MARKET COMMENTARY

No. 2, 11 June 2009

Commodities Derivatives Market Value Implodes; Gold Regains A Bit of Market Share

Conclusions

There was a sharp drop in the value of commodities derivatives in the second half of 2008. This trend was obvious in the market; the size of the liquidation now has been delineated with the release of statistics on derivatives positions by the Bank for International Settlements. There also was a drop in gold derivatives value, but not as severe.

It is unknown how fast the volumes of these commodities oriented derivatives will rise in 2009 and beyond. It seems likely that demand for commodities derivatives will rise, since institutional investors remain keenly interested in a range of commodities and derivative financial instruments are the primary investment vehicles available for buying exposure to commodities. Fund managers may be more cautious in the future, however, having suffered losses in these derivatives in the second half of 2008.

Gold accounted for nearly half of all commodities derivatives as recently as the late 1990s. While the volume of gold derivatives has risen at very high rates over the past decade, there was an even larger explosion in non-gold commodities derivatives, which reduced gold's share of the market. The liquidation of positions in the second half of 2009 was far larger in other commodities than in gold, which boosted gold's market share slightly.

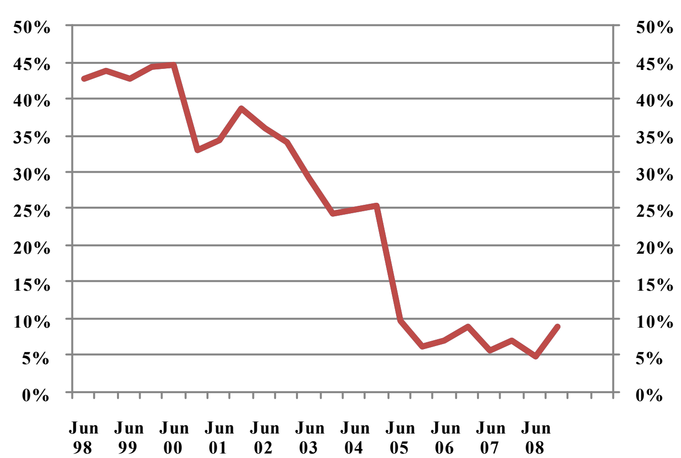
Background

The BIS collects and distributes data twice yearly on the international markets for all types of derivatives, including credit, currency, equity, gold, and commodities. The most recent data, through December 2008, was released in late May. As expected, it showed a decline in the total value of financial derivatives outstanding, on a notional value basis. The gross market value of all derivatives actually rose during the last six months of 2008, as a consequence of the sharp increase in private sector borrowing costs, the decline in the value of the U.S. dollar, and other market changes.

Regarding gold and commodities, the BIS statistics show that the notional, or face, value of commodities derivatives plunged much more sharply than that of other financial assets. Many of these positions were liquidated involuntarily, as credit lines for either the funds holding the derivatives or the banks that had issued them were withdrawn or reduced. This, along with the sharp declines in most commodities prices, caused the value of commodities derivatives to be cut more than two-thirds.

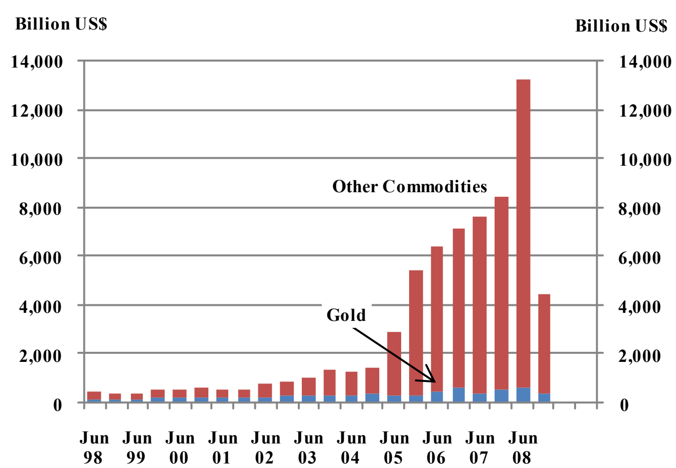
The value of gold derivatives also fell, but much less than the decline in derivatives written on other commodities.

