all that speculative ebb and flow is inherent in most financial markets, the sudden plunge in energy and metals prices was seeded by series of soft business surveys from the United States, China and elsewhere showing sky-high crude prices were starting to brake buoyant business confidence and activity.

Add in some weak signals from the U.S. labour market in the form of a sharp jump in weekly unemployment claims and jitters about the release next week of the latest Chinese inflation and production data and a brutal retreat in commodities ensued.

At its low just above $105 per barrel on Friday, Brent crude oil had lost more than 12 percent since Wednesday alone, the biggest two-day fall since the financial crisis over two years ago. But should the other financial markets, businesses and households run scared too or should they breath a sigh of relief that dangerous and inflationary commodity market excesses may have been lanced for now at least?

For many leading economists, the answer is the latter.

Some slowdown in breakneck industrial production growth is due and warranted, they argue, as the bigger risk to world growth going forward is one of overheating commodity demand that exaggerates headline inflation further and forces central banks to react by tightening credit and slowing their economies.

A French farmer holds dry earth in his hand as a tractor works in a field in Blecourt, northern France, May 12, 2011. REUTERS/Pascal Rossignol

In that respect, the commodity retreat is welcomed with open arms by policymakers such as European Central Bank chief Jean-Claude Trichet who have been trying to stem inflation fears by pushing up interest rates from supereasy, credit crisis lows.

"It (the commodities retreat) is good to take in terms of consolidating the recovery because any increase in the price of oil and commodities has an inflationary impact and a depressive impact (on growth)," Trichet said on Friday.

Economists at U.S. bank JPMorgan echoed that view, telling clients late on Thursday that if the drop in oil and food prices are maintained, "they will provide unexpected relief on inflation and household purchasing power."

Looking outside the United States, UK bank Barclays reckons that if a lower trending oil price of around $111 per barrel for Brent oil were to replace its existing assumption of $120, then its euro zone and UK inflation forecasts for this year would both be cut by 0.2 percentage points.

Significantly, that would then mean euro zone headline inflation peaked at 2.8 percent last month as opposed to topping out in the autumn at 3.0 percent.

For a graphic on key global economic and cyclical indicators: (http://graphics.thomsonreuters.com/11/05/GLB_ECN0511_SB.html)

BIG PICTURE

So, how does that fit into the big picture of world growth?

In broad context, sudden fears of a slowdown seem strange as a slight ebbing of a booming world economy this year has been the running assumption for months.

The International Monetary Fund, for example, already expects global growth to slow from 2010's blistering 5.0 percent to 4.4 percent this year -- even though that's still more than a percentage point above the 20-year average and it sees that pace at least sustained through 2012.

Using monthly business surveys from around the world as a weather vane for the twists and turns of activity shorter-term, it's clear that world manufacturing output -- expanding at annualised rates of a whopping 10 percent plus coming into this year -- has been the big driver of the recent boom.

But, as JPMorgan points out, this surge was not matched by final expenditure on goods and so unsold inventory in auto factories and the like started to stack up -- presaging a cooling of assembly lines and a drop in global manufacturing growth rates to an estimated 3.5 percent in April.

And that's why the outlook now hinges on sustaining final demand to start clearing that inventory, and hence the growing importance of the inflation and interest rate scenario on household behaviour and the overall growth picture ahead. The big problem then for most economists and markets in the short term is twofold.

(Continued on page 17)

Excess gas burns at a refinery in the harbour of Zarzis March 9, 2011. REUTERS/Pascal Rossignol

First, they are trying navigate a significant amount of erratic and likely short term economic data swings related to Japan's earthquake disaster, extreme weather -- such as the damaging U.S. tornados - and the fact that oil price swings themselves were likely exaggerated by the unprecedented unrest across the Middle East and North Africa.

Big output shocks in Japan, the world's third biggest economy, will likely distort aggregate global growth data for months, but most experts expect much of that to be corrected in the second half of the year as the country recovers rapidly.

And in the meantime, some argue, Japan's export hiatus may actually help drain inventory piles in competing manufacturers elsewhere in the world -- ironically sustaining output growth outside Japan for longer until its recovery kicks in.

MONETARY GUESSWORK

The second puzzle is the difficulty in parsing the inflation outlook and how the world's major central banks respond. And here's where commodity prices become as much of a driver than a reflection of the outlook.

Jim'O Neill, Chairman of Goldman Sachs Asset Management and a long-standing optimist on world growth, told clients this week the persistence of commodity-driven inflation in China and the rest of the world was his one gnawing concern about the prospect of what he terms a "happy slowdown".

"Some softening (of business activity) wouldn't be overly troubling, as we have risen so much in recent months, and any softening would simply add to the inclination of most Western monetary policymakers to be extremely slow in tightening monetary policy, if at all," he said.

He added that in the light of China's strategic plan to slow its economy slightly over the coming years and tilt more toward local consumption away from exports, "I can't see the case for so much bullishness on commodity prices."

"Moreover, if commodity prices were to ease, I can't really see the case for fears about inflation around the world."

Rout rids commodities of speculative froth, fundamentals intact

By Nick Trevethan

SINGAPORE, May 6 (Reuters) - Commodities prices steadied on Friday after brutal losses caused by worries over slowing global growth, but with very little change in market fundamentals, the rout was caused more by the removal of speculative froth than the end of an 8-year bull run.

Over the past week, some disappointing data and nebulous worries about Chinese growth and monetary policy have prompted some analysts to express concern over a possible decline in demand for commodities, and perhaps even an end to the bull run that started in 2002 and was briefly interrupted by the global financial crisis of 2008, before resuming in 2010.

The Reuters-Jefferies CRB index, a global benchmark for commodities prices, is on course for its biggest weekly fall since July 2008, after giving up about 8 percent so far this week. It dropped 4.9 percent on Thursday.

U.S. crude oil prices extended losses after closing below $100 per barrel for the first time since March.

Silver , which has been a catalyst for the broader commodity market selloff, extended losses after falling 10 percent on Thursday, its biggest one-day loss since October 2008.

"The recent data suggests a contraction in growth, but not a collapse," said Joel Crane, an analyst at Morgan Stanley in Sydney.

"Commodity prices have exceeded fundamental values, so a pullback is justified.

Weakness in the second quarter was to be expected given the challenge faced by the world in the past two months -- major political unrest in many of world's oil producers and the most costly natural disaster in modern times," Crane said in a reference to Japan's devastating March 11 earthquake.

Is the global economy slowing? (http://r.reuters.com/kej49r)

Correlations with the dollar: (http://r.reuters.com/wex39r)

Commodities performance: (http://r.reuters.com/nab49r)

Technical outlook on Brent (http://link.reuters.com/kuh49r)

Technical outlook on WTI (http://link.reuters.com/juh49r)

CBOE oil volatility index: (http://link.reuters.com/guh49r)

GROWTH IN CHINA LOOKS SOLID

But growth in rest of Asia, particularly China, looks solid with the world's top consumer of commodities and second biggest oil importer seen growing at a robust annual figure of around 8 percent in the next five years.

That has created a disconnect between the situation in Asia's big consumers of commodities and the mood among traders in Europe and the United States, where the economic situation is far more precarious.

"Capitulation or correction? This is a correction. There is an anchor for commodities -- the China growth story. That hasn't gone away -- nothing has changed fundamentally," said ANZ senior commodity analyst Mark Pervan.

"Investors had priced in a lot of good news, may be too much, and this week they have rushed for the door.

"There was already a good deal of speculative money flushed out in the past few days, but this is a good thing.

Chinese consumers will find prices far more attractive and we may start to see appetite for imported commodities pick up."

That view was supported by Shanghai-traded metals which lagged their internationally traded counterparts, and by data on the Chinese economy showing that growth continued.

The price premium for the benchmark London Metal Exchange copper contract narrowed to 1,200 yuan versus its Shanghai equivalent from around 2,000 yuan when Shanghai closed on Thursday.

"This tells me that London was a bit frothy, while China was trading closer to fair value," said a trader based in Perth.

"The fact Shanghai hasn't collapsed under the weight of selling on international markets should be seen a positive for the state of demand and the real price for industrial raw materials."

(Continued on page 18)

China's official purchasing managers' index fell to 52.9 in April from 53.4 in March, well shy of market forecasts for an increase to 54.0.

But some said the pessimism towards Chinese demand was overdone, with 26 straight months of expansion and economists polled by Reuters expecting growth at 9.5 percent in 2011 after last year's increase of 10.3 percent.

A halt to the weakness of the dollar, which hit its lowest in three years this week after a drop over the past 11 months, could be in sight. The end of a second round of quantitative easing by the Federal Reserve in June could be the first step away from the U.S. central bank's ultra-loose monetary policy.

A recovery in the greenback would make dollar-denominated assets like commodities cheaper for holders of currencies like the euro or the yen.

"The feeling has been growing that the dollar has done enough on the downside for the time being," a fund manager said on condition of anonymity.

He said commodity markets had traded sideways since mid-April had traded, with investors epitomised by Goldman Sachs saying it was time to take profits, while others argued that commodities were still tight and the dollar would remain weak. "In the last two days the market has broken down quite decisively as the world has decided maybe the Goldman view was right."

A man sifts dry earth from a wheat field in his hands, in this photo illustration, in Niort, southwestern France, May 13, 2011. REUTERS/Regis Duvignau

Fears of inflation in China also contributed to the weaker mood in commodities. However central bank officials expect Chinese inflation to moderate in the second half.

Yu Yongding, now a director in the Chinese Academy of Social Sciences, a top government think tank, said that soaring global commodity costs were the main source of price pressures, and that the Chinese economy was growing solidly but not overheating.

"If we address cost-push inflation just with monetary tightening, it will reduce supply and it will make inflation worse, so we must be cautious," he said.

Chinese consumer price inflation hit 5.4 percent in the year to March, a 32-month high. The government has raised interest rates four times and also restructured bank lending in a bid to tamp down on price pressures.

Many investors think the next tightening move could be just around the corner, but the nation may be reaching the end of tightening cycle.

"We are looking at one or possibly two more hikes by the end of the second quarter, at 25 basis points each," said Stephen Green, an economist at Standard Chartered.

"In the last cycle they stopped hiking rates three months before the CPI peaked. CPI will be the best thing to settle market sentiment."

Oil, other commodities still too pricey for China

By Fayen Wong

SHANGHAI, May 6 (Reuters) - Buying on dips is a strategy that has served China well as it feeds its impressive economic growth with a wide range of raw materials.

But those hoping Chinese buying will help reverse a sell-off in commodities in the short-term could be disappointed, as high stockpiles of copper, aluminium and zinc, and difficulties in securing loans, would keep some would-be buyers at bay.

Commodities fell further on Friday after crude oil prices crashed a record $12 a barrel on Thursday, copper fell more than three percent and silver dropped over eight percent.

"There is no reason to expect things to be different this time. When prices fall, China tends to make the most of that and go through a restocking cycle," said Andrew Driscoll, head of resources at CLSA in Hong Kong.

"But the buying activity could come in at lower levels than otherwise expected unless prices fall further to create a temptation they can't ignore," he said.

The 19-commodity Reuters-Jefferies CRB index fell 5 percent on Thursday, its fourth straight decline and the fifth biggest ever. The index has lost more than two-thirds of the gains it had made this year.

Reuters-Jefferies CRB index: (http://r.reuters.com/zyf49r)

(Continued on page 19)

WAIT-AND-SEE

For copper, expectations of further losses that would cause some end-users to adopt a wait-and-see approach over the next few days or weeks, said Yingxi Yu, a commodities analyst at Barclays Capital.

"We have seen healthy Chinese buying for most of the year until the past few days but the speed and scale of yesterday's sell-off will make buyers very nervous and their price expectations would also be lowered," she said.

Successive interest rate hikes and increases to banks' reserve ratio requirements have made it more difficult for commodities traders to obtain credit.

Swollen copper stockpiles in China, the world's top consumer of the metal, means traders and end-users can afford to bide their time and wait for even better prices before restocking.

Analysts have warned that stocks in Shanghai's bonded warehouses, which account for about 80 percent of China's total inventories, are hovering at around 650,000 tonnes.

This is equivalent to roughly four weeks of the country's domestic use and higher than the 200,000 tonne average over the past three years.

Aluminium stocks in the world's top producer are also at lofty levels of around 1.5-2 million tonnes, analysts said. For oil, traders in China shrugged off the drop as too little and said it was too early to judge if the correction would be sustained.

"The current oil prices are not low enough to trigger a big increase in crude imports.

It may not even be a good time for the government to build its strategic crude reserves since the previous reserves were filled when the oil prices were below $80 a barrel," said a crude trader in China.

The tumble in oil prices would benefit major refineries, he said, although he was doubtful current prices were low enough for the country's smaller "teapot refineries" to resume operations, since the government's last fuel price hike meant refiners could only cover crude prices at around $90 a barrel.

"Before this price drop, the market expected the government to raise fuel price again very soon. But now it is likely that the government will delay the fuel price hike or even not raise it at all if oil prices keep falling."

FUNDAMENTALS INTACT

China's purchases have a major influence on any view on the longer term commodities demand outlook and thus whether the falls are a short-term correction in a long bull cycle.

The long-term bullish view would change only if one turned bearish on Chinese demand, said CLSA's Driscoll.

He said this was unlikely given China's robust economic growth, ambitious plans to build tens of millions of social housing units and spend billions in expanding its power grids that would boost demand for steel, iron ore, copper and coal.

Although some have cited Beijing monetary tightening as a big risk to China's commodities demand in the short to medium term, survey results from Barclays showed many in China were still positive on the country's economic outlook for this year.

