Commodities Get Bold Push From Goldman

WSJ **COMMODITIES**

4/22/96 By SUZANNE MCGEE C1

Staff Reporter of THE WALL STREET JOURNAL

In a bold move, Goldman Sachs & Co. is telling its commodity investment clients to get "backwardated."

No, Goldman isn't recommending they take a bashful or simple-minded approach to commodities. Rather, the firm is suggesting investors adopt a controversial view that unusual pricing patterns now dominating many key markets will persist, generating big returns for those who play them the right way.

Backwardation is the term used to describe this atypical price curve for a commodity. Usually, the future or forward price of gold, base metals, crude oil and most other commodities is higher than the cost of obtaining immediate supplies, reflecting the time value of money and carrying costs.

But sometimes, an aberrant supply or demand situation can send the spot market price of the commodity soaring far above futures prices into what's called backwardation. That's typically seen in seasonal markets when something like a cold snap sends demand for immediate supplies of natural gas or heating oil soaring. But occasionally, unusual factors can cause a more prolonged backwardation in commodities prices as seen in the past 18 months in the higher prices for spot sup-

Please Turn to Page C14, Column 2

86

Goldman Sachs Backs Bold Move in Commodities

WSJ 4/22/96

Continued From Page C1

plies of copper compared with futures prices.

Now, some analysts argue, strong global growth and demand for commodities is creating similar patterns in products ranging from corn and crude oil to coffee. Some of the most striking examples are seen in the grain markets, where corn prices for delivery in May trade at a huge 40% premium to December corn. Investors looking for immediate supplies of crude oil would have to pay a 13% premium. Indeed, 11 of the 17 commodities contracts in the benchmark Knight-Ridder Commodity Research Bureau Index are now backwardated.

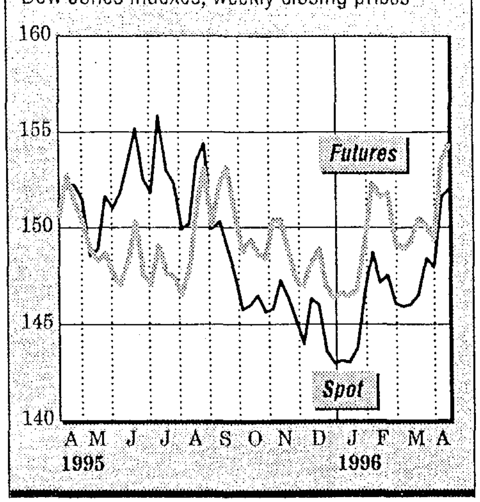
"There is a distinct statistical correlation between backwardation and high returns in the commodity markets," argued Steven Strongin, director of commodities research at Goldman. "The length of a commodity market rally is enhanced in a backwardated market."

Goldman's approach, reflected in its management of the 17 components in the Goldman Sachs Commodity Index, is to buy a futures contract which, in a backwardated market, trades at a discount to the contract closest to expiry. For instance, today, the May corn contract trades at $4.58 a bushel – its closing price Friday – a big 45% premium to the July contract. But Mr. Strongin believes that in a backwardated market, as long as supplies remain scarce, consumers are likely to bid up the price of that July contract as it comes closer to expiry. The big returns come from simply buying and holding the contract until it expires.

"You're investing in the future contract of a commodity in tight supply in the notion that the supply situation will make it momentarily more precious," said Mr. Strongin.

Commodity Prices

Dow Jones indexes; weekly closing prices



Friday April 19, 1996

	Close	Net Chg.	Yr. Ago
Dow Jones Futures	154.47	+ 0.44	152.82
Dow Jones Spot	152.06	+ 0.82	152.27
Reuter United Kingdom	2113.1	+ 2.1	2334.0
K R-C R B Futures*	257.62	+ 0.39	237.04

*Division of Knight-Ridder.

Goldman's approach has paid off over the last 12 months. While spot prices of the commodities in the index have risen 15.5%, the index's total return was 39.5%, thanks to the shape of the price curve. Even in cases where the spot price of a commodity barely moved for months at a time, such as crude oil, backwardation led to profits.

"Backwardation is a direct result of a shift by every industry to just-in-time inventory management," said Philip Verleger, vice president of Charles River Associates Inc., a Boston-based investment management firm. The reluctance of end users to stockpile large inventories of, say, gasoline or crude oil, means a dip in production of crude oil or gasoline, which translates quickly to higher spot prices.

Skeptics describe the GSCI's 12-month track record as enticing, but dangerous. In the previous 12 months, while spot commodity prices gained 4%, the GSCI fell 0.5%. And there's no guarantee that markets will stay backwardated.

"In these markets, a good part of savvy trading is making judgments on what the structure of the forward curve will be," said Harold Kamins, head of commodity derivatives trading at Morgan Stanley. He urges investors to look beyond the price curve to factors that might influence future demand and supply, and absolute price levels.

For instance, high current prices might encourage a mining company to bring new copper mines onstream. That will exert downward pressure on the price of copper for delivery on dates after the new supply is expected to reach the market, temporarily exacerbating the degree of backwardation. But the market fundamentals likely mean that at some point when the supply actually comes onstream, absolute price levels could plunge, Mr. Kamins points out.

"Backwardation seems most extreme when there's a fear of a glut in the near future," said Mr. Verleger.

Take the grain markets, for instance, where the "old crop" May contract trades at a 40% premium to the December contract. That backwardation reflects the fact that corn supplies are at their tightest level in more than 20 years, but it also shows the market is anticipating that large supplies of new corn could depress prices after this fall's harvest. With the removal of planting restrictions, good weather could result in a crop of as much as 10 billion bushels, predicts Daniel Basse, market research director at AgResource Co., a Chicago-based commodity research firm. That would be up from only 7.374 billion bushels last summer.

"And one of the problems with backwardation is that it does structural damage to the demand base," Mr. Basse added. The corn market could face a double whammy late this year as demand from livestock farmers or ethanol producers slumps just as new supplies arrive.

"You can make a lot of money this way, but only if you pay attention to price trends," said Mr. Verleger. "I've been looking for 30 years for a sure thing, and [betting on backwardation] isn't it."