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Trader's system says commodities are ready to run-up, for a change

Loaded Guns

An Interview With Michael Williams ◦ The proprietor of Genesis Partners, a commodities research boutique, and Genesis Trading Group, both of which just hitched up with the Price Futures Group in Chicago, started out trading stocks. Mike picked up his Series 7 securities license in 1982 at the tender age of 22, quickly set up his own investment firm, managed

portfolios for wealthy individuals and institutions and did mega-deals. But even though he's kept his hand in equity management - since 1990, his research has been riveted on commodities, which means this awesome bull market in stocks has largely passed him by. But, insists Mike, the research he and partner Mike Ferguson have done in the interim has positioned them to catch the next big wave. Would you believe in commodities? Read on.

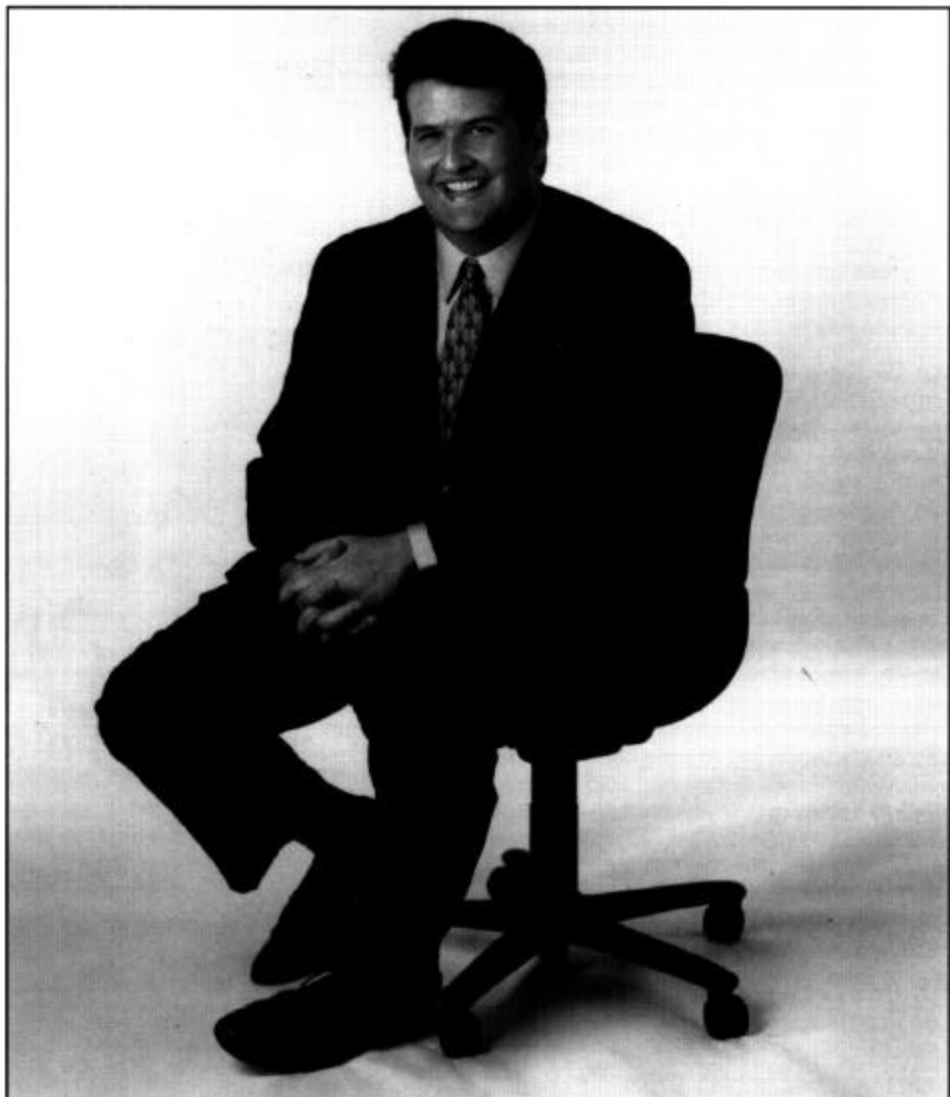
- Kathryn M. Welling

Barron's: *Just what is Genesis Partners, Mike?*

Williams: Genesis, for the last 10 years, primarily has been a research effort. I have done all the backlogging of data and research necessary to refine our method of comparing certain data streams, so that we can understand and help traders and/or investors understand - how commodities trading can be used on a regular basis in their investment portfolios. In a larger sense, our primary focus has been on figuring out what makes commodities markets move in trends; how you can find that information, and creating a way to project what is most likely to happen next. While that has taken a great deal of time, we have been able to catalogue a number of very clear-cut signals that go into analyzing the underlying supply and demand, which - in commodities - is the primary issue. In that sense, the commodities markets are a little different from stocks and bonds, where we can always print more paper or have another company go public: Only a certain number of soybeans are grown.

