

Information and Expectations

Lecture 3

1. Information and Expectations
2. Trading/Investing/Speculating
3. Admin

Mission Statement

Learn how commodity futures markets work,
Learn and practice risk management,
Formulate and test trading/hedging strategies,
In preparation for future professional roles

Federal Open Market Committee

FOMC meets 8 times a year to discuss/set the fed funds rate – the short term interest rate in the USD, amongst other things

Today is one of those 8 times. They release their statement around 2 pm on wednesday

Hawkish (aggressive) vs Dovish (peaceful)
raise rates higher vs keep low rates

Why it Matters:

Fed monetary policy has been driving global economy since 2008

'Carry' Trade

Carry Trade: Borrow cheap money to buy risk assets

In 90s, JPY was the carry currency

In late 2000s, USD became the carry currency

People (banks, businesses, housewives) effectively been borrowing USD to buy :

- Higher yielding currencies (AUD, IDR, MYR, INR, BRL, etc)
- Real estate (Australia, HK, SG, Canada)
 - Current debt to gdp levels close to US housing bubble at its peak in 06-07
- Riskier, higher yielding debt
 - in 2008/09 Indonesia borrowed at 20%
 - In 2011/12 Indonesia borrowed at 3%
 - In 2011: Mexico sold US \$1bil of 100 year bonds
- Commodities, including precious metals (AU, AG)

