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2011

Volume 7 Issue 2

“Money by itself doesn’t make the market move. The market has its own life that attracts or repels capital. Nowadays, it just happens with greater force.”

NEAL KOTTKE

FOUNDER AND CHAIRMAN
OF KOTTKE ASSOCIATES LLC



ON THE COVER

Beyond the immediate uptick in demand for commodities worldwide are deep structural changes in the market, providing plenty of room for the bulls to run.

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Exclusive on cmegroup.com/magazine

"Innovation" is a word that continues to generate a lot of buzz in the media. We look at some ways in which innovation has not only transformed businesses, but has also influenced the direction of civilization and improved society's collective outlook.



Craig Donohue (left) and Terry Duffy (right)

FROM THE TOP

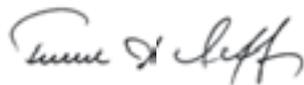
Where are commodities markets headed? While that question cannot be answered definitively, we can garner much from the underlying supply and demand fundamentals – and it appears we may be primed for an extended surge.

A fast-developing economy, such as we are seeing in China and Brazil, can largely alter the dynamics of the world's commodities landscape, even as the United States remains the prime market mover. Indeed, even amid the fluid regulatory environment, 2011 will possibly be remembered for its focus on commodity producers and consumers.

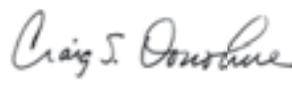
At CME Group, we remain mindful of the connection between what we do and what we make possible. Using our derivatives products, for example, farmers can lock in future prices, allowing them to plant more crops the world needs. Noted investor Jim Rogers offers some perspective on issues facing global commodities markets in 2011 as part of our cover story. Here are other highlights of what you'll find in this edition of *CME Group Magazine*:

- "The Epicenter of Energy" delves into crude oil – and uncovers several misconceptions.
- Noted scholar Dr. Craig Pirrong of the University of Houston provides a perspective on position limits.
- Kottke Associates' founder and chairman, Neal Kottke, shares his thoughts on how commodities markets have changed – and how they have not.
- "Green Exchange" explores opportunities for market-based solutions that can help curb climate change, despite regulatory hurdles.

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TERRENCE A. DUFFY
Executive Chairman



CRAIG S. DONOHUE
Chief Executive Officer





**THE
GLOBAL
COMMODITIES
SURGE:
NO
EXPIRATION
DATE?**

From Chinese and Asian demand to tight supplies around the globe, 2011 may shape up to be an historic year for commodities.





“We are on a collision course where world grain stocks are nearing historically low levels and we need the world’s farmers to plant 26 million extra acres in this year ahead.”

DAN BASSE, PRESIDENT OF AGRESOURCE CO.

THE RECENT GAINS IN COMMODITIES REFLECT A BOOM in economic growth that has consumers from Chongqing to Chicago demanding more gold, grains and gasoline. The global emergence from the Great Recession is an obvious reason for the recent strength, and it lays the groundwork for 2011 to be an exceptional year for commodities. Yet, beyond an immediate uptick in demand are deep structural changes in the market, providing plenty of room for the bulls to run.

“The rally may not be for just a year. I think there are several years ahead, given the convergence of underinvestment in capacity, the rise of developing world demand and fears of inflation,” says Dan Basse, president of agricultural research firm AgResource Co.

EAST AND WEST Scanning the landscape of demand, it is no surprise to see China as a major factor across the commodities complex. The nation is the world’s largest consumer of copper, iron ore, natural rubber and zinc. In energy, as recently as the mid-1990s, China was an exporter of oil; today it is the world’s second-largest importer thanks to

demand doubling to 10 million barrels per day in just 10 years. It is not just China’s factories that are gobbling up commodities, the country’s people are, too. As China continues to embrace the benefits of world trade, there is burgeoning demand for agricultural products, so much so that U.S. Secretary of Agriculture Tom Vilsack in February predicted China may supplant Canada this year as the primary importer of American commodities. The reason is simple: the growing Chinese middle class eats as any other middle class does, with more beef and pork on their plates. With one-fifth of the world’s population, but only 7 percent of its arable land, China is destined to be a buying force in world grains too. For the first time in recent memory, China imported corn and likely needs to boost buying to rebuild its strategic grain reserves.

While China dominates the conversation, sustained demand growth is coming from many other nations too. Indonesia, for instance, dropped out of OPEC in 2008, as domestic needs in the world’s fourth-most populous nation transformed it from oil exporter to importer. Its demand for steel and related commodities is surging as well, supporting the infrastructure expansion its annual 6-percent GDP growth generates.

Elsewhere, Brazil – once a notable corn exporter – now consumes all of its corn supply to feed a burgeoning beef industry, Basse notes. “The BRIC countries are jumping up their beef demand rather quickly and, of course, if you are consuming beef or pork or poultry, you are consuming bushels of grain turned into that,” he says.

While slower-growing, the United States remains the prime mover of the commodities markets. Adding to the natural demand from the improving American economy is the growing ethanol mandate. In the latest crop-year, the biofuel commanded a record 40 percent of corn crops. With the U.S. Environmental Protection Agency (EPA) set to expand the maximum ethanol-gasoline blend from 10 percent to 15 percent for many vehicles, crop demands will expand even further. Even Europe is legislating greater use of ethanol to reach aggressive fleet emissions reduction targets. The European Union, once able to meet its own ethanol demands, is now slated to be a regular importer from Brazil.

The recovering economy also means more pressure on metals, with the auto industry serving as a prime example. With 2009 U.S. auto sales estimated to be as much as 2 million cars below annual replacement requirements, the pent-up demand means quickening need for many metals. For instance, the average car uses 100 pounds of copper, plus

palladium, platinum and/or gold for catalytic converters, as well as increasing amounts of aluminum – trimming weight to meet efficiency standards. Here too, China is an emergent force, having recently supplanted the United States as General Motors' main market.

TIGHT SUPPLIES “The reason why we are here is not just a China demand story, it is more a production problem,” explains Rich Nelson, director of research at Allendale Inc., a commodity research advisory firm.

