Testimony of

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before the

Committee on Agriculture
United States House of Representatives

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Chairman Peterson and members of the committee, thank you for the opportunity to appear before you today to discuss this critical piece of legislation. As we have witnessed in the last 18 months, what happens on Wall Street can have a huge impact on Main Street. The implosion of Wall Street has destroyed trillions of dollars in retirement savings, has required trillions of dollars in taxpayer money to rescue the system, has cost our economy millions of jobs, and the devastating aftershocks are still being felt. Worst of all, this crisis was completely avoidable. It can be characterized as nothing less than a complete regulatory failure.

The Federal Reserve permitted an alternative, off-balance sheet financial system to form, which allowed money center banks to take on extreme amounts of risky leverage, far beyond the limits of what your typical bank could incur. The Securities and Exchange Commission allowed investment banks to take on the same massive amount of leverage and missed many instances of fraud and abuse, most notably the $50 billion Madoff ponzi scheme. The Commodities Futures Trading Commission allowed an excessive speculation bubble to occur in commodities that cost Americans more than $110 billion in artificially inflated food and energy prices, which in turn amplified and deepened the housing and banking crises.[1]

Congress appeared oblivious to the impending storm, relying on regulators who, in turn, relied on Wall Street to alert them to any problems. According to the Center for Responsive Politics "the financial sector is far and away the biggest source of campaign contributions to federal candidates and parties, with insurance companies, securities and investment firms, real estate interests and commercial banks providing the bulk of that money."[2] Clearly, Wall Street was pleased with the return on their investment, as regulation after regulation was softened or removed.

So I thank you today Mr. Chairman and members of this committee for your courageous stand and your desire to re-regulate Wall Street and put the genie back in the bottle once and for all. I share your desire to focus on solutions and ways that we can work together to ensure that this never happens again.

I have included with my written testimony a copy of a report that I am releasing, along with my co-author Adam White, which provides additional evidence and analysis relating to the commodities bubble we experienced in 2008, and the devastating impact it has had on our economy (electronic copies can be downloaded at www.accidentalhuntbrothers.com). I would be happy to take questions on the report but I want to honor your request to speak specifically on this piece of legislation that you are proposing.

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[1] See our newly released report entitled "The 2008 Commodities Bubble: Assessing the Damage to the United States and Its Citizens. Available at www.accidentalhuntbrothers.com.

[2] "Finance/Insurance/Real Estate: Background," OpenSecrets.org, Center for Responsive Politics, July 2, 2007. http://www.opensecrets.org/industries/background.php?cycle=2008&ind=F

I believe that the Derivatives Markets Transparency and Accountability Act of 2009 goes a long way toward rectifying the inherent problems in our current regulatory framework and I commend you for that. While Wall Street will complain that the bill is overreaching, I believe that, on the contrary, there are opportunities to make this bill even stronger in order to achieve the results that this committee desires.

I am not an attorney and I am not an expert on the Commodity Exchange Act, but I can share with you what I see as the critical elements that must be part of any effective regulatory framework, and we can discuss how the aspects of this bill mesh with those critical elements.

TRANSPARENCY

Effective regulation requires complete market transparency. Regulators, policymakers, and ultimately the general public must be able to see what is happening in any particular market in order to make informed decisions and in order to carry out their entrusted duties.

In recent years, the big Wall Street banks have preferred to operate in dark markets where regulators are unable to fully see what is occurring. This limited transparency has enabled them to take on massive amounts of off-balance-sheet leverage, creating what amounts to a "shadow financial system."

Operating in dark markets has also allowed the big Wall Street banks to make markets with wide bid-ask spreads, resulting in outsized financial gains for these banks. When a customer does not know what a fair price is for a transaction, then a swaps dealer can take advantage of informational asymmetry to reap extraordinary profits.

Regulators cannot regulate if they cannot see the whole picture. If they are not aware of what is taking place in dark markets, then they cannot do their jobs effectively. Regulators must have complete transparency. Given the speed with which the financial markets move, this transparency, at a minimum, must be available on a daily basis and should ideally be sought on a real-time basis.

The American public, which has suffered greatly because of Wall Street's failures, deserves transparency as well. Individuals should be able to see the positions of all the major players in all markets on a delayed basis, similar to the 13-F filing requirements of money managers in the stock market.

The best way to bring over-the-counter (OTC) transactions out of the darkness and into the light is to make it mandatory for all OTC transactions to clear through an exchange. Nothing creates transparency better than exchange clearing. All other potential solutions, like self-reporting, are suboptimal for providing necessary real-time information to regulators.

For these reasons, I am very glad to see the sections of this bill that call for exchange clearing of all OTC transactions. This is a critical prerequisite for effective regulatory oversight. For that reason, it should be a truly rare exception when any segment of the OTC markets is exempted from exchange clearing requirements.

I am further encouraged by Sections 3, 4 and 5, which bring transparency to foreign boards of trade and make public reporting of index traders' and swaps dealers' positions a requirement.

Lack of transparency was a primary cause of the recent financial system meltdown. Unsure of who owned what, counterparties assumed the worst and were very reluctant to trade with anyone. The aforementioned provisions in this bill will help ensure the necessary transparency to avoid a crisis of confidence like we just experienced.

Wall Street would much prefer that the OTC markets remain dark and unregulated. They will push to keep as much of their OTC business as possible from being brought out into the light of exchange clearing. They will argue that we should not make major changes to regulation now that the financial system is so perilously weak.

From my perspective this sounds like an intensive care patient that refuses to accept treatment. The system is already on life support. Transparency is the cure that will enable the financial system to recover.

Congress must prioritize the health of the financial system and the economy as a whole above the profits of Wall Street. The profits of Wall Street are a pittance when compared with the cost to America from this financial crisis. We must clear all OTC markets through an exchange to ensure that this current crisis does not recur.

SYSTEMIC RISK ELIMINATION

The other primary factor in the meltdown of the financial system was the liquidity crisis, brought on by excessive leverage at the major financial institutions.