"A majority cited price volatility and rising costs as their key challenges, with only a few concerned about weak demand and difficulties in getting finance," Barclays said in a May 4 report based on its survey of around 50 representatives from major producers, consumers and trading houses.

Commodity rout no threat to Australia mine projects -- yet

By James Regan

SYDNEY, May 6 (Reuters) - Billions of dollars in investments in Australian mining may need a rethink if the sudden collapse in world commodities markets signals an end to the post-global financial crisis boom in the asset class.

Australia is the world's biggest exporter of iron ore and coking coal, ranks second in uranium, third in nickel and fourth in copper. Its biggest miners have placed big bets on the commodities boom - they have committed over $30 billion so far this year to expand to meet rising demand in Asia led by China.

The one-day rout on Thursday was the most brutal correction in commodities in two years, in part fuelled by gloomy economic data in the U.S. and Europe.

But there is a way to go before lower prices make these huge investments unprofitable, and little sign of slowing demand for raw materials in Asia.

"It's early days and no one knows if this is a one-off correction or if portends things to come," said a mining executive whose plans to expand an iron ore mine is sitting with his company's board of directors.

"That's not to say we wouldn't act if the outlook appeared dire and I don't think we're alone there," he said.

Reuters-Jefferies CRB index: (http://r.reuters.com/zyf49r)

Reuters Insider TV on gold: (http://r.reuters.com/cag49r)

Technical outlook on Brent (http://link.reuters.com/kuh49r)

There was no indication yet that the committed investments from the likes of BHP Billiton, Rio Tinto and Xstrata and others are in jeopardy, nor that another $100 billion investment planned over the next five years has been derailed.

Australia also has around A$200 billion in liquefied natural gas projects on the drawing board, much of the gas destined for China, which is looking to cut its reliance on coal.

"These guys are fully aware of the volatility that occurs in commodities markets," said Lawrence Grech, a mining analyst for Austock in Sydney. "It will take a lot more than what's occurred this week rattle them." BHP declined to comment on the commodities rout, but a spokeswoman said none of the company's expansion blueprints outlined earlier this year had changed.

The company has earmarked $9.5 billion out of a staggering $80 billion proposed spend over five years to dig more iron ore mines in Western Australia and expand coal mining in eastern Australia's Bowen Basin.

BHP Chief Executive Marius Kloppers has long maintained the firm takes a long-term view on market conditions, placing little emphasis on day-to-day movements for investment decisions.

(Continued on page 20)

The 19-commodity Reuters-Jefferies CRB index fell nearly 5 percent on Thursday, the biggest fall since March 2009. Four straight days of falls have wiped out more than two-thirds of the gains on the index so far this year.

In the hours before the routing in commodities took hold in Europe and the U.S., Rio Tinto Chairman Jan du Plessis gently cautioned shareholders at the company's annual general meeting to expect volatility in commodities markets.

"Persistent economic and financial imbalances continue to pose risks," he said. "(But) Our long-term growth fundamentals are strong."

The implications of a bull market turning bearish are widespread in Australia, where miners are putting thousands more workers on payrolls, erecting outback mini-cities to house them, laying thousands of kilometers of rail lines and commissioning a small navy's worth of new shipping vessels.

The last time prices collapsed in 2008, BHP shuttered and then sold its $2 billion Raventhorpe nickel mine, sold the Yabulu nickel refinery and slowed the expansion process at its Olympic Dam copper and uranium mine.

Rio Tinto curtailed aluminium and iron ore production, giving workers an extra-long Christmas break, as did Fortescue Metals Group .

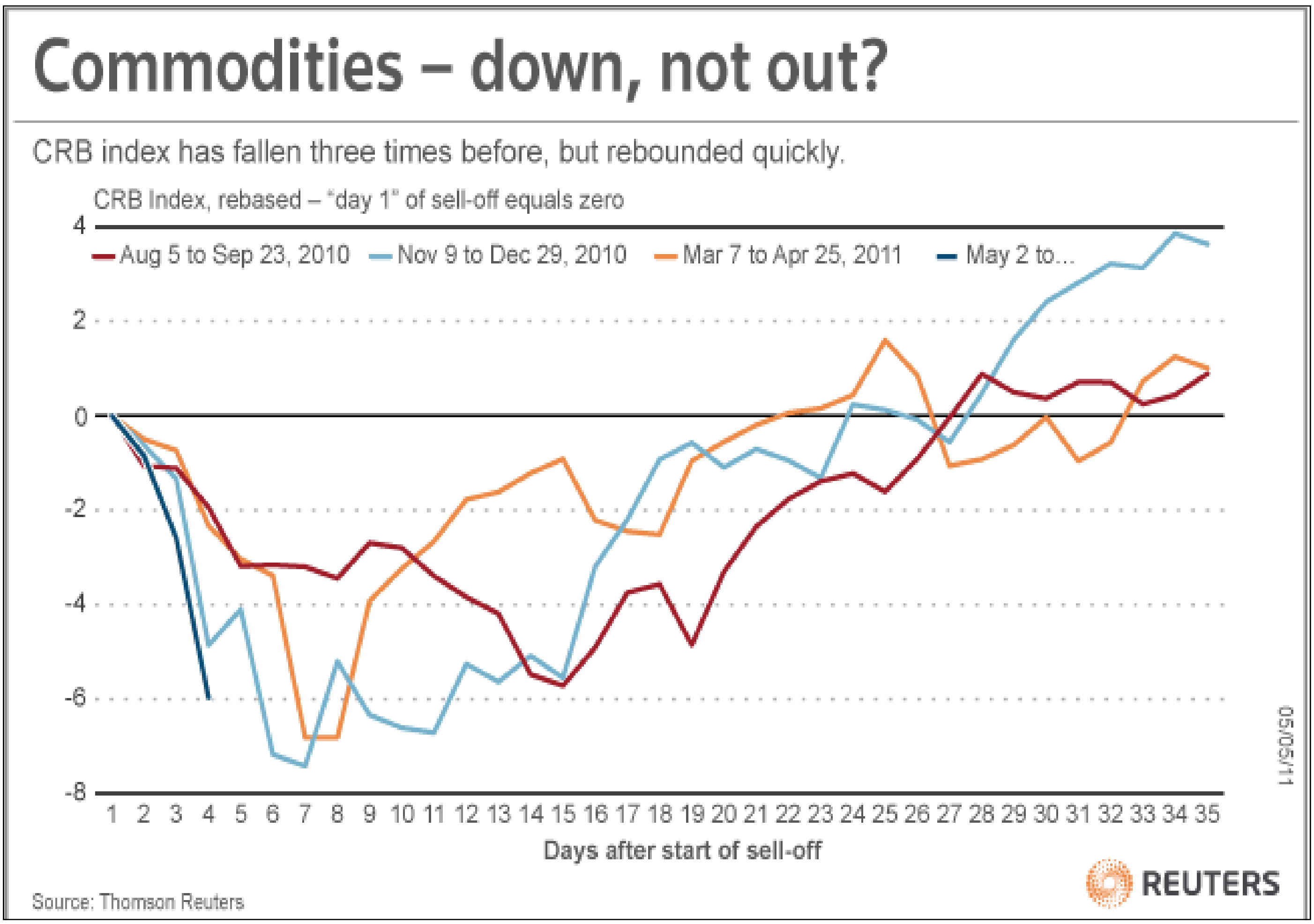
In the island state of Tasmania, the then Oz Minerals-owned Avebury nickel mine was closed, as were nickel mines owned by Xstrata, Norilsk and Mincor

The lion's share of Australia's iron ore and coal heads to China and just about all the rest is sold elsewhere in Asia -- the engines justifying Australia's rapid push to beef up its commodities exports over the last two years.

Likewise for much of the hundreds of thousands of tonnes of copper, nickel, zinc lead and other industrial staples coming out of Australia.

A long-awaited recovery in industrial activity in the United States and Europe, which has stubbornly lagged well behind Asia and now may not occur at all, has always been viewed by Australian mining companies as little more than gravy on the Asian platter.

The Australian arm of China's Minmetals said progress on the said on Friday progress on the company's internal project pipeline was continuing, and the board approved a $22 million investment in expansion at its Golden Grove copper and zinc mine.



MARKET REACTION

Oil crash pits floor veterans vs computer algos

By David Sheppard, Emma Farge and Jonathan Spicer

NEW YORK, May 6 (Reuters) - A day after oil prices plunged an unprecedented $12 a barrel, a New York trader sat on the steps of the dormant oil futures pit, playing a word game on his tablet computer.

Back to business as usual for floor traders, a vanishing breed in a market now dominated by machines and algorithms, a fact that some of them say worsened one of the most shocking -- and baffling -- trading sessions ever.

On the waterfront of Manhattan's southern tip, veterans of the New York Mercantile Exchange's (NYMEX) pits recounted how the crash reminded them of the heyday of the trading floor.

"Yesterday was organized chaos down on the floor, it was right back to the old days," said Chris Kenny, crude oil options trader at Lloyd Group. "The size of the move was almost unprecedented and you could see it all there. Greed and fear, that's what this job is all about." Action in the options pit was still lively, they said, reminding them of the jostling and jousting of days gone by.

Miles away from the emotional rollercoaster that marked Thursday's puzzling rout, the new breed of computer traders counted their profits in anonymous offices across the country.

High-frequency and algorithmic traders, comprising half the oil market, seem to have weathered Thursday's mayhem without breaking a sweat, unlike many of the new breed who took a beating in the stock market "flash crash" exactly a year ago.

"We continued to trade normally and be involved in the market the whole time, no differently than the day before. We didn't change our risk parameters or our model parameters," an oil futures trader at an proprietary algorithmic trading firm told Reuters. Unlike with the stock market's "flash crash," few old-school traders blamed the algos for the fall, although some did blame them for the end of a way of life that aided both transparency and liquidity in an often opaque market.

"When you get massive electronic long-liquidation like that the price just moves rapidly. It wouldn't have been the same on the floor," said Bob Penny, an individual trader of crude oil and sugar who has been in the business for 31 years. "You didn't get price vacuums there. Funds don't try and finesse it -- when they decide to sell they just hit it."

While conventional wisdom would have suggested buying on the dips in such a seemingly illogical and abrupt decline, computer programs said otherwise as the fall continued.

"If you'd followed conventional wisdom... you would have got killed," said Jeffrey Grossman, President of BRG Brokerage.

Analysts at investment bank Credit Suisse said automated trading probably did play a role in the fall. "We believe the magnitude of the correction appears in large part to have been exacerbated by algorithmic traders unwinding positioning."

NOSTALGIA

Many oil trading veterans returning to the NYMEX building on Friday swapped war stories of the previous day. Many still work out of booths and offices at the NYMEX, where open-outcry trading has withered due to the rise of electronic trading over the past decade.

The open pit still exists, but only a few thousand lots ever trade there, a fraction of the million-plus that trade almost round-the-clock.

Veteran traders at NYMEX, a unit of CME Group Inc , recalled price swings linked to some of the biggest moments in recent U.S. history, including the 9/11 attack and Hurricane Katrina. The difference this time? Even a day later, most are unable to pinpoint exactly what set off the frenzy.

The bout of panic selling jump-started trading in the oil options pit, which has resisted the migration of volumes to electronic screens. Traders and brokers still stand shoulder to shoulder, communicating complex deals through a series of shouts and hand gestures incomprehensible to outsiders.

Brokers described near chaos in the pit as traders loaded up on $95 and $100 a barrel option contracts to protect against further price falls. "People were getting their faces ripped off yesterday, everyone was yelling and screaming all day," one crude oil options broker said, who asked not to be named.

NEW GUARD

The way prices move has changed with trading practices. Lightening-fast, algorithmic traders, known as "black box" players, have multiplied in recent years. Many used to trade open-outcry, yet they are viewed as the antithesis of the old-fashioned pit trader.

Manoj Narang, CEO and chief investment strategist of Tradeworx, a hedge fund that also runs a high-frequency unit, called Thursday a "great day" for his fund, which trades commodity-linked Exchange Traded Funds (ETFs) and stocks.

Narang said that unlike Wall Street's "flash crash" last May, automated trading was not behind oil's plunge. Instead, he cited traders who had gone long-commodities and short the dollar, but were caught out when the U.S. currency bounced up. "It was a very crowded trade," Narang added. Even as prices plummeted, oil brokers also stood to gain from the huge jump in trading volumes.

On the sun-drenched plaza outside the exchange overlooking the Hudson River, long-term broker Dominick Caglioti was in good spirits. "It was great for business because there was a lot of action," he said, extinguishing a cigarette before heading back into the exchange.

"It was still quieter than it used to be, but I guess screens don't yell."

West's oil agency urges OPEC: pump more, or else

By Muriel Boselli and Richard Cowan

PARIS/WASHINGTON, May 19 (Reuters) - The West's energy watchdog urged oil producers to protect the global economy by boosting supply to cut fuel costs, and appeared to suggest its members could release emergency stockpiles if OPEC failed to act.

"The governing board urges action from producers that will help avoid the negative global economic consequences which a further sharp market tightening could cause, and welcomes commitments to increase supply," the International Energy Agency, or IEA, said after a governing board meeting on Thursday.

The statement comes just weeks ahead of OPEC's June 8 meeting and a day after price hawk Iran said its hardline President Mahmoud Ahmadinejad would represent Tehran at OPEC as Iran's caretaker oil minister.

The 12-member Organization of the Petroleum Exporting Countries says world supplies are adequate.

"The IEA governing board expressed serious concern that there are growing signs that the rise in oil prices since September is affecting the economic recovery," the statement said.