Bad weather is the main culprit in recent grains tightness. In particular, awful conditions slashed wheat crops around the Black Sea, with Russia's production down 33 percent in 2010, Ukraine's down 18 percent and Kazakhstan's plummeting 45 percent, Nelson notes. Other producers faced their own troubles, as crops in the United States and Argentina delivered less than estimated last year. This year, corn plantings are expected to rise, but experts expect inventories to remain tight in corn. Soybeans are not looking any better, as analysts at Minnesota's Country Hedging predict U.S. soybean stocks to fall to 35-year lows.

“We are on a collision course where world grain stocks are nearing historically low levels and we need the world's farmers to plant 26 million extra acres in this year ahead,” AgResource's Basse says.

In most cases, planting more of one crop means transitioning out of another. However, with record prices in other crops – cotton, for example – such a shift could result in further price pressures elsewhere. Both Basse and Allendale's Nelson add that unless the weather cooperates to create nearly ideal conditions for farmers over the next plantings, the supply troubles may extend beyond 2012.

Unlike prior commodity price spikes in 2008 and the late 1970s, energy cartel supply restraints are not leading the way this time around. This fact has many people believing the gains in commodities may be far more sustainable than the short-lived bubble of 2008, when oil hit \$147 a barrel and corn touched record highs. While oil showed tepid price growth in 2010 and inventories started 2011 at comfortably high levels, the lack of new oil field discoveries has set the stage for a severe energy crunch, one that will require the discovery of the equivalent of four new Saudi Arabias by 2030, according to the Energy Information Agency. It appears economic recovery will again pressure energy prices, moving producers and consumers further toward alternatives such as biofuels – which will stand to reinvigorate the commodity bulls once more.

“We could end up in some real dire trouble,” Basse says of the real possibility of extending the current commodity crunch. “It's a year I haven't seen in my 30 years in this business.”

Jim Rogers: The ‘Investment Biker’ Rides High on Commodities



Decades worth of capacity neglect in commodities means the bull market has only started, says famed commodities investor Jim Rogers, author of *Investment*

Biker: Around the World with Jim Rogers.

“There was very little investment in productive capacity for 25 years,” he says. “Look at Asia and look at the world; we're using more and more of everything. Declining supply and increased demand means higher prices. It has been going on for thousands of years and there is nothing new about it.”

The bear market of the late 1990s is part of the reason for the historical lack of new capacity, a situation compounded by the financial crisis of 2008, which stifled new investment just as producers were inclined to gear up, Rogers explains.

While lack of new supply is most obvious in metals and energy, market participants are making a mistake if they believe agricultural commodities are immune to underinvestment.

“Orange trees, coffee trees, cocoa trees take years to grow,” Rogers says. “Even if you wanted to plant more wheat next year, the land has to come from somewhere and you're probably taking something else out of production – and then you worry about weather.”

While Rogers garnered more popular notice as the self-styled “investment biker” and “adventure capitalist” traveling the world, he made his fortune with shrewd timing of the commodities markets.

“Commodities still have several years to go in a bull market,” Rogers says. “Don't sell your commodities yet.”



THE MIGHTY MINI

The debut of the E-mini S&P 500 contract 14 years ago gave retail traders their first real chance to trade equity futures. Now the retail market is adopting the next generation of retail contracts: micro-futures contracts.

Sometimes you have to start small. Many retail brokers in the industry credit the original E-mini contract, E-mini S&P 500 futures, with opening the door to futures for individual investors. The 1997 launch of the contract was well timed, with the rise of electronic trading and the explosion of self-directed trading and investing.

Today, with commodities and currencies garnering strong interest among individual investors, CME Group's E-micro forex and E-micro gold futures contracts also appear opportune. Several factors, from global economic uncertainty to demand for commodities, have provided a strong backdrop for E-mini and E-micro products among retail traders.

"All these issues are coming together to play in the commodity arena," says Jim Gombas, director of Lind Plus, Lind-Waldock's broker-assisted division. "It is front-page headline news and that makes people aware of what impacts prices. They think of how to benefit and how to participate. There are so many ways to be engaged. As you learn about one market you see how it's tied to another."

The E-mini S&P futures also paved the way for many other E-mini contracts and allowed individuals to trade on lower margins with a better handle on leverage. The recent introduction of E-micro forex – which includes euro-U.S. dollar, U.S. dollar-yen, British pound-U.S. dollar, Australian dollar-U.S. dollar, Canadian dollar-U.S. dollar and Swiss franc-U.S. dollar – as well as the E-micro gold contracts, has given investors more efficient access to these markets.

Not every futures contract has an E-mini counterpart, but a successful E-mini and E-micro contract offers electronic access via CME Group's Globex electronic trading platform, deep liquidity and flexibility, retail brokerage executives say.

"You can dollar-cost average into a position, accrue contracts at different prices and times in a way that might not be available with larger contracts," Gombas says. "It allows you to lighten up but maintain some exposure in your core position. To do it incrementally is appealing."

Risk and buying power Donna Heidkamp, president of RJO Futures, the private client division for R.J. O'Brien, says E-minis can help manage risks in a more capital-efficient manner.

"When using strategies that combine both options on the big contracts and mini futures, traders can position themselves to earn money in both directions, similar to an option straddle or strangle, without paying as much up front," Heidkamp says.

Russell Wasendorf Jr., president and chief operating officer of PFGBEST, says E-minis and E-micros help retail traders avoid over-leverage, which he says is the top reason individual traders lose.

"The last thing you want is for them to blow themselves up and have a bad experience," Wasendorf says of retail traders. "Then they think the market is bad, not that they over-leveraged themselves."

The E-micro contracts are sized at one-tenth the size of the standard forex futures contract, and the E-minis are one-fifth the size of standard-sized contracts, such as the S&P 500 futures. Those sizes mean retail traders can achieve more access to selected markets and more buying power, Heidkamp says. Take gold for example. In 2000, the precious metal was trading around \$250 per ounce. With demand for gold rising, from Asian consumers to investors worried about inflation, it topped \$1,300 an ounce.

"I know, with the significant increase in prices and without the E-minis, many retail investors would be priced out of the market," Heidkamp says.

Many retail futures traders come from the equities world and the transparency of futures is a big draw, says Daren Markisic, head of retail futures, MF Global Australia Ltd.

"John Smith, who has a \$20,000 funded futures account, trades on the same market and has the same opportunities and risks as a major global hedge fund," Markisic points out.

