

Meet Your New Investment Partner and Adviser

Commercials are for more than television.

The sole purpose of this book is to get you in investment alignment with the billion-dollar successful traders and pools that move in and out of the marketplace. They will become more than your mentor; they will become your investment partner, whispering in their own way to you each week where they have been placing their money. I will be teaching you who these people are, and several ways to follow them to add to your understanding of how markets work.

While most market followers look at charts, you will be looking at the actual condition that affects price change: large buying and selling, true supply/demand pressure that we will be able to see each week as the billion-dollar successful traders and pools enter the marketplace.

Since these guys are our partners, let's meet them. Let's find out all we can about this group of traders so respected—and feared—they must register with the U.S. government and reveal all their market actions. A karate fighter having to register his powerful fists at the local police station is a good analogy.

The government in this case means the Commodity Futures Trading Commission (CFTC). Here's a little more about who they are and what they are supposed to do. The mission of the CFTC is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.

Futures contracts for agricultural commodities have been traded in the United States for more than 150 years and have been under federal regulation since the 1920s. In recent years, trading in futures contracts has expanded rapidly beyond traditional physical and agricultural commodities into a vast array of financial instruments, including foreign currencies, U.S. and foreign government securities, and U.S. and foreign stock indexes.

EVOLVING MISSION AND RESPONSIBILITIES

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The agency's mandate has been renewed and expanded several times since then, most recently by the Commodity Futures Modernization Act of 2000 (CFMA). Today, the CFTC ensures the economic utility of the futures markets by encouraging their competitiveness and efficiency; ensuring their integrity; protecting market participants against manipulation, abusive trading practices, and fraud; and ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk.

HOW THE CFTC IS ORGANIZED

The CFTC consists of five commissioners appointed by the U.S. President to serve staggered five-year terms. The President, with the consent of the Senate, designates one of the commissioners to serve as chairman. No more than three commissioners at any one time may be from the same political party.

The chairman's staff has direct responsibility for providing information about the Commission to the public and interacting with other governmental agencies and the Congress, and for the preparation and dissemination of Commission documents. The chairman's staff also ensures that the CFTC is responsive to requests filed under the Freedom of Information Act. The chairman's staff includes the Office of the Inspector General, which conducts audits of CFTC programs and operations, and the Office of International Affairs, which is the focal point for the CFTC's global regulatory coordination efforts.

The Chairman's staff is also responsible for liaison with the public, the Congress, and the media. The Office of External Affairs (OEA) is the CFTC's liaison with the domestic and foreign news media, producer and

market user groups, educational and academic groups and institutions, and the general public. The OEA provides timely and relevant information about the Commission's regulatory mandate, the economic role of the futures markets, new market instruments, market regulation, enforcement actions, and customer protection initiatives, actions, and issues. The OEA also provides assistance to members of the media and the general public accessing the CFTC's Internet web site (www.cftc.gov).

The CFTC monitors markets and market participants closely by maintaining, in addition to its headquarters office in Washington, offices in cities that have futures exchanges—New York, Chicago, Kansas City, and Minneapolis.

By law, traders must register and report their activities, and by law, the CFTC issues reports where you will learn to read what your soon-to-be partners as hedgers are doing. We will further identify them as taking positions in the market for commercial purposes as opposed to those who use the markets for speculation. These are truly the large players in the market. In fact, while you or I or a group of traders known as “large traders” can own only so much of a commodity, the hedgers or commercials (our partners in all this) have no limit to how much of a commodity they can buy or sell.

That means when the commercials see an opportunity in the markets they can step up to the plate and buy millions of pounds, bushels, or contracts of a commodity. They are the best-capitalized players in the game. They have the deepest pockets and one core reason to be in the markets: they actually use or produce the product. It is their professional business to buy and sell; they know the markets better than the outsiders, you and I. Here's an analogy. I'm not too keen on cars and never learned much about mechanical things. So if I'm going to buy a new car I can read up on cars, then talk to a salesperson, and perhaps even take a test-drive (sorry, no test-drives in the marketplace) to arrive at a somewhat informed decision.