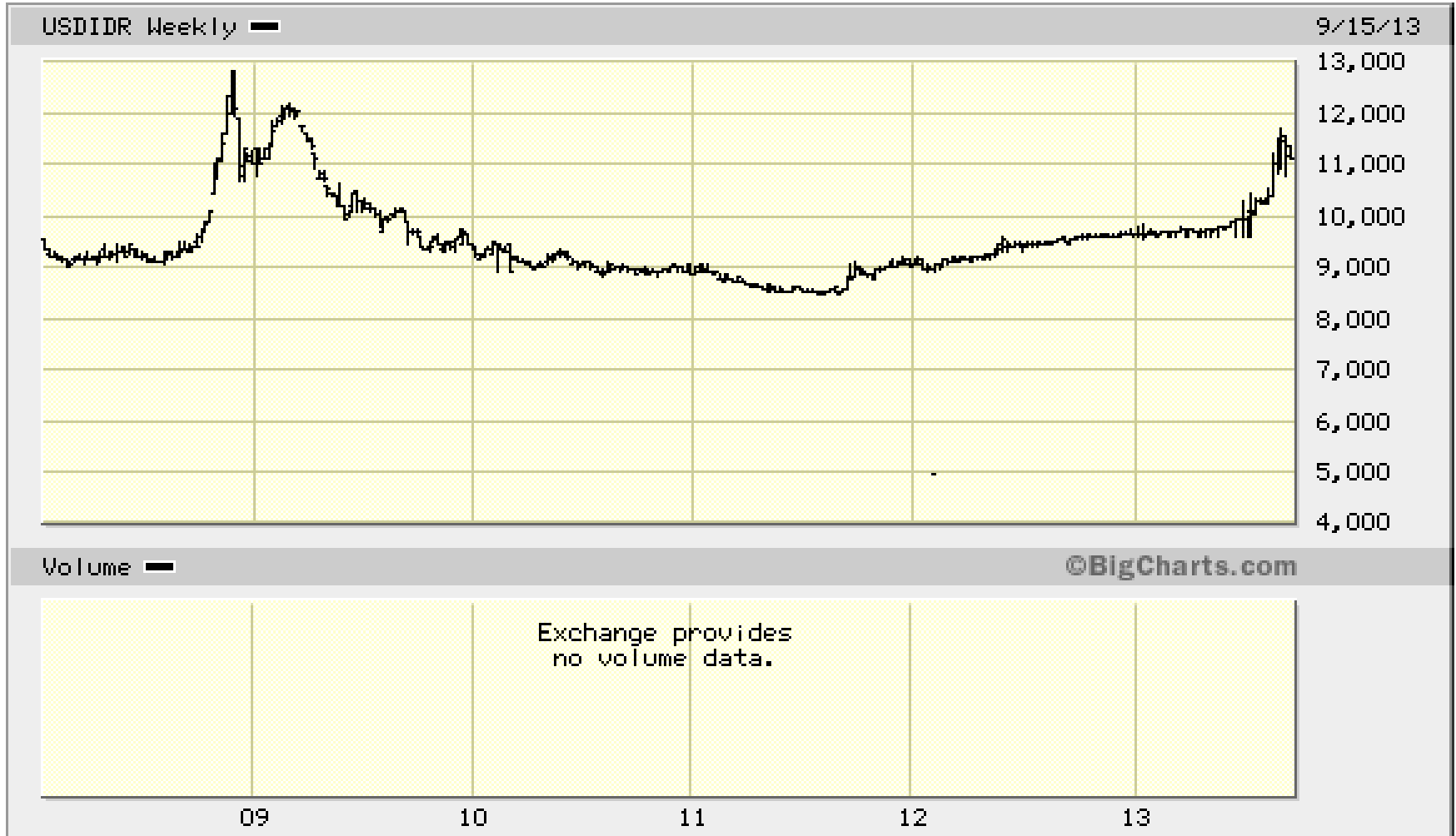
Markets have a short memory

Mexico defaults

(1827, 1833, 1844,
1850, 1866, 1898, 1914,
1928-1930s, 1982)

Carry Trade is unwinding as people flee risk assets (again)

USDIDR



USDINR



Gold



Information and Prices

Information



Expectations



Prices

**Some human
intelligence**

If actionable

The price of information