Wasendorf and Markisic agree that even though the E-mini S&P is a fraction of the full-sized contract, it has grown out of reach for some – meaning there is an opportunity for individuals to take advantage of E-micros. Markisic says that the micro-sized contracts allow customers to post smaller margins, which in turn allows them to spread out and diversify their investments.

"After all, that is what the professionals do," Markisic says. "They can easily achieve this due to the amount of capital they have at play."





The **EPICENTER** *of* **ENERGY**

If you look toward the core of energy markets, you will undoubtedly see oil. With improved levels of transparency, investors and oil market professionals are afforded a top-down view of what is happening – a fact that will become more prominent as more over-the-counter business flows through clearing houses.

Oil as a portfolio investment is a relatively new phenomenon.

Historically, crude oil has been traded by professional traders in the energy industry with years of experience, often starting in an entry-level job at a major oil company. But oil as an investment began in the 1980s when investment banks began to see it as a profitable asset class and advanced further with the advent of crude oil futures on the New York Mercantile Exchange, now part of CME Group. Financial traders who were not schooled on physical oil markets understood trading futures, and the exchanges provided a baseline upon which to begin.

And today the refrain in the crude oil markets is simply this: "Oil is money. It is a currency like any other."

In the 1990s as global demand was on the rise, hedge funds looking for fresh alpha were drawn to oil and commodities. Meanwhile, key nations were heavily influencing prices. China, in its run-up to the 2008 Olympics, was using and stockpiling oil in unprecedented quantities.

Add the recent explosion of exchange-traded funds (ETFs), and retail investors suddenly were positioned alongside the professionals. The oil-as-investment approach came to fever pitch when West Texas Intermediate (WTI) crude oil futures hit an all-time high of just over \$147.27 in the summer of 2008.

Since then, crude oil has not strayed far from the investor spotlight. It again surpassed \$100 a barrel early in 2011 when protests in Egypt, Tunisia and around in the Middle East began to worry traders. Those taking long positions in physical oil had already pushed North Sea Brent prices far higher than WTI – a switch from the \$3 "normal" spread late in 2010.

Time and Tide Higher oil prices frighten equities markets and economists alike due to the fragile nature of the economic recovery. Consumer spending, for a start, would suffer if gasoline topped \$4 a gallon again.

But things are different this time, says Walter Zimmerman, vice president and chief technical analyst at energy analysis firm United-ICAP.

"There are issues in 2011 that did not exist in 2008 when crude oil topped \$147 per barrel," Zimmerman says. "We don't have increasing real estate prices today, and in 2008 we didn't have chronically high unemployment. Also, we no longer have unlimited credit. There are serious clouds over the market now."

According to Citi Futures Perspective, the fundamentals are indeed quite a bit weaker than in 2007-2008. U.S. petroleum inventories as of Feb. 11, 2011, covered 56.5 days of four-week average demand, for

example, an uptick from the 55 days of coverage a year earlier and 4.6 days above the five-year average.

OPEC, which held just under a million barrels per day of spare capacity in July 2008, now has 4.65 million barrels per day of spare capacity, according to data from the U.S. Department of Energy's monthly Short-Term Energy Outlook. So growing investor interest may push prices higher, but without a tighter physical market to support it, crude oil will not be a true bull market, says Tim Evans, energy analyst at Citi Futures Perspective.

Zimmerman likens the current mood to the tides. "The collective mood of the market is like the underlying ocean, with the tides being major peaks and troughs," he explains. "Major peaks are where everyone is bullish and major troughs are where everyone is bearish. We are at a bullish excess currently. We won't be able to hold onto \$100 crude."

'Financialization' Treating a physical commodity as if it were a financial instrument has given oil markets a dramatic boost in volume and volatility. Zimmerman calls it the "financialization" of oil.

"Crude oil became financialized in 2007 when the stock market and commodities collapsed and investors became intensely aware of deflation," he says.

Not everyone believes the financialization of oil is a good thing. Evans is more of a traditionalist on this point because oil is not something the average person can store like stocks or even gold.

"The threat of physical delivery may not be so much of an issue when it's a matter of putting a few gold bars under the bed, but not many futures traders are really equipped with a backyard oil storage tank," Evans says.

Plus the buy-and-hold nature of commodities investment can lead to market anomalies which in turn lead to fears over speculation. The Brent/WTI spread, for example, is indicative of the financialization of oil, and has only become an issue in the past few months.

"In my view, the wide Brent/WTI spread is a market distortion that has been created by trade flows – money managers attracted to the Brent market's stronger calendar spread structure and stronger price momentum have chased that market higher," Evans says.

The Brent/WTI spread blow-out from a "norm" of \$3 to roughly \$14 also raised a debate about whether WTI remains a viable benchmark for crude oil. Some analysts and academics have called for a study into a more viable benchmark, but traders and industry pundits are nonplussed.

"The criticism of WTI as a benchmark came during extremes in the Brent/WTI spread," Zimmerman

says. "It is easier to blame the underlying system than to blame your own trading decisions."

Open interest for WTI remains nearly three times that of Brent. And WTI production is increasing while Brent has peaked and is dwindling. A new pipeline running between the United States and Canada will mean that WTI becomes even more fungible and that Cushing, Okla. – the contract's point of delivery – becomes even more of a center for oil. The pipeline will be able to carry between 150,000 and 200,000 barrels per day from Canada to Cushing. CME Group, which launched the Western Canadian Crude Oil futures contracts last July, opened an office in Calgary in 2010 to be closer to these markets.

Panning for Alpha The collapse of the credit bubble sent investors scrambling into the marketplace to find new areas of profit-generating asset classes. Oil became one of them, attracting investment from hedge funds, big banks and ordinary investors. No longer is it solely the domain of refiners trying to balance their crude slates.

Evans notes that investment demand – including ETF and index fund investments – has certainly been a big part of the rise in oil prices. Commodities, historically, have trailed behind the equity markets when exiting recessions, due to high stocks and surplus capacity that take time to work off.