Q: So you're tracking crop reports, weather patterns and such?

A: Not at all. What Genesis has been able to do is create a process through



Photographs: David Barnes for Barron's

which we can now track, every day, what the major investors in the commodities markets are doing - so we can understand the supply and demand situation in any commodity market - and therefore

understand where we want to take our investment risks.

Q: Nice theory. Bid how does it work in practice?

(over please)

A: I have been using it for quite a while for myself and for a few private accounts - using it more in what I call a campaign style, where you may not be trading every day - in fact, most of the time you are not. But we've used it a few times to establish metals positions. We've done it a few times in grains. We've done it a couple of times in the bond market. Still, trading hasn't been our main focus research has been. Now we have a broad enough base of data that we can sit down with just about any type of investor, understand his or her goals and then show them how to understand the data and use it advantageously.

Q: If it's such a great system, why are you still working for a living?

A: An excellent question. I believe it is and we are - that good, but only because we've spent these 10 years researching the data. The commodities business is a different kind of game than stocks and bonds. You have to do a lot of research. Now, I will say this, for the past six months the principals here at the Price Group have watched all of our data. While they didn't trade large accounts, they used it to trade with their own money and the returns have been substantial - which is kind of why we merged.

Q: We have to ask. Your background is in equities. Why in the world have you spent the last decade researching commodities - in the midst of the most marvelous bull market ever in stocks?

A: Another good question. I did well during my time and still invest in stocks and bonds. All three asset classes can usually be used quite well together in portfolios. But I've always been fascinated by the thing that everyone hates. Being contrari- in perspective, it's dynamic to watch these two asset classes work against each other. In the mid'Eighties no one thought we'd ever again see no inflation and interest rates of 5%. If you had told someone that in 1984, they would have thought you were nuts. Which is what they think today when you tell them something different than that inflation is a non-event. But our research is telling us that we are at a real inflection point.

Q: How so?

