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In Mystery Cotton-Price Spike, Traders Hit by Swirling Forces

By ANN DAVIS
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Alarm over the price of oil has sparked controversy over the role of "speculators." But it's an unusual and damaging price spike this year in a different commodity, cotton, that has market watchers scratching their heads.

Waking up on March 3, cotton merchant Alan Underwood in Lubbock, Texas, flipped on his computer and got a shock: In the middle of the night, cotton had soared, to far above the price at which he had agreed to sell some.


Alan Underwood

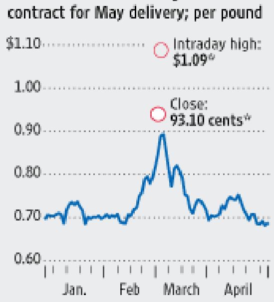
He frantically called his contacts in the markets. "I couldn't find anything, no news at all, to change the fundamentals of the cotton business," he says. Yet by day's end, prices on the usually staid market had leapt 15%, and the next day 16% more, before falling back. Investors faced two bleak choices: Come up with far more cash to keep the losing bets on, hoping for a turnaround, or unwind them for steep losses.

The sudden price jump has had lasting effects. By hurting traditional users of cotton futures and forcing them to curtail trading, it continues to hamstring a market on which farmers, merchants and processors rely to hedge risk. The dislocation is fueling arguments both about what caused the spike and about oversight of the market for futures, which are contracts to buy or sell something at a set price on a set date.

Many in the old guard blame billions of dollars in new bets by big institutional investors for distorting prices; some cry market manipulation. The Commodity Futures Trading Commission is conducting an investigation of whether cotton prices were "artificially inflated."

The probe isn't complete. But a Wall Street Journal examination of the March events reveals how several unusual factors merged to cause a damaging upheaval:

Cotton Puff
A sudden surge in cotton prices disrupted trading and has spurred a regulatory investigation.
IntercontinentalExchange contract for May delivery; per pound



*March 3 close and March 4 high were on options-market 'synthetic futures'
Source: Thomson Reuters Datastream

First, after new financial investors poured into their market, some cotton merchants themselves traded more aggressively. Adding to their vulnerability was the abolition, that very day, of their usual source of market insight: floor traders.

Another blind spot was the growing off-exchange trading by hedge and pension funds, a force the CFTC can't fully track. In the midst of this brewing storm, a little-used exchange rule suddenly kicked in, blindsiding merchants and then forcing them to unwind sell orders with a torrent of buying totally unrelated to supply and demand for cotton.

The price spike was extraordinary because U.S. cotton inventories were at their highest in four decades, and the housing slump weakened sales of towels and other fabrics. Global supplies were also high, buoyed by better farming techniques in India.

Cotton is one of the smaller commodity markets, its $16 billion in futures and options contracts dwarfed by oil's $440 billion, according to a June Barclays Capital estimate. But some big investors saw cotton as due for a rally. Art Samberg of hedge fund

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Pequot Capital Management, for one, recommended cotton in Barron's in January 2007.

Some investors reasoned that farmers would divert cotton acres to food crops like corn at a time of rising food prices. Others figured costly oil would push up the price of a petroleum-based competitor of cotton, polyester.

Shippers and brokers say a trader at Pequot, Lewis Johnson, began attending industry conferences around the world, displaying a deep command of data on inventories, farm output and textile trade. They began calling him "Jet Boy" after, they say, he boasted over drinks he would make enough from cotton bets to travel by private plane. Mr. Johnson, who left Pequot in November, didn't return calls seeking comment. Pequot's cotton bet "worked out very well," says the fund's chief investment strategist, Byron Wien.

The market had long been dominated by industry players such as cotton merchants, who buy farmers' growing crops and sell futures to lock in a profit. But this year, merchants stepped up their own trading, partly because there was a record crop to hedge. By late February, merchants held more than twice as many contracts to sell cotton as at that time in 2007 and 2006, says Jeffrey Korzenik, a money manager who has analyzed CFTC data on the cotton market.

Jump in Buying

While they were selling, institutional investors were buying. Their bullishness rose after a crop report in February said U.S. farmers would plant the fewest cotton acres in 25 years. The investors poured new money into bets on indexes representing baskets of commodities. A Schroders PLC agricultural fund raised $2 billion more in January and February.

COTTON CHART ART

From its high of $1.09 a pound on March 4, cotton has since tumbled to 67.28 cents. After the spike, two crudely illustrated charts made the rounds among traders.