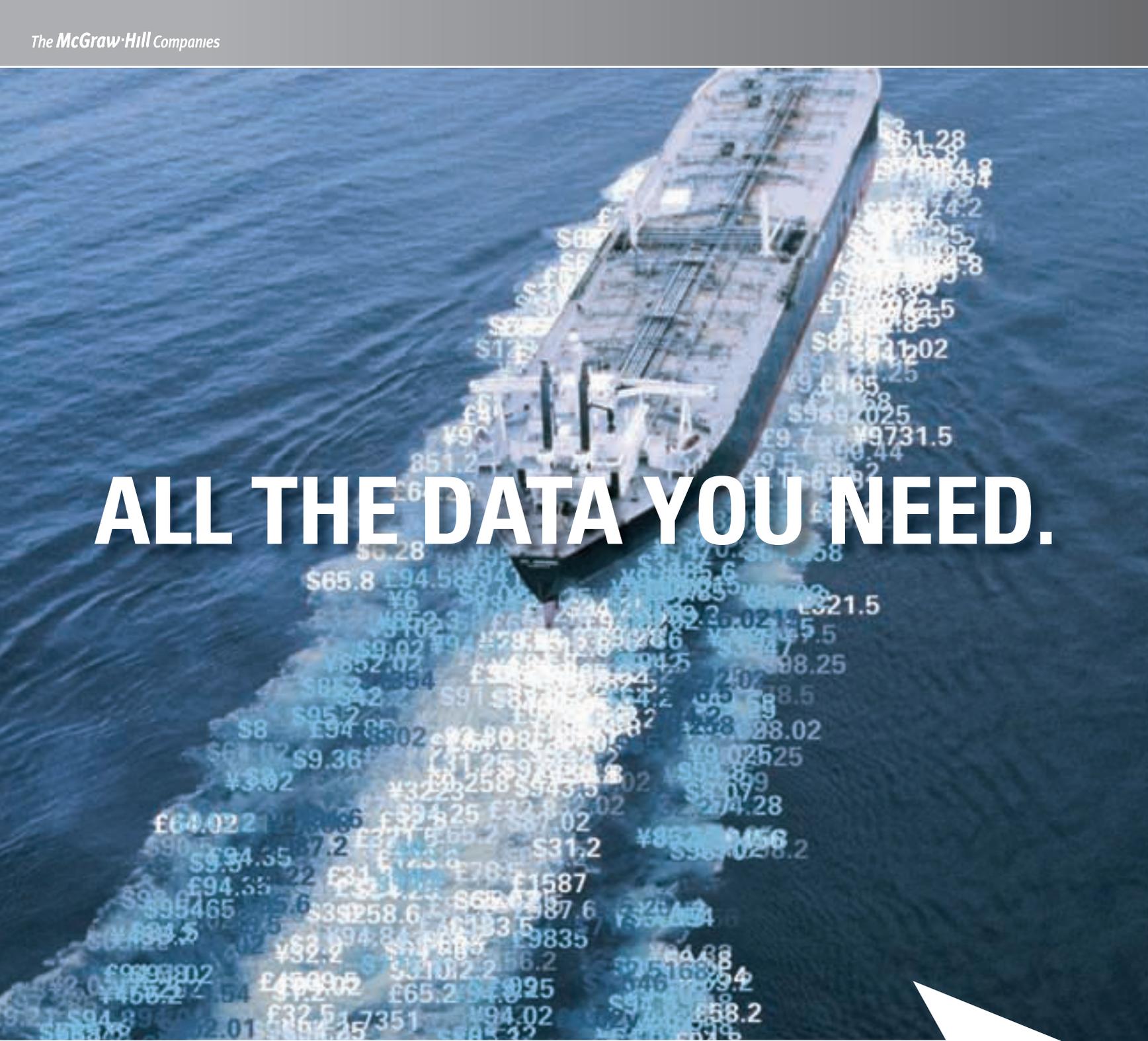
"In the current cycle, we still have the typical high stock levels and relatively high OPEC spare capacity, but prices have snapped back to the upside due to the investment demand story," Evans says.

In other words, investors are willing to overlook high oil inventories with the assumption that the market will tighten eventually. ETFs and long-only funds deploy largely buy-and-hold strategies, which can add to upward pressure.

Fortunately, in oil markets, transparency is improving steadily, allowing investors and oil market professionals a top-down view of what is happening. The Commodity Futures Trading Commission, for example, has bulked up its reporting over the past two years, revamping its Commitments of Traders Report with more specific categories. And as more over-the-counter business flows through clearing houses, participants will be able to see even more of that side of the market.

"We now have a clearer view than ever of what goes on in the futures and options market," Evans says. "There may still be some dark corners around the wider global market, but there is growing interest, both in the United States and internationally, in tracking and understanding trade flows."

As that information flow continues to reach more people, experts say, the diversity and number of participants will likely grow as well.



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– A PERSPECTIVE ON –

POSITION LIMITS



Position limits are being proposed as a way to protect against “excessive speculation” and prevent large positions that could cause unwarranted cost increases to consumers around the world. Professor Craig Pirrong of the University of Houston says that new limits being proposed could ironically have the exact opposite effect.

HOW WILL THE REGULATORY CHESS MATCH SURROUNDING POSITION LIMITS PLAY OUT?

With the comment period on the Commodity Futures Trading Commission's (CFTC) proposed rule set to close, we will soon know more. But taking a deeper look at the current proposal and the perceived issue reveals that we may be looking at a solution in search of a problem.

According to the CFTC's website, the intended purpose of position limits is to "protect futures markets from excessive speculation that can cause unreasonable or unwarranted price fluctuations."

In modern derivatives markets, much speculation takes place through pools that aggregate large numbers of individual speculators. If regulations constrain these pools, the pools could not fully exploit their economies of scale and they would incur higher costs. This would raise the cost of speculation by small investors, which would effectively reduce the amount of speculation they undertake. A regulation intended to constrain the *big* would actually constrain the *small*.

The CFTC's currently contemplated limits would set maximum position size as a percentage of open interest. Therefore, permissible individual position sizes in big markets (e.g., crude oil) would be larger than those in smaller markets (e.g., wheat). But scale economies relate to absolute size, not percentages of total market size. Consequently, the kind of constraint under consideration would have a much smaller effect on the amount of speculation in big markets than in small markets, regardless of the elasticity of speculation with respect to transaction cost.

In his recent book, *The Big Short*, author Michael Lewis describes how a handful of traders bet against the real estate bubble. If such a bubble exists, we want people to lean against it. But position limits, and those based on concentration in particular, would constrain just that kind of contrarian trading. So if you worry about bubbles driven by mass speculation, position limits would do little to restrict the "flash mob," and would make it harder for those not suffering from the popular delusion to trade in ways that limit the price distortions resulting from it.