Gold Derivatives as a % of Total Commodity Derivatives



Source: Bank for International Settlements

Notional Amounts Outstanding of OTC Commodity Derivatives



Source: Bank for International Settlements

Going forward, it will be critical to see the extent to which institutional investors, and the commercial banks' proprietary trading desks and asset management operations return to gold and commodities over the course of 2009. There are no statistical data available yet to confirm it, but price and trading volume behavior in many commodities markets suggest that these investment operations are returning to commodities, although perhaps not with the vigor they demonstrated when they were building historically enormous positions from 2004 into the middle of 2008.

Nonetheless, a revival in commodities based derivatives should be expected over the next two years. If it is less dynamic than the surge from 2004 into the middle of 2008, that may reflect the fact that many institutional investors are smarting from the liquidations of the second half of 2008. Their interest in commodities remains, however. Insofar as institutional investors want exposure to commodities, some form of derivatives securities, whether futures, forwards, indexed notes, or other products, are the only way for them to build significant positions in most commodities. They can easily buy and store physical precious metals, but these are the exceptions. For most commodities if an institutional investor wants to build significant exposure it needs to accept and work with the risks related to commodities-linked derivatives.

Financial Derivatives

The decline in the value of all derivatives during the second half of last year was the first time a decline was regis-

Commodities Derivatives Markets
Notional Values, Billion US$

	Gold	% Change Year Ago	All Other Commodities	% Change Year Ago	Total	% Change Year Ago	Gold as % of Total
Jun 98	193		258		451		42.8%
Dec 98	182		233		415		43.9%
Jun 99	189	-2.1%	252	-2.3%	441	-2.2%	42.9%
Dec 99	243	33.5%	305	30.9%	548	32.0%	44.3%
Jun 00	261	38.1%	323	28.2%	584	32.4%	44.7%
Dec 00	218	-10.3%	444	45.6%	662	20.8%	32.9%
Jun 01	203	-22.2%	387	19.8%	590	1.0%	34.4%
Dec 01	231	6.0%	367	-17.3%	598	-9.7%	38.6%
Jun 02	279	37.4%	498	28.7%	777	31.7%	35.9%
Dec 02	315	36.4%	608	65.7%	923	54.3%	34.1%
Jun 03	304	9.0%	736	47.8%	1,040	33.8%	29.2%
Dec 03	344	9.2%	1,062	74.7%	1,406	52.3%	24.5%
Jun 04	318	4.6%	952	29.3%	1,270	22.1%	25.0%
Dec 04	369	7.3%	1,074	1.1%	1,443	2.6%	25.6%
Jun 05	288	-9.4%	2,652	178.6%	2,940	131.5%	9.8%
Dec 05	334	-9.5%	5,100	374.9%	5,434	276.6%	6.1%
Jun 06	456	58.3%	5,938	123.9%	6,394	117.5%	7.1%
Dec 06	640	91.6%	6,475	27.0%	7,115	30.9%	9.0%
Jun 07	426	-6.6%	7,141	20.3%	7,567	18.3%	5.6%
Dec 07	595	-7.0%	7,860	21.4%	8,455	18.8%	7.0%
Jun 08	649	52.3%	12,580	76.2%	13,229	74.8%	4.9%
Dec 08	395	-33.6%	4,032	-48.7%	4,427	-47.6%	8.9%
Compounded Growth Rate							
Dec 1998 - June 2008		12.9%		46.2%		39.1%	
Dec 1998 - Dec 2008		7.3%		29.6%		24.0%	

Source: Bank for International Settlements, CPM Group

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tered over a six-month period since the Bank for International Settlements began collecting and publishing data on derivatives markets in 1998. Most derivatives are based on interest rates, although foreign exchange, equities, and commodities all have significant derivatives markets based on them.

The notional value of all derivatives declined 13.4% from $683.7 trillion at the end of June 2008 to $592.0 trillion at the end of December 2008. The relatively small size of the decline may surprise many market observers and commentators: Many market commentators repeatedly wrote about a more severe contraction of credit and liquidity in international financial markets last fall. Part of the explanation lies in the fact that these statistics are for the end of December; by that time some of the markets already had stabilized from their worst conditions in October and early November. CPM Group had estimated that there had been a 10% contraction in financial assets during the second half of 2008.