- NYC: The \$100,000 phone call
- Bloomberg terminals – US24k a year

Inside Information:

Commodities, are subject to a different form of regulatory oversight compared to equities

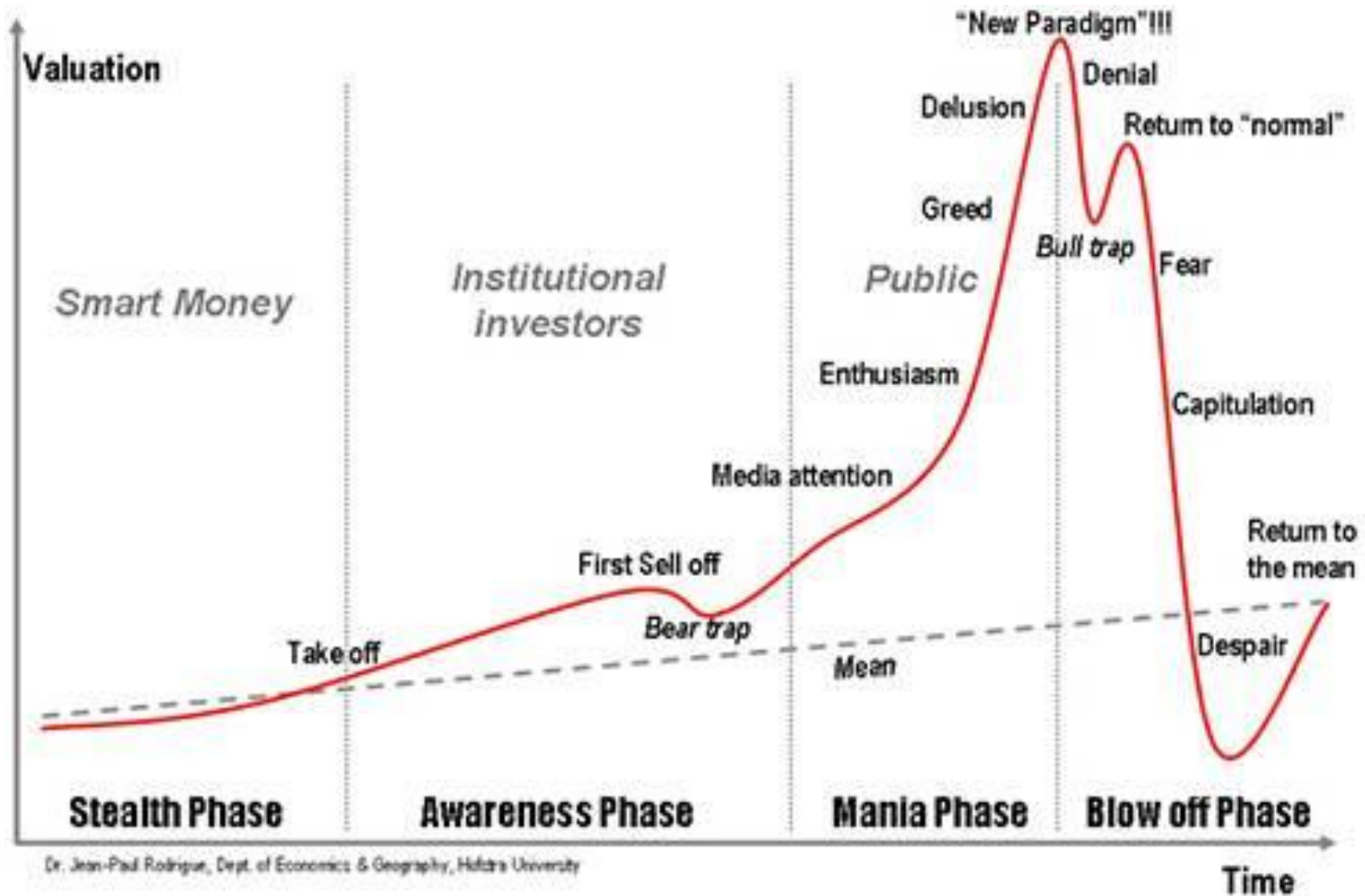
Stock regulations are designed to protect the ‘little guy’. Commodity futures have no such concern, the concerns are with default risk/contagion and market manipulation

