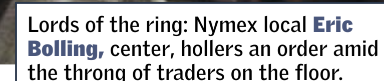
COMMODITIES CRUNCH

Pit Bulls

After a five-year rally, the commodities market has turned ugly. As prices tumble and hedge fund firms such as Amaranth reel, floor traders brace for a wild ride.

PHOTOGRAPHS BY PETER ROSS


Lords of the ring: Nymex local **Eric Bolling,** center, hollers an order amid the throng of traders on the floor.

By Edward Robinson

At 7:55 a.m., five minutes before the opening bell, Anthony Compagnino and Michael Ragazzo huddle in their office on the New York Board of Trade floor—a booth with a dozen telephones and no chairs—to plot their next move in the cocoa pit. "I should have picked a less stressful job, like bomb defusing," says Ragazzo, a commodities broker at East Coast Options Services.

After five years, the rally in commodity prices has hit a wall. For two days, Ragazzo and Compagnino, his boss, have been selling cocoa futures as prices have plummeted 15 percent. Hedge funds that have been riding the richest commodities boom in a generation have dumped cocoa en masse, upending the market.

Now, on July 19, the guys at East Cost Options agree that the worst is over. Compagnino, 46, wearing a blue and gold trader's jacket, hustles to the top rung of the cocoa pit, the tiered ring where trading takes place. Ragazzo, 48, in a matching coat, takes up a position nearby, a phone to each ear.

The bell sounds—and all hell breaks loose. One floor broker barks a bid to buy cocoa for September delivery for $1,517 a metric ton. Another hollers an offer to sell at $1,507. The traders down in the pit can't settle on a price. Compagnino starts selling.

"Thirty Seps at 18! Thirty Seps at 18!" Compagnino thunders, offering to sell 30 September contracts on cocoa for $1,518 per ton.

The fate of a single futures contract is just one worry for New York Board of Trade brokers and their counterparts around the world. The Reuters/Jefferies CRB Price Index, which tracks a basket of 19 commodities, sank to 313.73 on Sept. 11, its lowest level since March 9, 2005. Since May, the index had lost almost 12 percent as crude oil fell to less than $65 a barrel and gold slid below $600 an ounce. After doubling to a 24-year high of 19.3 cents a pound on Feb. 3, sugar plunged 40 percent.

For traders like Compagnino, that was no small milestone. The decline marks the market's first reversal since 2001, when China's voracious appetite for raw materials and trades by the $1.2 trillion hedge fund industry combined to send prices soaring.

The question now is whether the drop is nothing more than a hiccup in a bull market that still has years to run—or the start of a commodities bust.

Bears like Stephen Roach, New York–based chief global economist at Morgan Stanley, say the bust is already under way. “The megarun for commodities has run its course,” Roach, 61, says. China’s demand for industrial commodities, which has driven prices higher for years, is going to slacken, he says. The People’s Bank of China has raised interest rates twice this year to cool an economy that grew 11.3 percent during the second quarter.

Bulls like Jim Rogers, who co-founded the famous Quantum Fund with George Soros, say commodities have plenty of steam left. The previous bull market ran for 14 years, from 1968 to ’82, and this one will last at least that long, Rogers, 63, says. Rogers, chairman of Beeland Interests Inc., a New York–based investment firm, says the recent slump is a short-term correction. “The idea that this is a bubble is laughable,” Rogers says. Over the long haul, China and India will devour raw materials as they emerge as economic powers. Supply won’t be able to keep up with demand, he says. Just look at oil. As recently as 1992, China was self-sufficient in oil. Today, it’s importing 40 percent of its needs. (See “China’s Axis of Oil,” page 132.)

Caught in the middle of all this are pit traders like Compagnino. They make money either by buying and selling on behalf of trading desks, money managers and companies that produce or use commodities or by wagering their own money in the markets. Futures—agreements to buy or sell specific securities or commodities at a specific price on a certain date—are part of the $8.7 billion–a-day market in exchange-traded commodity derivatives, a family of instruments that also includes options.

