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# Finding sense and sensibility in global commodities

## TXF: The Week That Was

*Making sense of the bigger picture of the state of the global commodity markets is no easy task. But here, Jonathan Bell meets up with a long-time friend and real commodity guru in Geneva - Jean-Francois Lambert, former head of HSBC commodity finance, and now founder and managing partner of Lambert Commodities.*

**Jonathan Bell (http://www.txfnews.com/Tracker/keyword/Jonathan Bell)**
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PROJECT & EXPORT (/HOME/SECTOR/5488/PROJECT-EXPORT)

***TXF: How do you see the resilience of the global growth engine, the US dollar and the consequences on commodity prices?***

**Jean-Francois Lambert (JFL):** Fundamentally, the global economy is on a strong and resilient path with 3.7% growth and still forecast to be north of 3.5% next year. At this rate, the world economy will double in 20 years. But one cannot but wonder if/when this can be derailed by the current climate where the post-war order is challenged. Polarisation drives politics and the priority is given to selfish short-term interests and to growing geopolitical competition. As Robert Kagan puts it in his latest book: "the jungle grows back".

There are other and less fundamental reasons to worry and one has to do with the dollar strength. Emerging markets are suffering and when we know they have been the driver of world growth for the past 20 years or so, this could become a major issue.

Even China's growth decelerates – and this was expected, as no country can be the second economy in the world whilst sustaining a 6.7% growth rate for ever. Interestingly the RMB has never been as close to a level of 7 yuan for the dollar. All other emerging countries' currencies have strongly depreciated vs the dollar. Will China trigger this weapon amid its trade war with the US? A scary thought. It does not look like the government is willing to trigger the currency war weapon just yet.

A strong dollar does not help the US either: whist President Donald Trump believes he can fix the deficit by fiddling with tariffs, the strength of the dollar cripples US exports' competitive position. The Fed will continue to raise interest rates, but the pace should slow down. This should give the dollar a chance to lose some of its strength and that would be good news for the world and for commodities.

A weakening dollar would certainly be good news for commodity prices, but nowadays, the prevailing factor is fear. Fear of uncertainty over the consequences of trade wars; fear about China; fear of the consequences of sanctions against Iran and Russia.

***TXF: What have we seen in the commodity market over the past 12 months?***

**JFL:** It was not clear how OPEC/NOPEC could unwind its cuts without crashing prices. Supply issues (Venezuela, Libya) plus new sanctions on Iran have solved their concern.

Logistic issues created doubts about US shale production sustainability and their ability to keep pumping. Against this backdrop of anticipated drying supply, oil prices rose. Between September 2017 and October 2018, Brent rose by 53%. It dropped ever since by 17% to around $72 per barrel but still well above the September level of around $56.

Could oil remain above $80 next year? Already OPEC talks about reducing its production and this had an immediate effect. Also supporting the bullish trend is the often-forgotten fact that spare capacities are strained and representing 2% of global demand according to the IEA.

However, and besides Trump's probable damning tweet on Saudi's intention to slow its production, several factors support the view that oil should retract from current highs. First, at this price, demand growth momentum will decrease. The IEA has revised is forecasts downwards to 1.3 mbpd (million barrels per day) in 2018 and 1.4 mpbd in 2019. Second, falling Iranian supply has been more than absorbed by OPEC and Russia. The IEA said that in September 2018 overall supply is 2.6 mbpd above last year's level.

For the first time 100 mbpd of oil has been produced. Add to this the record production in the US, the fact that the logistic bottleneck affecting shale producers will get solved eventually, and more drilling fostered by attractive oil price and we might have a significantly over-supplied market in 2019.

***TXF: What impact will IMO 2020 have on the market?***

**JFL:** There are three possibilities to comply: removing sulphur from fuel with 'scrubbers', using lower sulphur fuel, or finding substitutes such as liquefied natural gas. Few ships have scrubbers and the risk is a draw on low sulphur supply and the disruption to trucks and aircraft supplies. The IEA believes 'the countdown to the IMO 2020 marine fuels specification change' can possibly push diesel cracks to levels where they can carry refining margins independently. Overall, we forecast refinery runs increasing by 1.3 mbpd in 2019, compared to refined product demand growth of just 1 mbpd.