The IEA said it stood ready to work with producers but added: "In this constructive spirit, we are prepared to consider using all tools that are at the disposal of IEA member countries."

The 28-member IEA oversees some 1.5 billion barrels of government-held oil inventories that can be released in the event of an emergency outage.

The loss of about 1.2 million bpd of Libyan exports in February is well short of the volumes that would normally trigger an IEA emergency release, but there has been speculation that the United States could tap government stockpiles if things get worse.

The Paris-based IEA could not give guidance on whether or not its statement was referring to a possible emergency release.

But oil prices fell more than $1 a barrel on Thursday as analysts said consumers seemed to be getting frustrated with what they see of lack of action by OPEC.

"This looks like a coded message to OPEC, a shot across the bows before the June meeting," said Bill Farren-Price of Petroleum Policy Intelligency.

U.S. RESERVES

President Barack Obama said in March a significant supply disruption or shift in the market could push him to use the reserves and that the administration had a plan that could be set in motion in a few days, not weeks, if needed.

The White House said on Thursday tapping the 730 million barrel Strategic Petroleum Reserve remained a possibility. "Tapping the SPR continues to be one of the options on the table," said spokesman Clark Stevens said.

But Interior Secretary Ken Salazar seemed to play down the likelihood of tapping the reserve now.

"Our position ... on the SPR is that it won't have significant impact on the price of gasoline," Salazar told reporters. He said historically the reserve has not been released to tackle high gasoline prices, but rather supply shortages.

Jeff Bingaman, the chair of the Senate Energy Committee, also said through a spokesman there was no need for a release in the short-term because U.S. supplies are ample. Oil stockpiles in the United States are hovering at a two-year high.

But calls by some U.S. lawmakers to use the reserve, including from Obama's Democratic party, continue as petroleum prices remain stubbornly high.

(Continued on page 23)

Women grade coffee beans in a coffee factory at Komothai in Ruiru January 25, 2011. REUTERS/Noor Khamis

RARE

The IEA normally does not comment on oil producers' policies."It is quite rare that the IEA goes out directly to give suggestions to OPEC," said Christin Tuxen at Danske Markets.

"It suggests the IEA is worried that we haven't seen OPEC increasing supply... Libyan production has basically come to a halt and Saudi Arabia has been very slow to increase supply," she added. As global demand for oil increases seasonally from May to August, IEA members said there was a clear and urgent need for additional supplies to be made to refiners on a "more competitive basis."

Oil prices have rallied sharply since the beginning of the year on unrest in North Africa and the Middle East, reaching near $130 per barrel. They corrected sharply in early May and Brent crude is now valued at $112 a barrel with signs that high prices are rationing demand in the West.

However many analysts, including from big banks like Goldman Sachs, Barclays Capital and Deutsche Bank, said they expected prices to return to or exceed recent highs at the end of 2011 due to tightening supplies.

OPEC has held its official output targets steady even as prices surged, saying supply was sufficient. Its biggest producer Saudi Arabia lifted output earlier in the year but has since cut back again, citing poor demand.

A delegate from one of OPEC's Gulf countries earlier this month raised the possibility of increasing OPEC's output targets to help lower prices as well as to bring official allocations back in to line with actual supply.

Some in OPEC, such as Iran and Venezuela, are likely to disagree. The attendance of Ahmadinejad at the June meeting has strengthened analysts' view the group is unlikely to act.

POLL-End of Fed's QE2 to hurt stocks, bonds, commodities

By Walter Brandimarte

NEW YORK, May 19 (Reuters) - Investors betting on a rise in stocks, bonds and commodities should prepare for a loud sucking sound in their portfolios next month when the Federal Reserve pulls the plug on its $600 billion stimulus program.

Stocks, bonds, gold and the euro are expected to fall in the three months after the end of the Fed's second massive bond buying operation, also known as quantitative easing, or QE2, a Reuters poll of 64 analysts and fund managers found on Thursday.

Investors and traders approach the end of QE2 with a sense of trepidation, worried that with the Fed no longer supporting the market, investments that have been profitable for the last nine months will plummet and rattle confidence in the shaky economic recovery.

The survey showed investors overwhelmingly thought government bonds would suffer from the Fed's exit, with 40 of 64 respondents saying the end of quantitative easing would drive up yields on U.S. 10-year Treasury bonds .

(Continued on page 24)

Workers load bags of nickel ore from state miner Aneka Tambang Tbk onto a ship to be exported, in a harbour at Pomala district in Indonesia's southeast Sulawesi province March 30, 2011. REUTERS/Yusuf Ahmad

Although equities and commodities prices have already been declining in anticipation, the end of QE2 will likely leave markets more vulnerable to issues that investors overlooked as long as the Fed was printing money at a record pace.

Concerns about the European debt crisis, the Chinese economic slowdown and the struggling U.S. jobs market, already gnawing away at investor confidence, may now take a big bite out of sentiment across a range of markets.

"The psychological impact of QE2 is more important than the action itself," said Jason Pride, director of investment strategy at Glenmede in Philadelphia, with $19.8 billion under management.

"QE2 is a statement that the Fed will act as a backstop," he added.

Graphic:

Changes in prices since first hints of QE2:

(http://r.reuters.com/gew59r)

Volatility is also poised to grow as declining global liquidity makes investors less willing to take on risk at any price. Out of 63 respondents, 36 said markets will become more volatile when QE2 ends.

The dollar, on the other hand, should gain as the Fed stops lowering its value by printing money. Out of the 64 participants, 38 expect the greenback to strengthen versus the euro, while 14 see no impact.

Still, the exchange rate between the two currencies will mostly depend on broader developments in the euro zone and the United States, both struggling to manage mountains of debt after the global financial crisis.

COMMODITIES, STOCKS TO SUFFER

At least half of the respondents expect oil and gold prices to fall further in the third quarter, hurt by a stronger dollar that will make them more expensive to non-U.S. investors.

Nearly half of participants also expect U.S. and emerging markets stocks to fall, as measured by the Standard & Poor's 500 index and the MSCI Emerging Market stock index.

"Equity indexes, like other tangible assets, were the beneficiaries of QE," said Ray Humphrey, who helps manage $159.6 billion at Hartford Investment Management Co.

"This is illusory, however, as much of the rise in equity and commodity prices can be attributed to measuring the value of these asset classes in a currency that is being devalued."

Despite the expected weakness in financial markets, most analysts were fairly confident the U.S. economy remains on a recovery path that will allow policymakers to reduce the monetary stimulus next month.

The probability of a third round of quantitative easing policies was only 10 percent, according to the median forecast from 59 responses.

The Federal Reserve remains caught between the need for more immediate economic support and the risk of long-term inflation, but analysts say the balance is beginning to shift toward the longer-term issue.

"The economy is slowing but I don't think there is much risk of a double-dip. The Fed will have little urgency there (for a QE3)," said Milton Ezrati, market strategist at Lord Abbett Co in Jersey City, New Jersey.

But David Joy at Boston-based Columbia Management, prefers to leave the door open for QE3.

"If you saw a slowdown over the summer months, especially one that was accompanied by a meaningful slowdown in the money supply, I think QE3 is a viable policy option."

Argentina says more output key to lower food prices

By Hugh Bronstein

BUENOS AIRES, May 19 (Reuters) - The best way to cool soaring food prices is to boost output, Argentina said on Thursday, following talks on a French proposal for increased regulation of commodity markets.

France is seeking support from the G20 group of wealthy and developing economies for reforms aimed at stabilizing the market by easing the peaks and troughs that are common in exchange-traded commodities.

Argentina is one of the world's biggest exporters of soybeans, corn and wheat. Like neighboring Brazil, it says bigger harvests are the solution to rising food prices that have fueled months of protests across North Africa and the Middle East.

"The challenge of world food security will be met with more production, better technology and more competition among more producers," Argentine Agriculture Minister Julian Dominguez told a joint news conference with his French counterpart, Bruno Le Maire.

Big food producing nations initially worried that France's proposal might involve price controls, but Le Maire sought to put those concerns to rest during his visit to Buenos Aires for a G20 working meeting on the regulation proposal. "We want to combat excessive price volatility," he said. "France does not want to limit prices."

Dominguez welcomed Le Maire's comments: "The clarification and interpretation that the minister has made is very important for our country and our producers." Brazil last month reversed its earlier position, coming around to back France's proposal for increased regulation of commodity markets. Brazilian officials also say that raising agricultural output is the best way to control price spikes.

As countries around the world grapple with food inflation, France hopes to reach consensus on its plan at a meeting of G20 agriculture ministers scheduled for June in Paris.

Global food prices have been on the rise amid tight stocks and crop trouble over the past year from Russia to Australia to the United States, forcing countries like China and India to tighten monetary policy to tamp down inflation.

Commods likely to recover after short correction-MF Global

By Randy Fabi

SINGAPORE, May 18 (Reuters) - Commodity prices are likely to fall further in the next month or two before rebounding towards the end of the year as demand continues to grow, prompting MF Global to expand its presence in the sector, a senior company executive said.

(Continued on page 25)

Brokerage MF Global Holdings, with a market value of $1.4 billion, maintained its long-term bullish outlook for commodities and expected prices to rise 10-20 percent over the next 12 months from current levels due to a weaker dollar, rising global demand and gradual inventory tightening.

"We will see some weakness between now and the end of summer and then I think we are going to see a steady move up," MF Global's head of commodities, Fred Demler, told Reuters on Wednesday. "I feel commodities are overpriced by 5 to 10 percent right now, but a year from now they will be 10 to 20 percent higher than they are now."

For commodities performance overview:

(http://r.reuters.com/nab49r)

Commodity correlations with the dollar:

(http://r.reuters.com/wex39r)

Higher commodity prices may lead to a temporary slowdown in consumption, Demler said, but added he saw no long-term demand destruction.

The 19-commodity Reuters-Jefferies CRB index has tumbled 9 percent since April 29 when hedge funds and other large financial investors began cutting their exposure to commodities.

Gold prices are down nearly 5 percent since April 29, with investor sentiment towards the precious metal turning more cautious as holders worry it may struggle to rise significantly after hitting record highs this month.

CONSOLIDATION

Gold rose for a tenth consecutive quarter in the three months to March, hitting record highs above $1,400 an ounce, buoyed by political turmoil in the Middle East and North Africa and lingering worries about indebted European countries.

Brent saw its largest daily drop in dollar terms on May 5, tracking the biggest one-day price drop in silver since 1980.

At one point, Brent was off by more than $12 a barrel, dipping below $110 for the first time since March.

U.S. crude has slid about 15 percent since the start of May, silver 28 percent and copper about 5 percent.

"We are in a period of consolidation right now," Demler said. "But this commodities cycle is a long-term cycle."

Commodities will likely start their steady recovery later this year as global inflation weakens the dollar, inventories tighten on rising industrial production and economic expansion boosts consumer demand, he said.

While the dollar had one of its strongest weeks last week, pushing the euro to its lowest since late March on Monday, the strength is seen short-lived by many and the greenback has still lost about 6 percent against the euro this year.

"In the longer term, we are going to see a weaker dollar, partly driven by inflation and that will be a longer-term positive for commodity prices," Demler said.

(Continued on page 26)

A farmer uses a donkey to transport newly harvested wheat grains at a field in Attcak village, in Punjab province, Pakistan May 6, 2011. REUTERS/Erik de Castro

Bermuda-based MF Global plans to expand its exposure to the commodity markets within the next few years, but Demler declined to provide a specific price outlook for oil, gold and other commodities.

MF Global, led by former Goldman Sachs Chief Executive Jon Corzine, plans to convert itself into an investment bank in the next 3-5 years.

The company, which is currently in the process of transitioning from a broker to a broker-dealer, said its business model will focus on institutional capital markets, retail services, transaction services and asset management.

"MF Global is looking to build on the company's strengths -- commodities and futures and options. So I think Corzine will build on that, not reduce it," Demler said in a telephone interview from Hong Kong, where he attended the launch of a new gold futures contract.

Investors less upbeat on stocks, commodities - BofA poll

By Natsuko Waki

LONDON, May 17 (Reuters) - Investors turned less upbeat on stocks in May as uncertainty grew over global growth, while they also became less positive about commodities after a sharp selloff, a closely watched survey showed on Tuesday.

The monthly global fund managers' survey from Bank of America-Merrill Lynch showed a net 41 percent of respondents were overweight equities in May, down from 50 percent last month.

This month's reading means the difference between overweights and underweights is 41 percentage points, compared with an all-time peak of 67 points set in February.

The poll, which surveyed 204 participants who manage total assets of $622 billion, also showed investors slashed their commodity allocations, halving overweight positions to a net 12 percent.

The survey was taken between May 6 and 12, just after a sharp selloff in commodity markets saw the benchmark Reuters-Jefferies CRB index stage its biggest weekly drop last week since late 2008.

Bond underweights fell to a net 48 percent from 58 percent last month, coming closer to the 10-year average of 38 percent. Cash holdings fell to a net 6 percent overweight from 10 percent in April, reflecting investor desire to put cash to work. Conflicting investor sentiment stems from subdued global growth expectations and easing inflation concerns.

The survey found only a net 10 percent of investors expect stronger global growth in the next 12 months, down from 58 percent in February. This helped ease inflation concerns with a net 61 percent seeing higher inflation, down from 75 percent in March.

"It's a re-run of summer last year where the prospect for global growth is increasingly questioned but liquidity is so ample and risk appetite is staying high," said Patrik Schowitz, European equity strategist at BofA Merrill.