The boom has been good to the folks on the floor. Exchanges like the New York Board of Trade are among the last places on Wall Street where a guy like Compagnino—who grew up on the Brooklyn waterfront and quit college after a year—can still strike it rich. A typical broker on the NYBOT, the world’s largest marketplace for commodities such as sugar, cotton, coffee and cocoa, earns about $200,000 a year. A hotshot on the New York Mercantile Exchange, the world’s largest energy exchange, can pull down $10 million.

“Never in my wildest dreams did I think I would make the money I made in the last couple of years,” Compagnino says. He’s used his winnings to buy a 5,300-square-foot (490-square-meter) house with a pool in the New York borough of Staten Island.

The New York Board of Trade has become a hot commodity itself. In September, IntercontinentalExchange Inc., an Atlanta-based electronic marketplace, agreed to buy the bourse for about $1 billion in cash and stock.

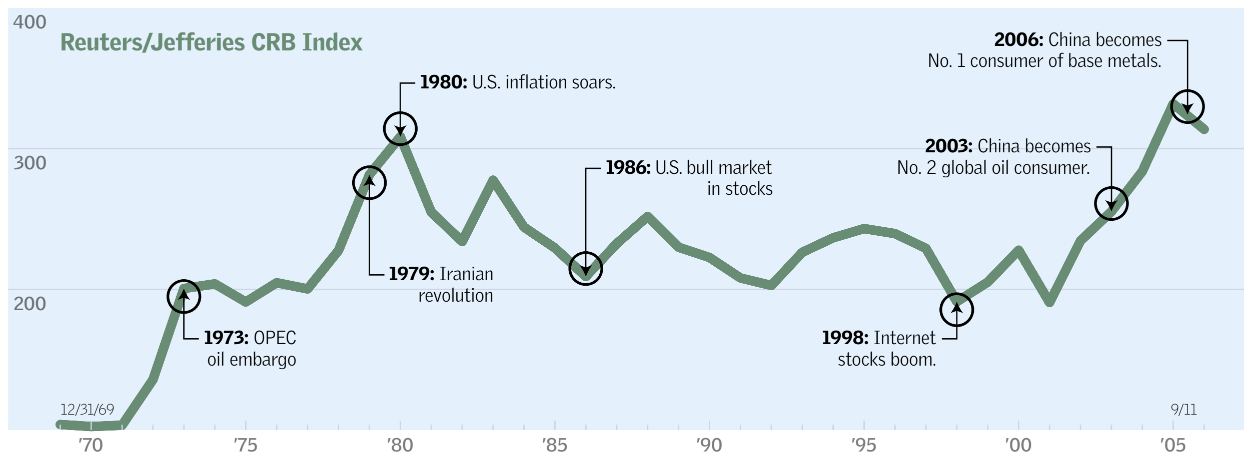
On the Nymex floor, Eric Bolling, an independent trader, or local, says he’s made a killing, too. Bolling, a square-jawed man who once played third base for a minor-league baseball team affiliated with the Pittsburgh Pirates, says he’s scored this year by betting that the prices of natural gas and crude oil would converge. He did so well that in August he jetted off for a vacation in the Bahamas. “I can’t go anywhere that doesn’t have a casino,” Bolling, 43, says.

Over at New York–based Comex, the world’s largest gold and silver marketplace, Kevin Grady says he’s thrived as a “scalper” in the gold pit. Grady trades for London-based Man Financial, a unit of Man Group Plc, the world’s largest publicly traded hedge fund manager. Grady tries to make money by watching what his rivals are doing—“reading the ring,” he calls it—and then dodging in and out of the market. “Markets change constantly, and gold traders have to sense that,” Grady, 42, says. Like Compagnino, Grady grew up in Brooklyn and came to the pits after dropping out of college.

