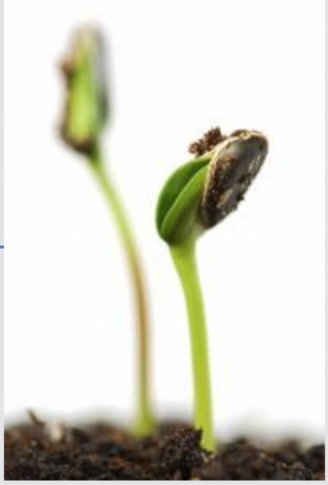

Food Investments

Food Prices Soared Over Past Decades

Increasing demand in particular from the above-average **growing population** in emerging countries, the increasing **competition with biofuel** and the negative impact of **climate changes** are seen as contributing factors. At times food prices rapidly advance. Especially in those periods it is debated passionately to which extent the increased **investments** in food commodities have not only supported those higher food prices but also **increased volatility.**
The general upward price trend remains unbroken, though (see chart 1 below).

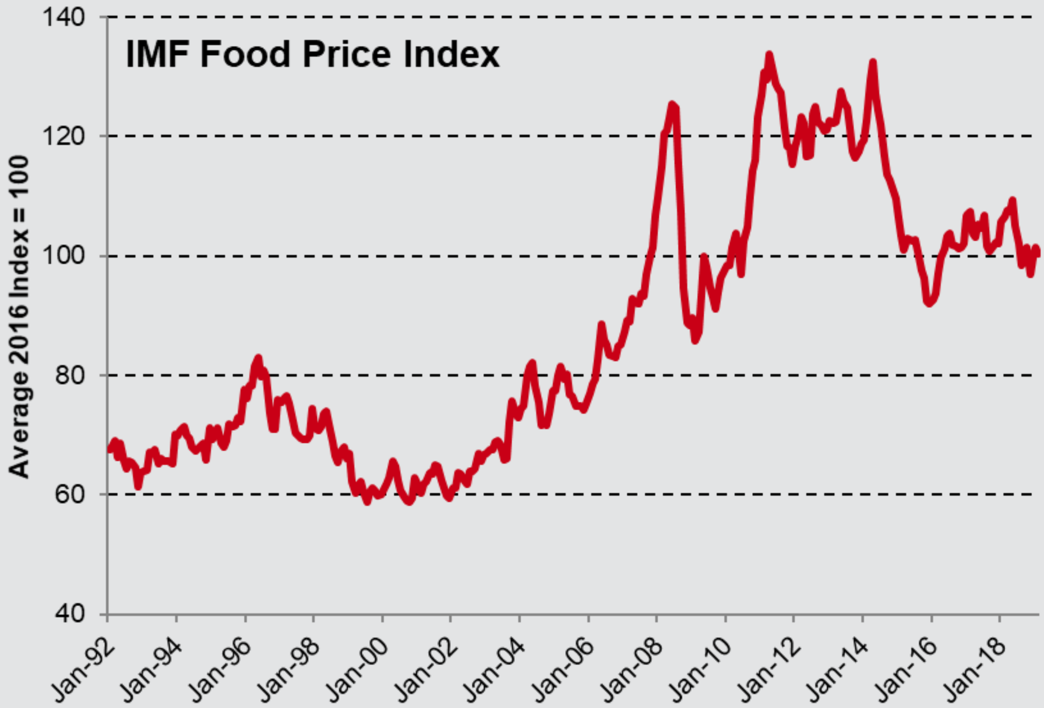

Chart 1: International Monetary Fund (IMF) Food Price Index. Monthly data in USD.
Source: www.imf.org/en/Research/commodity-prices

Is it Acceptable to Speculate in Food?

In the public view ‘betting on food’ and ‘food speculation’ are two highly negatively occupied phrases. It is both popular and easy to blame the ‘ruthless’ speculators for higher staple food prices, in particular when prolonged unfavorable weather conditions already induce a shortage of supply.

Understandably the topic is emotionalized because millions of human beings’ lives are potentially affected in an existential way. But the topic is also more complex than meets the eye.

The fact is that **raising food prices have a disproportionate impact on the world's poor**. People in the developing countries spend 50%-90% of their income on food, while it is only on average 10%-15% in the developed countries.

Lobby groups are demanding stricter position limits for speculators in food or banning financial institutions altogether to participate. Commerzbank, DZ Bank and its subsidiary Union Investment, Barclays, BNP, Nordea plus a number of other banks already announced to **refrain from issuing staple-based Exchange-Traded Funds (ETFs)**.

Two Sides of the Same Coin

When reflecting if speculators' investment activities would possibly cause indirectly poor people's suffering, the most intriguing argument that comes to mind is that they are just **as likely to sell as they are to buy** agricultural commodity futures. However, one never reads about speculators being criticized to have artificially depressed food prices by selling excessively. Speculators (short term investors) take both sides and cannot be restrained to sell only.