Information flows quickly nowadays



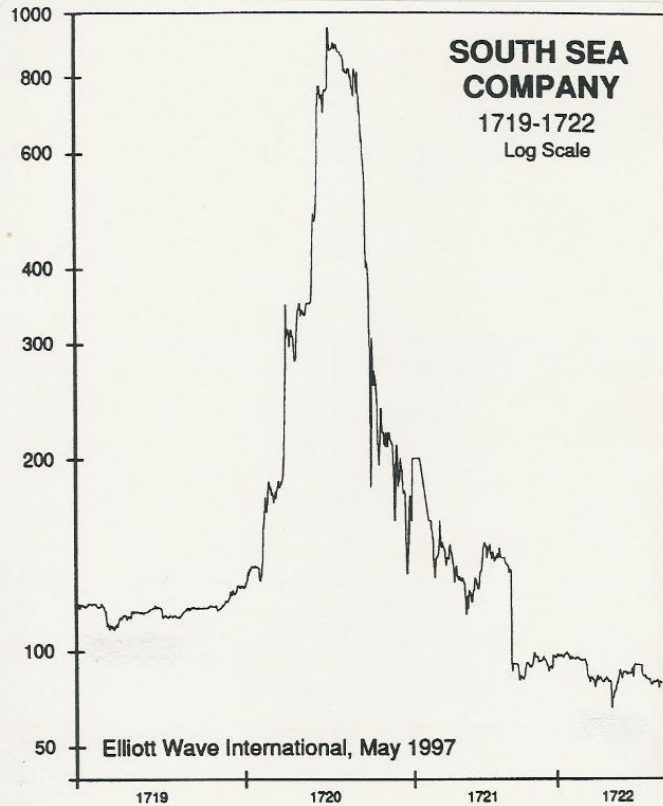
Corn at Last Week's Crop Report

But Human Behavior will never change: Anatomy of a Bubble

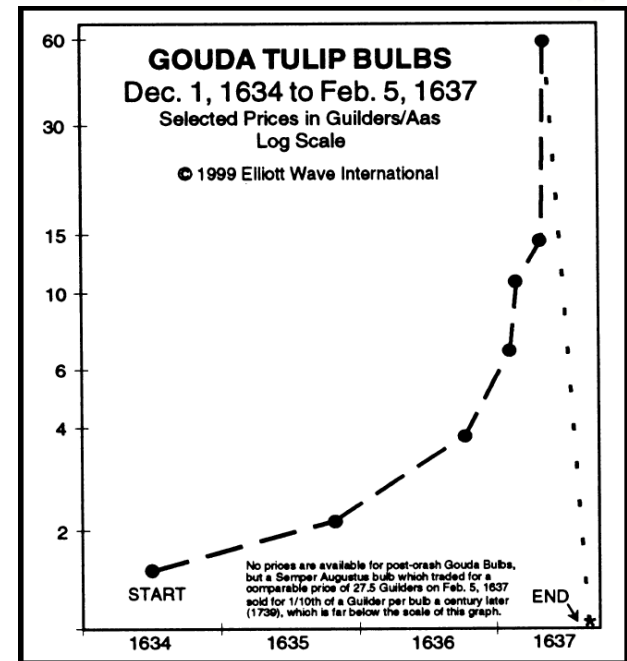
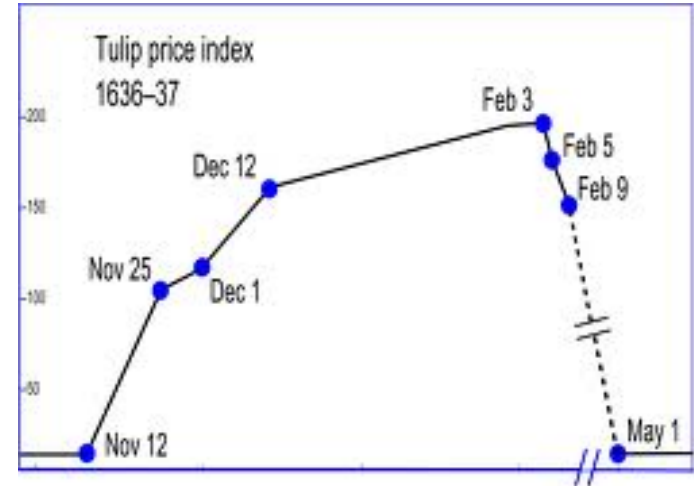


Bubbles

THE SOUTH SEA BUBBLE (ENGLAND) - JUNE 1720



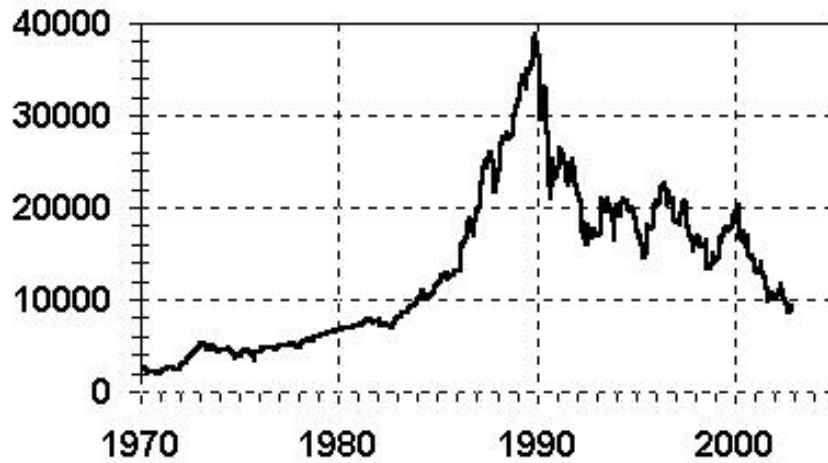
The speculative mania which swept Europe in the 18th century focused on England and France's economies. Beset by overspending for constant warfare with their neighbors, these two countries turned to schemes issuing securities to refill their depleted treasuries. The need to speculate, at this time, became all-encompassing. The above chart shows the "mania" that went extreme and then collapsed in mid-1720. In France, it was called the Mississippi Land Company. Courtesy: R. Prechter, "The Elliott Wave Theorist", May 21, 1997.