WSJ reporting

In one, traders drew a shark with some of its teeth formed by the cotton price's jagged spikes. "The ICE Shark," they call it.

WSJ reporting

The other features a ship hurtling toward an iceberg. It's labeled "COT-TANIC."

CFTC data show an eightfold jump in net buying from Feb. 19 to Feb. 26 by classes of investors that include pension funds and hedge funds. They also made many bets that would work only if cotton prices climbed sharply, according to options brokers and data from the operator of the cotton exchange, IntercontinentalExchange Inc., or ICE.

In February, cotton futures rose 18%. The contract for May delivery stood at 81.86 cents a pound at month's end. At that point, the ICE, which had bought the old New York Board of Trade, ended a 138-year-old tradition of floor trading in the cotton pit.

The next Monday, March 3, it switched to all-electronic trading, which then began at 1:30 a.m. Eastern time. Between 1:30 and 4:33 a.m., May cotton shot up three cents a pound -- the limit the futures contract could rise that day under ICE rules.

When U.S. traders awoke, phone lines were soon abuzz between New York and the cotton-trading hub of Memphis, Tenn. Frantic investors wondered where the price pressure was coming from. But with no more floor traders to consult for scuttlebutt, they were in the dark.

The futures market was dormant because the cotton contract had moved by its daily limit, but the ICE's options pit would soon open. It offered a way to keep trading. Options offer their purchaser the right to buy or sell something at a certain price in the future. Traders can duplicate the purchase of a futures contract by acquiring an option to buy cotton at a given price and selling someone else the right to sell cotton at that same price.

Such combo trades are known as "synthetic futures." On March 3 and 4, they tripped up unwary cotton merchants.

Commodity investors trade on margin -- that is, put up only part of the cost of the trade, usually 5% to 10%. If the price moves against them, they face a margin call, or demand for more cash collateral. The more the price moves against them, the bigger the margin call.

Exchange Rules

What some merchants didn't focus on was a rule that allows the exchange to use the options market's synthetic futures to decide what cotton's price is at the end of a day, for purposes of determining margin. Merchants had been among those supporting adoption of this rule back in 2003. The problem: The options market doesn't limit how much prices can move.

When the options market closed in midafternoon, the ICE jolted traders with an announcement: The day's price of the May contract was 93.90 cents -- 12 cents above the prior Friday.

Traders faced huge margin calls from clearing brokers, the firms that execute their trades and stand behind their obligations. Traders had to put up four times as much new money as they typically would need to in one day. All afternoon, traders shuttled in and out of meetings with incredulous bankers, with only hours to obtain giant new loans or have their trading positions closed out.

Margin calls ran to hundreds of millions of dollars collectively for large merchants, including Memphis giants Dunavant Enterprises and the Allenberg Cotton Co. unit of France's Louis Dreyfus Group, according to people familiar with the matter. Dunavant and Allenberg declined to discuss their trading.

Events in other crop markets heightened the crisis. The week before, several wheat markets had seen huge spikes. Agricultural lenders had provided merchants with large amounts of credit. With cotton now spiking, they were leery -- so unsure of cotton's value that they wouldn't accept additional physical bales as collateral.

'All Insanity'

By the next morning, March 4, merchants who had maxed out their credit prepared to exit their futures trades via offsetting options trades. Since the trades they had to unwind were sales of futures, to get out of them they were forced to buy futures, en masse. At 10:56 a.m., the barrage of forced futures buying drove May cotton to $1.09 a pound, even though cash cotton was in the mid-60-cent range.

"I was thinking that it was all insanity," says Mr. Underwood, the Lubbock merchant, whose phone was ringing with calls from desperate friends and trading rivals. "There was simply too much cotton in the world" to justify the price, he says.

He sent his clearing broker less collateral than it demanded and warned it to keep careful documentation if it liquidated his positions. "If I was going out, I was not going quietly," he says. The clearing firm refrained from forcing him out of the market. As the price began dropping the next few days, his finances recovered, although his business remains below what it was.

Others were less lucky. A Lubbock competitor, family-owned Canale Cotton Co., unwound its positions and bore a loss of some $2 million, family members confirm. Paul Reinhart AG, a 220-year-old Swiss trading firm, also took a large loss exiting its trades, people familiar with the firm say. It declined to comment.