Or, if I happen to personally know Roy Stanley, the owner of the local Chevy dealership, I can cut to the quick and ask him what's best for me. He's in the business of knowing cars, the business of buying and selling them. He's an insider in his world, so I treasure his advice.

The commercials seemingly have unlimited resources. Bill Meehan (see Introduction) told me they usually account for 60 percent of the volume in a market, so it pays to respect their judgment, to covet their wisdom, and to pay attention to what they do. To them the markets are a business, not a speculation.

The very bottom line for the commercials is that they attempt to minimize their losses as opposed to us speculators, who attempt to make profits. Let me explain. A commercial has an inventory of the product or

needs the product. His or her trading will be around the product—the need to buy it or sell it. If a commercial in, say sugar, knows his company will need a million pounds of sugar in the next month and he believes sugar prices are going higher, he is literally forced to step in and buy now, today. By the same token if he thinks sugar is due for a decline—lower prices—he will still buy some sugar because he needs it to make cotton candy or whatever. But he will not be as aggressive in his buying, and we can pick up on that in the weekly CFTC report.

Here's the unusual thing that has perplexed many followers of the commercials. In an extended decline they will buy all the way down. Hence, it looks like they are dumb as they bought at high prices. "Dumb as foxes," I say. The cheaper our friend can buy sugar, the more profit he has in his cotton candy as his base cost of the product is reduced by the lower sugar cost.

My point is the commercials are not like you and me. They buy to use the product or to protect against a sudden change in prices, to lock in a profit as a producer of the item. You and I, dear reader, have a different function. Our task is to buy low and sell high, to make money from market swings while our commercial mentors are using the markets to make money in their businesses.

We can sure as heck use these guys in our game plan, as when they get unusually bullish or bearish the markets are most likely to have major moves, often with the potential for making millions of dollars. I know—I have done just that in sync with the commercials, just as Bill Meehan showed us.

You and I have one large advantage over the commercials. They must transact in the marketplace every day. It is a permanent business for them. Day in, day out, they have to be doing their best to protect their positions. That's not true of us! We can come in and out of the markets at our fancy. We have the luxury of waiting, with great patience, for the perfect time, a time when the commercials have become uniformly biased and have become massive buyers or sellers in anticipation of a major market move.

Let me also add this: we live in an imperfect world. At times the commercials may be wrong or at least on a short-term basis appear to be on the wrong side of a market. I'm sure they don't want to be wrong. The future, however, is fragile and oh so hard to forecast correctly. If they were always right we'd all become instant millionaires, and what fun would that be?

Because they can be wrong, at least for a while, we need tools and tactics to protect our hard-earned speculative dollars from being taken from us. In later chapters I get into some of the techniques I use to make certain that my entry and exit points, as well as my money management, are effectively used to protect against the risk of ruin.

Nothing is for sure in the world of speculation; the commercials sometimes buy a little early, and with their deeper pockets it does not matter to them. But most of us with shallower pockets, or none at all, will need more precise entry levels and absolute control of our losses.

There are three primary classes of trading action we can see each week: the hedgers or commercials, large traders (large speculators), and small traders (small speculators). These groups all look at the same market yet act differently, as the market serves different missions for each of them.

Some traders are speculators and some are hedgers. Speculators expect the price to go up when they buy a contract and expect the price to go down when they sell a contract. The idea for speculators is to buy low, sell high, and make a profit on the difference. Large hedgers that are users want to buy at low prices, whereas large hedgers that are producers want to sell at high prices. The idea for hedgers is to guarantee some price they will get or give for the commodity, currency, or financial security they're trading.

Consider for a moment that you are a wheat farmer. You estimate you will produce about 50,000 bushels of wheat and that it will cost you close to \$3.25 a bushel to grow the wheat and get it to a grain terminal to sell. One fine day you open up your local paper and see that wheat, for delivery in December, is selling for \$4.10 a bushel. It's May and your crop is in the ground. The current price of wheat means you can make 85 cents per bushel if you sell in the market now against what you know you can deliver by December. Your profit would be \$42,500 (\$.85 times the 50,000 bushels), but there are problems.