"Investors are stuck in the middle. There is not so much movements across asset classes, but within asset classes people are taking off risk, out of cyclical and resources and into defensives."

Average cash balances rose to 3.9 percent from 3.7 percent, staying within the BofA's range of contrarian buy and sell signals threshold of 4.5 percent and 3.5 percent respectively.

Emerging markets returned as the most favoured region, with a net 29 percent of investors overweight the sector, followed by the United States which had a net 26 percent of investors overweight. The survey comes as world stocks, measured by MSCI, hit their lowest level in nearly a month on Tuesday as signs emerge that the U.S. economic recovery may be losing momentum.

Hedge funds, on the other hand, were happy to take on more risk, pushing their gearing levels to the highest since November 2007. The ratio of gross assets held by hedge funds relative to their capital rose to 1.53 from 1.49 last month. Their net exposure to equity markets -- measured as long minus short as a percentage of capital -- stood at 32 percent, compared with 33 percent in April.

Soros dumped most gold in Q1, Paulson stays put

By Frank Tang and Aaron Pressman

NEW YORK/BOSTON, May 16 (Reuters) - Billionaire financier George Soros, who called gold "the ultimate bubble," dumped almost his entire $800 million stake in bullion in the first quarter, well before a commodities slump blamed partly on reports he was liquidating his holdings.

Famed gold bull John Paulson held his ground, but Soros was joined in the retreat by several other big names, including Eric Mindich and Paul Touradji, according to 13-F filings with the U.S. Securities and Exchange Commission that provide the best insight into where hedge funds are placing their bets.

Gold prices barely reacted to the news, with spot gold up 0.3 percent at $1,494.29 an ounce by 0327 GMT. Rising inflation worries and a debt crisis in the euro zone should help prevent any sell-off in the precious metal, analysts said.

Soros, who has been bullish on gold in the past several years, cut his holdings in the SPDR Gold Trust to just $6.9 million by the end of first quarter, compared with $655 million in December, becoming the most high-profile investors to turn his back on one of the market's best-performing assets. He also liquidated a 5 million share stake in the iShares Gold Trust , the filings showed. His total holdings in gold-backed ETFs was $774 million as of December.

SPDR holdings at 1-year low as gold slips off record high:

(http://link.reuters.com/fej49r)

iShares Silver Trust and silver prices:

(http://link.reuters.com/gej49r)

Gold rose for a tenth consecutive quarter in the three months to March, hitting record highs above $1,400 an ounce, buoyed by political turmoil in the Middle East and North Africa and lingering worries about indebted European countries.

The gains accelerated in April, but peaked at the start of this month, reaching a record $1,575 an ounce on May 2.

(Continued on page 27)

Prices have since fallen more than 5 percent amid the biggest commodities slump since late 2008, a move partly triggered by a Wall Street Journal report that Soros' $28 billion fund was selling precious metals -- and fuelling fears other big funds were also seeing a peak.

Eric Mindich, who runs Eton Park Capital Management, nearly halved his stake in the SPDR gold trust to $326 million for the first quarter, a filing showed on Monday. Mindich's fund also owned $839 million worth of call options by the end of the first quarter, compared with $1.1 billion worth of put options at the end of the fourth quarter. Touradji Capital Management, one of the world's largest commodities-oriented hedge funds run by Paul Touradji, sold 173,000 shares in the SPDR Gold Trust during the quarter. Those shares would be worth about $25 million at current prices.

But John Paulson, who notched up the industry's biggest ever payout last year, kept his 31.5 million shares, or $4.4 billion stake, in the SPDR fund, remaining the biggest shareholder of the world's largest gold-backed exchange traded fund for the quarter, according to regulatory filings.

DEFLATION THREAT RECEDES

The sales make sense given that Soros said he had bought gold because he was worried about deflation, said Mark Luschini, chief investment strategist at Janney Montgomery Scott in Pittsburgh. "It's pretty hard to make the case for deflation right now so if that was a reason you were buying gold, you should take this signal from Soros," he said. Inflation is now the greater concern, Luschini said. So most investors should still keep about 3 percent to 5 percent of their assets in gold to protect against inflation and possible further problems in the world financial system.

"It's not the most bullish news I've ever heard in gold, but it's not the end of the world either," said Citigroup analyst David Thurtell. "With the euro zone sovereign debt problems still going on, inflation worries and the dollar weakness, gold's got good underpinnings at the moment. I think it will be well supported in the $1,450-$1,475 range. I don't see a widespread sell-off."

Still, many investors are likely to follow Soros' lead. "Obviously hedge funds and speculators have scaled back their long positions. But they are still holding massive positions in metals, so I won't be surprised to see continuous liquidation in all commodities," said a Hong Kong-based trader.

Soros also slashed stakes in gold and silver mining companies during the first quarter. The firm owned 1.4 million shares of Kinross Gold at the end of the quarter, down from 4 million shares three months earlier. Holdings in Novagold Resources dropped to 3.5 million shares from 12.9 million.

Gold ended the first quarter little changed, as the spot gold prices were only $10 higher to end at $1,430 an ounce on March 31, and the SPDR Gold Trust was up 1.3 percent.

In the second quarter, gold hit a record high $1,575.79 an ounce on May 2 fueled by the outlook of low U.S. interest rates. So far in the second quarter, SPDR Gold Trust's bullion holdings gained only about 1 percent to 1,229 tonnes by Friday, well below its record high of 1,320.436 tonnes set on June 29 last year.

Institutional investment managers are required to file form 13-F with the SEC within 45 days after the end of each quarter.

Bullish funds slash commodity bets by $17 bln-data

By Jonathan Leff and KT Arasu

NEW YORK/CHICAGO, May 13 (Reuters) - Big hedge funds and speculators cut their bullish bets on commodity markets by $17 billion in the week through Tuesday, the biggest bear turn since at least 2009, regulatory data showed on Friday.

The so-called "managed money" funds cut their overall net long holdings in 22 U.S. futures markets by over 222,000 contracts or 13 percent in the five days ended May 10, according to Reuters calculations based on the Commodity Futures Trading Commission's weekly Commitment of Traders.

The data, based on both futures and options positions, confirm that some big hedge funds, commodity trading advisors (CTAs) and other major speculators dramatically pared back long positions during a week in which prices abruptly collapsed before staging a modest rebound. But it also shows that in some markets, such as oil, the story was more complicated.

The one-week cut in holdings was the largest since 2010, when available data begins. Total fund length still stood at its highest since mid-March at 1.5 million contracts.

"I would view this as a bearish situation. We have a confirmed flow of selling with substantial remaining net long positions that can fuel an ongoing flow of that selling," said Tim Evans, energy analyst at Citi Futures Perspective.

The value of total fund holdings fell to $116.8 billion, less than a third of the total amount of investor capital estimated to be allocated to commodity markets worldwide.

Some of that money is in over-the-counter contracts or invested via banks, which are part of a different CFTC group.

Although it is an imperfect gauge, the CFTC data offers the best clues yet as to how traders positioned during the most volatile week in two years. Crude oil collapsed by $10 on May 5 in a rout that traders are still struggling to explain, taking commodities with them, but then rebounded Monday and Tuesday.

For a graphic on total length: (http://r.reuters.com/man59r)

For an Excel data sheet: (http://r.reuters.com/qan59r)

For market-specific graphics: (http://r.reuters.com/buv87r)

OIL LONGS SLASH $6.5 BLN

The biggest decline in the value of net long positions occurred in the crude oil market, where prices dropped by about 6.5 percent. The New York Mercantile Exchange's U.S. crude oil futures and the IntercontinentalExchange's lookalike contract saw speculators' net long position drop by $6.5 billion.

The notional figure is calculated by Reuters based on the change in the net position from a week ago, multiplied by the contract's value at the end of the period.

Because most investors trade commodities on margin, the drop in the value of positions is not directly equivalent to total divestment.

(Continued on page 28)

Bullish bets on oil fell to the lowest since late February, when traders were beginning to factor in more geopolitical risk from Middle East instability and war in Libya.

But the drop occurred even as the total open interest -- the number of outstanding futures contracts that haven't been settled -- rose to a record, indicating that more traders were opening positions than were closing them during the week.

While bullish speculators sold long positions actively during the week, bearish speculators also added new short positions, increasing the short interest to the highest since late February. The "swap dealers" category, generally big banks, covered some of their large net short position.

GOLD, SILVER LIQUIDATION

Precious metals also saw heavy selling during the week, although this was more the result of pure long liquidation than traders taking up new short positions.

Long holdings in COMEX gold fell by nearly 20,000 contracts or 10 percent on the week, a reduction equivalent to roughly $3 billion, the biggest drop since last November. Gold futures fell by about 1.5 percent that week.

Net length in COMEX silver, whose deep sell-off from a record high began the previous week, fell by nearly a quarter with funds cutting their bullish holdings by $1.1 billion.

Big hedge funds had actually begun paring positions weeks before prices reached an all-time high of nearly $50 an ounce. At about 19,000 contracts, speculative net length is at its second-lowest since early 2010.

The Chicago corn saw similar positioning dominated by fund managers taking profits. Bullish funds cut their length by some $950 million to take positions to their lowest in six weeks, and near the lowest since the middle of last year. Prices fell by a more modest 1.8 percent. "They still have a sizable amount and if things don't go their way, there could be more liquidation to come," said grains analyst Mark Schultz at Northstar Commodity Investments Co. in Minneapolis.

Additional CFTC data can be found at or or the CFTC website at (http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm)

End of QE to hit gold harder than oil -Goldman

By Claire Milhench

LONDON, May 13 (Reuters) - The end of quantitative easing (QE) will have a negative impact on gold, but demand for oil and industrial metals should be supported if there is real economic growth, said Jeff Currie of Goldman Sachs .

"Gold should directly reflect what has happened with QE, and we should see a substantial pullback," said Currie, who heads commodity research at the investment bank.

Speaking at a Platts oil conference on Friday, Currie said precious metals had run up on the back of quantitative easing, which had debased paper money.

Oil and industrial metals, on the other hand, have risen due to fears of supply shortages. If real, sustainable economic growth has been generated off the back of QE, there may be some slowing of this growth, but it should still support demand for industrial commodities, he said.

"We think we are at least 12 months away before we see some of these physical issues beginning to resurface, which is why we argue for a correction in the near term," said Currie.

"But if the economy holds together, we'd argue that oil will start to look like agriculture, with real physical shortages and much higher prices."

Currie said agricultural commodities are already at critical shortages, but oil won't get to this stage until 2012.

"The emerging markets have already crowded out the developed market demand for copper, and you will see the same dynamic play out in oil over the next decade," he argued.

"The end game has to be a policy response, because we're dealing with a situation in which there are political constraints on the free flow of investment.

Shorts up bets against oil after gasoline rout: data

By Lisa Shumaker and Robert Gibbons

CHICAGO/NEW YORK, May 12 (Reuters) - A second big drop in oil prices was likely caused as much by short-selling as by investor liquidation, according to data released on Thursday that suggested more volatility ahead for commodity prices.

Open interest, the net total of long and short bets on the market, across 28 commodities held steady on Wednesday, with several key markets such as crude oil and copper seeing an increase, according to exchange data.

A sharp drop in positions in the relatively smaller gasoline market, which led the collapse in prices, as well as corn and wheat was more than offset by gains in crude oil. The U.S. oil futures benchmark hit a record high open interest.

The data was similar to last Thursday, when oil prices fell precipitously, and means that for the second time in a week investors have reacted to a sharp commodity price decline by adding positions.

The new bets meant the notional value of these commodities markets fell only $228 million, a sign, traders said, that bulls were not panicking but that big bets were still coming in looking for a fall in raw materials prices.

The big bets came despite gasoline futures suffering their worst single day since the height of the financial crisis in September 2008, losing 7.6 percent.

The upshot is that the tug-of-war between bulls and bears in commodities has only intensified over the last week, setting the stage for more volatility in coming trading sessions.

"They may be seeing some speculative long liquidation on one side of the market but you may be seeing some consumer hedge buying interest on the opposite side of things," said Tim Evans of Citi Futures Perspective in New York.

Graphic: Commodity sell-off and open interest

(http://r.reuters.com/jum49r)

Spreadsheet of one-day change in OI on May 11:

(http://r.reuters.com/qug59r)

(Continued on page 29)

Spreadsheet of change in OI since April:

(http://r.reuters.com/pug59r)

TREND SIGNALS

Commodity investors typically look at the direction prices, open interest and trading volumes are moving for clues to the future direction of the market. Rising open interest with strong volumes and a falling price is seen as a sign that a market will continue to decline because more short sellers are entering.

The number of contracts traded on Wednesday exceeded the 30-day average by nearly a quarter. Nearly 820 million paper barrels of West Texas Intermediate crude oil changed hands.

U.S. crude futures on the NYMEX set a new record high for open interest on Wednesday as prices plunged more than 5 percent and took oil back below $100 per barrel.

Crude futures had also set a record open interest during the previous sell-off on May 5. Indeed, both commodity sell-offs in the past week may well have been exacerbated by the huge short bets, traders said.

But growing open interest in energy, which dominates the commodities sector, has obscured a shrinking of open interest in other areas.

Open interest in cotton is down 22 percent, soybeans have dropped 17 percent and silver has fallen 12 percent.

Coffee saw open interest hit a 1-1/2 year low on Wednesday as prices have tumbled from a 34-year high. Copper open interest is at the lowest level since October 2009 and many agricultural commodities, such as corn and soybeans, are at their lowest number of open positions since the fall of 2010.

