COMMODITY TRADING AND MANAGING RISKS

Commodity Trading

Commodities – food crops, minerals or man-made products – are simply the raw materials of manufacturing, food production and economic growth.

They are traded around the world, in *physical* deals in which a price is agreed, the commodity delivered and the contract settled, and in *derivative* deals, which generally do not involve the delivery of the underlying physical commodity and are settled by payment of cash.

The majority of commodity derivative trading occurs through contracts on futures exchanges. These exchanges trade contracts that can involve delivery of the physical commodity. However, most contracts are generally settled before delivery of the physical commodity is due and therefore involve payment of cash only.

Even where derivatives are traded away from the futures exchanges ("over the counter"), most are reflective of prices of a futures exchange based physical contract. This therefore ensures that these "OTC" prices are representative of the underlying physical commodity. Importantly, the payments on these "OTC" transactions are in cash and do not impact physical supply/demand balances.

Therefore, in either case of physical or derivative deals, movements in price are always underpinned by the fundamental laws of supply and demand in the physical markets. To take some examples from the energy sector alone:

- Natural gas prices peaked in 2005 when Hurricane Katrina destroyed oil and natural gas platforms in the Gulf of Mexico; since then, they have tumbled by over 70% as shale gas production in the US has flooded the global market;
- The devastation of the 2011 tsunami wiped out nearly a fifth of Japan's generating power and forced world energy prices up as Japan bought in liquefied natural gas supplies to fill the gap;
- In Canada, a combination of surging production, low demand due to refinery maintenance and a shortage of pipeline capacity recently brought the price of Canadian oil down to less than half the cost of a barrel of Brent, the global benchmark.

Dealing in derivatives, even those based on exchange-traded futures contracts, has the added complication that buyers are staking their money on *expected* prices. For example, the *forecast* of good weather in coffee-growing countries may drive prices down, or the *prospect* of greater demand for rice will force the prices of futures contracts up.

Commodities markets are influenced by producers, processors (for example, roasters who buy coffee to sell on to consumers), end users (including consumers) and traders, all of whom are managing risks arising from their various businesses.

Managing Risks

The priority of producers, processors and end users is to counter the possibility that their predicted profits may be hit by unforeseen events such as currency fluctuations or a fall in prices.

Traders, whether specialists or financial institutions, can either buy or sell commodities, including through cash-settled derivatives. They are therefore prepared to transact with producers, processors and end users using tools that underpin the value of the physical product, allowing such market participants to manage their risk. For example, the farmer who plans to grow the crop can then guarantee an acceptable profit, while the trader hopes to gain from changes in its value.

Some producers and end users/consumers are happy to accept the risk, and do not fix their prices in advance: others may accept some risk, and partly fix their prices. Risk cannot be completely eradicated – fixing a price means that the producer may lose out on possible price *rises*. But by sharing the risk of price changes, he guarantees a secure return.

Producers, processors and end users/consumers will for the most part look to minimise their risks and while it is possible that a producer may be lucky to find a consumer with a matching risk, this is extremely unlikely. Traders and financial institutions, however, do not have 'natural' market positions so can accept risk from all sides, for example through cash-settled derivatives. They are then able to manage that risk via other mechanisms such as selling it on to investors who themselves are willing to assume it in the context of a broader investment strategy.

Their commercial risk management specialists can identify risk factors and plan counter measures; institutions can provide credit facilities and a variety of trading services, and facilitate market access. Investors, taking on some of the risk in the hope of making a return on their funds, provide liquidity to the market. By assessing the fundamental value of commodities and responding when prices seem unreasonably high or low, they help ensure that prices reflect value, and act as a guide to other players. Ultimately, however the success of their transactions will be dictated, in large part, by the fundamental forces of supply/demand prevailing in the physical markets at the time of settlement.

These financial participants are, in fact, a crucial part of the wider market, and it is through their activities that physical traders in the commodity can enjoy stability, minimal risk and a secure profit. Efficient risk management, with buyers and sellers able to find each other quickly and efficiently, is in everyone's interest. This must be a prime consideration in any regulatory changes.