The commodities pits can be lucrative—and dangerous. Traders like Bolling, Compagnino and Grady must avoid getting steamrollered by the hedge funds and Wall Street investment banks that rush in and out of the markets. Since 1999, the amount

Booms and busts

Commodities rose in the 1970s amid supply shortages and inflation and slumped when stocks soared in the ’80s and ’90s. Now, after a five-year bull market, prices have stumbled again.



Sources: Bloomberg, Morgan Stanley, Reuters/Jefferies CRB Index

of money invested in commodities by pension funds, mutual funds and endowments has soared almost 17-fold, to $100 billion from $6 billion, according to Barclays Capital, the securities unit of London-based Barclays Plc. Hedge funds, commercial banks and Wall Street firms, meantime, have poured about $50 billion into the market, according to John Normand, London-based global currency, commodity and fixed-income strategist at JPMorgan Chase & Co.

Hedge funds have pumped up prices and trading in copper, natural gas and even cocoa, traders say. Richard Bernstein, chief investment strategist at Merrill Lynch & Co., found in June and July that many commodity prices were 20–50 percent higher than they should have been because so much hot money had flooded in.

"We used to think 200 contracts was a big trade, but hedge funds put on trades with 2,000 contracts," says Michael Overlander, a 30-year veteran of the pits and co-founder of Sucden (UK) Ltd., a London-based commodities brokerage. "They come in bullish and keep the market up, but when they turn, you can see some pretty severe reactions."

Some hedge funds have stumbled hard lately. Hedge fund manager Amaranth Group Inc. lost about $4.6 billion in September on wrong-way bets in the natural gas market. "We are in discussions with our prime broker and other counterparties and are working to protect our investors while meeting the obligations of our creditors," Nick Maounis, founder of the Greenwich, Connecticut–based firm, said in a letter to investors that was obtained by Bloomberg News.

MotherRock LP, a New York–based hedge fund firm run by Robert "Bo" Collins, the president of Nymex from 2001 to '04, lost about $190 million on natural gas in June and July. On Aug. 3, Collins, a former senior natural gas trader at El Paso Corp., sent a letter to clients saying MotherRock would shut down. "Let me say upfront that I regret MotherRock's terrible performance and its impact on your investments," Collins said in his letter, a copy of which was obtained by Bloomberg News.

Maounis, 43, and Collins, 40, declined to comment for this story.

Amaranth and MotherRock probably aren't the only hedge fund firms that have stumbled in the market. In early August, hedge funds held U.S. futures contracts on a total of 1.3 trillion cubic feet (37 billion cubic meters) of natural gas, 1.5 times the amount in storage along the Gulf of Mexico, according to the U.S. Commodity Futures Trading Commission and the U.S. Department of Energy. The number of contracts that haven't been closed, liquidated or delivered is known as open interest. "Given the stupendous level of open interest out there, there's probably more than one MotherRock floating around," says Stephen Schork, an analyst who edits the *Schork Report,* an energy markets newsletter.

It took hedge funds years to come around to commodities. Back in the 1990s, many of these private pools of investment capital couldn't have cared less about natural gas or cocoa. The CRB index fell 18 percent from 1989 to '99, while the Standard & Poor's 500 Index quadrupled. Floor traders got as much respect as weekend gamblers in Las Vegas. "The stock brokering fraternity deemed commodities as very 'spivvy,' very high risk," Overlander, 54, says. "We were treated with disdain."

Compagnino waited a long time for a run like this. He says that when he was 18, he wanted to be a doctor and enrolled at Brooklyn College. He dropped out after one year because he didn't like school and got a $150-a-week back-office job at Shearson Hayden Stone Inc., where Sanford Weill, the man who would go on to create Citigroup Inc., was chairman.

Hedge funds have roiled commodity prices by rushing in and out of markets. Now, some have lost big.

One day in 1980, Compagnino was dispatched to the World Trade Center to retrieve some trading tickets. There, he saw a gold trader make $15,000 in 15 minutes. "I knew that's what I wanted to be doing," Compagnino says. He joined East Coast Options in 1993.