Platts analysts believe IMO 2020 will cost the global economy $1 trillion over five years. Yet, let's not forget that high-sulphur marine fuel only accounts for 4% of global oil demand.

The concern will probably build over 2019. We can expect a lot of volatility in refining runs and this will certainly trigger attractive options for trading houses.

***TXF: Do you expect China and India to continue buying Iranian crude?***

**JFL:** Iran hopes to keep exporting 1 mbpd, with India and China, the prime potential customers. Six-month waivers have been given to a few countries amongst which are China and India. In addition, Russia has said it is ready to help Iran in intermediating Iranian trade.

All good then? In reality, the sanctions are likely to be strictly applied and very few counterparts, traders, intermediaries, Chinese and Indian buyers will take the risk to discard them.

***TXF: How much more will US and Canadian shale oil impact traditional crude producers and exporters?***

**JFL:** Both North American producers have a bright future ahead. US shale production is roaring, and its issues are only logistical. IEA sees Light Tight Oil (shale oil) production to grow in 2023, offsetting conventional production decline at 12.1 mbpd overall by then. The upside is therefore still very significant.

For Canada, IEA forecast production to continue to rise from 4.8 mpbp in 2017 to 5.8 mpbd in 2023, and oil sands climbing by 700 kbbd over the next 6 years.

***TXF: What future is there for coal and coke?***

**JFL:** Coal is the largest source of energy and, according to BP will remain such in 2040 when it should represent around 30% of the mix. Coal consumption will decline in OECD countries, but, says BP, will grow in India and South-East Asia. This is the ultimate paradox.

Societies at large despise coal, banks refuse to finance new projects and are increasingly reluctant to support existing ones, yet the world cannot do without coal. A problem in the making when we extract some 7.3bn tons of coal every year!

***TXF: Which agri-commodities are we seeing major changes with and why?***

**JFL:** Besides the usual influence of climatic conditions which often have a significant effect on soft commodities, this year the game changer has been politics!

The trade war with China has dislocated trade flows for US soybean and cotton which Chinese buyers have discarded. This benefits South American soybean producers, and primarily Brazil. The fall of the Brazilian Real amid political uncertainty lowered the Brazilian farmer cost base and fuelled their competitive advantage. The election of Mr Bolsonaro is opening another round of uncertainty, but so far, the effect of the Real has been positive.

Perhaps worth noting are the huge stocks of wheat (273mt or 36+% of the 2018/19 expected harvest). The Chinese are storing huge volumes of wheat but mostly for strategic purpose.

***TXF: What has been the impact of Trump's trade war with China on the agri sector?***

**JFL:** Exports of soybeans are tumbling when the harvest is historically strong. US farmers will get subsidies. As prices drop, crushing margins for soybean are at the highest and all ABCD's [leading soft commodity traders] are now reporting attractive profits on that front. Brazilian soybean is now in high demand and therefore benefits from a strong premium. China is now on a race to reduce their dependence on US farming but when last year they imported 36mt of soybean from the US, it looks like a long shot.

**TXF: What other spinoffs will we see on the agri front from the US-inspired trade wars? Who will the winners and losers be?**

**JFL:** US farmers will lose a lot, obviously. The Brazilian one's will win. Cofco International, China's largest trading arm now has a very strategic task on its hands: restructuring its supply chains to lower dependence upon the US. Cofco already announced last month that they were building a 60Kt silo complex in Mato Grosso in Brazil. We should expect more from Cofco group, and announcements of alliances with some ABCD's, in quest for partnerships. This would not come as a surprise.

If China continues to lower its US cotton purchases, that could prove to be good news for Egypt's, sub-Saharan Africa's and India's producers. But this is too early to tell.

***TXF: With the newly elected president in Brazil, what can we expect from that country on the agri-front?***

**JFL:** This is a difficult one. The new president took a very pro-business stance but for now the effect has been the appreciation of the Real which is not good for Brazilian exports.

Beyond the early days, there is a lot of uncertainty around the ability of this new president to deliver without harming Brazil's relatively young democracy, especially on the economic front. He himself has admitted his lack of knowledge on this front.