By mandating that OTC transactions clear through an exchange, the Derivatives Markets Transparency and Accountability Act of 2009 provides for the exchange to become the counterparty to all transactions. Since the exchange requires the posting of substantial margin, the risk to the financial system as a whole is nearly eliminated. When margin is posted on a daily basis, then potential losses are greatly contained and counterparty risk becomes virtually nil.

To protect its interests, Wall Street will try to water down these measures. The substantial margin requirements will limit leverage, and limits on leverage, in turn, mean limits on profits, not only for banks, but for traders themselves. Because traders are directly compensated with a fraction of the short-term profits that their trading generates, they have a great deal of incentive to use as much leverage as they can to maximize the

size of their trading profits. These incentives also exist for managers and executives, who share in the resulting trading profits.

One of the most dangerous things about OTC derivatives is that they offer virtually unlimited leverage, since typically no margin is required. This is one of the reasons that Warren Buffet famously called them "financial weapons of mass destruction."

This extreme overleveraging is essentially what brought down AIG, which at one time was the largest and most respected insurance company in the world. While by law they could not write a standard life insurance contract without allocating proper reserves, they were able, in off-balance-sheet transactions, to write hundreds of billions of dollars worth of credit default swaps and other derivatives without setting aside any significant amount of reserves to cover potential losses.

If AIG were clearing its credit default swaps through an exchange requiring substantial margin, it would never have required well over $100 billion dollars in taxpayer money to avoid collapsing.

I do not know the specifics of the clearinghouse that the Intercontinental Exchange (ICE) and the major swaps dealers are working to establish but I would encourage policymakers to look very closely at the amount of margin that swaps dealers will be required to post on their trades. If there is a substantial difference between what ICE requires and what CME Group requires then swaps dealers, in a quest for maximum leverage, will flock to the clearing exchange that has lower margin requirements.

This is exactly opposite of what regulators and policymakers would want to see. The stronger the margin requirements, the greater will be the mitigation of systemic risk. The weaker the margin requirements, the greater chance we face of having to bail out more financial institutions in the future.

I strongly urge Congress to resist all pressure from Wall Street to soften any of the provisions of this bill. We must eliminate the "domino effect" in order to protect the system as a whole, and exchange clearing combined with substantial margin requirements is the best way to do that.

EXCESSIVE SPECULATION ELIMINATION

Speculative position limits are necessary in the commodities derivatives markets to eliminate excessive speculation. When there are no limits on speculators, then commodities markets become like capital markets, and commodity price bubbles can result. If adequate and effective speculative position limits had been in place across commodity derivatives markets, then it is likely we would not have seen the meteoric rise of food and energy prices during the first half of 2008, nor the ensuing crash in prices when the bubble burst.

The fairest and best way to regulate the commodities derivatives markets is to subject all participants to the same regulations and speculative position limits regardless of whether they trade on a regulated futures exchange, a foreign board of trade, or in the over-the-counter markets. Every speculator should be regulated equally. If you do not, then you create incentives that will directly favor one trading venue over another.

The over-the-counter (OTC) markets are dramatically larger than the futures exchanges. If speculative position limits are not imposed on all OTC commodity derivatives then there is a gaping hole that speculators can exploit. It would be like locking one's doors to prevent a robbery, while leaving one's windows wide open.

The best solution is to place a speculative position limit that applies in aggregate across all trading venues. Once OTC commodity derivatives are cleared through an exchange, regulators will be able to see every trader's positions and the application of speculative limits will be just as simple for OTC as it is for futures exchanges today.

This type of aggregate speculative position limit is also better than placing individual limits on each venue. For example, placing a 1,000 contract limit on ICE, a 1,000 contract limit on NYMEX and a 1 million barrel (1,000 contract equivalent) limit in the OTC markets will incentivize a trader to spread their trading around to three or more venues, whereas with an aggregate speculative position limit, they can trade in whichever venue fits their needs the best, up to a clear maximum.

I applaud the provisions of your bill that call for the creation of a panel of physical commodity producers and consumers to advise the CFTC on the level of position limits. I believe it affirms three fundamental truths about the commodities derivatives markets: (1) these markets exist for no other purpose than to allow physical commodity producers and consumers to hedge their price risk (2) the price discovery function is strengthened and made efficient by the trading of the physical hedgers and it is weakened by excessive speculation and (3) speculators should only be allowed to participate to the extent that they provide enough liquidity to keep the markets functioning properly. Physical commodity producers and consumers can be trusted more than the exchanges or even the CFTC to set position limits at the lowest levels possible while still ensuring sufficient liquidity.

I understand the legal problem with making this panel's decisions binding upon the CFTC. Still, I hope it is clear that this panel's recommendations should be taken very seriously, and if the CFTC chooses to not implement the recommendations they should be required to give an account for that decision. I further believe that the exchanges and speculators should not be part of the panel because they will always favor eliminating or greatly increasing the limits.

CME and ICE may perhaps oppose speculative position limits in general out of a fear that it will hurt their trading volumes and ultimately their profits, but I believe this view is shortsighted. If CME, ICE and OTC markets are all regulated the same, with the same speculative position limits, then trading business will migrate away from the OTC

markets and back to the exchanges, because OTC markets will no longer offer an advantage over the exchanges.

I am glad that this bill gives the CFTC the legal authority to impose speculative position limits in the OTC markets, but I openly question whether or not the CFTC will exercise that authority. Like the rest of our current financial market regulators, they have been steeped in deregulation ideology. While I hope that our new administration will bring new leadership and direction to the CFTC, I fear that there will be resistance to change.

When Congress passed the Commodities Futures Modernization Act of 2000, they brought about the deregulation that has fostered excessive speculation in commodities derivatives trading. Now Congress must make it clear that they consider excessive speculation in the commodities derivatives markets to be a serious problem in all trading venues. Congress must make it clear to the CFTC that they have an affirmative obligation to regulate, and that a critical part of that is the imposition and enforcement of aggregate position limits to prevent excessive speculation.

