FT Commodity Tokyo Summit 5th Dec 2017

I just attended the first edition of the Financial Times Commodity Summit in Tokyo. Organized with the help of Nikkei, the English newspaper's parent, the summit gathered very good speakers in front of a mostly Japanese audience. Taking place at the end of an eventful year for the commodity world, the various panels both shed an expert light on 2017 and provided some perspectives for 2018.

Overall, and despite some geopolitical uncertainties, the environment looks pretty strong. Commodity prices are on the rise and against such backdrop, this is logical and expected. The combination of a low interest rate environment, non-inflationary economies and a robust growth engine across the board is very encouraging. This does not mean that the trading environment will be any easier in 2018, as volatility remains a scarce treat these days. Food and agri traders are definitely going to remain under pressure to differentiate and add value. Oil and petroleum trading is bound to continue to be under pressure from an enduring 'shale band'. Metals and mining will remain China-dependent although volatility may be fostered by speculations about electric vehicles wiring and batteries. The most attractive and promising business opportunities for trading, though, may lie with the emergence of a newly tradeable commodity: LNG.

Anyway, hereafter is my takeaway from what I thought was a very interesting day.

- The Macro environment.

  A goldilocks economy is how one economist described the state of the world. We are embarked on a smooth ride and one which is now close to the 1990 – 2007 average with growth exceeding 3.6pct.

OECD reported that the 45 leading economies (80pct of the world GDP) were all in expansion. A trend which economists see lasting for the next two years. To put things into perspective, if the world GDP was to keep a 3.6 -3.7 pct. growth momentum, it would double in 20 years!

After two very bad years, trade is back with a vengeance. This year, trade should grow by 6pct i.e. at a factor of 1.65 over GDP. Even if economists foresee next year's growth to be slower, trade is firmly back in the driver's seat of wealth creation.

Now, is this good omen for commodities? Yes, of course. Growth means consumption henceforth more commodities. However, whilst the developing countries are doing well (China) or better (Latin America), the GBP growth momentum lies with the developed countries which are much less commodity intensive countries.

- The LNG's awakening.

It is fascinating to witness the emergence of a commodity. What is happening in the world of LNG is exactly that. Two years ago, this "market" was run through long term take or pay contracts, no future exchange, virtually no spot market.
Now, 30pct of the world LNG flows are 'tradable', i.e. predicated on spot or 'hedgeable' forward contracts! Furthermore, this an industry in vast expansion (a journey from 250 million tons to 400 million tons): a bigger share of a bigger market. Exciting for the major trading houses which are all gearing up to intermediate LNG trade flows.

The paradigm shift is threefold:

- LNG buyers (power companies) are no longer willing to sign long term contracts. The last liquefaction projects to be launched were still enabled thanks to long term commitments, of course, but they were given by the very sponsors of the projects, not the LNG ultimate buyers.
- The large buyers – the Japanese power companies notably, are challenging the way the contracts are locked on destination: when complying with their contractual obligations to off-take, they want to be able to resell the excess quantities to any buyer anywhere, thus becoming LNG traders in their own rights.
- The cheap and nimble floating Storage Regasification units (FSRU) are opening a brand-new market for emerging economies in need for power supply, thus creating new regular flow opportunities for trading companies and, for the stronger amongst them, the possibility to be an active player in power generation.

- The future of agri trading.

  Large asset light agri commodity traders are increasingly challenged. This sophistication spreads all across the supply chains: from savvy producers enjoying ever more information about the quality and quantity of the crops, water usage optimisation and market intelligence, to the large food companies. As Sunny Verghese, the iconic CEO of Olam put it, “the asymmetry of information is gone”.

  When agri and food commodity prices remain stubbornly flat, when tracking and tracing, sustainability becomes the motto of consumers, is there still a place for trading houses?

  In niche markets, small traders can and will survive, especially when dealing with commodities where future markets are non-existent and attractive commercial margins are a necessary buffer to absorb price movements.

  In large, highly liquid markets though, the trader’s proposition alone is no longer bringing enough value. It is therefore likely that consolidations occur: producers and traders; traders and food companies; producers, traders and food companies’ alliances.

  Will 2018 end with the ABCD’s standing alone? At least I can think of three these letters that are going to be challenged…

- Coal and Iron Ore.

  Here is an interesting paradox: the world demand for thermal coal keeps rising. 65mio people still live without electricity. Yet it remains one of the cheapest source of energy. Pushing the paradox further, the banking industry is gradually shutting its financing capabilities for what it is perceived as THE wrong source of power. Yet as Peter Freyberg, Head of Global Coal Assets at Glencore put it, “the energy reality is that coal is needed”. Maybe a push to systematise carbon capture and storage facilities (CCS) could help improving the perception? So far, a tiny fraction of power generation benefits (the cost is still a major impediment) and CCS does not convince banks to change their strategy, worried as they are about any potential reputational risk in resuming support to the coal industry.

  Iron ore is China dependent. Two things are happening in the Middle kingdom: after a sharp development of steel production, it has now stabilised. But at the same time China is cutting its poor-quality iron or production. Combination means that China’s imports will keep growing and as Goldman Sachs put it, “China will no longer be transmitting price deflation but inflation”.