***TXF: The world has to eat – so what do you see as the future for agri production and financing?***

**JFL:** Agri and food prices have been stable over the last 50 years despite the global population trebling, and the urbanised middle class growing ten times to reach 3.3bn people. Yields, and science have transformed agriculture in agribusiness. Demographics are well known and by 2040, the global population will reach 9.2bn with a 5bn-strong urbanised middle class. What science and industrialisation have been able to achieve so far is encouraging for the future, but the big unknown remains climatic changes and a possible game changing problem around water supply.

***TXF: Price volatility has characterised the metals sector overall for the past year, but can you see some bright spots?***

**JFL:** China is the key driver for metals. If China's momentum slows, the effect on metal prices could be significant. Metal prices with the exception of gold (too long too cheap and a safe haven for geopolitical crises) should be subdued in 2019 after two years of strength. Nickel and cobalt will remain buoyed by the acceleration of the move towards renewables, and electric vehicles (EV) particularly in China. Copper will also be supported (steady demand increase and no big investments in production for several years).

***TXF: Of course, the fortunes of copper are very much dependant on what China does. The price is up and down depending on a myriad of factors supply/demand, strikes in Chile, the global sale of electrical equipment etc, so what does the future really hold?***

**JFL:** In the long run, demand for copper will accelerate (together with nickel and cobalt); EVs require three times the copper wiring than the 30kg required for conventional vehicles. More fundamentally, demand for metals will grow by 3% to 5% per annum. To cope with demand from now till 2050, we should mine more metals than we have since the origin of humanity (70,000 years), according to the World Bank.

Taking a shorter-term view, copper stocks are low and there has been little investment upstream for three years. The view on copper is therefore bullish.

Cobalt and rare earths are very much tied up in the renewables and EVs market.

***TXF: With much cobalt production coming out of the DR Congo how important is resource security?***

**JFL:** This is indeed a concern but that it has not translated into prices. Relying for a strategic resource on a single country and a rather unstable one for that matter is not comfortable. However, the dependence of DRC and Katanga upon exports of its mining product is so important that the country is unlikely to take much risk to antagonise its major buyers. All the more since the main buyer is China which already imports 80% of the DRC cobalt production.

That should probably be construed as a major concern for the European automotive industry, because the trend will be difficult to bend: when a smartphone requires only about 8 grams of cobalt, an EV requires 10 kg. As China is already the leader for battery production and aims at becoming the largest EV market, this will impede the non-Chinese automotive industrial development.

However, the problem is even more acute for rare earths. Some 90% of the world rare earths are produced out of China and 3/4 of the 130,000 tons produced is used there. At this rate, by 2025-30, China will need 100% of its rare earth production. When we know how important rare earths are to modern technology, this means that who controls these metals controls the most strategic supply chains. China's dominance is only starting to show.

***TXF: China is the biggest purchaser of a vast range of commodities – what are your views on such an important market and the problems it is facing with the current trade wars with the US?***

**JFL:** China's growth is decelerating. Not big news as 7% + growth was unsustainable, but the pace has been stronger than expected this year. For now, most economists agree that the economy should grow by 6.5% this year, which is still quite remarkable. However, the official Purchasing Manager's Index (PMI) fell to 50.2 in October. This is the lowest level in two years (below 50, an economy is deemed to be contracting).

It is positive that the government took measures aiming at underpinning the economy. It lowered the banking system reserve requirement. This will be injecting some $109bn into the Chinese economy. On the other hand, the fact that the government resolved to boost the economy when its prime objective hitherto was to clean the financial system and tame internal debt, is a testimony of the seriousness of the slowdown.

A decelerating economy when the activity could be affected by the trade war with the US is certainly not a good combination. So far however, the effects of the tension with the US have not been felt, with Chinese exports still growing (12.2% through the first 3/4 of 2018).

***TXF: The middle class in China has a much bigger potential purchasing power – how will this impact future global commodity sourcing?***

**JFL:** China will remain a key driver of the commodity world for many years to come and at least until the country's urbanisation matches the developed countries standard i.e. 70% of the population. In China 813m people live in cities - i.e. the ratio is 59%.

With an urbanised population come a change in diet with more proteins, and therefore industrialised supply chains around animal nutrition as well as direct supply of proteins for human consumption, be that in the form of agri products and meat. The biggest evolution we are about to witness is the growing demand for quality.