First, what if your crop fails? Maybe there will be a drought, "hoppers" will eat it alive, or you will get hailed on just before harvest. Then you won't be able to deliver all 50,000 bushels and might have a problem if wheat is selling for more than \$4.10 a bushel when it is time to deliver the contract. If you can't deliver the wheat, you will have to fork over the difference between what you sold it for and the current price.

By the same token, if wheat goes down in price and by the time delivery rolls around it is selling for less than \$4.10 a bushel, you have made yourself a profit (the current price minus what you sold it for). Of course, the fact you don't have wheat to deliver usually means a lot of other ranches don't have wheat to deliver. A shortage of a crop such as that usually means higher prices.

Also, what if wheat prices rally to \$8.10 a bushel and you could have sold at that price, making \$4.85 a bushel for a net gain of \$242,500? Ahh . . . you city slickers can see there is more to farming than running a tractor. For all these reasons, and a few more, a producer, be it wheat or gold, beans or bacon, will want to use the futures markets, but with care.

And now you can appreciate that if wheat starts to rally you will sell some of your crop at different price levels. At \$4.10 a bushel you may sell one-tenth of your crop, at \$5.00 a bushel you may sell another one-third, and by then you may know how abundant your harvest will be so you may decide to sell more at \$6.00 and the rest of it at \$7.00 a bushel.

You're happy as a hog in slop. You sold your entire crop at prices higher than your cost. You do not care if wheat goes to \$20 a bushel, though you will curse yourself for selling too soon. The weekly CFTC report will reflect your selling. If lots of farmers sold wheat at say \$5 a bushel and it rallies to \$10 it will look like dumb selling. But was it? The farmers were happy to sell at that price. They took a profit.

One of the important features of futures markets is the interaction between speculators and hedgers. Since speculators have different opinions about how prices will move, speculators may buy and sell contracts to each other. Also, hedgers who are producers want to guarantee the price they will get for what they're trading, and hedgers who are processors want to guarantee the price they will have to pay.

Since producers and processors both want to guarantee what return they will get or price they will pay or be paid, hedgers may buy and sell contracts between each other. However, contracts between traders are more often between speculators and hedgers.

When price goes up, speculators want to buy more contracts and producers want to sell more of what they're trading. This is an important law of the jungle we live in.

When price goes down, speculators want to sell more contracts and processors want to buy more of what they're trading. Think of the mind-set of the speculator who is trying to make money from the current down-trend; his or her bet is it will continue, so he or she sells short in the hope that prices will go down more and profits will accrue.

Meanwhile, the mind-set of the commercial hedger is quite different. The commercial is not trying (almost always) to make money from what the market is doing, but rather from the current price of the market or commodity. If the commercials see a price that is lower than they've been paying, they're tempted to buy, as now the cost of the product they make with the commodity is lower; hence the markup is better than it was when the cost of production was higher when the commodity cost more.

Does the commercial care if the trend continues and prices go still lower? No, not really; if prices go lower they have not lost money, as they buy to take delivery (in one form or another). The fact prices decline has no bearing on the excess profits they will make from their purchase, as their profits come from the markup on the product they make from the commodity.

If prices go lower they will want to buy more. What all commercial

producers would like to see would be a product cost of zero, and then all they would have to worry about is the cost of production—the cost of turning corn into cornflakes, wheat into bread.

Every futures market has a different mix of speculators and hedgers. Some markets, like financial markets, are dominated by hedgers buying and selling with one another; and others, like many commodities, are dominated by speculators buying and selling with other speculators.

However, most markets have speculators and hedgers on opposite sides of most contracts. This is an important point and one we will deal with at length when it comes to market timing and selection of what market to position ourselves in.

