Commodity trading

Back to operations …: Opportunities for 2016/17

Commodity trading revenues are still being challenged after a weak trading year 2015 and optimistic expectations for early 2016. Overall the outlook remains modest with markets still exhibiting signs of past investments, the correlation to a low oil price and weakening demand due to different reasons. As trading revenues are not expected to get back to previous levels medium term, some operational levers and opportunities might be considered.

Commodity trading revenues in 2015 were down compared to the previous year. Attractive oil trading revenues could not compensate the overall contraction of the sector. Reuters estimates overall commodity trading returns of the 12 large investment banks to be 18 percent down to USD 5.6 BN. With some exceptions also trading houses are facing challenging conditions. An early 2016 recovery of prices expected by several risk investors and traders did not happen although volatility patterns could be monetized.

Challenging market situations to continue

Oil: Although the oil price impact on the supply-demand balance may seems exaggerated, a low price but volatile market conditions remain. An inflow of significant investment is needed to compensate natural oil production losses. Additionally, an increasing demand of 1-1.5 MMBD needs to be met. Whether this supply challenge will be met as well as a potential alignment of interests within OPEC will demine the future price environment.

Coal: Most recently, WoodMackenzie expects thermal coal consumption to be down 40% by 2035. This will have a significant impact also on market conduct.

Metals: Changing requirements and material innovation in manufacturing and automotive as well as slowing construction activity is impacting metals trading. Strategic market participants are already acting on this trend.

Softs: Not only supply-demand patterns across the BRIC countries will influence future market conditions. China is a key driver of demand. It has cut commodity consumption due to a dim economic outlook as well as changing domestic demand profiles. In softs however, demand remains high and supply positions have been established (e.g. in animal products).

Overall, difficult market conditions will remain. Volatility in oil provides trading opportunities. Increasing oil prices driven by supply-demand measures might cause some relieve also impacting other commodity classes. However, interest rate policies of the Federal Reserve (FED) as well as additional quantitative monetary measures of the ECB might still be a burden on the commodity price environment.

Efficiency improvements in trading not exploited yet

Operational improvement levers have already been addressed by commodity traders elevating the efficiency challenge from the divisional agenda to the corporate level. To get to the next level of operational excellence will be more challenging as this requires process innovations potentially supported by technology.

Also FICC operations of large banks have made significant cuts. However, the focus has been on cutting front office costs. But improvement potentials at middle and back offices have not been addressed to a similar extent. Trader support ratios and cost income ratios (CIR) at large investment banks still remain high. CIR are in the (high) seventies. Hence, JPMorgan estimates that at some large investment banks, costs at middle and back office need to be cut by 25-30% in order get the businesses back in line with post regulation RoE.

Middle and back office operations improvements

Operations should still be on the management agenda offering degrees of freedom not seen in the recent past. Here are some examples:

- **Continue operational improvements and also facilitate cross opco best practice sharing:** Middle and back office operations continue to be an important lever. Strengthening processes will allow to integrate with technology and will create a more resilient operating environment.
- **Integrate dispersed and growing industrial operations into ops agenda:** As processing activities and industrial operations have increased, including these into the operational efficiency agenda is even more important compared to the past. Realizing improvement potentials without risking operational stability is however tedious compared to creating additional trading revenues.
- **Improve mid and back office capabilities:** Both activities should not only be viewed as cost positions but also as contributors to contain and manage risk exposure – not only market and credit risk but also operational risk. Given that banks need to restructure their FICC mid and back office operations – especially in Europe – allows to tap into a talent pool at attractive costs.
- **Review integration of financing/ treasury and tax management into ops agenda:** Integrating trade finance activities and the international taxation framework into the ops agenda adds value and is of strategic importance these days. However, in order to ensure seamless execution, a corresponding operating framework needs to be put in place.

Operations agenda supports overall strategic objectives

What will be achieved if a stringent operations agenda is followed?

- **More attractive operating economics:** Support ratios and support costs can be better understood and managed than in the past. Facilitating an internal exchange on operating economics and aligning these with the incentive system will lead to more attractive overall operating economics.
- **More resilient business model**: Clarity on processes and transparency of middle/ back office operations is not only increasingly demanded by equity and debt investors. It will also contribute to the stability of the business model impacting risk adjusted returns.
- **Improved financing capabilities:** As operational performance and effectiveness increase, financing capabilities will also be improved – a key strategic objective of commodity traders these days.
- **Better alignment of financial performance levers with business and operating model:** A supply chain set up in line with treasury and taxation considerations is essential for global commodity trading businesses and contributes directly to the bottom line.