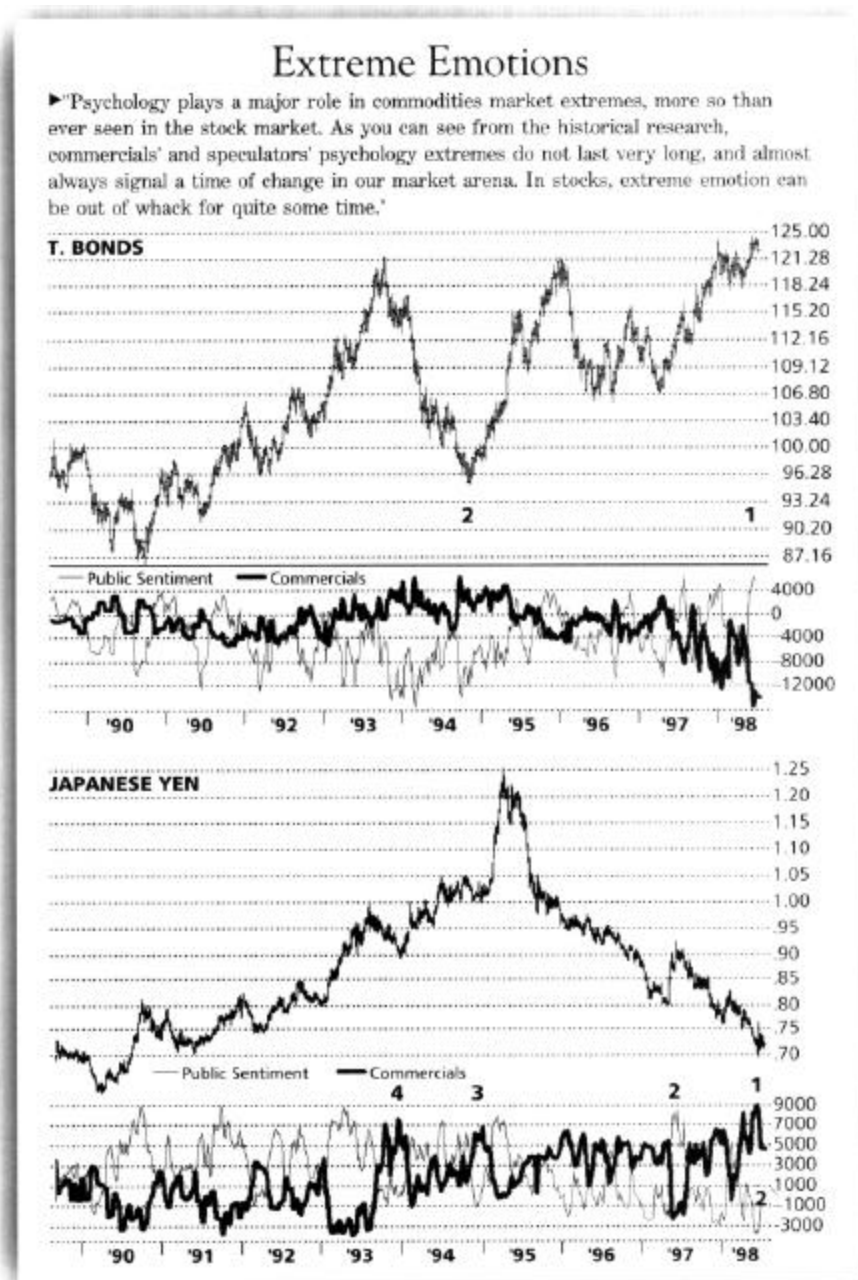
A: There's a true sense of change happening in the underlying mechanisms that make these markets work. Where you might think inflation is dead because of all the news stories saying that it is, those are basically just reports of what has happened, not what is about to happen, or what's going to happen next. In the 1980s, you thought inflation was never going away; now you certainly don't think it is coming back. But 15 years from now, people will not be checking their mutual funds. They will be checking how much soybeans

are selling for. This very interesting change is happening right now - quietly. Just like we didn't wake up 10 years ago to find interest rates were low. It starts slowly when no one thinks about it. Today, for example, commercials have never been more short bonds. Yet everyone in the world will tell you interest rates are going down.

Q: Commercials? You're not talking about the sort on TV, we take it.

A: No. This gets to the heart of reason commodities are different than stocks or bonds. Why it's a different kind of game. Someone uses every single thing that is grown, or mined, or somehow brought out of the ground. Which means that you

can understand the value of that real asset -determine what the demand for it is - by watching what the major users are doing with it. They are the commercials. What's more, there is no other market, no other asset class, as dynamically related to mass psychology. What our research has shown us is that mass psychology in the speculator camp is almost always incorrect in commodities. By contrast, mass psychology in the commercial camp is almost always correct. In other words, when the small traders and the hedge funds are extremely bullish, that's almost always when the commercials are very short. Because the commodities business is a zero-sum game.





Q: B-y definition.

A: Right. But think of psychology and emotion as the driver, the gasoline of the buying or selling decisions in a commodities market. Eventually, when every speculator is bullish, there is no more gasoline left. There is no one left to buy the next contract. And since the commercials have sold all of the contracts the speculators have bought, the pressure is on. No one can keep up against the commercials. There is not a group of speculative traders that has enough money to fight a commercial position. What is so fascinating about this is the psychology. While most people naysay the role of emotion, we've developed a very dynamic set of statistics that show that speculators make their choices about what they buy and sell in commodities on emotion - and that's why most of them lose money. They make the decision to buy based on emotion. They get out of the position based on emotion. And usually it's incorrect.

Q: What statistics?

A: The data streams we've put together in our charts, which show, for the last 10 years, every time commercials and speculators/hedge funds have been on opposite sides of the market. The top lines on the charts trace the commodities prices, the bottom two lines track the commercials' - the heavy black line - and the speculators' positions. When they get to extremes, we know that market is about to change - at least, that the odds are very high that it's ready to change. Not overnight. We don't catch these things on the day they happen, but we do catch the trend. We can see what is going to happen next. And these trends typically last from three months to a year, maybe two, depending on the market.

Q: Why do emotions hold such sway?