To its credit, the CFTC has set out specific ways in which large, concentrated positions can inefficiently destabilize markets. These circumstances could be described as a "Hunt brothers scenario," in which a levered player takes a large concentrated position in a market. As the events leading up to 1980's Silver Thursday illustrate, such a leveraged player may be forced to liquidate, and the liquidation of such a large position can cause extreme price moves and, perhaps, pose a systemic risk.

This indeed presents a dangerous situation, but the CFTC in its position limits proposal does not identify any other ways in which large positions can cause "unwarranted" price fluctuations, which is the root of its position limit mandate. In other words, the major problem with the proposed position limits is that they are over-inclusive – they would constrain the trading of many market participants who in no way pose the dangers of a neo-Hunt situation.

The proposal would particularly hinder trading by exchange-traded funds and pension funds, in which trades are driven by the decisions of large pools of investors and function far differently than a single trading entity like the Hunts.

Over-the-counter (OTC) market making – a legitimate activity – would feel the pinch as well. OTC deals (hedged by exchange transactions) are often the most economical way for some market participants to take on the investment or speculative positions they desire, and there is no reason to penalize this activity.

“POSITION LIMITS COULD DRIVE BUSINESS INTO THE PHYSICAL MARKETS, WHICH WOULD DISTORT THE PRICES PRODUCERS RECEIVE AND CONSUMERS PAY.”

By limiting liquidity, the proposed rule threatens to exacerbate large price moves in response to shocks. Prices have to move more in less-liquid, less-flexible markets in order to accommodate big shocks, so stifling liquidity would be counterproductive. Moreover, position limits could drive business into the physical markets, which would distort the prices producers receive and consumers pay. Again, this would pose an unintended consequence, since the alleged purpose of the limits is to prevent and diminish such distortions.

Ironically, the oft-evoked sentiment that speculation caused the price spikes of 2007-2008, or that it is causing the current run-up in commodity prices, is not explicitly addressed in the CFTC's current proposal. More important, though, I fear the proposal on the table would impede legitimate conduct that poses none of the risks the CFTC believes warrant regulation.

A replacement rule, if ultimately deemed necessary, should target the specific ill the CFTC identifies. Otherwise, we will be quaffing down a "cure" for a malady before the practitioners have pinpointed a diagnosis.

Dr. Craig Pirrong is a professor of finance at Bauer College of Business of the University of Houston and serves as energy markets director of the school's Global Energy Management Institute.

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HARVESTING KNOWLEDGE



Neal Kottke has been in the commodities business since the 1960s. He shares his thoughts on how the markets have changed and, perhaps more important, how they have not.

For those seeking a career in the commodities industry, the first piece of advice Neal Kottke would give them is to think not just about commodities.

"If you're going to come into this business, it's basically futures and options," says the veteran trader and market maker. "Second, you would be well served by working for a proprietary trading firm or an investment bank like Goldman Sachs, where you can get a broad look at the futures and options industry."

Kottke should know. At 71, he has spent his entire professional life around the grain business. The founder and chairman of Kottke Associates LLC, a clearing firm and futures brokerage, and former head of the Board of Trade Clearing Corp., he has seen sweeping changes in the industry, such as the dominance of electronic exchanges over the selling pit in the futures market, which have greatly expanded the marketplace.

"Virtually anybody on the globe now has full access to the exchanges," Kottke notes. "So place utility is displaced by the electron. In fact, the futures component of the industry has basically all migrated to the screen."

EXPANDED CUSTOMER BASE Kottke sees this change as an improvement for the industry.

"Electronic trading has increased the efficiency of capital access to the commodities markets, making them more liquid and responsive," he says.

Another major change Kottke has witnessed over the years is the makeup of the market drivers. When he first joined the industry in the 1960s, as a grain merchandiser for Continental Grain Co., exporters such as Continental drove price and volume. Today, exporters continue to be a major influence, but the markets also are affected by the rising demand for renewable energy and the dramatic growth of managed funds.

Corn, in particular, has been swayed by the significant demand for ethanol. And hedge funds, mutual funds and institutional investors have introduced substantial amounts of speculative cash into the market.

The size and power of such funds have generated considerable press, particularly in times of dramatic price appreciation. But Kottke remains unconvinced they are the dominating factors.

"I would argue that when someone is unhappy with the market, he blames the wrong kind of capital coming in," Kottke observes. "But I think that more is better than less. Very small, less-accessible markets are the ones that are susceptible to false signals and liquidity problems. Also, money by itself doesn't

make the market move. The market has its own life that attracts or repels capital. Nowadays, it just happens with greater force."

SCORNING THE MESSENGER Kottke acknowledges, however, that there is no simple solution to altering public perceptions about markets and cash flow.

"That's a question that's as old as man, because the market is simply a messenger, and when the message offends too many and too greatly, the messenger is scorned," he says. "I'm not saying that the industry doesn't have to address it and get out the correct message. But I think we're talking about some real basic natures here, and where those natures intersect is when the political clash becomes involved, and that makes progress extremely difficult."

Looking ahead, Kottke foresees continued price pressure on a number of commodities. Much of this demand is coming from emerging markets – especially in soybeans – a trend that is closely tied to swine and poultry production. Kottke notes China is having the greatest impact on this demand, but he has also seen significant growth in the Middle East, which he attributes to increased sophistication and industrialization of agriculture.

In spite of such price pressure, Kottke does not see bubbles developing in grain markets.