SUMMARY

We have now witnessed how damaging unbridled financial innovation can be. Wherever there is growing innovation there must also be growing regulation. Substantial regulation is needed now just to catch up with the developments on Wall Street over the last fifteen years.

This bill is ambitious in its scope and its desire to re-regulate the financial markets, and for that I am encouraged. These drastic times call for bold steps, and I am pleased to support your bill. My sincere wish is that it be strengthened and not weakened by adding a provision for aggregate speculative position limits that covers all speculators in all markets equally.

Fifteen years ago, before the proliferation of over-the-counter derivatives and before regulators became enamored with deregulation, the financial markets stood on a much firmer foundation. Today, with all of the financial innovation and the deregulation of the Clinton and Bush years, it is hard to look back and say that the financial markets are better off than they were 15 years ago. I think it is clear to everyone in America that this grand experiment, rather than delivering on its great promise has, in fact, turned out to be a great disaster.

THE 2008 COMMODITIES BUBBLE

Assessing the Damage to The United States and Its Citizens

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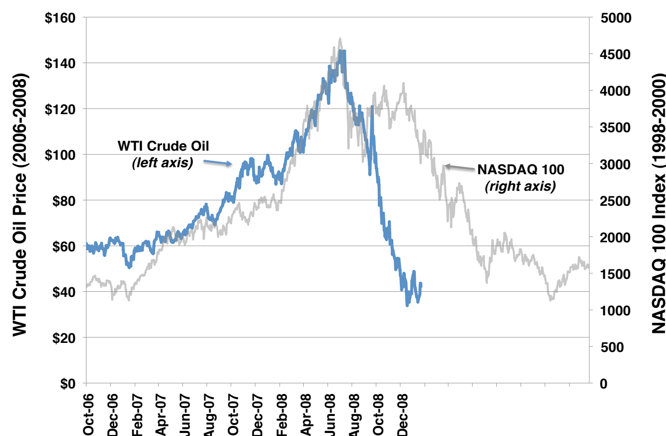
- **The U.S. entered a recession in December 2007. The supply of crude oil increased and the demand for crude oil decreased during the first half of 2008. During this time, crude oil prices defied the recession, defied the laws of supply and demand, and defied gravity by climbing an astonishing 60%, from $90 per barrel in January to $147 per barrel in July.**

- **Beginning in July 2008, the commodities bubble popped and crude oil and other commodities plummeted in price. Crude oil fell by more than $100 per barrel (75%) in just six months. Never before in history has price of crude oil fallen this dramatically.**

Chart 1. WTI Crude Oil Price 2006-2008 with NASDAQ 100 Overlay



Source: Bloomberg

- **The bubble in crude oil, natural gas, and other commodities cost the U.S. more than $110 billion in 2008, which translates to over $846 for every American household. The effect was to take an already weak and frail economy and push it down the stairs.**

- **The commodities bubble amplified the effects of the housing bubble and financial crisis, making them much worse and leading to more bankruptcies, more job losses, and more foreclosures than we would have experienced otherwise.**

- ***This was completely avoidable.* If speculative position limits had been in place across commodities derivatives markets, then there never would have been a commodities bubble in 2008.**

Special Report ***February 4, 2009***

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"You have a generalized commodity bubble due to commodities having become an asset class that institutions use to an increasing extent."

George Soros
One of the most famous and successful hedge fund managers of all time
April 17, 2008 Bloomberg article

"Oil is a huge mania, and it's going to end badly. We've seen it play out hundreds of times over the centuries, and this is no different. It's just the nature of a rip-roaring bull market."

Paul Tudor Jones II
One of the most famous and successful commodities traders of all time
June 2008 edition of Institutional Investor's Alpha Magazine

"You've got speculation in a lot of commodities and that seems to be driving up the price, . . . Movements are dominated by momentum players who predict price changes from Wednesday to Friday on the basis of the price change from Monday to Wednesday."

Dr. Robert Aliber
Distinguished Professor at the University of Chicago
Co-author of "Manias, Panics & Crashes"
June 13, 2008 Bloomberg article

"Commodities followed the euphoria cycle that we had along with housing,"

Robert Schiller
Distinguished Professor at Yale University
Author of "Irrational Exuberance"
October 13, 2008 New York Times article

"This is a market that is basically returning to the price level of a year ago which it arguably should never have left, . . . We pumped up a big bubble, expanded it to an impressive dimension, and now it is popped and we have bubble gum in our hair."

Tim Evans,
Energy Analyst at Citigroup
October 10, 2008 research report

This report is comprised of two parts. Part One discusses new evidence that has emerged which confirms the role of institutional investors in creating the commodities price bubble of 2008. Part Two talks about the devastating impact felt by America and its citizens as a result of the commodities price bubble.

PART ONE – NEW EVIDENCE EMERGES

We released two reports in 2008 that provided strong evidence that institutional investors had been responsible for inflating many commodity prices, including oil. Since those reports were released, we have seen three new and very significant pieces of evidence come to light that conclusively prove that oil and other commodities experienced a price bubble in 2008.

The United States Entered a Recession Prior to 2008

The United States economy is the largest in the world, contributing over 20% of the world's total economic output.[1] We are also the world's largest consumer of energy, with a similar share of the world's total energy consumption.[2] Looking just at oil, the United States consumes approximately 20 million of the 85 million barrels that the world produces each day.[3]

According to the Business Cycle Dating Committee of the National Bureau of Economic Research, the United States officially entered a recession in December of 2007.[4] Real economic output peaked in the fourth quarter of 2007, and began to fall as we entered 2008, marking the beginning of an economic recession.

Given this economic backdrop, oil prices should have been falling rather than rising. What can explain how oil prices could rise by an incredible 60% - from $90 per barrel in January to a peak of $147 per barrel in July - while the world's largest economy and consumer of energy was moving deeper into a recession?

Clearly, oil prices were not responding the way the economic textbooks would expect. Something else was driving the price of crude oil higher.

