Commodity Technology Advisory
E/CTRM Market Research, Analysis and Advisory

ComTechAlert

Striking the Balance

7 August 2013

by Dr Gary Vasey

Just a few weeks ago, I wrote a blog entitled “Under Attack” on our CTRMCenter web portal and I started the article with the following words –

These days it does seem a little like commodity markets aren’t the flavor of the month.

- so you can imagine that despite being on vacation, I eagerly consumed any and all news regarding banks and physical commodities in the US this last three weeks as it was reported that the U.S. Federal Reserve was "reviewing" a landmark 2003 decision that first allowed regulated banks to trade in physical commodity markets.

A few years ago, as Peter Fusaro and I[1] drew attention to the sudden swelling of hedge and other investment fund ranks in commodities, we also pointed to the ‘banks’ and their activities. The banks were in and then out of commodities over the last 20-years like a rapidly moving pendulum we noted. Of course, banks like Goldman Sachs and Morgan Stanley owned power generation, oil reserves and other hard industry assets but they did so as something other than ‘banks’. The real ‘banks’ largely traded paper happily helping reduce physical traders’ risks - as did many of the funds.

Then, in the mid 2000’s, commodities surprisingly and temporarily crashed. Investors got nervous and started pulling their money. A lot of funds died in the turmoil and the banks, well they were out and then they were in again.

What had we learned during this commodity price bubble burst? Well, everyone who was talking said that by not having any exposure to physical commodity markets, managers were slow to react. As you might have gathered by now, the banks were back in again keen to get better market intelligence via their physical exposure.

However, over the last decade or so, there have been grumblings. The grumblings were louder when oil prices rose and less loud when they fell but the volume of this chorus of grumblers has generally gotten louder in response to the financial crisis, the ‘too big to fail’ failures, the emergence of certain abuses such as the LIBOR scandal and so on. Generally, consumer groups and politicians, they have found support among each other in their search to limit ‘speculators’ in commodity markets. This growing political and consumer scrutiny of Wall Street's role in commodity markets has found fuel in complaints about ownership of metals warehouses, record fines against Barclays, and potentially, JPMorgan, over allegations that they manipulated U.S. power markets.

These days, the investment banks that led the way in to commodities are quietly moving out again. JP Morgan and Goldman Sachs, for example, are both said to be divesting themselves of assets and activities that don’t fit the mold of a normal commercial bank. Morgan Stanley is doing the same. In part, this may be due to the continuing and increasing ‘attack’ on commodity trading via increasing regulation and perhaps the banks also see that the shine is off commodities a bit. The 15-year super cycle for commodities that started around 2003 is already 10-years in and profits are decreasing as the paperwork increases.

As I stated in my blog article, just look at some of the signals we are seeing

We appreciate the support of our ComTechAlert sponsors

SUNGARD ENERGY

Allegro®

eka

As I stated in my blog article, just look at some of the signals we are seeing:

1. How the commodity transaction tax in India has been introduced and already had a significant dampening effect on transactions,
2. How the EU parliament continues to congratulate itself for staying the course on introducing a financial transaction tax here (at least in 11 countries across Europe),
3. How the clearers are now being pointed at as 'systemic risk' requiring 'further' regulation and
4. Now it seems the big traders are under scrutiny too as a 'risk' because their access to 'easy money' allows them to grow their physical positions too quickly.

The Indian finance ministry imposed a 0.01% tax on the trading of all non-agriculture and some agriculture commodity derivatives on July 1 to boost revenues. The result is that trading volumes are off up to 30%, prices are down and so are volatilities - but the cost of hedging is, of course, up. The government might argue 'objective achieved' in that, speculators have been forced out of the market others might say that derivatives, which are used mostly for hedging, should not be taxed at all. Time will tell.

Meanwhile, eleven countries in the EU are pushing on with the implementation of a similar tax with rates of 0.1% for trades in stocks and bonds and 0.01% for those in derivatives. However, the EU also says that participating countries should be allowed to apply a higher rate to riskier "over the counter" trades. The 11 participating member states are Austria, Belgium, Estonia, France, Germany, Italy, Greece, Portugal, Slovakia, Slovenia and Spain. The tax aims to discourage speculative trading and ensure that the financial sector pays back part of what it received from taxpayers during the financial crisis. It has faced a barrage of criticism from the banks and other EU countries and progress has been slow. Many issues are yet to be resolved most importantly being how it would be collected for certain derivatives and whether other countries not involved would need to collect the tax for entities trading there but based in one of the 11 countries.

Meanwhile, the banks have started pointing fingers at clearers and asking the regulators to look at what they claim is simply a shifting of systemic risk. As regulation and industry trends have moved trading more towards cleared transactions where the clearer sits between two counterparties and takes on the risk, more risk has been transferred there. The banks also claim that the clearinghouses are asking for lower quality collateral further increasing that risk. While this just may be a case of the banks trying to slow the move from bilateral OTC to electronic trading platforms, further regulatory involvement at this time is perhaps undesirable.

As if all of this were not enough, two research companies in Brussels came out with a report criticizing the growth of traders. "The use of financial leverage to increase physical holdings, through the easy access to international finance helped by accommodating monetary policies, may have systemic implications," they say and again seek further regulation to obtain disclosure of physical holdings and other information required to reduce the risks for governments. They also cited easy to come by finance as part of the problem?

So where does all this leave us?

While time will tell, I believe that the swing of the pendulum is now moving too far in the opposite direction and mistakes are now likely being made that will haunt us all in the future. Too many regulations, too little emphasis on 'free' markets perhaps? The fundamental problem with commodities is the same now as it was in 2006 – too many people chasing too few and diminishing resources. Under any economic system, this will mean either progressively rising prices or rationing. It also means there is money to be made by greedy and unscrupulous people. The key is getting the balance right.

---

1. Energy and Environmental Hedge Funds: The New Investment Paradigm, Fusaro & Vasey, Wiley Finance, 2006 and innumerable articles published on similar topics.

Welcome to ComTech*Alert*

Generation 10

SUNGARD CONSULTING SERVICES

About ComTech Advisory

Commodity Technology Advisory is the leading analyst organization covering the Energy and Commodity Trading and Risk Management (E/CTRM) technology markets. We provide invaluable insights, backed by primary research and years of experience, into the issues and trends affecting both the users and providers of the applications and services that are crucial for success in markets constantly roiled by globalization, regulation and innovation.

Contact Information

US: Patrick Reames
+1 281 207 5412

Europe: Dr. Gary Vasey
+420 775 718 112

Follow Us:

If you have enjoyed reading this article and know someone that might find the information valuable, please feel free to forward. If you have received this article from a friend and are not currently signed-up to receive it directly, you may register at http://www.comtechadvisory.com/register