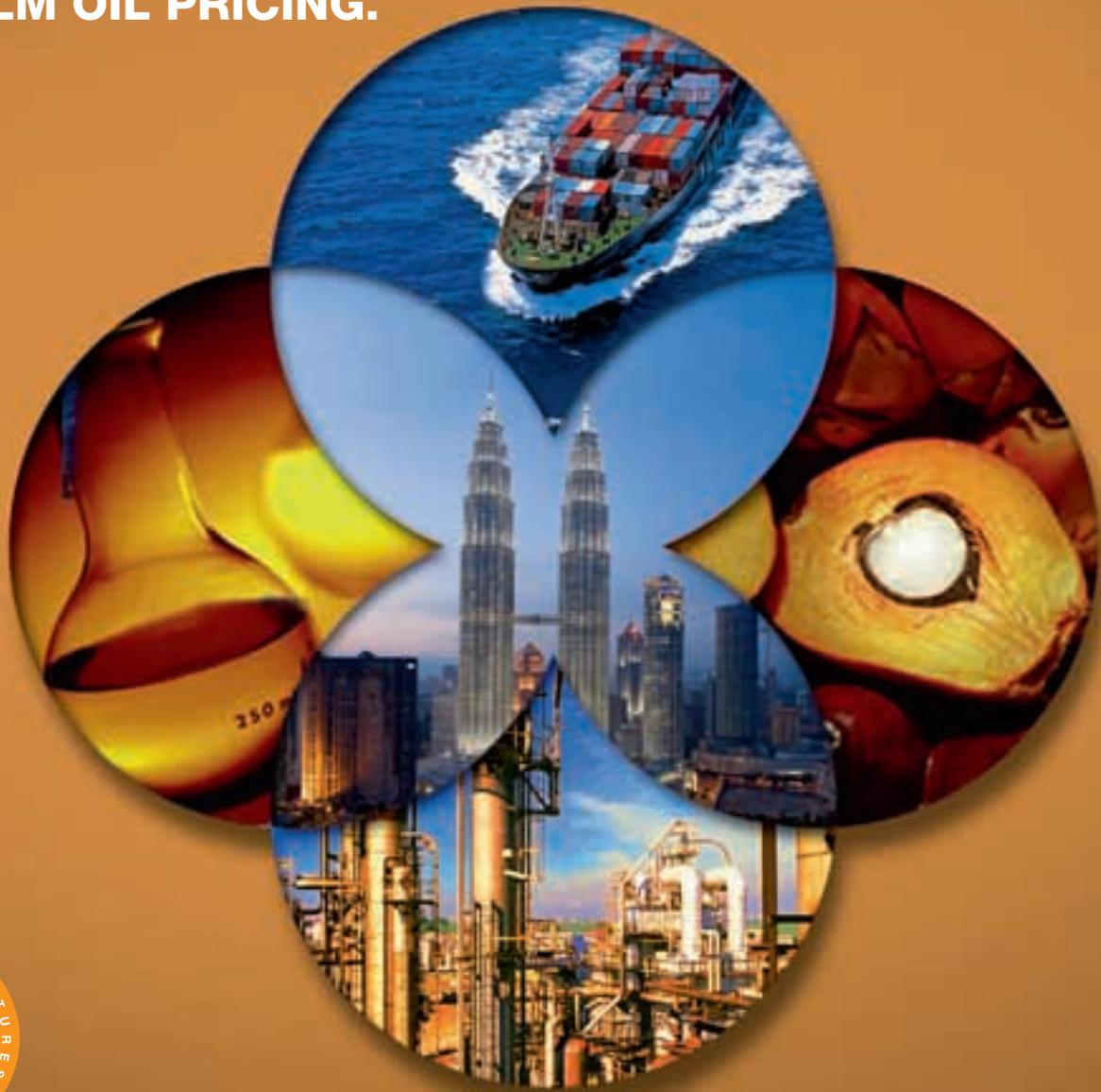
"You have to be careful about which commodities you're addressing when you talk," he points out. "It's true that we have had extremely high prices in grains, but the agricultural markets really reflect on a global basis a continued increase in real demand. The standard of living for a large number of people is increasing at a significant rate, and that's being manifested in greater consumption."

To be sure, there have been production problems, Kottke says, such as the dramatic setbacks for wheat in the Ukraine. But he quickly adds that such shortfalls happen on a yearly basis, and that worldwide numbers show agricultural production to be rising – just not enough to offset increased demand.

For all the changes Kottke has seen over a long, productive career, much has remained the same. Although futures have largely transferred to an electronic platform, his staff continues to operate as market makers from the trading pits, where most of the option trades are transacted.

Also, he owns and occasionally visits the farm on which he grew up in downstate Illinois. Harking back to his earliest roots, Kottke still enjoys seeing in a harvest.

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Green Exchange

In the few short months since the Green Exchange got the U.S. regulatory green light, it has secured major clearing support, leveraged the trading platform and global reach of partner CME Group, and set its sights on emerging emissions markets.

“The founding values of the company are confirmed now that financial services reform is at the forefront.”

TOM LEWIS, CEO OF THE GREEN EXCHANGE



Don't let the little things like the collapse of federal climate policy and international uncertainty get in your way.

Undeterred by the congressional defeat of U.S. cap-and-trade and slow progress at United Nations meetings in Copenhagen and Cancun, Green Exchange (GreenX) leadership sees plenty of opportunities for market-based solutions to help curb climate change.

GreenX can tap its financial exchange tie-up with CME Group at a time when there is more regulatory scrutiny of over-the-counter (OTC) transactions and greater demand for exchange-based clearing. GreenX also uses the CME Globex electronic trading platform, a vital cog in today's fragmented global emissions markets.

Emissions trading faced perhaps its biggest challenge to date early in 2011 when carbon credit theft temporarily shut down portions of European markets. It was a security breach that many observers pinned on the lack of a centralized European registry. Yet, for GreenX CEO Tom Lewis, these are all conditions that only reaffirm the design of his emissions exchange.

“The founding values of the company are confirmed now that financial services reform is at the forefront,” says Lewis. “Utilities, energy and financial institutions see in GreenX a real opportunity for liquidity, operational soundness and compliance. There is a real flight to quality under way.”

For Lewis, Globex and CME Group's OTC clearing service, CME ClearPort, are big parts of the story.

“Perhaps our greatest attribute as an exchange is that we offer up a tremendous platform for global trading hours and one-and-done clearing services well beyond what exchanges have been able to do,” Lewis says.

As for security, Lewis notes his exchange's ability to quickly find and eliminate any bogus trades in the wake of the European disruptions. The exchange also suspended trading in compromised European Union Allowances (EUA).