A: That is important for the trader to understand. The fact that emotion drives the speculator is a complete result of the leverage in a commodities contract.

Let me put it in terms stock traders will understand. Let's pretend for a second that I could buy Citicorp tomorrow, and let's assume it's trading at \$100 a share. Let's also say that my broker will allow me to buy Citicorp for three bucks. Now that's leverage, 30-to-1 leverage. Well, let's pretend that tomorrow the price of Citicorp goes down by \$3. I've lost 100% of my money. What people don't understand - they hear commodities and they think, "Oh, my gosh, you can lose all your money." Well you can - but as a result of leverage, not because the commodities market is that different from a stock or a bond. If you could employ the same leverage to buy stocks, the risk would be identical. It's the leverage that is the danger. That's what people need to understand. Our research shows that if we combine money-management techniques to tame the leverage with our data on the commercials versus the speculators, we have a reasonable way to manage capital in commodities markets.

Q: What about worrying about freezes in Brazil, or droughts in the Great Plains?

A: That's the fascinating thing about it. We're entering the freeze-risk period in Brazil right now. But we don't have to worry about what that means for the supply/demand balance in coffee - all we need to do is follow the commercials. And right now the commercials are holding a multi-year long position in coffee. Which is telling you that the data they follow imply a risk to growing conditions. Because they are buying coffee at these lows in prices. So I don't need to have 50 weather guys and four geologists and a whole staff of people following the growers of coffee or the miners of copper. What I do is follow the data on the commercials. Say to myself, okay, if the guys who actually use coffee every day are taking their buying of this market to extremes, and if, at the same time, the speculators are short, then I want to be on the opposite side of the market from the speculators. I want to be long coffee, or I want to be looking for low-risk entry points. Because the next likely trend in coffee is not down, it is probably up. You won't hear about weather scares until the market actually rallies. By then, it'll be too late to be buying coffee. You want to be buying it when no one is talking about weather scares. Just like grains. Just a few weeks ago, no one was talking about weather problems. Yet only days after we got our latest very bullish data on commercials' positions in grains, soybeans rallied over \$4,000 a contract inside of 10 days. So you don't have to worry about hundreds of different pieces of data, just what the commercials and speculators are doing.

Q: "Just." How do you track what commercials and speculators are doing?

A: In part, by reading *Barron's* statistical section. Every two weeks the government requires all commercial users of commodities to report what contracts they hold. They have to tell exactly what they've sold or bought, the government accumulates the data - and you print it.

Q: You assume that speculators hold everything that's left over?

A: Yes, but our speculator data stream is a proprietary combination of that calculation, which we do by using the information in your pages, with data on the large hedge-fund positions, which aren't normally reported in the press, and some proprietary data on the mass psychology of the very small trader. So our speculator data stream is basically a connect-the-dots theory. But if you take a long period of time and watch the ebb and flow of the commercial and speculator positions, you can see the extremes in emotion set up very easily.

Q: Can you be a little more specific about how you gauge speculator sentiment?

A: We deal with a whole series of outside contractors, who literally go from one end of the spectrum to the other of ways to understand what the small trader is up to. Some of the psychology-driven data sources actually sample, every day, 200 or 300 traders across the country. They literally go down a checklist:

"How do you feel about corn today?"

"Well, I feel bearish or bullish."

But you'll get some markets - like coffee right now - where they say, "Don't even talk to me about coffee, I hate that market."

Well, when the speculators hate a market and the commercials are long, we want to be looking for an entry point to buy. That's what we see as a loaded gun for a change in trend. At any one point in time you may have half a dozen of those unfolding. What this proves is that trading on emotion is exactly the wrong thing to do. You must trade on a fundamental understanding of the position of the market. If you cannot do that, you might as well go to Vegas, where you'll have a little more fun losing your money. Nonetheless, Mike and I have watched, for years now, as speculators literally kept fighting a war they can't win.

Q: Why is that?

A: I think it has to do with the emotional makeup of a trader, when he's in a position that isn't working. The one thing it's difficult for the speculator to do is admit that he was incorrect. I mean, he becomes married to a position in the commodities market much more strongly than he becomes married to, say, IBM.

Q: Because of the mesmerizing effect of leverage?