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[1] CIA World Factbook based on 2007 estimates. https://www.cia.gov/library/publications/the-world-factbook/index.html

[2] "World Primary Energy Consumption (Btu) 1980-2006," Energy Information Association - United States Department of Energy, December 19, 2008. http://www.eia.doe.gov/pub/international/iealf/tablee1.xls

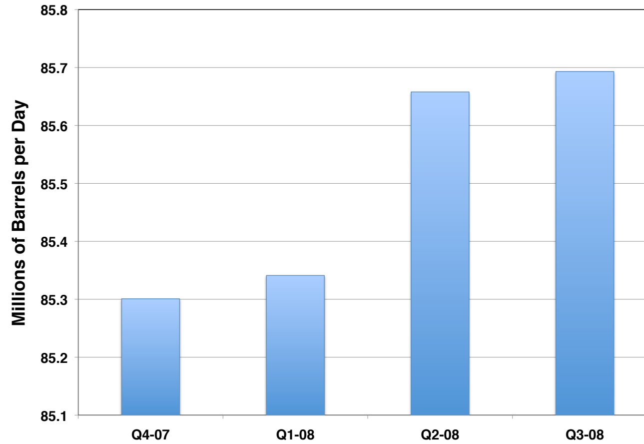
[3] "World Oil Balance 2004-2008," Energy Information Association - United States Department of Energy, December 19, 2008. http://www.eia.doe.gov/emeu/ipsr/t21.xls

[4] "Determination of the December 2007 Peak in Economic Activity," Business Cycle Dating Committee, National Bureau of Economic Research, November 11, 2008. http://www.nber.org/cycles/dec2008.html

World Oil Supply Was Rising While World Oil Demand Was Falling During the First Half of 2008

Almost every explanation proffered by anti-bubble theorists for oil's dramatic rise in the first half of 2008 focused on the supply and demand for oil. But we now have hard data that proves that the world supply of oil was actually rising while the world demand for oil was falling in the first half of 2008.

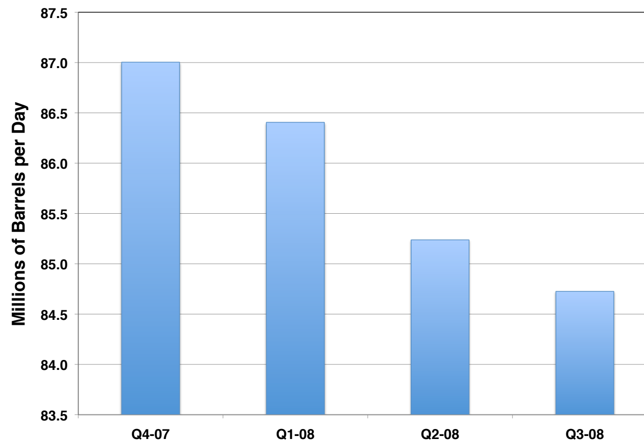
Chart 2. Worldwide Oil Supply



Source: Energy Information Administration, U.S. Department of Energy, "World Oil Balance 2004-2008," January 13, 2009.

The Energy Information Administration (a department within the United States Department of Energy) has released figures for world oil supply and demand. These figures (depicted in Chart 2 above) show that world oil production rose in the first quarter of 2008 and rose again in the second quarter of 2008. At the same time, as Chart 3 below shows, world oil consumption fell in the first quarter of 2008 and fell again in the second quarter of 2008.

Chart 3. Worldwide Oil Demand



Source: Energy Information Administration, U.S. Department of Energy, "World Oil Balance 2004-2008," January 13, 2009.

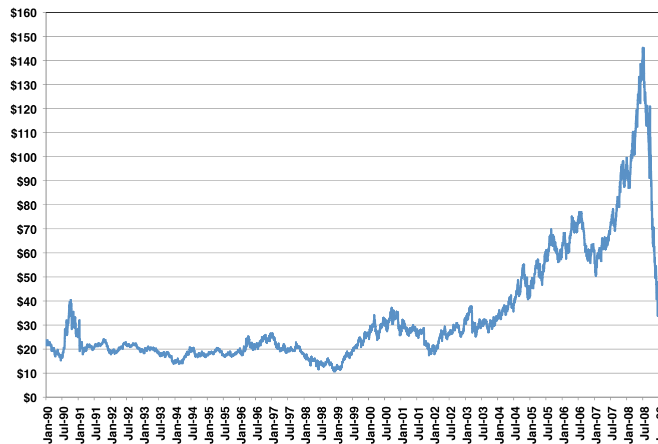
With supply increasing and demand decreasing, economic textbooks would predict that prices would fall substantially. How, then, can we explain the spike in the price of crude oil?

It was easier to theorize that the oil price spike was a function of supply and demand when there were no supply and demand figures to reference. But now that the EIA has released the supply and demand figures, we know that they cannot explain the price increase. Oil prices in the first half of 2008 defied a recession, defied the laws of supply and demand and defied gravity with their meteoric rise.

The Crash in Oil Prices Reveals Oil Was a Bubble

The recent crash in oil prices from a high of $147 to a low of $33 in less than 6 months is the greatest evidence that oil prices were grossly inflated at the peak. Never before in history have we seen a $100 drop in oil prices. Never before in history have we seen a 75% drop in oil prices in such a short period of time.

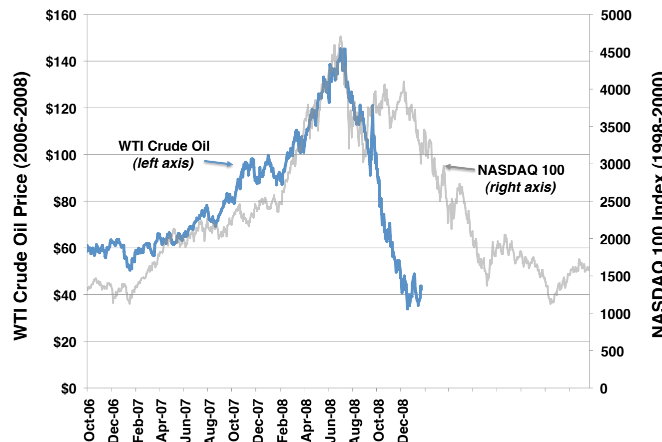
Chart 4. WTI Crude Oil Price 1990-2008



Source: Bloomberg

In the capital markets, where bubbles are commonplace, most oil watchers will privately agree that oil and other commodities experienced a bubble that finally popped in 2008. In Chart 5 we compare the bubble in oil to one of the most famous bubbles – the Internet / Tech Bubble of 1998-2000. As you can see, the Oil bubble expanded nearly as much as the Tech bubble, and burst much more violently.