Bubbles

Japan Nikkei
peak in 1990

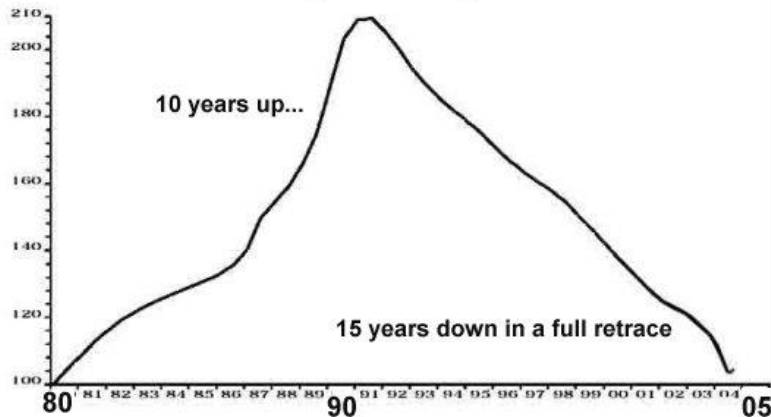
Nikkei Stock Index



China Shanghai Index
peak in 2007



Land prices in Japan



One guess for
China Real Estate

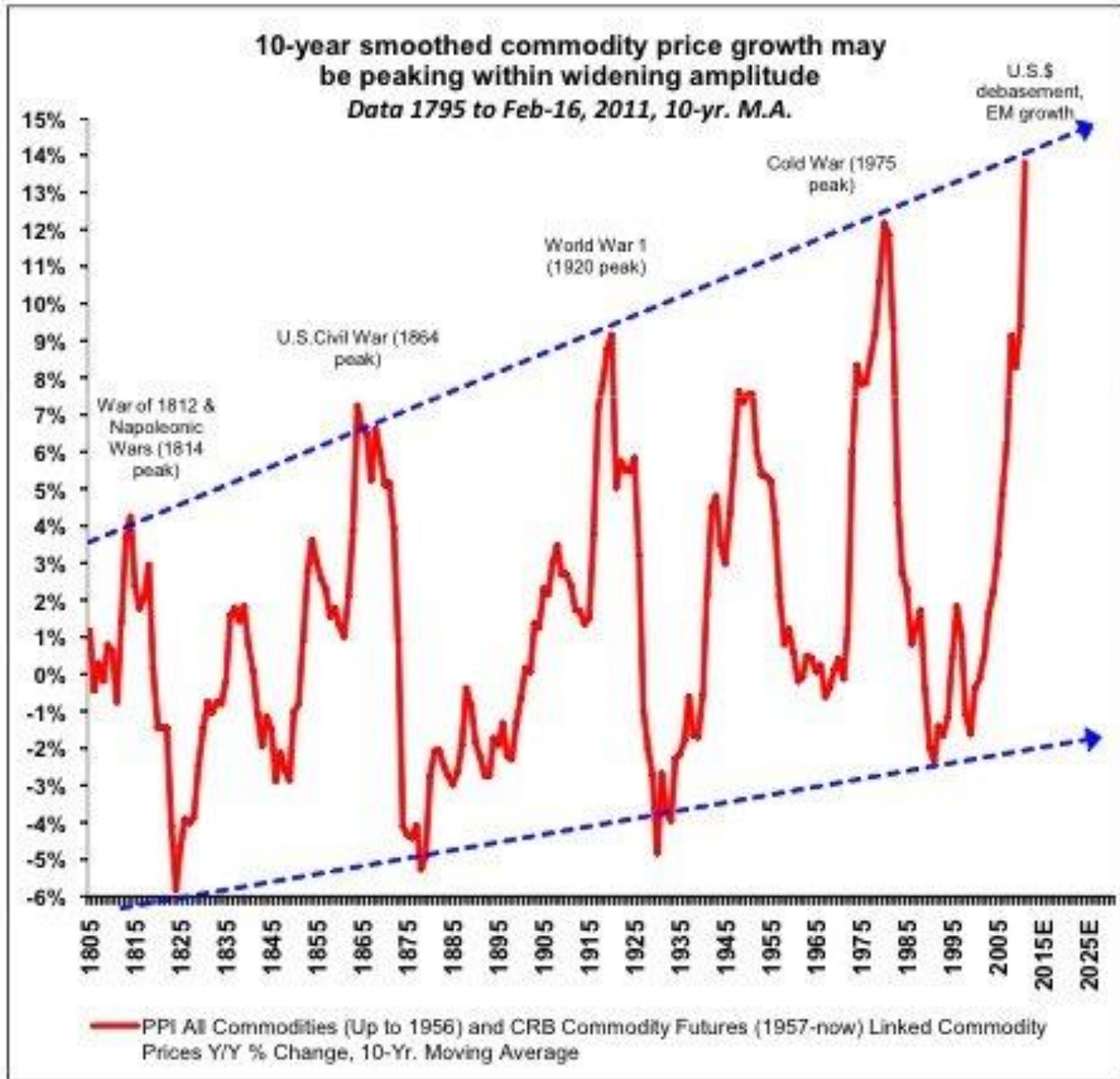
Tech bubble Nasdaq



Less common – Uranium Bubble

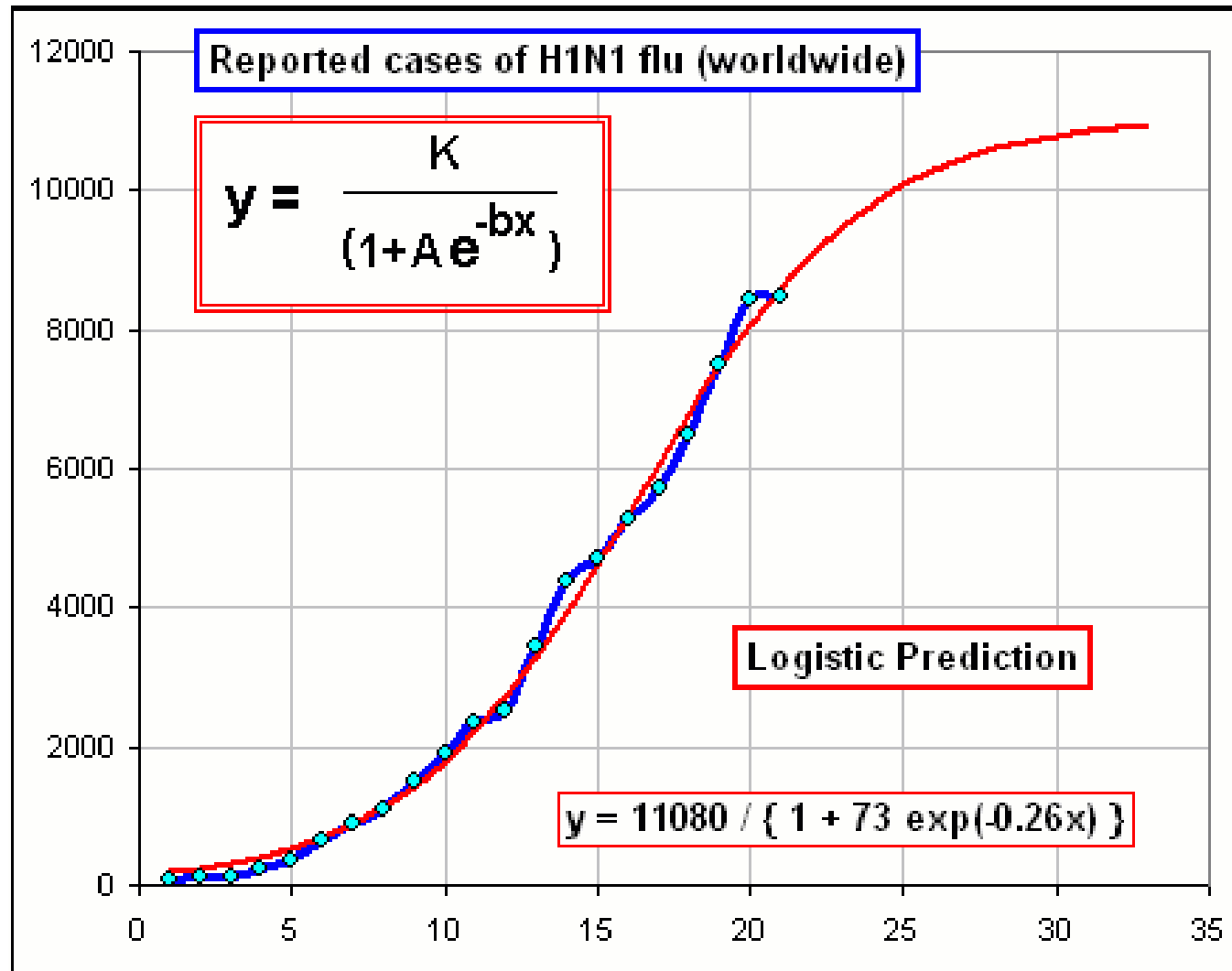


Current commodity super-cycle seems over



Information Transmission - just like the flu

Flu infection rate follows a logistic curve



Adoption effect on markets

Markets are based on human interaction

Information spreads in a logistic pattern

Short term implication: prices adjust slowly,
then rapidly, then slowly again

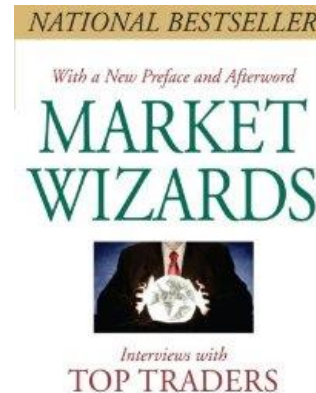