A: Good point. What I've observed is that a trader will do a lot of work to decide if soybeans are a good buy at \$5.25 a bushel. Once he's decided that's a good value, he's made a subconscious decision that soybeans are the right thing to invest in. If he's not willing to admit to being wrong, what does he do when they hit \$5? Unfortunately, the small trader most of the time decides beans are an even better value, and buys more. Quite rapidly, the financial pain turns into emotional pain and becomes quite awful, because of the leverage. And when they get emotional, I can't tell you how many times they'll sell right at the bottom. The most difficult thing for most traders to do is to cut their losses when they're small. That's why a very common mistake people make is going into the commodities market with the idea, way in the backs of their minds, that just like Uncle Harry - or better yet, Mrs. Clinton - they'll turn \$1,000 into \$100,000 in a trade or two. They think it's almost like the lottery, yet the true odds of it happening are like those of winning the lottery - almost zero. So they hold on for the wrong reasons, buy and sell for the wrong reasons. The easiest way to deal with that difficulty is to decide before you make your trade - that you're willing to lose X-dollars to find out if you're correct. Because the commodities game is a game of staying alive. If you lose all your money in two trades, you didn't give yourself a good chance of succeeding. And - I can tell you - even with the best research, most of your trades will still get stopped out at a loss. It's just the dynamic of the market. You have to be able to say, "I'm willing to take small losses to stay alive for the possibility of the future big gain."

Q: Are you implying that even when you see speculator and commercial positions at extremes, you can't tell when - or at what level - a price trend will reverse?

A: Commodities prices can take volatile swings and the trends can take a long time to unfold. The reason is that the commercials are taking positions based on the supply and demand fundamentals of the commodity. They don't particularly care about price. They're not there to make money on cattle. They're there to buy it when it is valuable because they know what their clients are demanding and what the available supplies are. Whatever the price, they are going to pass it on to their customers. So only the speculator is buying a commodity based on price. And there are only four possible outcomes in a commodities trade: We can lose a great deal of money. We can lose a little bit of money. We can make a little bit of money. Or we can make a

very large sum of money. So the first thing we've structured our research to do is negate, as much as possible, the possibility of losing a lot of money. If we can do that, the odds are very high we'll be successful in the long run. We can take small losses because the small losses will be offset by the small gains. Then we'll be around to catch the trends, which we know exist. So we don't take a position until these emotional extremes set up on the charts. And even when they do, still use very short-term entry techniques to trade. For example, after our charts showed the emotional extremes setting up in the soybean market recently, we entered the market three different times - and got stopped out three different times for very small losses before we finally entered at the right time and made those losses back, plus three times as much, in very short order. So clearly, once you have the loaded gun, you have to be willing to practice very dynamic risk management. Commercials can be long for a long time before the market turns around - and if the market sinks another 10% in the interim, the leverage inherent in commodities contracts could kill me. I'd rather get stopped out for a small hit, clear my senses, look at the market again for another entry point.

Q: Then your indicators tell you nothing about timing?

A: Not nothing. The longest I've ever seen something go before it turned in the direction of an extreme long or short position by commercials is probably 90 days. An interesting thing about the commodities markets is that they spend a good part of their time in range-bound trading, at a top or a bottom. Then they'll rapidly move between the two. When a trend starts, it moves fast, which is why you have to get positioned ahead of it.

Q: Where are your charts telling you the next major moves will come?

A: What our research is beginning to tell us is that all of the stories about no inflation and continuously dropping interest rates are about to prove fairy tales. We've reached the trough in psychology about inflation now - the opposite of that extreme back in the mid-'Eighties. Now the theory is that productivity will lick inflation forever. But what I'm here to tell you is that while I'm no wizard, and Mike and I don't know anything more than anyone else could, if they studied it long enough, there is something different taking place here.

Q: But virtually every commodities market is still trending down, much as it has been for at least the last decade.

A: What's different is that on all these lows, almost across the board, the commercial users are buying more than they have ever bought - and they are selling bonds. I'm no market guru, but I can tell you that's not a good sign for the bull market in stocks. Our charts show commercials selling more bonds than they have in 12 years - at the same time the financial press is telling us that rates are going to 5% or even 4 1/2%.

Q: Not all of it. But so what?

A: I like that - I can't tell you how many times the press chorus has gotten loudest, just as the market's direction was about to change. Meanwhile, what's fascinating here is that this short in bonds by commercials isn't just a fairly large position, this is a huge position. As you can see on the chart, it is about twice the size of their largest short position in the last 10 years. That's a pretty strong statement about interest rates.