Hedgers in futures markets are called commercial traders, while speculators are called noncommercial traders. All futures contracts are registered with the CFTC, the government regulatory authority for the industry. The cost for registering contracts is higher for speculators than for hedgers. Consequently, those traders who are producing or processing large amounts of whatever they are trading register as commercial traders, while all other traders are either large noncommercial traders with many contracts traded at a time or other traders with only a few contracts traded at a time.

The CFTC assembles a list of the contracts registered every day by each trader category in about 75 markets and publishes them every week on the Internet at www.cftc.gov. This report is called “Commitments of Traders” (COT) and includes open interest for commercial buyers and sellers, large noncommercial buyers and sellers, and other buyers and sellers (little guys, the public). From these reports it is possible to see how many contracts are held by commercial buyers and sellers—the big guys, our buddies.

What’s the world’s largest trading market? Immense as it is, it’s not the stock market, and it’s not bonds or commodities.

No, the world’s leading market is, believe it not, the currency exchange. In trading volume, daily currency exchange turnover now exceeds US\$1.5 trillion—more than 50 times greater than the New York Stock Exchange, the world’s largest securities market. I told you these guys are superpowers, and the math of the marketplace sure drives home that point.

Many people think currency trading is only for the wealthy. That’s not true. What is true is that superpowers are the big players and there is no other market that offers the potential to create great wealth in a relatively short period of time such as the currency markets offer. With the right guidance and following the right crowd, you can trade these markets very effectively with a modest account of US\$10,000 or US\$20,000, sometimes less.

It should be noted that in January 2005 the CFTC made a nominal change in reporting requirements, telling us:

The Commodity Futures Trading Commission has amended its large trader reporting rules. The large trader reporting rules require futures commission merchants, clearing members, foreign brokers, and traders to report certain position and identifying information to the Commission when the positions of traders equal or exceed Commission set contract reporting levels. The final rules, among other things, raise contract reporting levels, and as a result, impact the reports provided by the Commission on the Commitments of Traders (COT).

The Commission typically calibrates contract reporting levels so that the aggregate of all positions reported to the Commission represents approximately 70 to 90 percent of the total open interest in any given contract. The Commission periodically reviews information concerning trading volume, open interest, its surveillance experience with specific contracts, and the number and position sizes of individual traders relative to the reporting levels for each contract to determine if coverage of open interest is adequate for effective market surveillance. COT data provides a breakdown of each Tuesday's open interest for markets in which twenty or more traders hold positions that equal or exceed Commission set contract reporting levels. COT reports categorize positions as reportable or nonreportable, and provide additional information for reportable positions. The raised contract reporting levels alter the number of reportable positions and the information that is provided on such positions in COT reports. Persons that rely on COT reports should be aware of the impact of the raised contract reporting levels.

WHO OUR BUDDIES ARE

Our buddies, the guys the United States government labels the commercials, are often household names. You will be keying off the buying and selling of corporations like Pillsbury, General Mills, Cargill, Iowa Beef, and Nabisco when it comes to understanding the natural resource commodities. In all aspects of commercial or financial life there are companies or organizations that have made it their business to know, so they can survive and prosper, the true economic status of one particular market: the one they are engaged in.

When it comes to the abstract or financial commodities, we will be

queuing up with the likes of JP Morgan Chase, General Motors, and Microsoft along with all of the world's largest banks and brokerage firms. These people must hedge currency in interest rates, and do so on a daily basis—in positions large enough that they must be reported to the CFTC. Isn't that nice of them!

What is true today was just as true decades ago. The following comments from almost a quarter of a century ago by Bill Jiler, developer of the widely followed Commodity Research Bureau Index of commodity prices, need not have one word altered or removed; the powers then were the same as they are today. These comments are from his paper "The Forecasting Methodology," written in 1985.

Basically, we tried to determine the "forecasting" performance of the major identifiable groups of market participants—Large Hedgers, Large Speculators, and Small Traders. It was logical to assume that the larger and more sophisticated traders should have market insights that would enable them to predict futures price movements, if not infallibly, at least more accurately than the small traders who presumably included the "uninformed public." We also thought it was possible that the sizes of the various market positions, at different times, could well result in a type of self-fulfilling prophecy.