China has addressed the quantity issue: there is enough supply and disruptions are very unlikely. Middle classes will now get more demanding – in a similar fashion to what we witness in developed countries, about traceability and sustainability of the supply. How long will it take? Probably much less than it took the population in Europe for instance to become fond of organic food.

The concern about the environment is certainly now very high on Chinese urban citizen's agenda. Developed economies have started to feel the impact of such awareness. Already, China has stopped recycling the world's paper. It has now halted the recycling of plastics and developed countries supply chains have had to be reorganised in haste. China does not want to be the 'West's dumping ground' any more.

***TXF: How important is the health of commodity trading companies?***

**JFL:** Would we be able to sustain the commodity supply of the world developed economies without the intermediation of trading houses? This is very unlikely and if it were to happen, the costs for the consumer would be quite high. Trading houses know where, when and what to source. They also master the logistic and the risks along the journey of the goods from the field to the consumer. And what is remarkable is that they are able to make money in the process without creating bottlenecks for the consumers.

Commodity traders are therefore a central piece of commodity supply chains. Trading houses face challenges, as physical markets are getting efficient to the point where trading profitability shrinks unless there are some disruptions. Well, there are some, and particularly these days, but markets are increasingly more transparent, thanks to weather forecasts, science, technology and

widespread information. It is harder to make money in ever more sophisticated markets.

Financial markets play a fundamental role as they allow trading houses to protect and optimise the physical trade flows. However, these markets are also affected by technology. Already 2/3 of crude contracts and 50% of soybean contracts are automated.

Moreover, more players are intervening in the commodity financial markets with no interest in fundamentals (risk premia investors). This makes the development of a hedging strategy much more difficult for physical traders. As commodities become a more established asset class, these evolutions are likely to accelerate. How will trading houses adapt to this? Already more 'quants' are populating commodity trading floors alongside physical traders.

***TXF: Who is financing the small and medium-sized traders?***

**JFL:** Unless they enjoy a very attractive niche, small traders have less and less opportunity to make money out of commodity trade. They simply do not have the necessary critical mass to thrive. Banks are therefore less reluctant to extend support to these companies. The risk perception is higher and so are the capital requirements to take risk on this segment.

Small traders therefore turn to alternative funds for their funding. Alternative lenders are not hampered by regulatory capital treatment and are keen to generate attractive returns which they cannot get out of the more established trading houses. This pool of money is therefore both rather expensive and limited as funds are keen to maintain a diversified portfolio.

Mid-sized traders are still supported by banks (local and regional ones mainly), but also draw on alternative lenders to get the flexibility banks are reluctant to offer.

***TXF: Are alternative lenders really making a difference?***

**JFL:** They definitely have a role to play and make a difference, especially for the smaller players. Larger players talk to them also, but by and large because they want alternative lenders to play a role in supporting their supply chains, as traditional bankers are increasingly shy on that front and not able to look at the new frontiers that traders explore to find new pockets of opportunities.

***TXF: Have major banks lost their bottle?***

**JFL:** They have not. They are merely reacting to the regulatory pressure and building an ever-stronger ability to withstand the next crisis balance, the very demanding AML measures whereby every trade transaction is screened as a potential suspicious one and KYC processes (on customers, on customers' customers, on banks…). This forces them to deprioritise some less accretive (in the form of return on capital) and regularly reassess their choices. We probably have seen the worst of it as technology (digitalisation, artificial intelligence notably) will gradually help the banks steer through the regulatory requirement more effectively (and therefore more cheaply). That of course notwithstanding a further risk deterioration stemming from the economic and geopolitical environment.

***TXF: How much is credit and political risk, compliance, and new regulatory activity now adding to the cost of deals?***

**JFL:** Despite the narrowing of the bankers' market (they all focus on the same names, same risks, and same ecosystems) and higher constraints as already explained, competition has been quite efficient. Have margins or fees really increased? Not quite. In other words, bankers are less open and forthcoming than before, but because they all want to do the same thing with the trading houses, their pricing has been kept in check.

*NB: This is a slightly abridged version of the full interview – to read the full interview please visit: www.lambertcommodities.com (http://www.lambertcommodities.com)*

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