While the face value or notional value of all financial derivatives dropped 13.4% during the second half of last year, the gross market value — this is the cost of replacing all existing contracts at any given time, given market prices — actually rose sharply, by 66.5% from $20.4 trillion at the end of June 2008 to $33.9 trillion at the end of December. The fact that the gross market value, or replacement value, of these positions was 5.7% of the $592.0 trillion notional value is important to note, as market commentators who painted catastrophic visions of the collapse of the world's financial system made a great deal out of the enormous size of the notional value of derivative markets.

Commodities

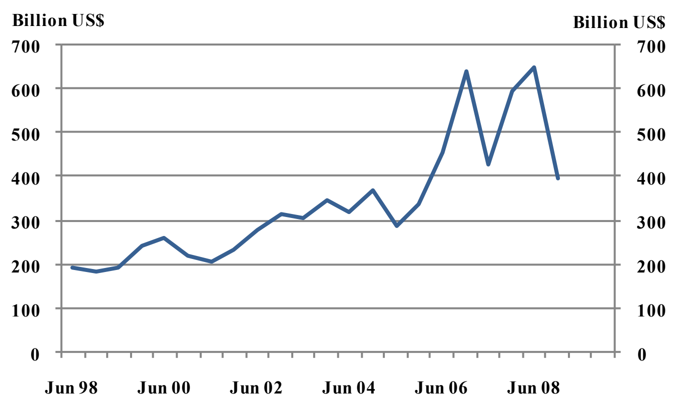
Commodities represent a very small portion of the total derivatives markets. Total commodities declined 66.5% in the second half of last year, to $4.4 trillion. Of that, nearly $0.4 trillion were derivatives based on gold. Gold derivatives had fallen 39.2%, while non-gold or other commodities derivatives had contracted in value by 68.0% to $4.0 trillion.

As recently as 1998—2000, when concrete data on the size of the over the counter commodities derivatives markets first became available, the lion's share of this market was dominated by gold. While gold only represented perhaps 1% of the dollar value of the world's physical commodities output, it accounted for 42% - 45% of the value of derivatives securities based on commodities.

This enormous disparity reflected two fundamental distinctions between gold and other commodities. First, gold was, and still is, primarily a financial asset. It trades more like a currency or a U.S. Treasury security, with an enormous volume of paper futures, forwards, options, and gold -linked notes and bonds written against it.

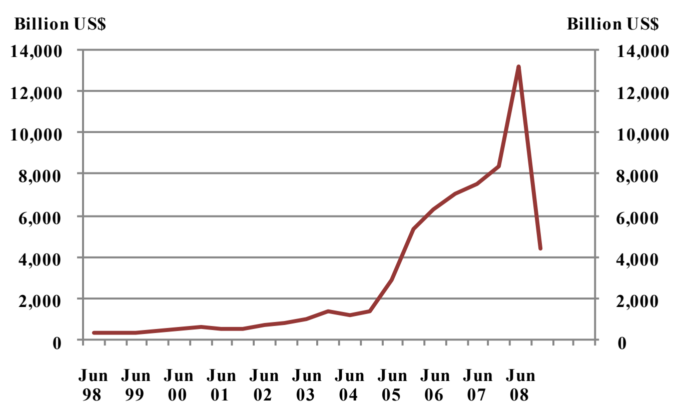
Other commodities, at least until a couple of years ago, did not trade in this way. If gold had a ratio of derivatives to underlying physical supply flows of 100:1, other commodities are estimated to have had ratios closer to 10:1. The second factor is that while gold had this tremendous volume of trading, investing, and speculative activity around it, other commodities did not. Most other commodities were largely ignored by investors around the world. Also, it should be noted that 1998—2000, the first few years for which the BIS data were available, was the depth of the bear market for commodities. While this was devastating for gold at that time, it was even more negative for other, industrial commodities, which were seen as

Gold OTC Derivatives: Notional Value Outstanding



Source: Bank for International Settlements

Non-Gold Commodity OTC Derivatives: Notional Value Outstanding



Source: Bank for International Settlements an investment wilderness.

From late 2004 until the middle of 2008 there was an enormous flood of investor money into commodities investments. Even as the volumes of gold derivatives were expanding at double-digit rates, the size of the non-gold commodities markets was growing several times faster. From December 1998 through June 2008, the peak of the commodities markets last year, the compounded annual growth rate of gold derivatives was 12.9%. Derivatives written on other commodities meanwhile expanded at a 46.2% compounded growth rate.