Commodity holdings steady despite price plunge

By Lisa Shumaker

CHICAGO, May 12 (Reuters) - For the second time in a week, open interest in commodity futures barely budged despite a massive drop in prices, indicating that players are still adding large short positions, an analysis of exchange data showed.

Open interest across 28 commodities held steady on Wednesday, with several key markets such as crude oil and copper seeing an increase.

Last week's rout -- the worst since 2008 -- actually saw open interest rise by $680 million.

Open interest in a futures market tallies long and short contracts that are not offset. Based on Wednesday's settlement prices, the dollar value of the open positions in commodity markets fell only $228 million on the day -- a far cry from the $30 billion drops that often came on days when commodity prices posted the largest losses. On those occasions, straight long liquidation was the main driver.

But both commodity sell-offs in the past week appear to have featured investors establishing large short positions, which could have exacerbated the plunge in prices, traders said.

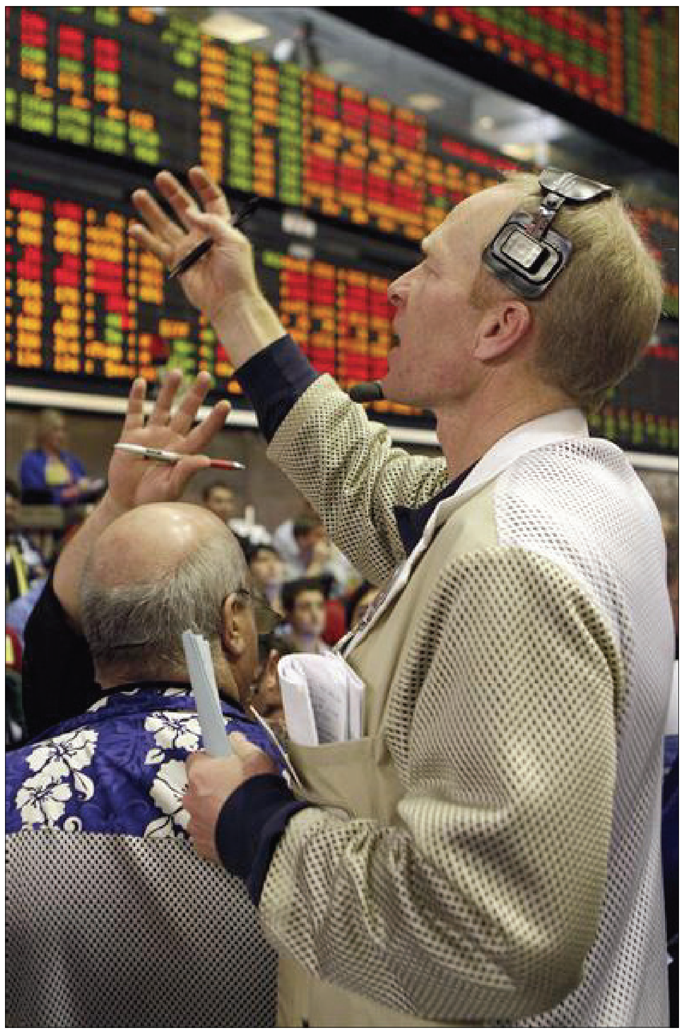
On Friday, traders will get a clearer picture of what happened when the U.S. Commodity Futures Trading Commission releases weekly commitments of traders data showing long and short positions of investors through Tuesday, May 10.

U.S. crude futures on the NYMEX set a new record high for open interest on Wednesday as prices plunged more than 5 percent and took oil back below $100 per barrel. Crude futures had also set a record open interest during the previous sell-off on May 5.

In the bigger picture, open interest has fallen sharply across many commodities since early April when prices peaked in a number of markets.

Open interest in cotton is down 22 percent, soybeans have dropped 17 percent and silver has fallen 12 percent.

Coffee saw open interest hit a 1-1/2 year low on Wednesday as prices have tumbled from a 34-year high. Copper open interest is at the lowest level since October 2009 and many agricultural commodities, such as corn and soybeans, are at their lowest number of open positions since the fall of 2010.



Traders in the Corn options pit at the CME Group signal orders shortly before the closing bell in Chicago. REUTERS/Frank Polich

CRB index posts biggest weekly fall since 2008

By Barani Krishnan

NEW YORK, May 6 (Reuters) - Commodities ended lower on Friday, retreating after a brief rebound from the previous session's plunge, and analysts said more market turbulence was in store after the steepest weekly decline since 2008.

U.S. crude oil bounced up early, but ultimately fell almost 3 percent on the day and 15 percent on the week. In dollar terms, oil posted its steepest weekly drop, $16 a barrel. Markets like corn and sugar also gave up early gains and finished lower.

The Reuters-Jefferies CRB index finished the week with a 9 percent drop. It was the biggest weekly decline since December 2008 for the CRB, which tracks 19 commodities and acts as a global benchmark for the asset class.

In early trade, news that private U.S. employers added jobs at the fastest pace in five years gave commodities a boost. But commodities erased those gains and resumed their drop as new worries about the euro zone boosted the dollar.

Investors also fretted that oil, metals and grains have more to lose after the chunk of gains made since July.

For traders watching price screens turn red in New York and Chicago, it was another surprising session, though not as shocking as Thursday's free-fall which lacked an obvious trigger.

"After yesterday's kind of historic trading day, the market's going to have increased price volatility which can lead to this kind of intraday swing, so we have to watch it," said Gene McGillian, analyst at Tradition Energy in Stamford, Connecticut. Most market strategists repeated their mantra of higher commodity prices over the long term, saying this week's sell-off

had changed nothing fundamentally. Yet some warned of more market swings in the days and weeks ahead.

A slew of U.S. macroeconomic data, including the Consumer Price Index or measure for inflation, is due next week.

Graphic on commodities performance overview :

(http://r.reuters.com/tyj49r)

From June 2010 to the end of April 2011, the CRB rose 45 percent. That was a bigger increase than the 30 percent CRB rise at the peak of the commodities boom between the end of 2007 and mid-2008. The latest surge was due to loose U.S. monetary policy; burgeoning demand from China, India and other developing economies; and supply scares in oil, corn and other commodities.

The bullish charge came to a sudden halt this week as the herd mentality reversed direction. On Thursday, the CRB fell 5 percent, a decline exceeded only four times before, three of those in the midst of the 2008 crisis. Silver plummeted almost 30 percent for the week, the steepest plunge of any commodity and almost twice as steep as oil's tumble.

On Friday, Goldman Sachs , the investment bank that correctly predicted in April a near-term bust in commodity prices, said it expected oil to sell off further in coming days but set new highs by 2012 as global supplies tighten.

Some analysts were not so sure, saying oil's fundamentals looked suspect especially with the dollar likely to rebound further from three-year lows if Europe's fiscal woes worsened.

The euro currency was headed for its biggest weekly drop against the dollar since January after a German news report, later denied, that suggested Greece had raised the possibility of leaving the euro zone. "If Greece were to leave, which is not easy to do, the European banking system would be in great trouble, damaging the economy and oil demand," said Bill O'Grady, Chief Investment Strategist at Confluence Investment Management in St. Louis, Missouri. "The oil market is worried about demand growth," he said.

U.S. crude settled down $2.62 to $97.18 a barrel. London's Brent fell $1.67 to finish at $109.13. Corn fell 3 percent as the stronger dollar and weaker oil triggered a fresh round of liquidation. Front-month corn futures on the Chicago Board of Trade ended below $7 a bushel, falling 9.4 percent on the week for their biggest weekly drop since October.

Prices at 4:38 p.m. EDT (2038 GMT)

In commodity rout, more traders getting in than out

By Lisa Shumaker

CHICAGO, May 6 (Reuters) - When commodities melt down as abruptly as they did on Thursday, the first assumption is that big investors dumped massive long positions.

This time around, that doesn't seem to be whole story, or even the right one. Exchange data shows that not all traders were running for the doors; some added to positions, many betting on more losses rather than locking in profits.

In the hardest hit markets -- oil and silver -- the number of bets on the market rose even as prices crashed. Because oil dwarfs the rest of the commodities, the rise in the number of bets on oil was enough to drive up the notional value of all commodities markets even though crude fell 9 percent in price.

Open interest, the number of individual contracts available on an exchange, rose by $680 million across 28 commodities, a far cry from the $30 billion drops that have accompanied past sell-offs.

Since every open contract needs two counterparties -- a long who wants prices to rise and a short who wants prices to fall -- a rise in the number of open contracts indicates that more people were betting on the market. While the data doesn't necessarily reveal the intent behind those bets, the fact that prices were falling rather than rising suggests the dominant force was selling, not buying.

"It suggests that investors are reversing course and that the new shorts were big enough to offset the longs. It also suggests there's more downside to go," said Bill O'Grady, chief investment strategist at Confluence Investment Management in St Louis.

Graphic on open interest:(http://r.reuters.com/jum49r)

Commodity correction in graphics: (http://r.reuters.com/tyj49r)

(Continued on page 31)

NOT LIKE BEFORE

That's what makes Thursday different from other massive sell-offs, such as Sept. 29, 2008, when U.S. House of Representatives voted down a $700 billion plan to come to the rescue of worsening financial markets, or March 15, a few days after Japan's nuclear crisis drove traders to safer assets.

On both those occasions the value of open positions across the spectrum fell as traders closed out positions and moved into other assets.

Anecdotal evidence suggests that algorithmic traders, whose computer systems would not have been caught up in the emotional turmoil of yesterday's unprecedented $12 collapse in Brent prices, may have been on both sides of the market.

"I think some of the momentum-type traders, their lanes got triggered into selling and then the market moved so much that it triggered some of them into short selling," said a senior oil trader at a major investment.

While far from conclusive, the data for Thursday suggest a different narrative: bears are mounting an attack on the market. But for open interest to go up even as shorts enter the market it means only one thing: someone else is going long, and long in a big way.

Rising open interest in a falling market is often seen as a bearish signal by traders, a sign that big money is coming in to force the market down.

It also means investors seeking a quick buck in a rebound rally may be getting into the market.

And if it is a sign of potential future price declines it is also a recipe for volatility. Effectively there are a lot of people convinced the market is going to fall, but also a lot who see space for a quick rally. Should either side capitulate, the market could move suddenly up or down.

For now the identities of the new longs and shorts is not clear and the first shreds of evidence won't be available for a week, when the Commodity Futures Trading Commission releases its Commitments of Traders report that will shed some light on the new positions.

To be sure, open interest is an imperfect gauge at best. Unlike the market capitalization of equity markets, where a corporation controls the issuance of new securities, open interest in futures markets is can keep growing so long as new money enters the market.

Commodity fund managers see sell-off as short-term

By Claire Milhench and Barbara Lewis

LONDON, May 6 (Reuters) - Fund managers investing in commodities futures and commodity-related stocks see this week's sell-off as a short-term dip before the prospect of tightening supplies drives a further rally.

Selling began in earnest on Thursday after weak economic data raised expectations of reduced commodities demand. It continued on Friday, taking one of the hardest-hit, silver , down almost 30 percent since the start of the month.

Brent crude , which hit a two-and-half-year peak above $127 last month, has fallen around 16 percent from April's close to a session low on Friday of $105.15 a barrel.

The 19-commodity Reuters-Jefferies CRB index rose by 0.3 percent in early trade on Friday after falling 5 percent on Thursday, its fifth biggest one-day fall on record, as traders and global macro hedge funds took profits.

Analysts said markets such as oil had plunged through significant technical levels and the selling had gathered momentum as trading models triggered sell orders.

Fund managers running some of the biggest commodities funds in Europe said the sell-off was a healthy correction and could pave the way for further rises over the medium to longer term. "No one wanted commodities to rise too fast and to constrain GDP growth," said Colin O'Shea, head of commodities at Hermes, which manages more than $2 billion across the asset class.

(Continued on page 32)

A farmer carries a bundle of rice stalks through a rice field at Gowa district, Indonesia's South Sulawesi province May 7, 2011. REUTERS/Yusuf Ahmad

"I see this as a positive for the market. This will take some steam out of the commodity rally -- I see it as more of a pause, a short-term correction, which should help the consumer globally."

O'Shea and others said that from a fundamental viewpoint little had changed as the market had been cleansed of excessive speculation, creating new buying opportunities.

Fabien Weber, co-manager of the JB Commodity Fund, which has some $700 million under management, said some traders had taken excessive positions on the oil market for instance in response to violent unrest in producer countries.

"The market is being cleaned of all the people who were indiscriminately long," he said.

TOO SPECULATIVE

Angelos Damaskos, manager of the equity-based Junior Oils Trust and the Junior Gold Trust, which have around $105 million under management between them, said monetary stimulus and the weak dollar had helped to drive the speculative push into commodities.

For now the move was exaggerated, but weakness in the dollar remained a reason to buy "real assets" such as commodities and particularly gold , which could reach $1,600 an ounce by the year-end, he said.

"We're still quite bullish medium term, especially if the developed economy starts growing and if demand from Asia continues to be strong, we could easily be in a situation where demand outstrips supply. "It (oil) could well hit all-time highs. I don't see very much supply coming on to the market."

For the second quarter, however, U.S. crude could fall below $85 a barrel, he said, the bottom of the broad $85-$100 range Damaskos predicted for the rest of the year.

Sean Corrigan, chief investment strategist at Diapason Commodities Management, also saw gold as among the least vulnerable commodities, saying it remained relatively a safe haven.

"Gold could go to the $1,425 area from here, but I would expect it to be the least damaged because there's a natural rotation back from cyclicals and gold tends to do relatively well in those circumstances," he said.

Weber agreed commodities could go lower before recovering, but added he remained overweight gold, livestock and energy.

