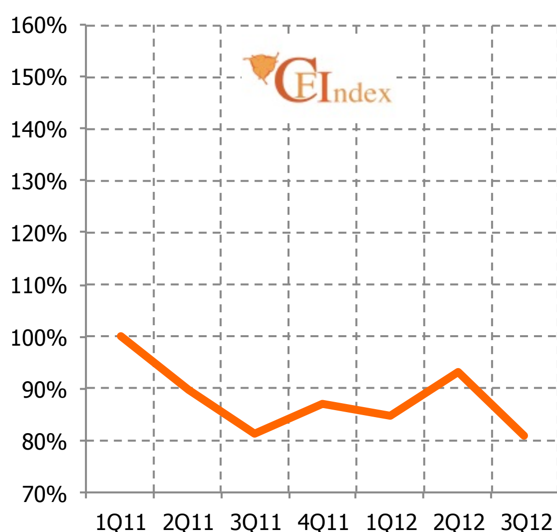
Commodity Trading Gets Physical

- Dodd-Frank and the actions of regulators are turning banks away from the US energy derivatives market. Since the start of 2011, Tricumen's Energy Client Flow Index (CFIndex) has fallen by 20% …
- … while the volume of metals traded has grown at a compound annual growth rate of 17%.
- The combined effect has been switch away from financial and into physical trading: physical assets at banks have grown by around 55% while commodity derivatives have fallen by 45%
- We expect that banks adopting this strategy could improve product RoAEs by 3-6%

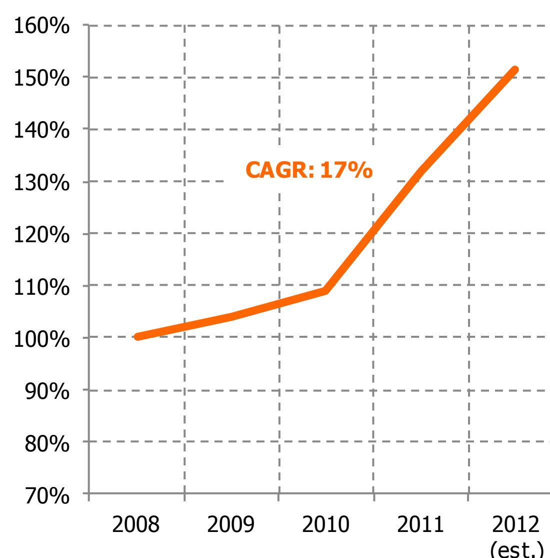
As banks adapt to the Dodd-Frank regulation, there has been a shift from energy trading towards the metals market. That Dodd-Frank would impact the things has been long anticipated, but the market has also been hampered by low client demand for large structured trades and the ever-watchful US electricity regulator, Federal Energy Regulatory Commission (FERC). In mid-Nov-12, FERC banned J.P.Morgan from trading in the US electricity markets for six months. It has proposed a $435 million fine for Barclays for on the grounds that they broke anti-manipulation rules between 2006 and 2008, proposed a $245 million fine for Constellation Energy and alleged that Deutsche Bank has also manipulated the energy markets.

Unsurprisingly, banks are reviewing their strategies: our *Energy CFIndex* (one of our family of Client Flow Indices, which track specific client revenue pools) shows a 20% drop since Jan-11. During the same period, we estimate that the volume of metals traded by banks has grown by 17% per annum.

Energy Client Flow Index



Metals Trading volume (est.)