In addition, trading is a **transaction between two parties**. A speculator on the buy side, makes the seller, selling at that very same price, equally responsible for the subsequent price move. With no sellers, speculators would not be able to execute buys. Should at some point in time speculators be net buyers then another market participant group has to be net sellers – these are likely to be the producers themselves.

It therefore seems one-sided to blame solely 'the speculators' for upward price moves without considering what else is attached to their doing.

Balanced Composition of Market Participants

The official and exam-tested role of a speculator is a useful and positive one of providing liquidity to the market. These special market participants assume price risks by temporarily bridging the gap between e.g. food producers and processors. Consequently, bid and ask narrows and volatility decreases.
As such, speculators even reduce food prices as hedging costs for the 'real' buyers and sellers are lowered. Generally speaking, more speculators should therefore be welcomed in order to absorb volatility.

However, that generic textbook view is an oversimplification of reality. The dose makes the poison. **More relevant than the quantity of market participants is their composition**. Both, an over- or under-representation of one type of market participant would have an adverse (negative) effect.

Long term investors form another important group of market participant (next to producers, processors and speculators) contributing also to market depth.

How would the landscape of market participants influence price volatility and direction?

- Food producer and processor trading only among themselves would result in **highly illiquid markets** with substantial price swings, leading to increased hedging costs and therefore ultimately to higher food prices. Excluding speculators altogether is certainly the wrong way.

- Relatively too many speculators (of the subtype trend-followers or momentum traders) would also have a counterproductive effect. Price movements would likewise be **amplified in both directions** without connection to the real demand and supply situation. Beyond a certain threshold of speculators volatility would increase instead of being dampened.
  The group of speculators itself is inhomogeneous. Swing traders, for example, would partially off-set transactions from trend-followers and momentum traders. Ideally, one would need to further sub-divide the speculators by their investment style – certainly not an easy task.

- A direct and, more importantly, a one-way impact on food prices have long term investors in the corresponding food ETFs. Hundreds of billions of U.S. Dollars have been collected over the past years by investment banks issuing those ETFs on food indices.
  True, initial buyers would eventually become sellers, though having a net zero effect on price direction. But initially, these **ETFs have a clear buy bias** with all the fresh money pouring into the food segment. Irrespective of real demand and supply, **food prices are under upward pressure** from these investments.

Supply and Demand

In comparison to the physical market, the financial market in food commodities is substantially smaller. And it is still **the real, physical market that fixes prices** based on supply and demand.
The most important food staple for human consumption, rice, is dominantly grown and consumed locally. Only about 5% of the world rough rice production would be exported at all. The rough rice futures volume traded on the U.S. exchange is therefore tiny in relative terms. And speculators in turn would make up only a fraction of that total trading volume. It would be far-fetched to make these market participants responsible for excessive rice prices.
Instead it is the **main producers' responsibility** (in this case China and India) to match foreseeable rice demand. Sufficient production land is to be allocated and sufficient storage capacities are to be provided and maintained to at least partially absorb possible supply shocks caused by natural disasters or prolonged droughts.

Also improper storage leads still to unacceptable amounts of rotten food.

Naturally staple food prices are linked to one another. Rice prices could also increase as a result of spiking prices in its main substitute wheat. Main wheat producers likewise are called upon to prevent shortages.

Conclusion

A general damnation of short term investment in food is not justified. Firstly, a healthy number of speculators serve the important primary purpose to **support food producer and buyers** to manage their risk. Secondly, they offer valuable investment style and asset class **diversification to investors**.

Desirable is however a realistic and flexible regulation of speculators by **government authorities to confront over-crowding**. Suitable measures include position limits concluded on verifiable figures and scientific research. Already, the Commodity Futures Trading Commission (CFTC) established specific net limits for the grains and soybean complex and cotton that any one trader or group may hold. In addition, exchanges approved by the CFTC have position limits on other contracts in place.

Market transparency needs to be improved by restricting or even prohibiting food-related private over-the-counter contracts (central clearing instead).

Likewise, it is comprehensible that investment banks **no longer produce high-volume investment products based on basic food**. Investment decisions in food ETFs are often detached from the real supply-demand situation in a specific commodity. Instead financial conditions, like low interest rates (cheap money) or inflation expectation play a role.

Nowadays agriculture and energy are linked because of direct competition for biofuel farmland and because agriculture itself is an energy intensive industry.
Therefore next to keeping speculators and investors in check, both, **agricultural and energy politics** should ensure **sufficient food staples supply**.

After all, food is more than a commodity – and clearly not just a financial asset.

March 2019

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