GETTING STARTED In July 2010, the U.S. Commodity Futures Trading Commission approved GreenX as a designated contract market. Its products are based on commonly traded instruments in the European and U.S. markets: EUAs, U.N.-certified carbon offsets (CERs), U.S. Regional Greenhouse Gas Initiative carbon allowances (RGGIs), U.S. emissions allowances (SO₂, NO_x) and Climate Action Reserve Climate Reserve Tonnes (CRTs). In addition to California, the regional Western Climate Initiative, a group of western states and Canadian provinces, may draw increased market interest in coming months and has the attention of GreenX. The exchange is also pursuing European regulatory approval. GreenX estimates that the European emissions market, supported by a six-year-old cap-and-trade, could see trading activity increase 15 percent this year.

GreenX stakeholders combine energy and financial services interests. The owners of parent company Green Exchange Holdings LLC include CME Group, Constellation

NewEnergy, Credit Suisse Energy, Evolution Markets, Goldman Sachs, ICAP Energy, J.P. Morgan Ventures Energy, Morgan Stanley Capital Group, RNK Capital, Spectron Energy, TFS Energy, Tudor Investment and Vitol. Clearing members Citigroup, Mizuho Securities USA and Prudential Bache joined around the start of the year, and Lewis says the exchange is close to securing several more clearing members.

“GreenX will continue to grow principally in two markets: the European Union's Emissions Trading System (ETS) and the California market,” says Peter Fusaro, chairman and founder of Global Change Associates, a New York-based advisory.

CALIFORNIA DREAM Observers also expect considerable impact from California, which is set to launch its carbon market in 2012.

Andrew Ertel, GreenX board member and president and CEO of Evolution Markets, an environmental and energy market brokerage and merchant bank, expects an OTC-structured market to first take hold in California, to be followed by increased interest in futures and options trading. Global Exchange Associates' Fusaro agrees that it is a key carbon market.

“California is a key market, as it is the world's eighth-largest economy and emissions reductions will impact electric utilities and industries until 2015,” Fusaro says. “There will be increased pre-compliance trading this year in California and the price valuation reflects the integrity of the market.”

Fusaro says the even bigger news is that California has created a green financial infrastructure with protocols and offsets that are understood by the business community, since these were the people involved in the process of shaping the regulation.

“It seems likely that California will create the DNA for a federal program in 2015 when Congress gets back to considering the issue of climate change,” Fusaro predicts.

Ertel also stresses the importance of input from utilities, energy firms and financial firms in helping GreenX determine its product offerings. This input, he says, allows for more innovation and encourages market confidence in the early stages, and he notes that GreenX is able to leverage its relationship with CME Group, yet narrow its focus to environmental products.

“People knew there was a better mouse trap out there, they just weren't familiar with it,” Ertel says. “But with underlying liquidity in EUA and CER, people get comfortable and liquidity fuels more liquidity.”

GreenX products also benefit from their proximity to established markets, specifically energy and agriculture, which encourages cross-commodity arbitrage, Fusaro says.

“The bottom line is that there will always be competition in emissions trading with both exchanges and OTC trading,” Fusaro says. “The future looks very bright for GreenX as emissions trading scales up over the next decade.”

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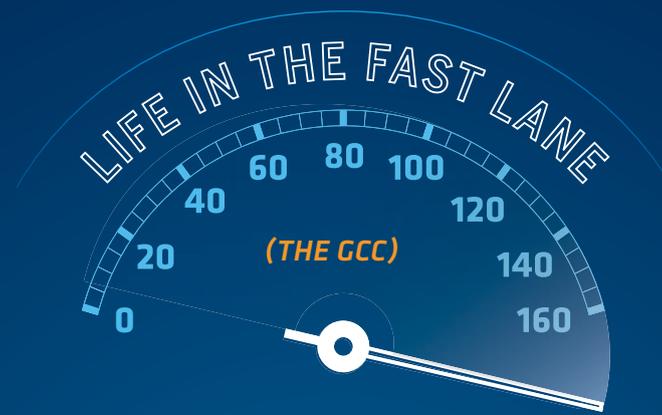
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The need for speed in the derivatives markets grows stronger every day for CME Group customers. Upgrades on the CME Globex platform that are trimming execution times 50 to 75 percent are designed to meet those demands.

There is no doubt one of the keys to any exchange's success today is the ability to execute trades in milliseconds. Traders demand it and exchanges such as CME Group are pushing to bring world-class speed to them.

So it is no surprise that CME Group's metals and energies contracts received a boost in December 2010 and January 2011, respectively, on CME Globex, the ubiquitous electronic trading platform. Trades in those contracts now occur, on average, in a range of 10 milliseconds to sub-3 milliseconds depending on volatility or trading matching dynamics. And just how fast is a millisecond? Well, a blink of an eye takes about 300 to 400 milliseconds.

GLOBEX EVOLUTION

Such is the pace of change in today's global financial marketplace. It would be fair to say the Globex platform has undergone a major transformation since it was first launched by CME on June 25, 1992. On day one, the electronic platform handled 1,893 Deutsche mark and Japanese yen futures. By 2004, the platform hit the one-billion contract milestone.

The first version of Globex was based on a partnership with Reuters. By 1998, the next generation of technology used the Paris Bourse's NSC system. That system served the exchange well and was eventually transitioned into an updated technology platform. That upgrade brought more flexibility and complex order functionality to Globex and is credited for expanding CME Group's stature as a premier electronic trading venue. Most recently, over the past 18 months, that technology has given way to another technology system from CME Group, which was designed in large part to handle CME Group's options trading.

The migration of contracts to the faster technology began with foreign exchange, equity index, agriculture and alternative products and, most recently, metals and energies. Next up will be CME Group's interest rate complex, with its Eurodollar and interest rate futures in the second half of 2011.

CME Globex not only serves as the key platform for CME Group products, but it also is the matching engine for other markets around the world, from the Kansas City Board of Trade and Minneapolis Grain Exchange to international markets such as Bursa Malaysia Derivatives Berhad and the Korea Exchange, trading the Kospi 200 futures contract outside Korea's hours, among others.

Contracts now being transacted on the new technology are seeing a sizeable boost in execution speed. Customers are seeing a 50-percent to 75-percent reduction in response times.

CRANK IT UP

Today's markets are heavily populated by electronic trading systems. High-frequency traders depend on exchanges and their own cutting-edge technology to execute thousands of trades in a matter of seconds. When CME Group steps up the speed of its trading engine, greater volumes tend to follow.

Analysis of the system shows some interesting results after product groups are migrated onto the faster upgraded technology. For example, Globex has seen up to 40-percent higher peak volumes in terms of order flow in certain contracts, particularly in energy markets.