Since then, Compagnino has become the biggest sugar broker on the New York Board of Trade, which moved into the Nymex's building in lower Manhattan after its World Trade Center trading floor was destroyed in the Sept. 11, 2001, terrorist attacks. Dressed in different-colored jackets, many adorned with World Trade Center commemorative pins, the traders look like members of different clans. Most know each other. Two in five live on Staten Island. After the close of trading on Thursdays and Fridays, many unwind over beers at nearby bars such as P.J. Clarke's on the Hudson, the downtown offshoot of a venerable East Side saloon.

Compagnino doesn't socialize with other traders. "I don't want people to know how I think," he says. "These guys are my competitors, and the more they know about you, the more vulnerable you are."

Compagnino buys and sells futures for investors, as well as for sugar growers, chocolate makers and other companies. His gravelly voice is testament to his years of hollering in the pits. In 1995, he opened his mouth to speak and no sound came out. It took him almost five years of voice therapy to restore his vocal cords to full strength.

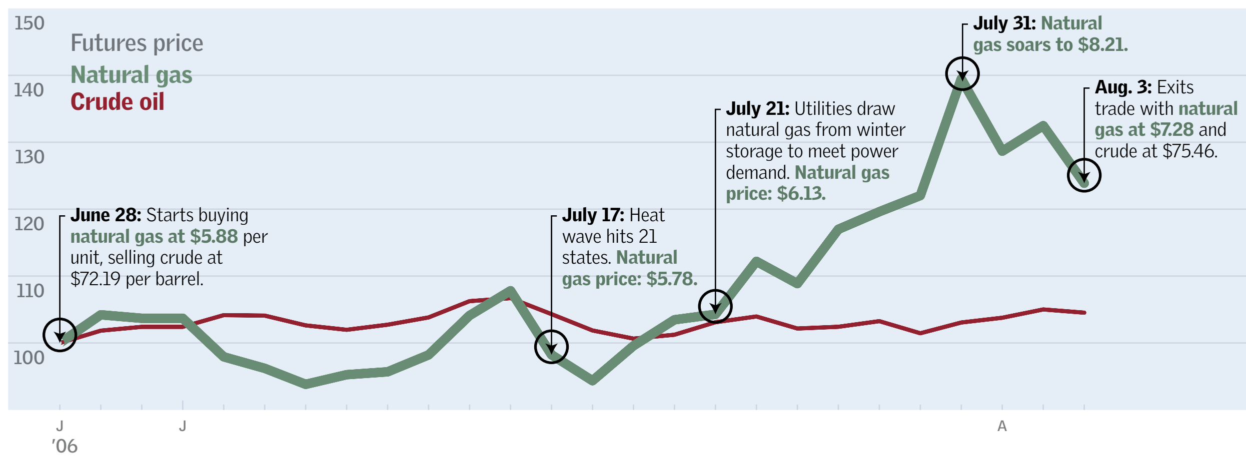
A heavyset man who wears a diamond-encrusted cross around his neck, Compagnino studies crop reports and visits sugar growers to get a bead on the market. He says he bought sugar in November 2005 for delivery in May 2006, betting that demand for Brazilian sugar cane–based ethanol would rise as oil prices marched higher. He bailed out in January, pocketing a sweet 42 percent return. The swoon was part of the sweetener's worst quarter since 1981.

This past July, Compagnino took another wild ride, this time in the cocoa market. First, cocoa shot to a 15-month high of $1,734 per metric ton as hedge funds piled into the market.

TOM STOCKILL

Anatomy of a trade

Eric Bolling bet that natural gas would rise and crude oil would decline. Though crude oil rose 4 percent, the 41 percent jump in natural gas made the trade pay off.



Index: June 28, 2006 = 100. Source: Bloomberg

Then, on July 17, prices went into a free fall as the funds started to sell. Traders rushed the cocoa pit. One of them, throwing his arms back and forth and shouting orders, slammed another in the nose and knocked him to one knee.

