

S&P Dow Jones Indices

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Talking Points:

In the Wake of Fallen Oil



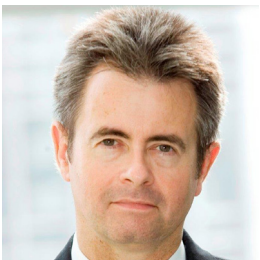
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In the wake of fallen oil, lower commodity volatility, and increased regulation, many commodity desks and asset managers have been forced to shrink or close altogether. However, as one door closes another opens, bringing the potential for new return opportunities to fill the void, especially on the long side, as speculators pull out and the impact of fundamental rebalancing becomes clearer.

*In our latest Commodities Masterclass, CME Group, Euronext, and ICE Futures joined S&P DJI to discuss what could be in store for commodities, the role the futures market continues to play, and which individual commodities and sectors are being most influenced by the current environment. To view the entire Masterclass, watch **Who Profits in the Commodity Futures Market Now?***

1. What are some of the main external forces driving commodity markets today?

Nicholas Kennedy: There are going to be immense changes to the regulatory environment starting in January 2018, which could have significant impacts on the whole ecosystem of derivatives. The aim is more transparency and security for the market, but the amount of work required is absolutely colossal. It involves everyone from the producer to the clearing partner, the trading member, the exchanges, the marketplaces, and the clearinghouses. For example, what's going to change in January for market participants investing in Euronext grain contracts is that they will have an obligation to report their positions, which is something that has never been done before in Europe. Also, there will be limits on these positions. Then the exchange has to report that back to the European regulator, which allows for visibility of the commitment of trader (CoT) report to know who

has a speculative position versus a commercial position. More importantly, it allows for the measurement of position changes over time and for Europe to finally have something that's been in existence in the U.S. for many years.

2. How might the increased transparency requirements affect Brent crude, since it's such a large part of the global benchmark for oil pricing?

Mike Davis: There is a piece that is new in the sense of the specifics of method, but in many cases a lot of the work around the transparency of the world benchmark system has been done already. For example, the Intercontinental Exchange (ICE) has CoT reports and has had them for a number of years, and it is now rolling them out for the Dubai benchmark as well. Position reporting and management are integral parts of market supervision for most futures markets and have been for a while. In the case of Brent crude in particular, transparency is effectively part of the DNA of the contract. There is already a specific benchmark regulation with an oversight committee of the Brent crude index, which is the expiring mechanism for Brent crude. So a lot of this work has been done either voluntarily or at a national competent authority (NCAs) level. However, there have been some different cultural approaches between jurisdictions. For example, ICE historically used more of a position management approach in regard to Europe rather than a fixed position limit approach, but one is not necessarily better or worse than the other. While there are new requirements, there is a long history of change, and on-screen futures have been the gold standard for transparency. Public numbers for the settlements are available to anyone online, with seven years of history and seven forward years of prices that show a wide scope of the oil price. It is important since a lot of other prices are based on Brent crude.

3. Might the increased transparency in Europe influence more visibility in other markets like China? How can more transparency be brought to metals, given their use as collateral for Chinese debt?

Erik Norland: There has been a high degree of transparency in the U.S. for a long time. For example, Comex copper already has a CoT report, so it is clear who is using those futures and how, but that doesn't necessarily change the opaqueness of what's going on in China. If people in their domestic markets are using copper essentially to finance currency transactions, that implies a buildup of inventories. So the way in which that is reflected in the market is by knowledge of inventory that's built up, but there is uncertainty regarding its size. So the put options on the copper future are much more expensive than similar call options. The market seems resistant to the idea of writing inexpensive downside insurance on copper, in part because

there's a fear that if China one day liberalizes this exchange rate, which is also somewhat opaque, it could create the liquidation of these inventories and some downside in the price of copper, and perhaps other industrial metals.

4. Does the basic insurance function of the futures market remain, or can the use of the metals as collateral change the profile of how the futures can be used to manage risk?

Erik Norland: The basic function of the futures market to manage risk stays the same as it was before the collateral usage, even if an important feature of one particular country (China) does have a strong presence in the industrial metals market. However, anybody looking to lock in prices because of concerns about prices going down or prices going higher can still use futures contracts in the same manner as before, irrespective of country of residence. In terms of options, the same is true, as there is currently a high price on the downside potential for copper, but that doesn't necessarily imply that the way in which the market functions has changed in any meaningful way.