Chart 5. WTI Crude Oil Price 2006-2008 with NASDAQ 100 Overlay



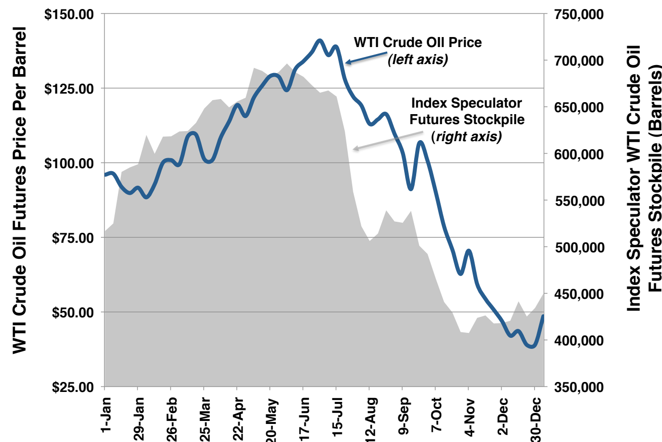
Source: Bloomberg

The Best and Simplest Explanation for the Oil Bubble Is the Flow of Speculative Money into and out of Crude Oil Futures

We have continued to track the flow of Index Speculator money into and out of crude oil futures through the end of 2008. In the first six months of 2008, Index Speculators poured between $50 and $60 billion into commodity indices such as the S&P-GSCI and the DJ-AIG, raising total investment from approximately $178 billion in January to $317 billion in July. This resulted in the buying of between 130 and 170 million barrels of WTI crude oil in the futures markets, and raising Index Speculators' stockpile of crude oil futures from approximately 517 million barrels to 665 million barrels. We believe this was the primary factor driving the rise of crude oil prices from $90 in January to $140 at the end of June.

In July, Index Speculators began to pull money out of commodity indices causing the bubble to burst. In the last six months of 2008, we estimate that between $60 and $80 billion flowed out of these trades causing total investment to fall from $317 billion in July to approximately $87 billion at the end of December. This resulted in the selling of between 220 and 240 million barrels of crude oil in the futures markets, and taking Index Speculators' stockpile of crude oil futures from 665 million barrels in July down to 435 million barrels by the end of December. This selling on the part of Index Speculators, combined with the de-leveraging of hedge funds and other traditional speculators, were two of the major factors behind oil's historic crash from $140 to $40.

Chart 6. WTI Crude Oil Price Versus Index Speculators' WTI Crude Futures Stockpile



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon Commodities Futures Trading Commission's COT/CIT report

Chart 6 shows the price of crude oil graphed against Index Speculators' stockpile of crude oil futures expressed in barrels. One can see that as Index Speculators were buying large amounts of crude oil futures and increasing their stockpile, the price of crude oil was rising. As they were selling large amounts of crude oil futures and reducing their stockpile, the price of crude oil was falling. The buying and selling by Index Speculators correlates closely with the rise and fall of crude oil prices. In contrast with explanations offered by others, this is the only one that correlates with the facts.

PART TWO – ASSESSING THE DAMAGE

We have experienced the first bubble in commodity prices since the Commodity Exchange Act was passed in 1936. This historic price bubble was made possible by the deregulation of the commodities derivatives markets and the effective elimination of speculative position limits.

Commodity price bubbles are much more devastating than asset price bubbles. While asset price bubbles are expanding, people feel good about the fact that their paper wealth is increasing. But commodities are not assets; they are raw materials consumed by each and every person on the planet. So as commodity price bubbles expand and prices rise dramatically, the negative impact is felt by every human being around the globe.

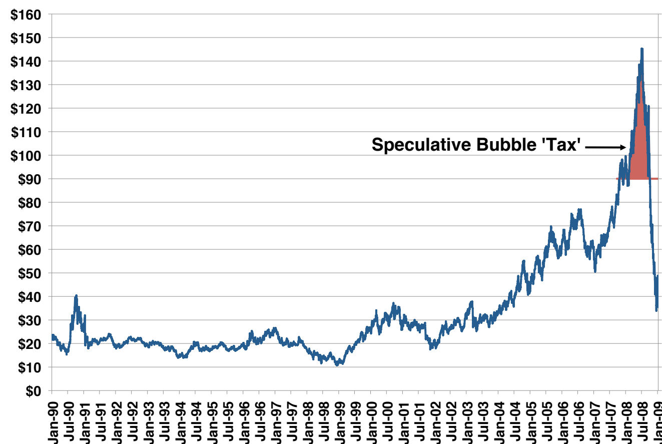
The 2008 commodities bubble has now burst, leaving in its wake a devastating impact on the world economy. We must assess the true cost of this commodities bubble so that society might resolve to never let this happen again.

The Oil & Gas Bubbles Cost Americans More Than $110 Billion

The oil bubble could not have peaked at a worse time for the American economy. We now know that the United States was already entering a recession as 2008 began. The average oil price in the fourth quarter of 2007 was $90.50, and oil started the year in the low to mid $90s. As supply was rising and demand was dropping, the price of oil should have been falling instead of rising.

