Term-Structure, Basis Volatility and Speculative Demand
- Irregularities in cocoa markets –

After the burst of the dot-com bubble in 2000, financial investors in search of higher returns in a low interest environment, new hedging opportunities against inflation and currency fluctuations, possibilities for portfolio diversification, and unexplored grounds for outright speculation increasingly entered into commodity derivative markets. As a consequence, commodity markets across the board experienced an increasing inflow of financial investment. The number of commodity contracts outstanding on the exchange almost quadruple between 2002 and 2008 and the amount of outstanding over the counter commodity linked derivatives was 13 times as high in 2008 as in 2002.

This development was preceded by an increasing consolidation of downstream commodity value chains by transnational corporations. Increasing market concentration was precipitated by inter alia the sweeping liberalisation of production and marketing activities since the 1990s and a general trend of multinational corporations utilising derivative markets for strategic risk management and hence additional revenue generation. The high entry barriers to derivative market participation and the need for large amounts of liquidity in a highly volatile price environment caused many smaller companies involved in commodity trade and processing to cease business.

The paper argues that these two developments, commonly understood as the ‘financialisation’ of commodity markets, can lead to an alienation of physical and derivative markets reflected in increasing volatile market basis and term-structures. As futures markets commonly serve as a yardstick for price setting in contracts concluded in the physical market, the impact of ‘non-traditional’ speculative demand in derivative markets directly impacts cash markets. In order to disentangle the effect of the ‘financialisation’ factor from traditional ‘fundamental’ factors, a comprehensive understanding of commodity specific market fundamentals is inevitable as discussed by Rahmani. This paper suggests an alternative way, by analysing time periods in which arbitrage mechanisms failed and hence the bond between cash and futures markets disbands. The difference in driving factors underlying price discovery on both markets will then be revealed in a price spread between markets.

Such irregularities in the relationship between cash and futures markets severely impede the fundamental functions of commodity derivative markets, which are price discovery and risk management. The failure of convergence observed in many commodity markets in recent times caused hedging strategies to become increasingly costly and ineffective. On the example of the cocoa cash and futures markets in particular and the soft commodity complex in general the paper will present potential causes and consequences of these developments with special emphasis on small scale producers at the high end of the value chain.