From the statistics in the "Commitments of Traders" report, we were able to approximate the net positions at the end of each month for Large Hedgers, Large Speculators, and Small Traders. We averaged their month-end statistics over a number of years to find out what their normal positions would be at any given time of the year. We then compared each group's actual position with their so-called normal position. Whenever their positions deviated materially from the norm, we took it as a measure of their bullish or bearish attitude on the market.

By studying subsequent price movements, we were able to establish "track records" for each of the groups. As anticipated, we found that Large Hedgers and Large Speculators had the best forecasting records, and the Small Traders the worst, by far. We were somewhat surprised to find that the Large Hedgers were consistently superior to the Large Speculators. However, the predictive results for the Large Speculators varied widely from market to market.

The differences between their current net open interest position and the seasonal norm supply us with a tangible percentage measure of the degree of bullishness or bearishness of each group towards a particular market to a certain extent. From these "net-net" figures, we obtain a configuration of market attitudes of the

principal players. From our research and long experience we have drawn up some general guidelines:

The most bullish configuration would show Large Hedgers heavily net long more than normal, Large Speculators clearly net long, Small Traders heavily net short more than seasonal. The shades of bullishness are varied all the way to the most bearish configuration which would have these groups in opposite positions—large hedgers heavily net short, etc. There are two caution flags when analyzing deviations from normal. Be wary of positions that are more than 40% from their long-term average and disregard deviations of less than 5%.

We'd like to present some examples of how we utilized this open interest analysis in our "Technical Comments" section of the CRB Futures Chart Service. In late August of 1983, we turned bearish on sugar when it was over 10¢ a pound. Throughout 1983 and 1984, we advocated a bearish stand even though prices had dropped below 4¢ to 16-year lows. An important reason for our doggedness, in addition to the bearish chart, was our analysis of the "Commitments" report. For over two years, the Large Hedgers' average net short position was over 20% larger than their previous 6-year average. Small Traders, despite tremendous losses, averaged almost 20% higher net long positions throughout the entire debacle.

In August of 1983, Chicago wheat futures soared to new contract highs. The charts were very bullish, which we acknowledged in our "Comments" of August 12, 1983. However, we noted that the latest "Commitments of Traders" report sounded a negative note. Large Hedgers were 36% net short and Small Traders were 24% net long, both way over their 10-year averages at that time. Subsequently, the market topped out and prices trended lower for the next 6 months.

A study of the open interest configuration for corn and soybeans just prior to their spectacular bull move in the summer of 1983 will show how the analysis "did" and "didn't" work. It worked for corn, which showed Large Hedgers with net long positions well above normal and Small Traders net short. This bullish pattern was just the opposite of the soybean open interest. Here, Large Hedgers were heavily net short and Small Traders had a net long position of 20% versus a more normal 10% for June. Yet, both commodities enjoyed similar bull moves. An unforeseen drought that summer probably accounted for the strange results.

While we have shown only some relatively recent examples of this kind of open interest analysis, our experience with the technique goes back over two decades. The performance patterns are

fairly consistent. Yet, we have to admit that there were exceptions that proved to be quite dramatic. Therefore, it is important also to utilize other available technical and fundamental tools to arrive at a high probability of success in forecasting prices. The nature of the events that shape price trends of futures contracts should keep even the most proficient of technical and fundamental analysts on their guard and flexible at all times. International developments, weather, and politically-motivated legislation are among the unpredictable forces that can change the direction of the markets in an instant. There is no master key that can unlock all the doors to successful price forecasting. Nevertheless, we believe that the proper interpretation of the "Commitments of Traders" reports is valuable and belongs on the analyst's key ring.

To best use the data from the commercials, recall the line from the song "Rawhide": "Don't try to understand them, just rope and tie and brand them." As you will see, it's pretty simple to follow the commercials. There are no labyrinths to explore or complex matrixes to crawl through; just know these guys play the game better than anyone else.

They're pretty good company to keep, these mega-powers of commerce and industry!

Next let's learn how to follow them. . . .