It is our strong belief that every dollar above $90 per barrel represented a "tax" imposed by excessive speculation upon oil consumers (see Chart 7 below). Ed Morse, former oil analyst at Lehman Brothers (now with Louis Capital Markets), was recently quoted saying essentially the same thing: "the move above $90 a barrel was driven by financial flows rather than fundamentals" of supply and demand."[5]

Chart 7. $93 Billion 'Tax' Imposed by Excessive Speculation in Oil



Source: Bloomberg, author estimates

[5] "OPEC Calls for Curbing Oil Speculation, Blames Funds (Update2)," Maher Chmaytelli, Bloomberg News, January 28, 2009. http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a44ddDuoFSe8

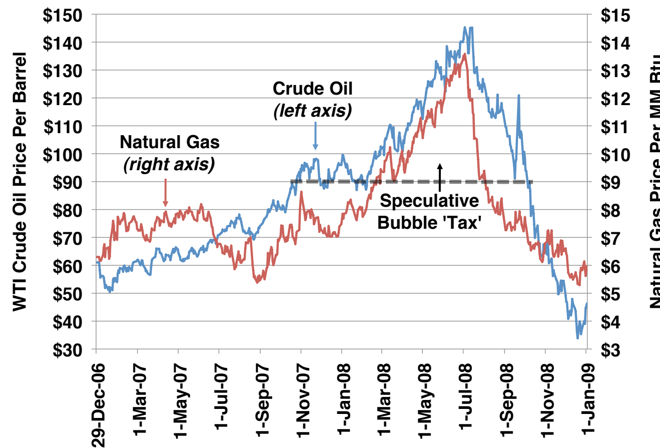
This is a conservative statement to make, considering that oil experts have consistently estimated that oil's marginal cost of production ranged from $60 to $75 per barrel in 2008.[6] With oil around $40 per barrel today, even a $90 per barrel price seems grossly inflated. It is hard enough to come up with a rational explanation for $90 per barrel, let alone $147.

If we seek to quantify the direct cost to Americans from the oil bubble, it is fair to say that every dollar spent over $90 per barrel was an unnecessary "tax" imposed by excessive speculation. Let's begin with the fact that Americans consume 20 million barrels of oil per day. If we calculate the daily premium above $90 and multiply it times this figure, we can arrive at how much the oil bubble directly cost Americans. By our calculations, we estimate the direct cost of the oil bubble to be $93 billion. The direct cost to the world was approximately $393 billion.

If we had chosen a less conservative and more realistic assumption by considering anything over $75 per barrel to be excessive then the total cost to America would be $170 billion just from the oil bubble, with a cost to the world of $724 billion.

Turning to natural gas, we believe that every penny over $9 per thousand cubic feet can be attributed to excessive speculation. Chart 8 below shows that natural gas has historically traded around one-tenth the price of crude oil and that both commodities experienced a bubble in 2008. By our calculations, we conservatively estimate the direct cost of the natural gas bubble to be $17 billion. Combined with crude oil the cost of these two bubbles was $110 billion. That means the average American household was forced to pay $846 more for energy in the first half of 2008 because of excessive speculation.

Chart 8. WTI Crude Oil and Natural Gas Bubbles 2007-2008



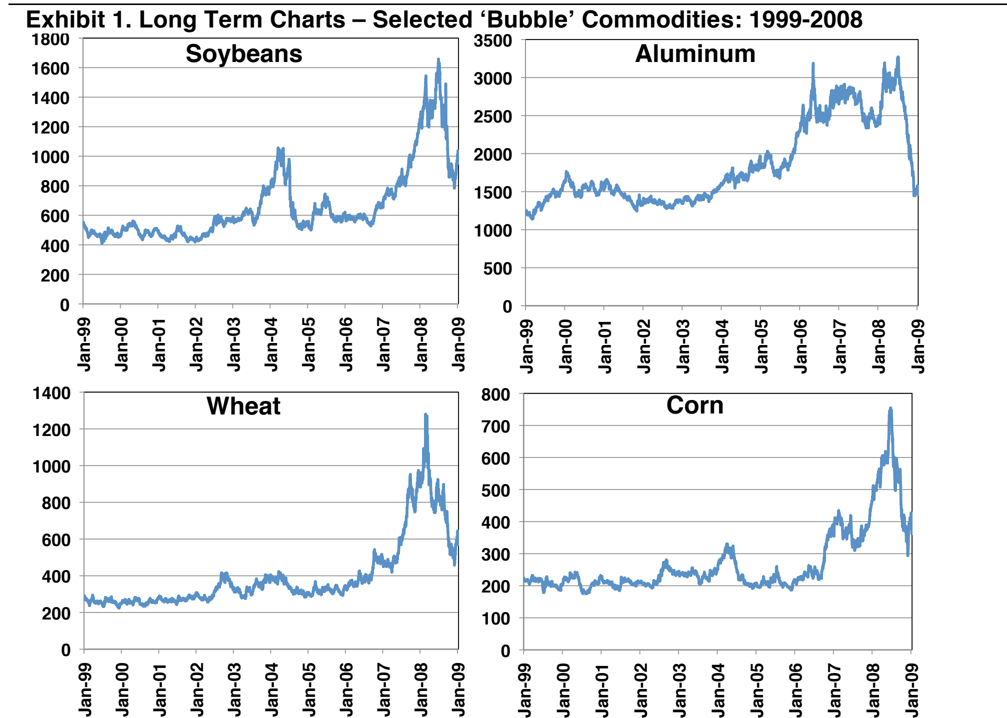
Source: Bloomberg, author estimates

This figure only represents the direct cost of excessively high energy prices. It does not attempt to estimate any of the economic multiplier effects that result from such a large "tax" being imposed. It also does not take into account the bubbles in other commodity prices.

[6] "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation? – Part II," House Energy Committee, Subcommittee on Oversight and Investigations, June 23, 2008. http://energycommerce.house.gov/cmte_mtgs/110-oi-hrg.062308.EnergySpec.shtml

While we have not performed the same in-depth supply and demand analysis for other commodities to assess the cost of excessive speculation, simply looking at their long term charts in Exhibit 1 shows that many commodities experienced bubbles that popped in 2008.