After the two-day rout, Compagnino and Ragazzo are meeting in East Coast Options' booth on the exchange floor. Ragazzo hands Compagnino a chart tracking the price of cocoa and its 200-day moving-average price, now $1,529. After checking London prices, they agree that cocoa has probably hit bottom and is likely to rally toward that average and then trade from $1,527 to $1,537. A client has called in a sell order, and Compagnino wants to execute the trade above the previous day's closing price.

As trading erupts, Paul Dapolito, a local in a maroon jacket standing next to Compagnino, signals he's buying.

"Seventeen bid for 1,000 Seps!" Dapolito shouts, moving his arms as if he's raking in the pot in a poker game. He's offering to buy 1,000 September contracts at $1,517. In response, other traders shout offers to sell at $1,505 and $1,507, signaling with their palms out. No one can agree on price.

"Stop trading! Stop trading!" shouts Patrick Quinn, the "head caller" who referees trading from a perch above the pit. Quinn points to Dapolito, asks him to repeat his bid, and then points from trader to trader, around the ring, trying to match buyers and sellers and break the logjam. At this point, Compagnino starts selling. "All of a sudden you hear that the market is lower than what you expect, so you have to change your mind-set," Compagnino says later. "It was very aggressive selling out there."

Morgan Stanley's Roach says the bust is here. 'The megarun for commodities has run its course,' he says.

Compagnino says hedge funds were behind the tumult. The number of outstanding cocoa contracts held by hedge funds had jumped 60 percent to 62,029 contracts in the four weeks ended on July 11, according to the CFTC. That combined long position shrank by almost 20,000 contracts, or 30 percent, to 43,349 contracts on July 25. "This whole move was preordained by the hedge funds' going long and then getting out," Compagnino says. He says he was selling for hedge funds himself.

Over in the Nymex natural gas pit, Bolling has had to avoid getting bulldozed by hedge funds. Bolling has been in the thick of the oil and natural gas rings for almost two decades. A Chicago native, he got into energy trading after he tore his rotator cuff in 1985, ending his hopes for a career in professional baseball. The father of his girlfriend at the time was an energy trader at now defunct Enron Corp., so Bolling decided to give that a go. After stints as a broker at Prudential Bache Inc. and Shearson Lehman Brothers Inc., he went solo as a local in 1989.

Bolling says he didn't get hooked on the job until January 1991. That month, oil surged 18 percent as the U.S. prepared to go to war with Iraq. "It was the first time I saw anything move that violently," Bolling says. "It awakened me to the fact that there was tremendous risk—and opportunity—in the energy markets."

Today, Bolling trades other commodities, too, but natural gas is his favorite. Gas is as unpredictable as the weather. More than 20 percent of U.S. electricity is generated by burning the fuel, so heat waves and cold snaps wreak havoc on prices. Bolling, like many commodity traders, uses past prices to try to predict future prices. "I cannot manage money without looking at a historic record," he says.

On a late June day, Bolling stares at a number on his computer screen and grins. Crude oil futures are trading at $72.19 a barrel, and natural gas futures are at $5.88 per million British thermal units. The difference—Bolling's number, $66.31—is the widest he's ever seen, he says. So, betting that gas will rise and/or oil will fall, he starts buying gas futures and selling crude contracts. The spread has to narrow, he says.

Amaranth lost billions on natural gas trades. 'It's the $1,000 table in the casino,' Bolling says of the market.

At first, the trade looks dicey: The spread widens for two weeks. Then, during the week of July 17, a heat wave rolls across the U.S. and demand for power spikes. Natural gas futures climb more than 14 percent on July 31 alone. Bolling exits his trade on Aug. 3. In all, natural gas prices have shot up 41 percent while oil has gained just 4 percent. Someone who made 10 spread trades like Bolling's would have pocketed $140,000.