Q: The butt market in bonds is kaput?

A: I can't say that. The chart could be pointing to a change in the direction of rates that lasts only four or five months. This could be a four-point correction in bonds - on their way to 3%, who knows? But the position of the commercials says that they don't see rates going to 4 1/2% right now. They may go back to 7% first. I'm not calling an interest rate here.

Q: It sure sounds like you are.

A: What I'm telling you is that they are putting their money on interest rates going up, for the foreseeable future, until they change that position. And I wouldn't bet against them and hope the commercials are wrong.

Q: So, you are short bond futures?

A: Yes. In fact, we shorted them up at 123.26, to be exact, which was about a point off the high. Not only are the commercials extremely bearishly positioned, but speculators have only been this bullish on one other occasion - and they were wrong then. So I would not be going long bonds today. There's just too much evidence that you either stand aside or go short. This is not going to end well for bonds. And until bonds trade back above their high, say clear 125, this signal won't be negated.

Q: And you see similar disparities in the commercials' and speculators' positions in other commodities?

A: Yes. Take the deutschemark, which has just experienced three or four little legs down. We were looking for that move a month ago. It happened almost on cue. There's been hardly any notice of it, but it amounts to several thousand dollars a contract. We knew the odds were good for a good move when the commercials reached a 10-year extreme in being short the deutschemark about six weeks ago, while the speculators just loved it. Now they are not buying it any more. In fact, they are selling it probably at a bottom. The even bigger story is what's going on in the yen.

Q: The intervention, you mean?

A: Well, it's interesting that while many market watchers say the yen went up because [U.S. Treasury Secretary Robert] Rubin stepped in and protected it, our research says that's putting the cart before the horse. Long before Rubin stepped in, the commercials - who know more about the dynamics of the yen than we're ever going to know - had placed an extreme bet that the yen had gotten low enough. In five days, that move was worth over \$6,000 a contract. Especially in currencies, these moves can happen very fast. We saw the same sort of thing in silver, well before Warren Buffett's position was announced. I suspect that we've probably heard the last of the really bad news about the yen. The more people talk about how bad it can get, the more likely it is not to get worse - that's what the commercials are saying, not just in the yen, but in about every hard asset.

Q: They are?

A: Our gold chart is actually frightening to me because I like to watch the stock market go up. But our data are telling us that the commercials are very long gold and very short bonds. That tells me that they don't see these deflationary trends lasting for the next 10 years. Money is flowing into crevices that are saying interest rates might have gotten about as low as they are going to get right now. They may get lower in the long term, but not right now. And gold isn't going to \$200 an ounce. In fact, it may not go much lower than it is right now. We are long gold and profitable.

Q: What about the ag commodities?

A: The same sort of interesting picture is starting to form, whether you look at sugar or coffee or soybeans or all the grains - commercial positions at or near long extremes, while speculators can't stand the stuff. In coffee, for instance, these current price lows are being bought by the commercial users. That implies that the next trend in prices will be bullish. The same with sugar, where the move has already started. We read the commercials' position as at a long extreme when sugar was at seven cents a pound. It's already almost nine cents, producing a gain of a couple thousand dollars per contract.

Q: And oil?

A: It's funny, but the one thing that fixes low prices is low prices. A natural dynamic unfolds when a price gets too low. If I'm an OPEC country and the price of oil gets too low, I'm going to do one of two things. I'm going to stop selling it, or I'm going to have a meeting and convince all the other producers to stop selling it, too, because I can't make a profit at current levels. So we are going to stop getting so many barrels out of the ground. Then psychology changes, people start fearing a shortage and, bang, prices go up. Right now, commercials are buying the dips in oil, heating oil, natural gas and unleaded gas they're not at bullish extremes like in some other hard assets, but the speculators absolutely hate these markets. They've been beaten to death in crude for the last six months as every \$2 rally has been followed by a \$2.50 drop. It's a classic bottoming. These markets are setting up for trends to the upside, not the downside.

Q: Are you long?

A: We're long crude oil. Went long about a dollar ago. But most speculators are short - and probably will be until we get back up to the \$15-\$16 area. I'm making the bet because I can't find a place, in any market, on any chart, where speculator sentiment has been above 90%-95% in one direction where betting against their position hasn't been the right thing to do.

Q: Thanks, Mike.