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Steven Pearlstein: You bet it's another bubble

By Steven Pearlstein, Published: November 4

Silly you.

You actually thought companies existed to make products and profits.

You thought houses were meant to provide a place for people to live and office buildings a place for people to work.

You thought food was meant to be eaten, oil and gas to be turned into energy, and metals to be turned into cars, bridges and downspouts.

You weren't sophisticated enough to realize that these really are just different "asset classes" meant to give investors around the world something to speculate in and to diversify their portfolios.

Even worse, you actually believed all that stuff about prices being set based on market fundamentals. Little did you know that it's no longer the supply and demand for companies, houses, office buildings, natural gas or wheat that sets prices. More likely it's the supply and demand for the futures, swaps and other derivative instruments linked to those things.

Maybe they thought we wouldn't notice that the financialization of the economy brought with it higher prices and a more volatile economy, along with higher profits for the financial services industry.

The latest example is the market for commodities: corn, wheat, cotton, silver, copper, oil, natural gas. In the past decade, hundreds of billions of dollars have flooded into the market, largely through swaps contracts and commodities index funds, ETFs and mutual funds.

These markets have long since outgrown their original function of providing producers and consumers of these commodities with a way to hedge their risks by guaranteeing supply and locking in prices. All futures markets require a certain number of "speculators" to take the other side of the contracts from commercial users and producers. Typically, these speculators would represent 30 percent of the participants in a healthy futures market.

But today, because of a sudden desire to earn higher returns and diversify investment portfolios, there are more people wanting to invest in corn and copper and oil than there is corn and copper and natural gas produced and consumed. But no problem. The financial wizards on Wall Street have magically conjured up synthetic corn and copper and West Texas oil so that speculators can provide hedging opportunities for other speculators. Instead of 30 percent of the market, these "passive investors" typically account for 70 percent or more.

Who are these new passive investors, as they are politely called? They are pension funds and university endowments whose overpaid consultants tell them that if they want to earn big returns like Harvard and Yale, they have to put money into "alternative" investments such as private-equity funds, hedge funds, real estate investment trusts and commodity pools. More recently, however, they have been joined by individual investors turned off by the stock market and looking for higher returns than they can get from money market funds. While in the past, small, unsophisticated investors have been unable to invest in risky and volatile commodities, the financial services industry has rushed in to satisfy the new demand with exciting products.

Because most of the new investors hope to ride the commodities boom caused by a weak dollar and a strong China, there is an imbalance in the futures and swaps market — more people are betting prices will go up than down. That asymmetry has the effect of driving futures prices even higher, bringing even more investors into the "long" side of the market — the herd effect common on many financial markets.

The strong demand for commodities futures also put upward pressure on the actual prices paid for those commodities by real producers and consumers, if for no other reason than many private sales contracts are settled at a price linked directly or indirectly to futures prices.

At a hearing last week of the Senate permanent investigations subcommittee, Wallace Turbeville, a derivative specialist with Better Markets, a nonprofit research and advocacy group, told the senators that before 2004, the curve showing prices on most commodity futures markets was typically downward sloping — that is, futures prices for the next month were generally higher than those a year or two years out. But with the explosive growth of speculative commodities investing, Turbeville testified, the curves now typically are upward sloping — that is, anticipating a steady increase in prices. Those expectations have become a self-fulfilling reality, as anyone who buys food or gasoline or copper gutters has surely discovered.

Not that the upward path of commodity prices has been a smooth one. To the contrary, commodities prices have been extraordinarily volatile. A recent paper by Kenneth Singleton, a professor at Stanford Business School, found a strong connection between the flow of investment money into the commodities markets and the boom and bust of oil from $50 a barrel to $145 and back to $35 between January 2007 and March 2009. And since then, of course, it hit $125 a barrel before settling back to $75. You can't explain that by changes in supply and demand.

Paul Cicio, president of the Industrial Energy Consumers of America, told the subcommittee that the increased volatility has driven up the price that its members must pay to hedge their risks on the commodities markets. And that increase eventually makes its way into the price of products produced with natural gas.

Earlier this year, the chief executive of ExxonMobil, Rex Tillerson, estimated that speculation was then contributing an extra $30 a barrel to the price of oil.

And no less an expert on coffee prices than Howard Schultz, chief executive of Starbucks, blames "financial speculators" for driving up the price of your double-skim espresso macchiato.

Chairing last week's hearing was Sen. Carl Levin (D-Mich.), whose committee blew open the scandal of Goldman Sachs and other investment banks creating risky mortgage-backed securities that it sold to unknowing customers while secretly using its own money to bet that they would default. Last week, Levin was focused on the growing role of mutual funds in the commodities market.

By law, mutual funds are supposed to derive 90 percent of their income from investments in stocks, bonds and other securities, under the regulatory supervision of the Securities and Exchange Commission. So to get around that prohibition and offer commodity funds, some clever securities lawyers in the mutual fund industry came up with the idea of setting up shell companies in the Cayman Islands for the sole purpose of investing in commodity futures and swaps. By selling shares in the offshore subsidiary to their sponsoring funds, the mutual funds are able to meet the requirement that they only invest in securities, and can also pass the subsidiary's profits on to mutual fund investors without paying a corporate profit tax. And because these are subsidiaries of mutual funds regulated by securities regulators, they escape oversight of the Commodities Futures Trading Commission.

What's clear from this tale is how little the financial services industry has really changed since the crisis of 2008. The financialization of the economy continues undeterred, creating a bubble in commodities just as it did with houses and office buildings. The industry is still engaged in clever games to circumvent regulation, increase risk and find the cracks between one regulatory agency and another. And when regulators step in to try to restore some sanity to the markets, they inevitably run into a political buzz saw created by the industry and its Republican allies.

A case in point is the recent rule adopted by the CFTC, at the instruction of Congress, setting limits on how much a commodities market can be controlled by one investor or dealer. The industry responded with its litany of explanations for why it's harmful and unnecessary.

There's the one about how futures prices have no effect on market prices. Yeah, right.

There's one about how speculators bring needed liquidity to the market, ignoring the obvious dangers of having too much liquidity.

There are the dire warnings that if any curbs are imposed, the entire industry will simply pick up and move to other countries — an argument made while also waging a furious campaign to prevent adoption of similar rules in Europe and Asia.

Finally, when all else fails, the industry claims the regulation is being rushed through without sufficient data and analysis, citing dozens of academic studies (many of them funded by the industry) that came to varying conclusions.

These were the same hackneyed arguments the industry used to block restrictions on savings and loans before that industry imploded in the 1980s. They were the same arguments used to push back regulators who wanted to tighten corporate accounting and disclosure rules before the Enron and telecom scandals of 2001. And they were the same arguments used successfully to curb restrictions on reckless and abusive mortgage lending before the bursting of the housing bubble in 2008.

Now you can bet what's left in your 401(k) that there's about to be a commodities bubble — one that will generate big fees for Wall Street and leave a mess for everyone else.