"If you don't believe in a strong worldwide economic slowdown, the consumption of crude oil will continue to rise," he said. "I see this as a short-term correction."

Christopher Wheaton, who runs the Allianz RCM Energy Fund, with more than 174 million euros ($252.8 million) under management, also took the sell-off in his stride.

"This is a wobble," he said. "There was little fundamental reason for the oil price to do what it did -- you're just seeing a healthy reassessment of views."

But he thought the wobble could go on for some time. "It's almost like Wile E. Coyote when he runs off a cliff -- his legs are still going, then he stops and looks down, and that stops and looks down moment is what we've just had in the market." "It's started but it hasn't finished. I suspect this will go on for a while -- we are only three days into it," Wheaton said.

OPEC delegates see oil price fall as welcome

By Alex Lawler

LONDON, May 6 (Reuters) - Oil's sharp slide this week is welcome because high prices may hurt the world economy and in the longer term accelerate the use of alternative fuels, OPEC delegates said on Friday.

Oil fell below $109 a barrel on Friday, extending a record rout in the previous session, which wiped as much as 10 percent from the price, on concern about the strength of global economic recovery.

"The price had been going too high, to $120 a barrel, which is not good for consumers because it can affect the world economy," said an OPEC delegate, who declined to be identified. "A price in the range of $90 to $100 will be ideal." Separately, Venezuelan oil minister Rafael Ramirez said there was no need for quota changes at the meeting next month.

"Oil prices have risen a lot, it goes up and down. It is the typical characteristic of the instability of the market and what is happening in Libya also influences a lot," Ramirez said of a $12 drop in Brent crude prices on Thursday. "We should keep working to keep prices at an adequate level. The fluctuations have to do with the violence in North Africa, it is out of OPEC hands to regulate the market."

Oil's drop was prompted in part by the death of al Qaeda leader Osama bin Laden, the delegate said, rather than any fundamental change in supply and demand for oil. A second OPEC delegate made similar remarks. "High prices will affect demand and encourage the trend towards renewables," the second delegate said. "The price is more affected by geopolitics. It was not fundamentals."

The two delegates were speaking for a country in the moderate Gulf core of the 12-member Organization of the Petroleum Exporting Countries and one of its four African members. No one at OPEC's Vienna headquarters was available for any official comment on the oil market on Friday.

POLITICAL UNCERTAINTY

Despite the loss of Libyan supply and rising prices, OPEC has maintained there is no shortage of crude and no need for any increase in the group's formal production target. OPEC has not officially changed its oil output policy in more than two years.

It meets on June 8 in Vienna and is likely to keep output policy unchanged, the first delegate said. "I do not think we're prepared to change the quota at the moment due to the geopolitical uncertainty.

Libya's production has dropped dramatically, but there has been a compensation by Saudi Arabia and other members." Even so, other delegates to OPEC see the need for a clear signal in June that the group is prepared to take action to bring oil back below $100 a barrel.

Leading OPEC producer Saudi Arabia has become increasingly frustrated that, despite its unilateral effort to pump more, prices have stayed high.

Riyadh insists it prefers a "fair price" of $75. "I think OPEC may consider raising production as a psychological factor that would help prices come down," a delegate from one of OPEC's Gulf countries said on Thursday.

(Continued on page 33)

Goldman sees new oil rally; JP Morgan ups forecast

By Dmitry Zhdannikov and David Sheppard

LONDON/NEW YORK, May 6 (Reuters) - Goldman Sachs , which in April predicted this week's major correction in oil prices, said on Friday that oil could surpass its recent highs by 2012 as global oil supplies continue to tighten.

The Wall Street bank, seen as one of the most influential in commodity markets, said it did not rule out a further short-term fall after Thursday's near record drop, especially if economic data continued to disappoint.

But the bank reaffirmed its traditional long-term bullish view of oil, helping crude to pare some of its earlier heavy losses on Friday. And it wasn't alone: JP Morgan took the bold step of raising its oil price forecasts for this year by $10, becoming the most bullish of 27 forecasts in a Reuters poll.

"While financial bushfires or perhaps a rapid resolution to the Libyan civil war could radically alter market dynamics, the balance of both risks and fundamentals still points to a supply-constrained world," JP Morgan analysts, including Lawrence Eagles said in a note late on Friday. They said oil would rise to $130 in the third quarter to check demand.

Goldman, meanwhile, stuck largely to the same view it first aired three weeks ago -- a medium-term correction followed by a renewed ascent. "It is important to emphasize that even as oil prices are pulling back from their recent highs, we expect them to return to or surpass the recent highs by next year," Goldman Sachs' analysts said in a research note.

"We continue to believe that the oil supply-demand fundamentals will tighten further over the course of this year, and likely reach critically tight levels by early next year should Libyan oil supplies remain off the market," it said.

Oil prices remained extremely volatile on Friday, roiled by better than expected U.S. jobs data, which eased fears about global economic recovery that contributed to a 10-percent price crash on Thursday .

Goldman said it believed this week's correction in oil prices, which fell from above $125 per barrel of Brent crude to below $106 on Friday, was sparked by disappointing economic data releases and U.S. oil inventory data.

"The sell-off yesterday (May 5) has likely removed a large portion of the risk premium that we believe has been embedded in oil prices, which could suggest further downside may be limited from here."

At 12:30 p.m. EDT (1630 GMT), Brent crude oil was up $1.05 at $111.85 a barrel, having earlier hit a 2-1/2 month low of $105.15. U.S. crude was down 5 cents at $99.75 a barrel, having earlier dropped to $94.63 a barrel.

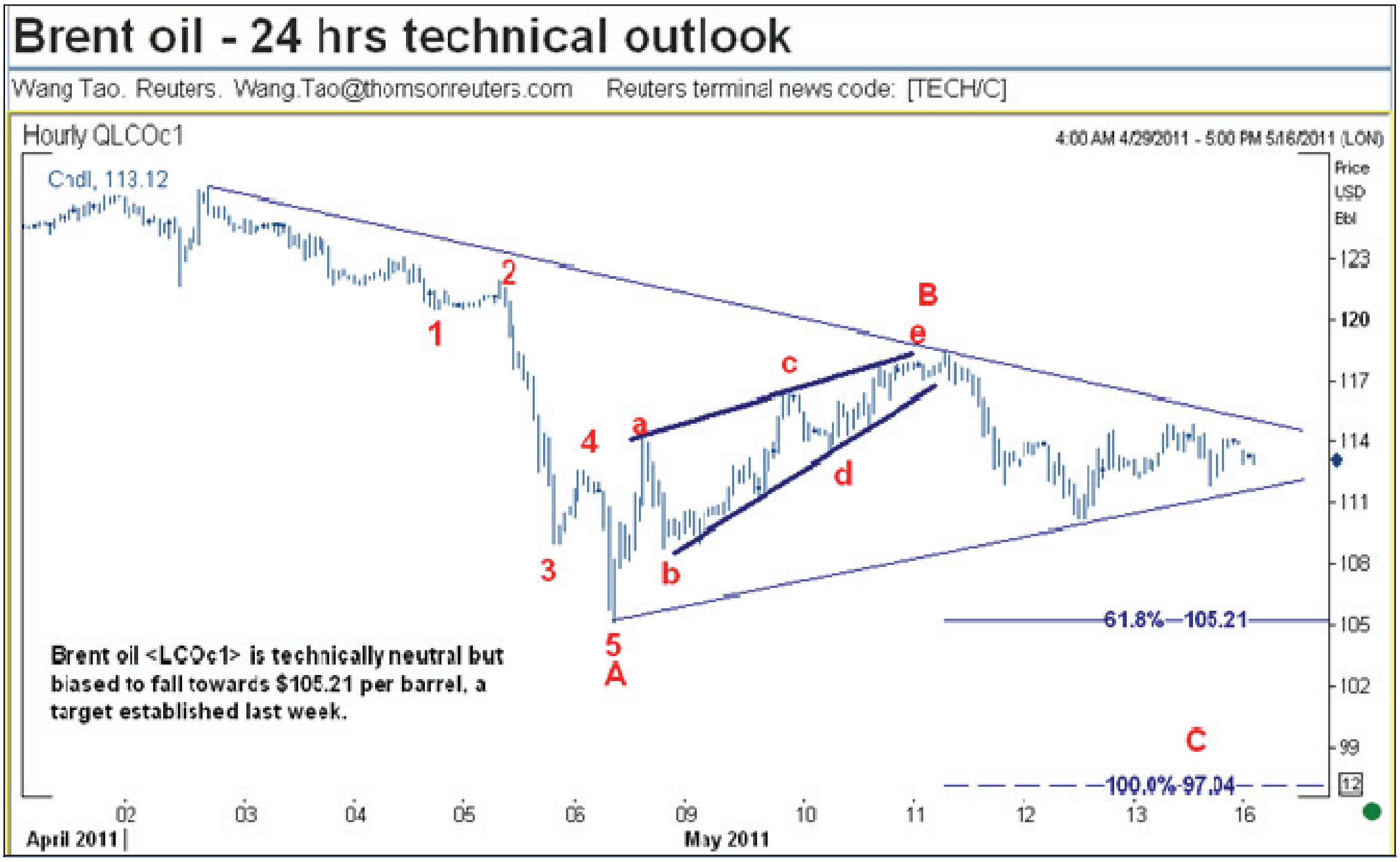
ROCKING MARKETS

Goldman rocked markets in April by calling a nearly $20 fall in Brent, saying speculators had pushed prices ahead of fundamentals.

Goldman was one of the first banks to predict $100 oil last decade, in 2005 when prices were closer to $50 a barrel, but it stayed bullish for some time after oil peaked at $147 in 2008. "In terms of timing, Goldman got it (the crash) right this time. Well done," said an oil trader with a major rival bank.

"It (this week's fall) was a move driven by macro funds after U.S. and German data disappointed and (European Central Bank President Jean-Claude) Trichet did not deliver on yet another rate rise," he said. "With Asian funds having liquidated some of their position today I think we will now see prices stabilizing he added.

(Continued on page 34)



JP Morgan, which last raised its forecasts in late March, is now predicting $120 a barrel for Brent in both 2011 and 2012.

It has averaged about $110 a barrel so far this year, but fell by a record more than $16 this week, closing below $110 a barrel for only the second time since Libyan exports were cut.

GOOD BUYING OPPORTUNITY?

Goldman's short-term view was rejected by many of its banking rivals back in April, with both Barclays Capital and Morgan Stanley arguing there was little evidence higher prices were causing demand destruction in the United States, the world's largest oil consumer. Barclays Capital and Deutsche Bank said on Friday the current levels might be a good buying opportunity.

"While further downside from potential weaker macro releases cannot be ruled out, the general trend from here should be higher, rather than lower, in our view," said Amrita Sen, an oil analyst at Barclays.

She added that worries about tight supplies and unrest in the Middle East will outweigh concerns about U.S. gasoline demand destruction or slower Asian demand due to inflation.

Deutsche Bank commented: "We believe composure will return to commodity markets as underlying fundamentals remain bullish in our view... We believe the collapse in oil prices this week is more a positioning event than a change underlying fundamentals." Andrew Moorfield, the head of oil division at Lloyds, said he saw oil at around $110 in 2011 and $100-$110 going forward.

"Despite this week, the demand curve for oil remains with an upward trajectory... Globally, this general fall in commodities prices will reduce the drag many were starting to think they were having on economic growth."

Colin O'Shea, head of commodities at Hermes, who helps manage over $2 billion, also said the correction was a good opportunity for investors to get into the market if they missed out on the previous rally.

Net outflows rise for commodity, energy funds-EPFR

By Daniel Bases

NEW YORK, May 6 (Reuters) - Concerns about the global economy prompted investors to pull cash from commodity and energy-focused mutual funds in the week ended May 4, data from fund tracker EPFR Global showed on Friday.

To view graphics on 2011 commodity price performance, please click on http://r.reuters.com/nab49r

Commodity funds had net outflows of $1.47 billion while energy funds had net outflows of $1.06 billion, reflecting a rout in commodity prices.

At the same time investors were getting troubling information on the slowing pace of developed market economies, they plowed sizable amounts of cash into their equity funds, with the lion's share going into exchange-traded funds.

(Continued on page 35)

An investor reacts in front of an electronic board showing stock information at a brokerage house in Huaibei, Anhui province May 12, 2011. REUTERS/China Daily

"Behind those numbers was a shift that favored defensive sectors, some diversified fund groups and ETFs over actively managed funds," EPFR's director of research Cameron Brandt said in the firm's weekly statement.

Overall net inflows into all equity funds was $4.7 billion while all bond funds absorbed a net $4 billion, the Cambridge, Massachusetts-based company reported.

Large-cap U.S.-focused equity funds, with 95 percent of the week's total inflows coming into ETFs as institutional investors outweighed retail redemptions, resulted in a net inflow of $4.48 billion.

Developed Europe took in $298 million while Japan equity funds had net inflows of $107 million.

South Korean funds continue to benefit from exporters taking market share from competitors, notably Japan. Funds took in $131 million, while money market funds took in a net $6.83 billion, the fifth week of inflows out of the last six "despite the minimal returns on offer and the dollar's slide."

As commodity and energy funds lost out to economic fears, defensive sectors took in cash. Healthcare/biotech had inflows of $843 million.

Expectations for steady and low U.S. interest rates helped attract $59 million into financial sector equity funds and $165 million into real estate.

EMERGING MARKETS

Emerging market equity funds made up a major portion of the equity inflows, bringing in a net $1.2 billion. This was the sixth straight week of inflows, with the bulk of the cash going into the diversified global emerging market equity funds.