During the past year or so, natural gas has been particularly volatile. Prices surged in the months after Hurricane Katrina devastated the U.S. Gulf Coast. Nymex futures rose 42 percent to $15.37 per million BTUs on Dec. 13. Later, after traders realized the U.S. was going to have a mild winter, prices plunged 32 percent during the first three months of 2006. "It's the $1,000 table in the casino," Bolling says of natural gas.

Gold has had a rocky run, too, and Grady, who's been trading the metal for 17 years, says he doesn't like to hold positions long. The price of gold tends to rise in times of political turmoil. There's been plenty of that lately. In April, as North Korea prepared to test long-range missiles and Iran pressed ahead with its nuclear program, gold rose to $654.42 an ounce, up 26 percent for the year. Then, on May 12, concern that U.S. inflation was accelerating drove the metal to $732, a 26-year high.

Grady, who stands in the same place every day on the top rung of the pit, says he'd never witnessed a run-up like that before. He sold some long positions as soon as gold hit $700. "The market had come too far, too fast," Grady says. "It was a market-overboard condition."

Gold eventually sank to $629.60 on June 1 before rallying again when war broke out in Lebanon. Speculators rushed back into the market. Open interest held by such short-term investors rose to 143,202 on July 18 from 128,310 on June 27, according to the CFTC. Once again, Grady smelled a sell-off. He says he shorted gold on July 18, and gold fell 2.6 percent, to $613.20 an ounce, over the next four days.

Like Compagnino, Grady was born in Brooklyn—in Grady's case, in Bay Ridge, an Irish and Italian neighborhood that's stocked the ranks of the New York police and fire departments for generations. Grady says he dropped out of St. John's University in Queens, New York, because he decided he didn't want a white-collar desk job. His mother, then a vice president at Refco Inc., the now defunct New York–based futures brokerage, got him a job in Refco's mailroom in 1984. "My friends said, 'You're out of your mind,'" Grady recalls. "But I couldn't see myself sitting behind a desk."

Five years later, Grady became a floor trader for Refco, where his two brothers, Stephen and John, also worked. Refco filed the 15th-biggest bankruptcy in U.S. history in October 2005, a week after disclosing that former Chief Executive Officer Phillip Bennett allegedly concealed $430 million in debt. Bennett pleaded not guilty to federal fraud charges in November 2005 and is awaiting trial. Man Group acquired Refco out of bankruptcy.

Commodity reversal

Many commodities have fallen from record highs this year.

Generic futures contract price, percentage of change

From Jan. 3, 2006, to Sept. 11, 2006. Sources: Bloomberg, London Metal Exchange

So far, prices of industrial metals have held up better than prices of other commodities. Construction in China has spurred record demand for copper, nickel and zinc.

The nickel shortage is especially acute. This year, global stockpiles fell 83 percent to 6,120 metric tons as of Aug. 17, according to the London Metal Exchange. On Aug. 16, the three-month futures contract for the metal, which is used to make stainless steel, blew through the $29,000-per-metric-ton level for the first time. Steelmakers have

turned to the futures market to obtain immediate deliveries of nickel.

You can see the intensity of demand in the trading ring at the LME. The exchange is an oasis of civility compared with the raucous shoutfests in the New York pits. Traders face each other on a round, red-leather sofa, and must stay seated during trading or pay fines. They also must wear jackets and neckties and are forbidden from unbuttoning their collars. Profanity is frowned upon. Copper, aluminum, lead, zinc and nickel are traded in five-minute turns.

In August, when nickel was off the charts, traders politely bought and sold futures like it was just another day at the office. Then, in the final 10 seconds of the session, the ring opened to cash bids and offers for immediate delivery. The traders erupted, yelling buy orders, gesticulating wildly and risking penalties by leaping to their feet.

When demand is low, a commodity's spot price tends to be less than its price for future delivery. Traders call this upward pricing curve "contango." It reflects the costs of storage and insurance.