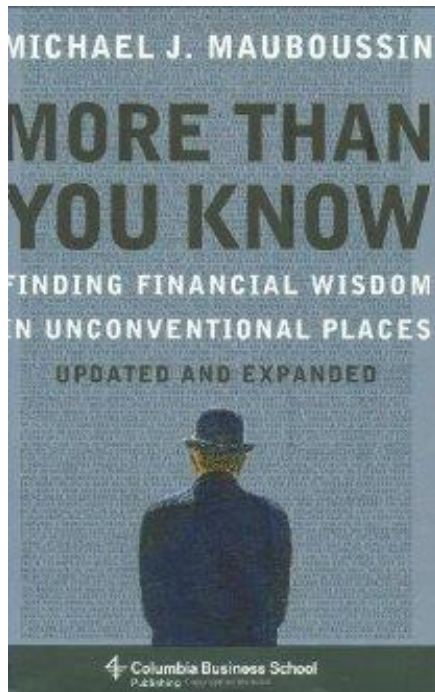
Expectations also spread accordingly

Longer-term implication: human exhibit herdish behaviour as beliefs and expectations converge – bubbles form, inevitable booms and busts, Apple at \$700

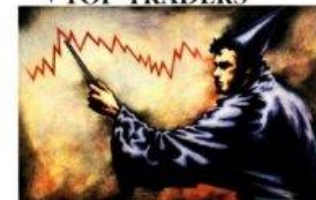
Some Interesting Resources

Barry Bannister – Expert on
cyclicals (includes commodities)

<http://www.financialsense.com/contributors/barry-b-bannister>



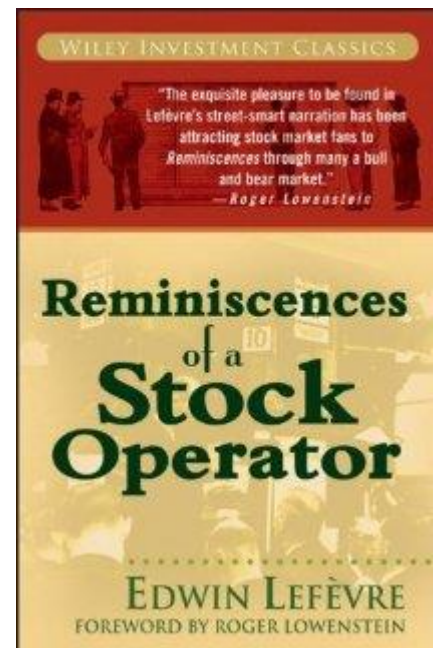
JACK D. SCHWAGER



JACK D. SCHWAGER
Author of MARKET WIZARDS

"A must to read.... Readers will pick up plenty of trading tips."
—USA Today

**Psychology of
traders**



Investing vs Speculating

Same Goal:

To end up with more than one started with

Different approaches:

Productive vs. Non-productive

Farming – planting one seed to harvest many later

Robbery, Gambling – taking from others, the fruit of their labour

What is trading?

Buying Goods where they are plentiful and Selling them where they are scarce

Local Setting: retailers and distributors are traders
grocery stores, supermarkets, stationery shops

Regional Setting: traders move the goods between regions

Rural-Urban, Inter-city, Inter-country

Large commodity trading firms: ADM, Bunge, Cargill, Dreyfus, Wilmar, Noble

Market-makers: provide liquidity to aid functioning of market

Prime brokerages (banks), used car shops