In preparation for a panel held on the 9th of November 2018 at the outset of the TXF Geneva 2018 Structured Commodity Finance, Jonathan Bell TXF's Editor in Chief, sent a long list of topical questions about the market. This looked to me a very good opportunity to reflect and to articulate some thoughts that I am now pleased to share. Happy reading!

JFL (12 November 2018)

1. MACRO

- On the resilience of growth engine, USD and the consequence on commodity prices

Fundamentally, 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, world economy is to 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. Polarization 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. A strong dollar does not help the US either: whist Donald Trump believes he can fix the deficit by fiddling with tariffs, the strength of the dollar cripples the US exports' competitive position. The Fed will continue to raise the 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.

- Could the result of US mid-term elections alter course re trade and sanctions?

The mid-term election is a draw, not altogether a defeat for the President. The ruling party did much better than they did for previous administrations. Arguably the loss of the House will complicate the president’s life, notably domestically. Internationally however, let’s not forget that there is a large bipartisan consensus on getting tougher with a China. Russia has also very bad press in America, from the New-York time to the Washington post and Iran’s mullah’s regime does not find any support from republicans to democrats. There are therefore little chances that the protectionist genius gets back in the bottle anytime soon.

2. ENERGY

- What have we seen in the market over the past 12 months?

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. Besides, 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 17pct to c72$ per barrel but still well above September level i.e. c56$.

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 IEA.

However, and besides Mr Trump’s probable damning tweet on Saudi’s intention to slow its production, several factors support the view that oil should retracts from current highs. First, at this price, demand growth momentum will decrease. IEA has revised is forecasts downwards to 1.3 mbpd in 2018 and 1.4mpbd in 2019. Second, the falling Iranian supply has been more than absorbed by OPEC and Russia. IEA said that in September 2018, the overall supply is 2.6 mbpd above last year’s level. For the first time 100 mbpd have 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.

- How do we see the OPEC/Russia pact playing out?

It is no longer in play for now. Russia is keen to increase its production and OPEC to slow it down. If prices move sharply down new year (this is unlikely but…) then Riyadh will reach to Moscow. It does not look necessary these days.

- Can we expect the relative stability of the price of crude to continue?

Stability is never a commodity market reality. Would price likely to climb down? Probably, but caveats get bigger nowadays. Political uncertainties are rising to levels unseen for decades. Supply is very tight and unexpected accidents could propel prices to new highs.

- Are strategic stockpiles full?

This is a difficult one. US strategic petroleum reserves (SPR) are still representing some 35 days of domestic consumption and are unlikely to fall significantly.

China's SPRs, should be reaching c320mb by the end of the year according to IEA. That would represent 64% of the official objective of 500mb. It is likely that China will keep accumulating SPRs as they are building new reservoirs. For now, and notwithstanding the use of commercial storage, China should be at near full capacity.

Overall, IEA assesses that commercial stocks built by 0.5 mbpd in 2Q18 and look likely to have done the same in 3Q18. lends weight to the argument that the oil market is *adequately supplied for now*

- What impact will IMO 2020 have on the market?

There are 3 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 disrupt Trucks and Jet supplies

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 $1tn over five years (FT). Yet, let's not forget that high-sulphur marine fuel only account for 4% of global oil demand.

The concern will probably build over 2019 especially since, so far attempts to delay implementation or to add an "experience-building phase" have been put off. We can expect a lot of volatility in Refining runs and this will certainly trigger attractive optionalities for trading houses.

- Are China and India going to continue buying Iranian crude?

Iran hope to keep exporting 1 mbpd. With India and China, the prime potential customers. 6 months weavers have been given to a few countries amongst which China and India. Besides Russia 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.

- How much more will US and Canadian shale oil impact the traditional crude producers and exporters?

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 up 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 4.8mpbp in 2017 to 5.8mpbd in 2023, oil sand climbing by 700kbbd over the next 6 years.

- What is the future for African oil and gas?

For oil, Opec Africa producers Angola and Nigeria have little room. Angola's production will gradually decline from 1.6 to 1.3mpbd by 2020. If Nigeria has the ability to increase its production from 1.7 mbpd currently to 1.83 in 2020, it should decline back to 1.75 from there on. Non Opec African producers' production will plateau below 1.8 mbpd.

As to gas, Egypt has a strong potential, but also huge needs. The future production is likely to be total absorbed by domestic consumption.

- Can we expect more upstream activity in oil and gas – and where?

Appetite for upstream is a function of market prices? Exxon is just about to start its off-shore production in Guyana. That was in the offing for months? We saw a peak in discoveries in 2006 to 2010 i.e. when prices were attractive and off shore production viable. Not surprisingly, in 2017, the amount of oil found dropped to another record low, with less than 4 bn barrels of crude, condensate and NGLs discovered around the world., not since the 1930s was so little oil found says Rydstad Energy.

- What future is there for coal and coke?

Coal is the largest source of energy and, according to BP will remain such in 2040 when it should represent c30% 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 ever year!