Exhibit 1. Long Term Charts – Selected 'Bubble' Commodities: 1999-2008



Source: Bloomberg

The fact that unrelated commodities such as aluminum, soybeans and natural gas all demonstrate very similar price patterns is further proof that Index Speculators and other institutional investors have been driving commodities prices. While we cannot put a price tag on the cost to America of these inflated prices across all commodities we are confident that the total cost to Americans from the commodities bubble easily exceeds $110 billion.

In our new world of trillion dollar Wall Street bailouts, $110 billion does not seem as shocking as it once did, but this number must be put it in perspective. The U.S. Congress and President Bush passed the Economic Stimulus Act of 2008 in February of last year. It called for tax rebates of between $300 and $600 per person.[7] By the time this stimulus finally reached the average American, the high cost of energy and food prices had nearly canceled out the entire economic benefit of the bill. At that point, the Stimulus bill simply helped Americans pay the "excessive speculation tax" levied on energy and other commodities.

[7] http://en.wikipedia.org/wiki/Economic_Stimulus_Act_of_2008

The Commodities Bubble Inflicted Pain on American Businesses

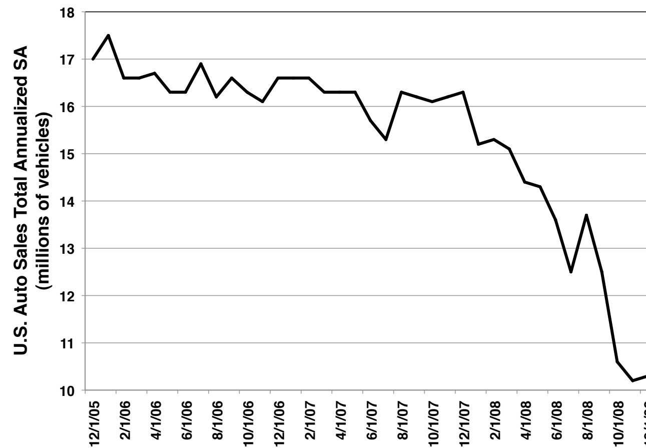
High energy costs made almost everything in America more expensive. It takes energy to produce goods, and it takes energy to transport them through the supply chain. Petroleum is the basis for petrochemicals such as plastic, so the cost of packaging for most goods increased as well.

A single company, Proctor & Gamble, experienced annual cost increases of $2 billion due to high energy costs.[8] Dow Chemicals, one of the largest petrochemical manufacturers, was forced to announce an across-the-board 20% price increase for all of their products.[9]

These companies were actually the fortunate ones. Many companies that are more directly impacted by rising fuel costs, such as airlines and trucking companies, were forced into bankruptcy. Many retailers were also forced to go out of business because high food and energy prices led to weak demand for non-essential goods. Against this backdrop of flat to weakening retail prices, many retailers could simply not absorb the rising costs.

For the U.S. Auto Industry, which directly and indirectly employs approximately 2.1 million Americans, the oil bubble was a crushing blow that might yet prove to be fatal.[10] With astronomically high gas prices, consumer preferences shifted away from SUVs, trucks and other “gas guzzlers” to smaller, lighter, more fuel-efficient cars, and as a result, Detroit suffered huge declines in car sales.

Chart 9. U.S. Auto Sales 2006-2008



Source: Bloomberg

The Commodities Bubble Led to Increased Unemployment

As American consumers were forced to spend dramatically more on food and energy, they were forced to cut back spending on non-essential items. Facing weakening demand, businesses were squeezed between rapidly escalating raw materials and

[8] “Oil Prices Raise Cost of Making a Range of Goods,” Louis Uchitelle, New York Times, June 8, 2008. http://www.nytimes.com/2008/06/08/business/08oil.html?_r=1
[9] ibid.
[10] “One in 10 jobs Tied to Autos? Not so Fast,” Russell Goldman, ABC News, December 19, 2008. http://abcnews.go.com/Business/story?id=6491455&page=1

transportation costs on the one side, and weak or no pricing power on the other. While their costs were going up, their revenues were stagnant or declining.

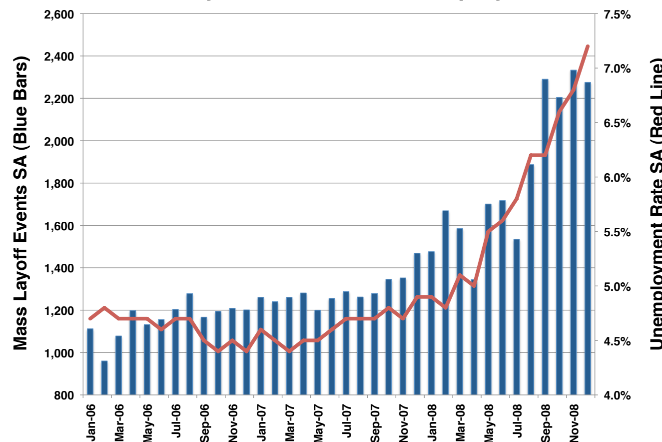
Many businesses went bankrupt, and most that were able to stay in business were forced to cut workers' hours or lay them off completely. This, of course, fed a vicious cycle that continues to play itself out in the economy today.

Chart 10. Average Weekly Hours Worked and Overtime Hours Worked SA 2006-2008

Source: Bureau of Labor Statistics

Chart 10 above shows that average weekly hours worked has been dropping since mid-2007. Not coincidentally, oil prices doubled from mid-2007 to mid-2008. Chart 11 below shows the number of mass layoff events along with the unemployment rate. Again, one can see that layoffs and unemployment began to rise in earnest in mid-2007 and have continued to increase since then.

Chart 11. Mass Layoff Events and Unemployment Rate Seasonally Adjusted



Source: Bureau of Labor Statistics

The Commodities Bubble Made the Banking Crisis Much Worse

Because of the commodities bubble, Americans were forced to pay dramatically more for food and energy, leaving them with less money to use to pay their debts. Many were faced with the grim choice between filling up their gas tanks and feeding their families or making their debt payments.

Looking at quotations by James Chessen, the Chief Economist of the American Bankers Association, one can clearly see the role that high food and energy prices played in debt delinquencies.