5. How do futures help manage risk, or does the post trade matter more?

Nicholas Kennedy: The starting point is with the basic use and reason of a futures contract for its price discovery. Whether you are a commercial entity or a trader looking at prices for hedging purposes, or if you're a financial user with the goal of having an accurate exposure to a given underlying index, it continues to be the case that futures for price discovery is the main goal. It does very well across the globe; new listed futures contracts are growing pretty much everywhere. The post trade may be interesting, as it brings back transparency to a certain extent. While this refers to the listed futures and the security that they offer, now the questions are how to gain more transparency in more opaque over-the-counter (OTC) markets and how can a more formal approach be applied. One of the aims is to be able to give more visibility, so the post-trade element comes in basically to bring on board a platform of OTC prices then have them cleared in a central counterparty clearinghouse. It brings the best of both worlds together by combining the OTC bilateral and the security of clearing.

6. Is there a difference between how the current environment affects Brent crude versus the other commodities in the petroleum sector?

Mike Davis: There is currently a highly dynamic oil market, not just in terms of the differentials across crude oils but also the margin prices expressed for gasoil against crude, or gasoline against WTI. Oil prices have recovered a long way from the lows of January 2016, and many of the spreads have become unusually strong or weak. For example, the current Brent-WTI spread, which is one of the traders' favorite expressions, is large, meaning there is a great amount of crude oil being exported from the U.S. The large draw on U.S. production is helping to adjust prices, and the arbitrage function is also a key part of global oil markets. This is positive because it means the oil is moving from places where the price is relatively low, and when production is plentiful, to places where there is less oil. It's a useful process in that sense, particularly when there are natural disasters and the diesel market tends to be strong. Now the market is firming up abruptly, so the spreads inside of Brent crude's curve are such that the near-dated oil is more expensive than the further out. However, for WTI, there is more supply because of the production environment from shale or tight oil that's different in the U.S., so the near-dated price is lower and the interaction between the two creates high volatility in those spreads. Therefore, there is a lot of movement of oil globally, but there's also a massive export market into Europe where there is almost a permanent short position, since Europe doesn't produce enough diesel for its own consumption. Diesel is sent from the U.S., Russia, the Middle East, India, and increasingly from Asia. The resurgence in demand from Asia in particular is pulling a lot of oil eastward, and that is having a dynamic effect, so the current environment is bearing on all of those elements.

7. What are the supply growth prospects for energy and industrial metals and how much does supply actually influence price?

Erik Norland: The current differential between Brent crude and WTI that has widened out has to do with the surge of production in the U.S., which has nearly doubled since 2000. The U.S. appears to be one of the world's swing producers that is driving the volume of trading in WTI, which has increased substantially over the past few years. It has been further aided by the lifting of the U.S. oil export ban, making it so that the U.S. actually can export oil in significant quantities, which was not the case for the past 40 years.

With respect to metals, it's also interesting that copper can be profitably mined near USD 1.80 per pound, and so a few years ago when a futures price got down to around USD 1.90-2.00 per pound, that really squeezed the margins of the miners. Mining production growth actually stayed

positive in 2015 and 2016, but it was slow growth compared to previous years. Now that the price is back up to USD 3.30, that means something like a 60-65% operating margin for metals miners, and that will probably incentivize new production. However, incentivizing new production can be a long haul, perhaps over five years, as miners could possibly bring back capacity that they took offline during the period of low prices.

8. Agriculture has been lagging energy and metals this year. What's weighing down the sector and how does it change the risk/return profile?

Nicholas Kennedy: From a regional standpoint, there is a global surplus, apart from a specific area that just happened to be the largest-producing area in the world in Europe and France, in particular, which were badly hit, so they had a double whammy of low prices and competition in world markets. The reality is that today, there is a lot of consolidation going on in the industry. In Europe, with Euronext's history of about 20 years in futures compared with peers with hundreds of years of experience, new solutions for working within the ecosystem are a good starting point. Now, 97% of the French grains community uses Euronext futures either directly or indirectly, which is huge. Additionally, Europe could get inspired by what happens in some of the other exchanges in energy and metals, like with collateral. For example, the risk/reward of grains is hard to capture despite the low prices. It might be surprising, but there's no current way to monetize carry-on European grains, since it just doesn't exist in the structure of the market. The first action may be to look through a system of warrants. For example, market participants should be able to monetize storage and use that as collateral for financing for the banks. In the process of massive shifts in agriculture, Europe is basically playing catch-up with the rest of the world, so there's a lot going on that is positive for the sector that has been going on for years in oil. The big carry situation with storage has led to the ability to absorb short-term price shocks.

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