An interesting dimension re steel is that the scrap market is required to grow if we are to face demand growth by 2022-2030: “more of a fact, less of a debate”.

Some food for thoughts: the financializing of iron ore i.e. the ability to use market instruments to optimise/hedge iron ore flows has been very successful with SGX, Dalian and now HK offering an adequate pool of liquidity (a good omen for LNG as only a few years ago, iron ore price was discussed behind closed doors every year). Steel, however, remains one of the largest commodity without a proper financial market support and this because cocking coal, a key ingredient aside iron ore, is a volatile commodity, with a hard price discovery. SGX Australia Fob future contracts might help improving this.

- Oil markets.

On the face of it, the Vienna meeting in November was a resounding success: not only cuts have been confirmed until the end of 2018, but Russia and Saudi appear in full agreement and even Libya and Iraq have agreed to keep the current level of production throughout 2018.

A few doubts have emerged though:

- Behind the scene, the entente cordiale between the Saudi’s and the Russian is doubted. With Brent exceeding 60$bbl, there is growing pressure in Russia to turn the spigot.

- Besides Russia, there are still lingering doubts about declared and actual level of production of the 24 countries. One panellist, former Exec from PDVSA candidly admitted at the summit that statements of production are usually largely distorted…

- As Bob Takai, the CEO of Global Research at Sumitomo put it, OPEC/NOPEC cuts look more and more like QE (quantitative easing): Easy to do but difficult to unravel: “what exit strategy?”.

- And last but not least, the known unknown: shale production. How fast are the US shale boy going to ramp up their production? Even if it has been said in the press that the US shale producers would not focus on profitability rather than volumes, it remains doubtful that they do so when oil nears 60$bbl. US shale is described as “a constantly developing short cycle” industry. We can therefore get surprised by its nimbleness.

In the meantime, the current price level is one nice to lock in through hedge. However, hedging has an effect on the WTI price which is lagging well behind

the Brent. This is because its ascent in 2017 has led to a flurry of hedging activity throughout the year.

Neil Atkinson, IEA's Head, Oil Industry and Markets Division, forecast that US (shale and conventional together) will grow its production by 800kb/d in 2018. So, overall, two conclusions can be drawn: one is that the potential for upside, baring a geopolitical accident, is rather limited. Second, is that the shale band is an enduring concept even when we have witnessed the 2017 price increase.

Another unknown in the market in 2018 is the behaviour of bunker fuel. New regulations will cap sulphur content in marine fuel oil use from 2020. The cut from 3.5 to 0.5 sulphur content in marine fuel could increase shipping costs very significantly. Kenya Matsumoto, Head of Distillate at Vitol said that this could create a situation where 1mb/d high sulphur fuel oil could not find destination.

- Geopolitics and Commodities.

Geopolitics are the big unknown and highly interesting discussions took place. Unsurprisingly, two black spots were identified:

One which is obviously the chief concern in Japan is the North Korean nuclear program and its consequences. Would China do anything about it? Certainly, but keeping North Korea as a buffer against US troops stationed in South Korea is equally an imperative China will not compromise on.

The other spot is of course the middle east and the degrading relationship between Saudi and Iran.

On the backdrop of this lies yet another big uncertainty: The US administration behaviour which has become rather unpredictable, with a president who has a knack for fostering fire bushes (the transfer of the US embassy to what should the capital of Israel – Jerusalem being the last avatar).

In these circumstances, why gold is still hovering around 1,250$? Well, said Bob Takai, gold has in fact strengthened this year – it was below 1,130$ one year ago and it hit a high of 1,350 in September. It certainly has the potential to rocket to new highs if the geopolitical situation further deteriorates (and 'rocket' might be the right word).

Another interesting observation is how skilful China has been to rebalance its energy supply mix with long term partnership stricken with Russia, CEPC stake, in Rosneft and, unbeknown to many in the audience, the fact that Turkmenistan is now selling most of its production of gas to the Middle Kingdom through the biggest pipeline connecting the country to a consuming country. Ten years ago, the only way out for this quasi land-locked country was

toward Russia. “China has taken over Turkmenistan”. Mr Xi’s One Belt one road grand design will certainly further anchor many central Asian countries towards the south east.

- Japan and commodities.

Strategic commodities are a concern for non-producing countries. Naturally. But coming from Europe where, whilst the same interest exists but is not really addressed strategically at governmental levels, the Japanese way impresses. Throughout the conference, officials stated time and again the importance of a diversified and stable inflow of commodities, and chiefly of crude oil and products.

Nowadays, said Yota Ono, Director-General, Oil, Gas and Mineral Resources at METI (Minister of Economy, Trade and Industry), the country’s 80pct dependency upon Middle East supplies remains a primary concern. He also clearly indicated that more Japanese Companies had to seek long term investment in helping securing supply.

Clearly, energy supply is Japan economy’s Achilles heel. The concern that the 3th largest economy in the world could be deprived of its strategic feed is on top of the agenda. Then again, this is hardly surprising in the context of geopolitical tensions simmering in Asia and Middle East on the backdrop of questions about the reliability of the American sponsor.

It was in this context a bit of a paradox that none of the Japanese large trading companies cared to participate to what was a very interesting summit. This was a first of its kind in Tokyo and probably not the last one. Japanese tradeco’s will therefore have (at least) another chance…