For the week, GEMs took in a net $1.29 billion while those that are long-only dedicated emerging market funds had net inflows of $1.24 billion.

Russia maintained a strong position, taking in cash for the 29th out of 31 weeks, with a net inflow of $86 million despite the pummeling of commodity and energy funds.

However, the BRIC-dedicated funds (Brazil, Russia, India, China) continue to be shunned, with outflows of $93 million.

EPFR reports that year-to-date this group of funds has posted outflows of cash in 16 out of the last 18 weeks, for a total of $2.4 billion.

Outflows from China-focused funds hit a 12-week high, with net redemptions totaling $248 million.

Vietnam's equity funds had net inflow of $8.3 million, a 22nd week of fresh cash as investors buy into the nation's low-cost manufacturing story. Latin America continues to lumber along with outflows of $148 million. This was the 14th out of the past 15 weeks where investors have pulled cash from their equity investments.

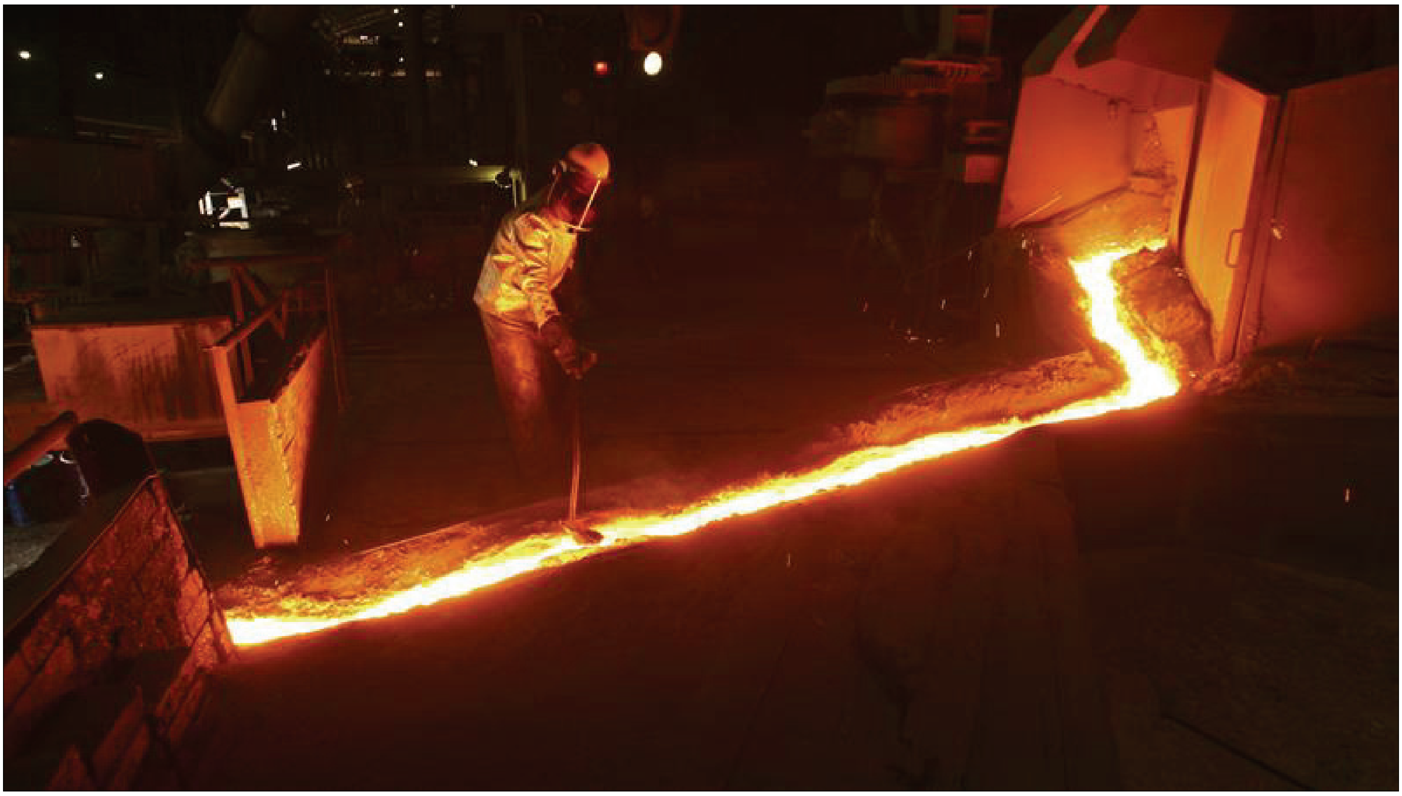
DEBT

Emerging market debt funds were among the winners in the fixed income space, taking in a total $652 million.

The attraction of higher yields versus what's available in developed markets has kept investors sweet on this sector.

Local currency bond funds had net inflows of $411 million, hard currency took in a net $211 million and blended funds attracted $30 million in fresh cash.

High yield funds had net inflows of $754 million, again because of the higher yields. As expected, U.S. municipal bond funds had outflows, losing $643 million to net redemptions for the week.



An employee works in a ferronickel smelter owned by state miner Aneka Tambang Tbk at Pomala district in Indonesia's southeast Sulawesi province March 30, 2011. REUTERS/Yusuf Ahmad

FACTBOXES

Silver margin changes by CME since 2009

May 10 (Reuters) - CME Group Inc raised margin requirements for the 5,000-ounce silver futures five times over a two -week period by a total of about 84 percent.

The margin hikes, cited as one of the triggers for the broad-based rout in the commodities complex last week, sparked a slide in silver prices since touching a record high of $49.51 an ounce on April 28.

Following are some details of the increase:

* CME, the world's largest commodities exchange, hiked margins to $14,000 per contract from $12,000 effective May 5, and again to $16,000 effective May 9. Prior to April 25, the margin stood at $8,700 per contract.

* Margins are deposits paid by investors in futures markets, where full payment is made when contracts mature, to an exchange or clearing house to cover the risk of default by that investor and typically are based on the largest most-likely daily market move.

* Exchanges typically raise margins to mitigate risks as price volatility in the market increases.

* However, margins can also be used as a tool to curb speculative trading activity, particularly "hot money," by reducing the number of positions a party can hold by leveraging a particular amount of money.

Following are the percentage changes in the COMEX 5000 silver futures (Tier 1) maintenance margins since 2009 (in U.S. dollars per contract).

EFFECTIVE	INITIAL	MAINTENANCE	PERCENTAGE
9-May-11	$21,600	$16,000	14.3
5-May-11	$18,900	$14,000	16.7
3-May-11	$16,200	$12,000	11.6
29-Apr-11	$14,513	$10,750	13.2
26-Apr-11	$12,825	$9,500	9.2
25-Mar-11	$11,745	$8,700	5.5
21 Jan. 2011	$11,138	$8,250	6.5
17 Dec. 2010	$10,463	$7,750	6.9
16 Nov. 2010	$9,788	$7,250	11.5
11 Nov. 2010	$8,775	$6,500	30
01 Oct. 2010	$6,750	$5,000	0
7-Jun-10	$6,750	$5,000	17.7
30-Apr-10	$5,738	$4,250	-15
2-Mar-10	$6,750	$5,000	0
12 Feb. 2010	$6,750	$5,000	11.1
15 Dec. 2009	$6,075	$4,500	12.5
21 Aug. 2009	$5,400	$4,000	-33.3
26-Jun-09	$8,100	$6,000	-14.3
28-May-09	$9,450	$7,000	16.7
22 Jan. 2009	$8,100	$6,000	-6.3
08 Jan. 2009	$8,640	$6,400 --	

Crude oil margin changes by CME since 2009

BANGALORE, May 10 (Reuters) - CME Group Inc has raised the margin call for crude futures for the fourth time since February, the biggest hike since at least 2009.

Oil dropped more than a dollar on Tuesday after the CME Group increased margins by 25 percent.

Following are some details of the increase:

* CME, the world's largest commodities exchange, said on its website it had hiked margins for crude oil futures on the New York Mercantile Exchange by $1,250 per contract. With open interest in the contract topping 1.65 million lots last week, that would amount to an increase of over $2 billion.

* The cumulative increase in margins on U.S. crude benchmark West Texas Intermediate positions since February 2011 is 67 percent, from $3,750 to $6,250 per contract.

* Initial margins started 2009 at $9,112.50 per contract, after prices slumped from records near $150 a year earlier to less than $40 a barrel. They then shrank over the course of the year as volatility decreased, and are now at $8,438.

* Margins are deposits paid by investors in futures markets, where full payment is made when contracts mature, to an exchange or clearing house to cover the risk of default by that investor. They are typically based on the largest most-likely daily market move.

* Exchanges typically raise margins to mitigate risks as price volatility in the market increases.

* However, margins can also be used as a tool to curb speculative trading, particularly "hot money", by reducing the number of positions a party can hold by leveraging a particular amount of money.

For a list of historical crude oil margin changes by the CME, click: (http://www.cmegroup.com/clearing/risk-management/files/CL_2009_to_december_2010.pdf)

Following are the percentage changes in the WTI financial futures (Tier 1) initial and maintenance margins since 2009

(in U.S. dollars per contract)

EFFECTIVE DATE	INITIAL	MAINTENANCE	PERCENTAGE
12-Jan-09	9,112.50	6,750.00	--
2-Mar-09	7,087.50	5,250.00	-22.22
26-Mar-09	7,762.50	5,750.00	9.52
21-Aug-09	7,087.50	5,250.00	-8.7
16-Sep-09	6,075.00	4,500.00	-14.29
13-Nov-09	5,400.00	4,000.00	-11.11
23-Apr-10	5,062.50	3,750.00	-6.25
25-Feb-11	6,075.00	4,500.00	20
4-Mar-11	6,750.00	5,000.00	11.11
10-May-11	8,438.00	6,250.00	25.01

(Continued on page 37)

Monthly changes in precious metals ETF holdings

LONDON, May 10 (Reuters) - Holdings of the world's largest gold-backed exchange-traded fund, New York's SPDR Gold Trust , rose for a second consecutive month in April, although global ETF holdings of gold fell, while platinum holdings rose for a fifth straight month.

Exchange-traded funds, the most widely recognised type of ETP, back each security issued with physical stocks of a given commodity, creating a product they say is free from counterparty risk.

Following is a list of the main exchange-traded products backed with precious metals, and their holdings.

The figures above are those reported to Reuters by the organisations involved by telephone or email on the date shown, or those that are publicly available on their websites.

* ZKB physical gold, silver, platinum and palladium funds are fully backed by physical precious metal and investors are entitled to physical delivery of them.

** Shareholders in the Julius Baer Gold fund can elect to hold "A class" shares, which are fully backed by physical gold. Investors in that class are entitled to physical delivery of the precious metal. Investors may also elect to hold "AX" class shares, which are fully backed by physical gold. Investors in that class are not entitled to physical delivery of the precious metal.

*** Month-on-month changes are calculated from the last working day of one month to the last working day of the next. This may differ from the last actual day of the month.

NAME	COMMODITY	HOLDINGS(OZ)	DATE	% CHG (M/M)	ORIGIN
SPDR Gold Trust <GLD>	Gold	39,534,241	4/29/2011	1.52	U.S.
ETF Securities gold funds (excluding U.S.)	Gold	8,477,156	4/29/2011	0.94	UK
ZKB Physical Gold <ZGLD.S>	Gold	6,283,472	4/29/2011	2.83	Swiss
COMEX Gold Trust <IAU>	Gold	4,322,536	3/31/2011	7.33	U.S.
Julius Baer Physical Gold Fund**	Gold	2,956,431	4/29/2011	3.48	Swiss
ETFS Physical Swiss Gold Shares <SGOL.P>	Gold	899,200	4/29/2011	-0.05	U.S.
NewGold ETF <GLDJ.J>	Gold	1,590,450	4/29/2011	2.48	S.Af
TOTAL		64,063,486	4/29/2011	-1.59	
iShares Silver Trust <SLV>	Silver	354,344,233	4/29/2011	-1.06	U.S.
ZKB Physical Silver <ZSIL.S>	Silver	71,147,019	4/29/2011	-6.55	Swiss
ETF Securities silver funds (ex-U.S.)	Silver	30,540,081	4/29/2011	-1.02	UK
ETFS Physical Silver Shares <SIVR.P>	Silver	20,196,337	4/29/2011	10.29	U.S.
Julius Baer Physical Silver Fund	Silver	12,732,000	4/29/2011	21.18	Swiss
TOTAL		488,959,670	4/29/2011	-1.01	
ETF Securities platinum funds (ex-U.S.)	Platinum	487,168	4/29/2011	1.33	UK
ETFS Physical Platinum Shares <PPLT.P>	Platinum	441,584	4/29/2011	-0.07	U.S.
ZKB Physical Platinum <ZPLA.S>	Platinum	367,300	4/29/2011	0.43	Swiss
TOTAL		1,296,052	4/29/2011	0.59	
ETFS Physical Palladium Shares <PALL.P>	Palladium	1,047,070	4/29/2011	0.9	U.S.
ETF Securities palladium funds (ex-U.S.)	Palladium	635,838	4/29/2011	4.91	UK
ZKB Physical Palladium <ZPAL.S>	Palladium	442,395	4/29/2011	-0.04	Swiss
TOTAL		2,125,303		1.87	

Biggest drops in commodity open interest

May 6 (Reuters) - The most massive sell-offs in commodities have mainly occurred in the last three years as investors have steadily pumped more money into the sector.