3. AGRI-COMMODITIES

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

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 discard. This benefits for soybean to south American producers and chiefly Brazil. The fall of Brazilian Real amid political uncertainty lowered 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.

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

- What has been the impact of Trump's Trade War with China on the agri sector?

Exports of soybeans are tumbling when harvest is historically strong – US farmers will get subsidies. As prices drop, crushing margins for soybean are at the highest and all ABCD's 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 mast year they imported 36miot of soybean from the US, it looks like a long shot.

- What other spinoffs will we see on the agri front from the US-inspired Trade Wars? Who will the winners and losers be?

US farmers will lose a lot, obviously. The Brazilian one's will win. Cofco International, China's largest trading arm has now a very strategic task on its laps: 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 announcement of alliances with some ABCD's, in quest for partnerships, 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 African's and Indian's producers, but this is too early to tell.

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

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 the Brazilian relatively young democracy,

especially on the economic front as he himself admitted his lack of knowledge on this front.

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

Agri and food prices have been stable over the last 50 years despite population trebling and 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 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.

- Are we improving on the agri sustainability front? (i.e. palm oil)

As middle-class populations grow, environmental awareness gets more prevalent. Demand for traceability and sustainability amid developed countries will soon be echoed by the urbanised Chinese population. Chinese families, leaving in huge cluster cities are deeply concerned about the environment and the nutrition quality of the diet of their unique child.

4. METALS – Base, ferrous and PGMs

- Price volatility has characterised the metals sector overall for the past year, but there are bright spots. Iron ore, copper, cobalt, nickel, rare earths

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 to cheap and a safe haven for geopolitical crisis) 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 EV particularly in China. Copper will also be supported (steady demand increase and no investment in production for several years).

- On the ferrous front, iron ore has climbed back somewhat – is this gain totally reliant on the car manufacturing and the construction sectors?

The fight against pollution will accelerate the closing of lower quality iron or production in China and the imports of higher ferrous content ore. Already the premium for 65% ferrous content iron ore in China is huge: 65%Fe cost 95$ vs 69$ for 58%Fe.

- The fortunes of copper appear to be 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 hold?

On the long run, demand for copper is to accelerate (together with nickel and cobalt); EV require 3 times copper wiring that the 30kg required for conventional vehicles. More fundamentally, demand for metals grows by 3 to 5 pct. per annum. To cope with demand from now till 2050 (35 years), 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 3 years.

The view on copper is therefore bullish.

- Cobalt and rare earths are very much tied up in the renewables and electric vehicles market. With much cobalt production coming out of the DRC how important is resource security?

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 antagonize its major buyers. All the more since the main buyer is China which imports already 80pct 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 10kg. 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 earth. 90pct of the world rare earth 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 100pct of its rare earth production. When we know how important rare earth 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.

5. CHINA

- China is the biggest purchaser of a vast range of commodities – what are your views on this important market and the problems it is facing with the current Trade Wars with the US?

China's growth is decelerating. Not a big news as 7pct + 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 or PMI felt 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 effect of the tension with the US have not been felt with Chinese export still growing (12.2pct through the first 3 quarters of 2018).

Another positive is the fact that whilst the RMB is getting close to the psychological level of 700 for a dollar, it does not look like the government is willing to trigger the currency war weapon just yet.

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

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 813mio people live in cities i.e. the ratio is 59pct (the Economist).

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 than 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 found of organic food.

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

6. COMMODITY FINANCING AND THE MACRO ECONOMIC & RISK PERSPECTIVE

- How important is the health of the commodity trading companies?

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. They 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 house to protect and optimize the physical trade flows. However, these markets are also affected by technology: algo trading is spreading fast in the commodity sector. According to the FT, 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 hedging strategy much more difficult for physical traders. As commodities become a more established asset class, these evolutions are likely to accelerate. How trading houses will adapt to this? Already more ‘quants’ are populating commodity trading floors alongside physical traders.

- Who is financing the small and medium sized traders and producers?

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 henceforth are the capital requirement 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 attracting returns that cannot be out of 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.

- Have major banks lost their bottle?

They have not. They are merely reacting to the regulatory pressure for ever stronger ability to withstand the next crisis balance, the very demanding AML (anti money laundering) measures whereby very trade transaction is screened as a potential suspicious one and KYC (know your customer) processes (on customers, on customers' customers, on banks…). This forces them to deprioritize some less accretive (in form of return on capital) and top regularly reassess their choices. We probably have seen the worst of it as technology (digitalization, artificial intelligence notably) will gradually help the banks steering 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.

- Are alternative lenders really making a difference?

They definitely have a role to play and make a difference, especially for the smaller players (see above). Larger players talk to them also, but by and large because they want alternative lenders to play a role in supporting their supply chain 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 optionalities.

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

Despite the narrowing of the bankers 'market (they all focus on the same names, same risks, and same ecosystems) and higher constraints (as explained above), 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.

- If deals continue to be priced so cheaply, will anyone be left to finance them?

For now, this is not a worry. Nobody is exiting the market and certainly not the usual suspects (banks with a long track record in financing commodities). And liquid Asian banks are quite keen. So far so good, therefore.