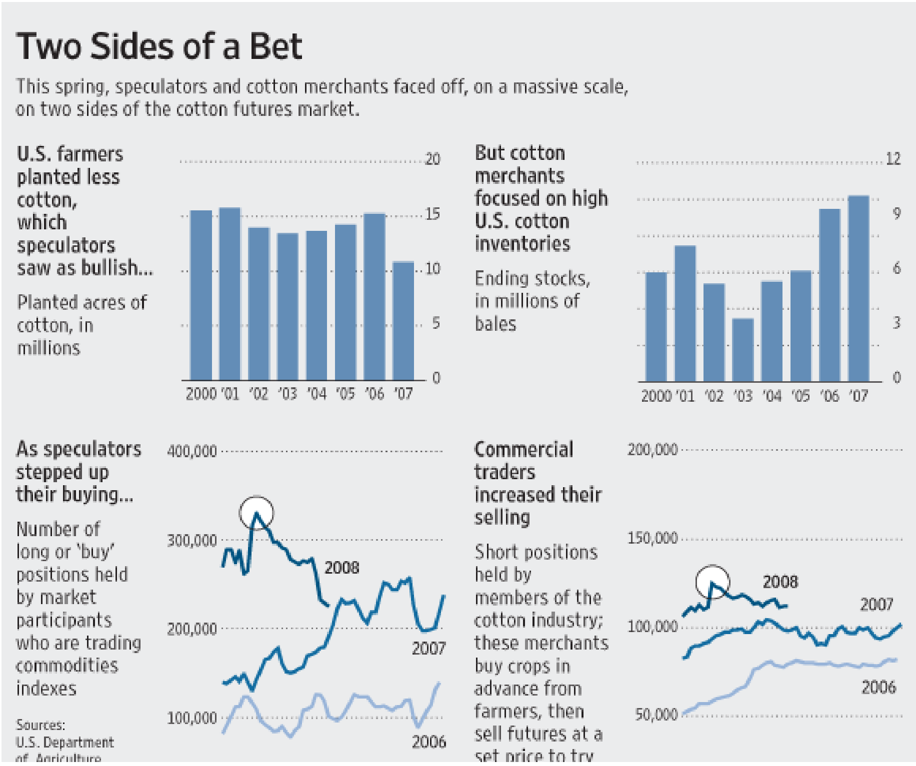
Cotton-industry groups attacked the ICE for saddling them with such high margin requirements on March 3 and 4. The exchange says its move was "based upon a published, transparent set of rules" adopted with the input of industry groups.

For investors in the publicly held ICE, volatility was a boon. The ICE says that "extreme volatility does not inherently indicate a problem with the function of the market itself."

But it has changed the rule that led to the extraordinary margin requirements March 3 and 4. The ICE now will base margins on the daily-limit price move in the futures markets.

Angry Merchants

Later that March week, in Washington, angry merchants confronted the acting chairman of the CFTC, Walter Lukken. Some participants say the agency indicated it hadn't noticed any problems brewing before prices soared. In June, Mr. Lukken said there was concern at his agency "that the fundamentals of the cotton market didn't readily support the runup in prices."



The CFTC can't track all commodities trading. A large part of it occurs off-exchange, as Wall Street firms execute private contracts called swaps with institutional investors, allowing those investors to bet on futures without directly trading them. The Wall Street firm then buys or sells futures or options itself, to offset the risk it has taken.

This system means hedge funds and their ilk can avoid exchange limits on

the size of their bets. Wall Street
firms, by contrast, are allowed to trade in large quantities because the CFTC regards them as commodity dealers.

The system also means that part of hedge and pension funds' buying gets lumped into the category of buying by "commercial traders." Thus, the presence of financial buyers and sellers, sometimes known as "speculators," is partly obscured.

Writing to a House committee last month, the ICE said a review of nonpublic cotton-trading data found "no significant or unusual buying activity" by financial investors, and thus the data don't support assertions "that these traders acted individually or collectively to manipulate the price of cotton futures in the Feb. 29-March 4 period."

The ICE looked only at those days. Its letter didn't concern late February, when CFTC data show higher-than-normal futures selling by merchants and far higher buying by financial investors.

The ICE also sent the letter without consulting the CFTC. That regulator says its own investigation of the two-day March cotton spike is continuing.

Fallout has been significant for farmers, traders and textile mills. Many cotton shippers are no longer bidding for crops months before harvest and thus are rendering futures markets less effective as risk-management tools, Undersecretary of Agriculture Mark Keenum told the CFTC in April. That situation continues.

And the prices of cotton? After touching $1.09 a pound in the tumult of early March, it closed Tuesday at about 67 cents.

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