"No relief for consumers is in sight as food and gas prices remain stubbornly high and income growth is anemic."[11]
- Q4-07 comments on delinquencies

"It was a tough quarter for some people. . . . Faced with rising food and gas prices and little income growth, fewer resources have been available to manage debt."[12]
- Q1-08 comments on delinquencies

"The tax stimulus is helping to boost personal income, but persistently high gas and food prices will eat away at overall resources."[13]
- Q2-08 comments on delinquencies

In addition to the direct tradeoffs between paying for food and energy versus paying down debts, there was also a disturbing trend in 2008 that was widely reported: consumers opted to pay their credit cards bills rather than make their home mortgage payments. One credit counselor described it this way "Their homes are at risk, and they know it. But people say, 'I don't want to let my credit cards go because that's my cash flow.' "[14] Many people were forced to rely on credit cards to purchase the gas and groceries that they needed, even if it meant risking losing their house to foreclosure.

The Commodities Bubble Made the Housing Crisis Much Worse

We discussed how inflated food and gas prices made it more difficult for people to make their mortgage payments, and how some of those people lost their homes to foreclosure, which put downward pressure on home prices. But that is not the only way high gas prices affected home prices and new home construction.

A study by Joe Cortright, an economist with the non-profit "CEOs for Cities," published a white paper entitled "Driven to the Brink: How the Gas Price Spike

[11] "Consumer Delinquencies Up In Fourth Quarter," American Bankers Association press release, April 3, 2008.
http://www.aba.com/Press+Room/040308ConsumerDelinquencyBulletin.htm
[12] "Weak Economy Pushes Consumer Delinquencies Higher in First Quarter," American Bankers Association press release, July 2, 2008.
http://www.aba.com/Press+Room/070208DelinquenciesFirstQuarter08.htm
[13] ibid.
[14] "More Americans Using Credit Cards To Stay Afloat," Kathy Chu, USA Today, March 30, 2008. http://www.usatoday.com/money/perfi/credit/2008-02-28-credit-cards_N.htm

Popped the Housing Bubble and Devalued the Suburbs."[15] In the report, he presents very compelling data that shows that as gas prices rose dramatically, so did the transportation costs for families living in the suburbs and exurbs. This made living in the 'burbs much less desirable, reducing the demand for homes, and causing home prices to drop. Since most of the new home construction was taking place in the 'burbs, high gas prices undermined the demand for new home construction and contributed to the housing crisis.

Summary

The bursting of the housing bubble and the financial meltdown of Wall Street have had huge negative effects on our economy. Those effects would have been very painful for America even if there had been no bubble in commodities prices. Knowing that the commodities bubble directly cost Americans at least $110 billion, and understanding that there were many indirect costs as well, we know that it made our present situation dramatically worse. The commodities bubble had the effect of taking a weak and frail economy and pushing it down the stairs.

The extreme volatility that we have seen in commodity prices has been unprecedented in history. This volatility is bad for consumers and producers alike. No one has escaped the damage that this bubble has inflicted.

There is no way to know how our economy would have been performed if there were no commodities bubble in 2008. Perhaps we would have endured a Category 3 storm instead of the Category 5 we are experiencing today.

We do know this: the commodities bubble was completely preventable. If Congress will take action to impose speculative position limits across all commodities derivatives markets, then we can be assured that it will never happen again.

[15] "Driven to the Brink: How the Gas Price Spike Popped the Housing Bubble and Devalued the Suburbs," Joe Cortright, CEOs for Cities, May 2008. http://www.ceosforcities.org/newsroom/pr/files/Driven%20to%20the%20Brink%20FINAL.pdf

Michael W. Masters

Michael W. Masters, 42, is a long /short equity hedge fund portfolio manager and the founder of Masters Capital Management, LLC. Mr. Masters is a 1989 graduate of the University of Tennessee (Knoxville) with a B.S. in Finance. While at the University, Mr. Masters was a student athlete (Swimming) and was awarded All-American honors. Mr. Masters was employed as a salesman by both J.C. Bradford & Co. and Oppenheimer and Co. (both since acquired). In 1994, Mr. Masters founded Masters Capital Management, Inc. (later merged into Masters Capital Management, LLC) and remains the managing member of the successor company today. Masters Capital Management is a global investment management firm that trades and invests in public and private domestic and international bonds and equities. In March of 2005, Mr. Masters and Wilbur L. Ross, Jr. formed a partnership that focused on investments in early-, mid- and late-stage companies employing nanotechnology- enabled products and solutions. Masters Capital currently manages a family of alternative assets, and is based in St. Croix, U.S. Virgin Islands.

Mr. Masters was profiled in the book "Stock Market Wizards" (Copyright 2001, 2003 by Jack D. Schwager, HarperCollins, Inc.) and was the winner of the "Open Your Heart" award in 2004 (Atlanta) from the organization Hedge Funds Care. Mr. Masters has founded several foundations including St. Croix Mission Outreach and the Atlanta Men's Enterprise Network. Mr. Masters currently serves on the boards of several charitable and private organizations.

Mr. Masters lives in St. Croix, U.S. Virgin Islands with his wife (Suzanne) and 3 children.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

Name: Michael Masters

Address: c/o Partnership Financial Consulting 3060 Peachtree Rd, NW, Suite 1815, Atlanta, GA 30305

Telephone: 404-364-2019

Organization you represent (if any): ____________________

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: ____________________ **Amount:** __________

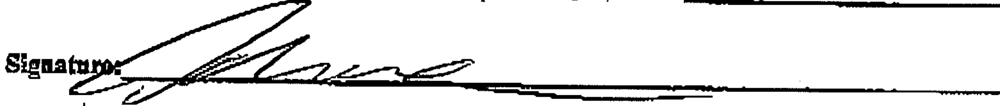
Source: ____________________ **Amount:** __________

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

Source: ____________________ **Amount:** __________

Source: ____________________ **Amount:** __________

Please check here if this form is NOT applicable to you: ✓



Signature: ____________________

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.