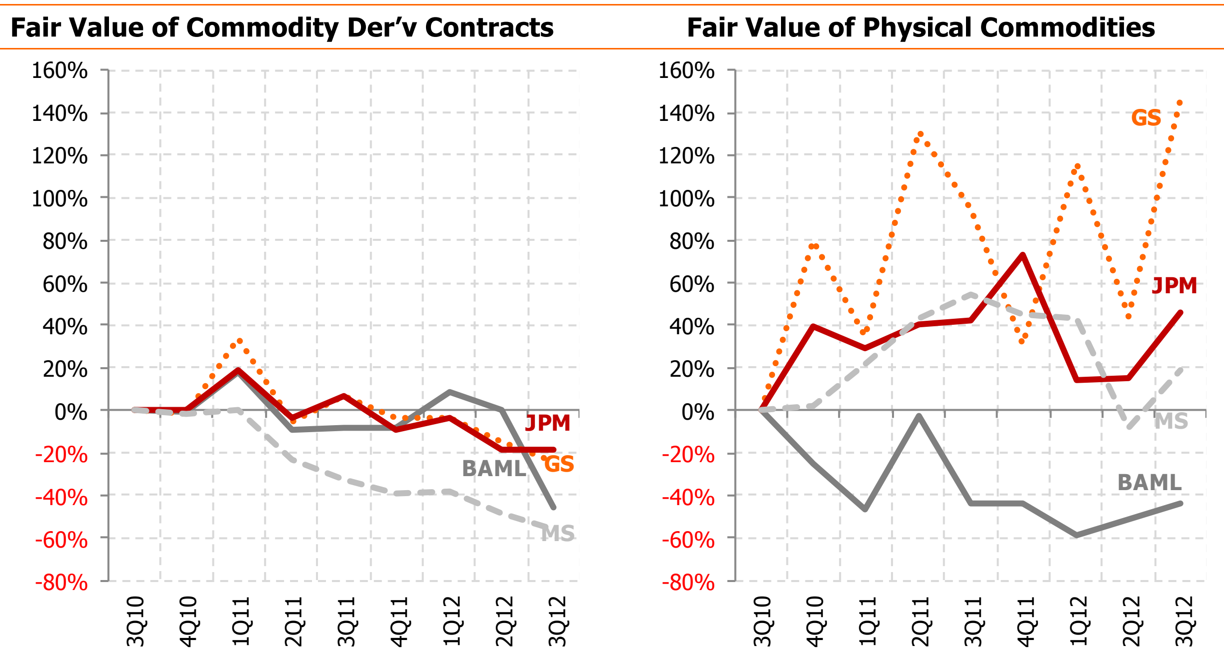
Source: Tricumen..

Metals - and physical metals in particular - have become attractive as an asset class to banks, especially as they can gather information on the determinants of supply and demand such as knowing when mines will come to the end of their useful life, production margins, end-user demand, government policy and even likely commodity M&A activity.

Banks have also found that trading in physical assets avoids some of the more onerous aspects of the Dodd-Franks legislation. Such moves have not been without criticism: in July-12, Senator Carl Levin's *Permanent Subcommittee on Investigations* opposed J.P.Morgan's plan for an ETF linked to copper on the grounds that this will disrupt supplies and create a price bubble[1].

[1] *This is a long-running saga. Broadly speaking, the opinions are split between traditional industrial consumers and financial institutions (led by J.P.Morgan and Blackrock) formulating new client products. In Sept-12, J.P.Morgan stated that ETFs would have no appreciable impact on the price of metals – a claim not universally accepted by market commentators.*

The extent to which individual banks have switched away from financial and into physical strategies is evident on their balance sheets. Taking the four of 'our' US banks as an example we note that, since 3Q10, Morgan Stanley has reduced its derivative positions by 56%, while J.P.Morgan by a comparably modest 19%. During the same period, physical holdings surged. At the extreme, Goldman Sachs has more than doubled its exposure. Bank of America/Merrill Lynch is an exception, having kept its holdings low.



Source: Bank financial reports, Tricumen.

We expect banks to move further down this approach with time, especially if the Asian business continues to grow in importance. This makes Commodities more attractive for banks remaining in the market. That commodity returns from the traditional energy and financial (derivatives) business have fallen has been documented by a number of commentators. However, the physical business brings a way of reversing this decline in the form of new revenue streams and improved capital usage. We expect that banks adopting this strategy will be able to improve product return on attributed equity (RoAE) by 3-6%. "Getting physical" could therefore be the difference between meeting an RoAE hurdle or not.

Notes & Caveats

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