The system is about more than just speed, however. CME Group is also expanding the robustness of its platforms to handle those peak periods when orders come flooding in. CME Globex now is handling peaks in excess of 30,000 orders per second.

"It's clear CME Group's enhancements to Globex have created a more robust system for their customers and members," says Chris Hehmeyer, CEO of HTG Capital Partners. "We've noticed better fills, especially during the peak volume periods, and we've had an easier time executing the complex multi-leg spreads that some traders used to shy away from."

The system upgrades are welcomed by various types of trading firms, not just the high-frequency trading groups. For firms such as Global Advisors, an island of Jersey-based CTA which trades a variety of commodity markets in a medium-term time frame, holding positions for two to three months, the enhancements to Globex still provide benefits.

"I do think that firms our size benefit indirectly from the speed enhancements anyways," says Dwayne Drexler, director at Global Advisors, which trades about 35 different commodity markets. "Our orders get the advantage of faster execution flow for the counterparties of our trades – and to the extent that their orders are shown more quickly to the market, that means our trades are able to find the other side in a more efficient fashion."



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CURRENT PULSE

This Record Speaks Volumes

Three times in early 2011 CME Group posted record volume for the global benchmark light sweet crude oil West Texas Intermediate (WTI) options contracts. On Feb. 23, WTI options reached a record 324,655 contracts, a 10.3-percent increase from the previous record. CME Group posted record volume of 294,411 WTI options contracts on Jan. 31, following the previous record of 290,365 on Jan. 28.

WTI futures also reached a record of 1,472,088 contracts on Jan. 28, nearly 50,000 more than the previous record of 1,423,536 contracts set on April 13, 2010.

"CME Group is the leading crude oil options marketplace for both WTI and Brent Crude Oil," says Joe Raia, managing director, energy and metals products at CME Group. "As unrest continues in key parts of the world, customers come to CME Group to manage their crude oil risk because of the depth of liquidity and unmatched transparency of our products."

WTI is the largest, deepest and most liquid global energy market benchmark, trading more than 1.1 million futures and options contracts daily, on average – more than double the size of its nearest competitor.



An Ultra Anniversary

In January, CME Group celebrated the launch of the one-year anniversary of the Ultra Treasury Bond contract – the fastest growing interest rate product ever launched by the CME Group exchanges.

The Ultra Bond was launched on Jan. 11, 2010, in response to strong customer demand for a contract that mimics the duration of a 30-year Treasury bond. Milestones include:

- Nearly 4,500 contracts changed hands on its first day of trading;
- First-quarter average daily volume surpassed 14,000 contracts;
- Fourth-quarter average daily volume exceeded 52,000 contracts;
- On Nov. 24, the Ultra experienced record volume of 349,000 contracts traded, and record open interest of 380,000;
- As of Dec. 31, open interest was more than 307,000.

Watch Robin Ross, managing director of interest rate products, and Jonathan Kronstein, associate director of interest rate products, discuss the Ultra Bond anniversary here:

<http://at.pscdn.net/008/00102/videoplatform/110103Ultra.html>.



All Natural

CME Group in early February launched three new natural gas futures, physically delivered at Pine Prairie Energy Center (PPEC): PPEC Physically Delivered Natural Gas Daily/Weekend Futures, PPEC Physically Delivered Natural Gas BALMO Futures and PPEC Physically Delivered Natural Gas Monthly Futures. They were designed to meet the fast-moving, short-term and long-term base load needs in today's natural gas marketplace. The launch of these innovative contracts illustrates CME Group's commitment to providing customers with access to the broadest array of products for managing global energy risk.

PPEC is a highly-flexible salt cavern storage facility located in Evangeline Parish, La. It is strategically located 50 miles from the Henry Hub natural gas pricing point, and has nine interconnects to eight major pipelines that service the Gulf Coast, Midwest, Northeast and Southeast markets.

The contracts are traded on the NYMEX floor and electronically through CME Globex, and they are available for clearing services through CME ClearPort.

To learn more, visit www.cmegroup.com/trading/energy.



Derivatives Exchange of the Year

Risk Magazine named CME Group the Derivatives Exchange of the Year in its annual Risk Awards. The awards recognize best practices and innovation in the risk management and derivatives markets in more than 20 categories across banks, brokerage houses, investors and market providers.

“Being named Derivatives Exchange of the Year is an acknowledgement not just of the success of our exchange, but of the importance of our industry in the rapidly transforming global financial marketplace,” said Craig Donohue, CME Group chief executive officer, at the Risk Award Dinner in London. “This is a tremendous achievement for our company and our employees.”

The award’s judging criteria include risk management, client service, forward-thinking on regulatory issues and liquidity provision. The awards were judged by a *Risk Magazine* editorial panel of senior editors and staff writers.

Learn more about *Risk Magazine* and its annual awards at www.risk.net.

Duffy Testifies Before Congress

CME Group Executive Chairman Terry Duffy on Feb. 15 testified before the U.S. House Committee on Financial Services to help assess the regulatory, economic and market implications of the Dodd-Frank Act. Just days after presenting similar testimony to the House Committee on Agriculture on Feb. 10, Duffy addressed several areas that will be impacted by the Dodd-Frank rulemaking process.

CME Group encourages regulatory approaches that will bring greater transparency to derivatives markets – without damaging the well-functioning, regulated futures markets and clearing houses. As Duffy testified, CME Group’s markets comprise a “highly successful principles-based regime that has permitted U.S. futures markets to prosper as an engine of economic growth for this nation.”



Reaching Globally

Two significant recent hires at CME Group’s London office signify the company’s commitment to further globalizing its business and placing leadership in regions with great opportunities for growing markets and client base.

Roger Rutherford, managing director, global head of FX products, is responsible for leading CME Group’s global FX business line, the company’s fastest-growing business line during non-U.S. hours. Rutherford’s deep knowledge in this market will play a key role as CME Group continues to develop and diversify its global business.

Harriet Hunnable, managing director, metals products, has more than 20 years of experience in global metals markets and brings deep market expertise and extensive client relationships to CME Group. She will be responsible for developing and executing the company’s global metals business strategy.

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THE EPICENTER OF ENERGY p 16 **A PERSPECTIVE ON POSITION LIMITS** p 20