The biggest drop in commodity open interest, in terms of dollar value, happened on March 19, 2008, when the market dropped $32 billion across 19 U.S. commodities. Investors were spooked by the sale of prominent U.S. bank Bear Sterns for $2 a share to JPMorgan on March 16.

In comparison, the dollar value of the open interest of those same 19 commodities fell only $227 million on May 5. Using a broader range of markets -- 28 commodities including those traded in Europe -- the value of open interest actually rose by $680 million on Thursday as investors likely opened a large number of new short positions in addition to liquidating long positions. Here are other prominent dates that triggered large drops in commodity prices:

* March 17, 2008 - Day after fire sale of Bear Stearns, which hastened the global financial meltdown.

* July 17, 2008 - End of the 2008 commodities rally when prices hit record highs.

* Sept. 29, 2008 - U.S. House of Representatives voted against a $700 billion bailout plan and Europe announces it will spend billions rescuing troubled banks.

* Nov. 12, 2010 -- Commodities crashed on speculation that China, one of the biggest importers of commodities, would raise interest rates to curb high inflation.

* Nov. 16, 2010 - Markets spooked by talk that China, the No. 2 economy and a major commodities consumer, would raise interest rates to quell rising inflation. Markets were also nervous about the debt crisis in Ireland and the Federal Reserve's plans for a second round of economic stimulus.

* March 15, 2011 -- Nuclear crisis in Japan sent fear rippling through financial markets, driving investors toward safer assets.

SOURCE: Thomson Reuters data

DATE	DOLLAR VALUE OF OI	CHANGE IN OI	
3/19/2008	$501,846,415,887	($32,110,834,570)	-6.00%
11/16/2010	$489,635,683,682	($31,669,036,906)	-6.10%
3/17/2008	$528,838,702,903	($28,262,048,238)	-5.10%
7/17/2008	$552,398,528,593	($25,500,629,245)	-4.40%
9/29/2008	$353,222,666,613	($25,140,203,151)	-6.60%
11/12/2010	$516,352,828,402	($24,494,286,749)	-4.50%
3/15/2011	$555,404,107,108	($24,234,116,534)	-4.20%
5/5/2011	$574,940,234,485	($226,806,704)	-0.30%

* Dollar value based on settlement prices of 19 U.S. commodities -- crude oil, natural gas, heating oil, RBOB gasoline, gold, copper, silver, corn, soybeans, CBOT wheat, KCBT wheat, MGE wheat, soybean oil, soymeal, rice, sugar, coffee, cotton and cocoa.

An investor closes his eyes in front of television sets showing stock information at a brokerage house in Shenyang, Liaoning province May 4, 2011. REUTERS/Sheng L

COMMENT

COLUMN-Commodities and defunct economics (Part 1): John Kemp

-- John Kemp is a Reuters market analyst. The views expressed are his own --

By John Kemp

LONDON, May 16 (Reuters) - Establishment economists and policymakers dominating central bank policy committees have a curious blind spot when it comes to commodity prices.

Prominent economists ranging from Fed Chairman Ben Bernanke, Vice-Chairman Janet Yellen and New York Fed President William Dudley to former Vice-Chairman Donald Kohn, Bank of England Deputy Governor Charles Bean and Nobel Economics Laureate Paul Krugman all insist rising food and fuel prices are not a sign of excess demand and have nothing to do with macroeconomic policy.

In their view, rising prices are a microeconomic phenomenon. Price increases in those markets are driven by unique supply and demand factors and have no broader significance. As long as spare capacity, high unemployment and stable expectations prevent commodity prices from sparking a wage-price spiral, commodity markets have no bearing on interest rate policy.

DIAMOND IN DIFFICULTY

This view was most recently on display when Fed nominee Peter Diamond told his confirmation hearing before the Senate Banking Committee, "I view commodity prices as driven by micro factors, not general stimulation of the economy."

Diamond's nomination has already been blocked twice. His answer on commodities has not improved his chance of being third-time lucky. The Banking Committee voted to send his nomination to the Senate floor but divided 12-10 along party lines.

Senator Mike Johanns of Nebraska, the only committee Republican to support Diamond last year, withdrew his support, complaining, "We must be increasingly wary of the threat of inflation, yet the Fed continues to print money with reckless abandon."

Senator Richard Shelby, the ranking Republican on the committee, was even more blunt: "I believe he is an old-fashioned big government Keynesian". Diamond is not the first senior policymaker to be assailed about the rising cost of basic necessities. In a question-and-answer session in March, the New York Fed's Dudley was asked by a member of the audience, "When was the last time, sir, that you went grocery shopping?"

His attempt to point out other, less visible items such as consumer electronics that were falling in price backfired and drew a sharp retort: "I can't eat an iPad" .

DIALOGUE OF THE DEAF

The Fed insists its policies including ultra-low interest rates, a $600 billion round of asset purchases and the accumulation of excess bank reserves have nothing to do with the renewed surge in commodity prices over the past eight months.

But most congressional Republicans and some of the public blame Bernanke and his colleagues for sparking a rally that has cut living standards for households, since food and fuel prices are rising much faster than income.

It has led to a damaging stand-off that threatens to undermine the Fed's political independence and its credibility with voters. Diamond's nomination has languished in limbo for months. Unfilled vacancies have cut membership of the Fed's Board from seven to five -- the minimum it needs to make emergency lending decisions. Bernanke's reappointment in 2014 threatens to be controversial.

FED: IT'S NOT OUR FAULT

Senior Fed officials and other establishment economists have tried several defences to disclaim responsibility for rising commodity prices -- none of them very convincing.

Yellen has argued, "recent developments in commodity prices can be explained largely by rising global demand and disruptions to global supply rather than by Federal Reserve policy".

She singled out emerging market demand as well as concerns about oil production in the Middle East and North Africa, droughts in China and Russia and other weather-related disruptions that have contributed to the jump in food prices. (http://www.federalreserve.gov/newsevents/speech/yellen20110411a.htm)

But while Yellen dismissed financial factors as unimportant, she ignored the run-up in speculative long positions, which has coincided with the second round of bond buying, and did not explain why quantitative easing would affect the price of financial assets such as equities, bonds and the dollar, but not real assets such as commodities .

DUELLING DEAD ECONOMISTS

The second line of defence has been to deny the importance of macro factors altogether and insist prices are set in a highly orthodox microeconomic framework of supply, demand and inventories, possibly with a hyper-rational, forward-looking component.

The Bank of England's Bean deployed this argument when quizzed about rising oil at the press conference to present the bank's latest inflation forecasts. Bean relied on the theories of long-dead economists Harold Hotelling and Holbrook Working, who argued spot and forward prices were driven by a strategy of optimal reserve management and revenue maximisation.

But while Hotelling's model is elegant, it has little or no explanatory power in the real world of lumpy investments, uncertain reserves and wildly fluctuating demand and prices. Like other policymakers, Bean seemed at a loss to explain short-term price volatility, especially the crashes in the oil market on May 5 and 12. Gyrating commodity prices are one reason the bank's own macroeconomic forecasts keep going wrong.

Once commodity prices become forward-looking and expectations enter price determination, commodities become subject to the same "animal spirits" as other asset markets, as John Maynard Keynes, another long-dead economist, could have explained.

QUESTIONABLE ECONOMETRICS

The third strand of defence has been to argue that there is "no evidence" that the influx of investment money has affected commodity prices and to cite a battery of econometric studies, which could not identify a clear statistical link between commodity long positions and price rises, especially during the earlier part of the decade.

(Continued on page 40)

But absence of evidence is not evidence of absence. Given the relatively poor and incomplete data on commodity investments and the complex, non-linear links between speculation, fundamentals and prices, it is not surprising econometric studies have not produced a "smoking gun".

Lack of a clear link may say more about the limitations of the econometric techniques than how prices are determined. In any event, evidence is mixed. Some studies by the IMF, ECB and professional economists have found links between commodity prices and macroeconomic variables such as global liquidity.

The current consensus has softened from a position that there is no evidence of speculative impact and that supply and demand account for all observed price changes to a more nuanced position, in which supply and demand determine the direction if not the full extent of price changes.

"The available evidence illustrates that oil price movements between 2003 and 2010 are largely explicable in fundamental terms, even if it is impossible analytically to determine whether those movements were precisely appropriate in fundamental terms, or to some extent also influenced by financial investment flows," wrote Adair Turner, Jon Farrimond and Jonathan Hill in a paper from Britain's Financial Services Authority, published by the Oxford Institute of Energy Studies.

But even they admit that oil and other commodities markets are characterised by "multiple equilibria" and a wide "range of indeterminacy", within which prices can settle. It is not clear how their fundamentals-led approach can account for recent gyrations in oil, gasoline and silver prices.

COLUMN-Commodities and defunct economics (Part 2): John Kemp

-- John Kemp is a Reuters market analyst. This is the second of two articles. The views expressed are his own --

By John Kemp

LONDON, May 16 (Reuters) - The last and most important line of defence for central bankers and economists trying to disclaim a link between monetary policy and soaring commodity prices has been to argue that the effect is probably only temporary.

Food and fuel price increases are portrayed as a one-off adjustment in response to a series of discrete and unrepeatable shocks rather than an ongoing process of inflation that signals excess demand. While they will push up the headline rate of inflation, the effect is expected to be transitory, according to the Federal Open Market Committee.

Once food and fuel prices level off, headline inflation will converge back to the core rate. This thinking permeates the Fed's thinking, and is central to the projections of the Bank of England. It was also recently articulated by Nobel Laureate Paul Krugman in a blog for the New York Times.

Much the same argument was used three years ago in February 2008, when then Fed Vice-Chairman Don Kohn promised that inflation would soon come down and argued, "This projection assumes that energy and other commodity prices will level out, as suggested by the futures markets." This was before the oil market began its final ascent to $147 per barrel. (http://www.federalreserve.gov/newsevents/speech/kohn20080226a.htm)

Echoing this, current Fed Vice-Chairman Janet Yellen said last month, "The current configuration of quotes on futures contracts -- which can serve as a reasonable benchmark in gauging the outlook for commodity prices -- suggests that these prices will roughly stabilise near current levels or even decline in some cases."

Krugman endorsed this thinking: "The idea is that even if the recent commodity price rise is permanent, as long as it levels off it will lead only to a temporary bulge in broader inflation. And the appropriate response of the Fed is to keep calm and carry on." (http://krugman.blogs.nytimes.com/2011/05/13/commodities-and-inflation/)

CIRCULAR THINKING PROBLEM

But is this argument correct or an example of circular reasoning? Ignore for a moment the question about whether it is possible to extract useful predictions about future cash prices from futures contracts, which is very questionable.

The argument seems to run as follows: (1) commodity prices are determined by micro supply and demand factors rather than macroeconomic policy; (2) food and fuel price rises are one-off responses to a specific supply and demand situation rather than an ongoing process; (3) prices will eventually level out irrespective of policy, and when they do so the impact will drop out of inflation numbers; therefore (4) the Fed need not respond to rising prices because they do not signal excess demand.

The conclusion implicitly assumes the premise.

The counter-argument is that commodity prices are rising because of excess aggregate demand in the global economy and excessively loose monetary conditions transmitted from the United States to the rest of the world through the system of semi-fixed exchange rates.

Excess demand is showing up where the bottleneck is tightest, which at the moment is commodities rather than manufacturing or labour markets. By the time the Fed and other central banks have stimulated demand enough to close the gap in labour and manufacturing markets, pressure on commodities will be intense and prices will be surging.

This argument is at least as plausible as the ones advanced by Fed Chairman Ben Bernanke, Yellen, New York Fed President Dudley, Krugman and others. But if it is true, then increases in commodity prices are part of an ongoing process rather than a one-off adjustment. So long as policy remains stimulative, commodity prices will continue to rise, not level off.

In fact that is precisely what many hedge funds are expecting. Money managers have been running record long positions in crude oil and many other commodities, according to reports from the U.S. Commodity Futures Trading Commission.

MARKETS POINT TO HIGHER PRICES

Contra Yellen, who thinks the futures market is predicting prices will level off around current levels, at least half the market thinks prices will rise further. These are the very sophisticated financial investors whose hyper-rational expectations are central to theories such as those of Britain's FSA and of a host of research economists.

The "smart money" thinks commodity prices will continue rising in the medium term, promising no let-up in headline inflation.

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Who is to say that the smart money is wrong? Given the deep cyclical nature of commodity markets, it would be surprising if commodity prices fell significantly as the global economic expansion matured.

It is much more likely they will continue to increase if global central banks try to keep the economy on its present course.

The more the Fed and other central banks try to (over)-stimulate the global economy and make it grow faster than the available supply of raw materials allows, the longer and further commodity prices are set to rise, until rising input costs finally choke off the recovery.

In this sense, rising commodity prices are as much a product of monetary policy as the rise in equity values and the fall in the dollar.

The Fed is focusing on the wrong "output gap". It should be looking at the output gap globally and in commodity markets, rather than in the United States and the labour market and manufacturing.

IMPRISONED BY THE PAST

On the question of monetary policy's role in rising commodity prices, popular opinion is basically correct, and the economics and central banking establishment is wrong. While central bankers and Keynesian economists are willing to embrace the importance of animal spirits in guiding monetary and macro-economic policy, they cling to a strangely classical theory of commodity pricing, which leaves them largely unable to explain what is happening in the real world.

It was John Maynard Keynes who remarked, "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood " Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

In this instance, progressive thinking about macroeconomic policy has been strangely allied with conservative and unrealistic theories about raw material pricing that cannot explain why prices have risen so far so quickly and are contributing to serious errors in forecasting and policy. It is time for a rethink, with more emphasis on the real world and less on abstract theory.

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