When demand is high—as it has been for nickel lately—then the opposite happens. The spot price exceeds the future price, a situation known as "backwardation." In August, spot nickel was trading at a 15 percent premium to the three-month contract and a 32 percent premium to the 15-month contract. "The cash-to-forward price in nickel is just nasty," says Russell Plackett, head of metals trading in the London office of Paris-based BNP Paribas SA. In two decades of metal trading, Plackett, 38, has rarely seen spreads like those, he says.

Traders thrive in volatile markets—provided they bet right. Blowups at hedge fund firms such as Amaranth and MotherRock show what can happen when trades go wrong.

"In big moves, there's always someone who scores huge and someone who gets crushed," says Ed Silliere, an independent gold trader on the Nymex. Now that commodity prices have tottered, pit traders can only hope that investors who've rushed into the market won't trample them running for the exits.

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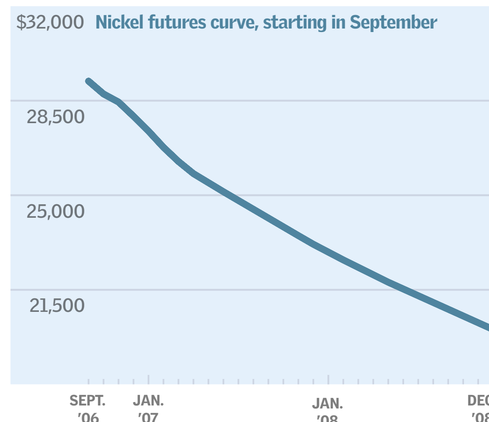
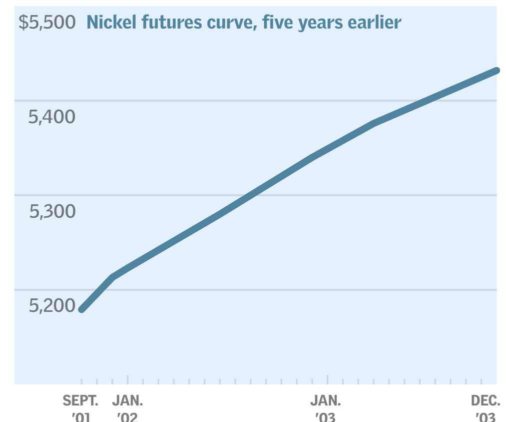
Nickel needed

Strong demand for nickel pushed the price for immediate delivery in September higher than the price for delivery in the future. In bear markets, such as in 2002–03, futures prices run higher than cash prices.

BACKWARDATION: DECLINING CURVE



CONTANGO: RISING CURVE



Prices per metric ton. Source: Bloomberg

Following Commodity Futures

To display a historical price graph for more than one commodity at a time, type G <Go> 1 <Go> to create a new graph worksheet. Click on Multiple Security Historical, and enter a name for the graph, such as *OIL VS. GAS*. Press <Go>, define the date range and press <Go> again. Click on Add a Security. Enter *CL1 <Cmdty>* for the generic crude oil futures price in the SECURITY field, and press <Go>. Type 1 <Go> to add another security, enter *NG1 <Cmdty>* for the natural gas futures price and press <Go>. Press <Menu> to display the graph with prices of both commodities.

To show the change in the price of each commodity relative to the prices at the start of the time period covered in the graph, click on the Edit button, select Normalization and click on Factor. Keep *100* in the field that appears, and press <Go>. In the normalized chart, both prices start at the level of 100 and move up on gains and down on losses.

To track the actual price spread between the prices of the two commodity futures contracts, type NG1 <Cmdty> CL1 <Cmdty> HS <Go>, as shown below. The Historical Spread function graphs the difference between the prices of the oil and gas contracts. Press <Page Fwd> to display graphs of both prices and of the spread between them. Press <Page Fwd> again to list all of the daily price data for both contracts and the spread.

SHIN PEI

For the Global Commodity Prices & Data function, type GLCO <Go>.