UP FOR DEBATE

China, oil prices and the impact of regulation were among the topics hotly debated at *Energy Risk*'s inaugural Commodities Trading and Investment Summit held in Geneva last month. Ned Molloy reports

Fund managers, chief investment officers, investment consultants, and traders gathered in the Hotel President Wilson next to Lake Geneva on June 21 for *Energy Risk*'s inaugural Commodities Trading and Investment Summit, which attracted a panoply of speakers analysing commodity markets and investment strategies.

A broad examination

Keith Wade, chief economist and strategist at Schroders, kicked off proceedings with his macro view of the economy and the outlook for commodities.

Although China has become the world's largest energy consumer, it still has a long way to go on a per-capita basis, Wade said. The average Chinese person consumes two barrels of oil per year compared to an average of more than 20 barrels in the US. If China were to match US consumption levels, it would require all the world's current energy supply.

Wade next analysed the chances of several key emerging markets overheating. He noted that food price increases had a much bigger impact on inflation in developing countries because they formed a greater proportion of people's personal expenditure and, hence, of the overall basket of goods used to measure inflation.

Hidden risks panel: Sean Corrigan, Diapason Commodities; Julian Mayo, Charlemagne Capital; Jean-Marc Bonnefous, Tellurian Capital Management; and the moderator Tony Hall, Duet Commodities Fund

Nevertheless, Wade said Schroders foresaw a soft landing in China and did not put any serious weight to the scenario of the Chinese bubble bursting and dragging down the world economy.

Risk watch

Next up was Tony Hall, explaining the approach of Duet Commodities Fund to managing market risk. The fund is agnostic on price direction, it expects 20% returns year on year, and is run on 99 Value at Risk, one-year one-day historical, Hall said. As well as the usual stress tests, Duet runs scenario-specific analyses, testing the resilience of the fund to specific extreme market-moving events.

Following Hall's talk was a panel discussion on emerging market risks. Julian Mayo, co-chief investment director at Charlemagne Capital, pointed out that China was still at an early stage of development. Convergence between the developed and developing world could actually happen with the shrinking of incomes per capita in the West, particularly with the US recovery losing steam, he said.

Jean-Marc Bonnefous, managing partner at Tellurian Capital Management, criticised the simplistic approach of treating commodities as just a gross domestic product (GDP) trade. Sean Corrigan, chief investment strategist at Diapson Commodities, agreed there was only a loose correlation between GDP and commodity prices.

Bonnefous stressed the magnitude of sharp slowdown in growth in China for global commodity markets. "If there's a hard landing, they will sell everything," he said, explaining that this presented the opportunity to buy lots of commodities cheaply and profit over the next five years.

The panellists clashed on whether quantitative easing (QE) in the US was helping or hindering China. Some thought China was telling the US to stop QE, while secretly wanting it. But Mayo argued that the unpopularity of QE in the US was because it transferred wealth from the middle class in the long term, to traders and bankers in the short term.

Corrigan criticised the widespread adulation of the Chinese economy as misplaced, criticising its centralised model as creating major distortions and inefficiencies. The mass power shortages in China were because of price suppression, he argued.

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>
> *Sabine Schels, senior director and global strategist at Bank of America Merrill Lynch*

Commodity contest

After the break, the conference split into an energy stream and a softs and metals stream.

In energy, senior research fellow at the Oxford Institute of Energy Studies, Patrick Heather, warned the conference that the US shale gas revolution could not be repeated in Europe, where costs were much higher and geological resources more limited. There would be no significant shale gas volume produced in Europe before 2020, he said.

Sabine Schels, senior director and global strategist at Bank of America Merrill Lynch (BAML), next answered the question of whether we were going to see a repeat of 2008 in oil markets. She noted that although the absence of the Organisation of Petroleum Exporting Countries as a limiter of upward risk made a 2008 repeat more likely, it was still not BAML's main view. However, the second round of US QE helped push all commodities upwards, especially oil.

Schels argued that negative real interest rates generally led to high and bubbly oil prices. Conversely, India's raising of interest rates by 50 basis points led to the sell-off in commodities in May.

The world was fast losing its spare productive capacity in oil, Schels said, with an obvious supply/demand imbalance. If Libyan production doesn't return in 2012, we will eat into another one million barrels per day of spare capacity.

Next, Henrik Hasselknippe, managing director of product development at Green Exchange, provided a look into the future of carbon trading. He noted some upcoming jurisdictional clashes in Europe, while the UK carbon allowances are treated as normal property rights. The Markets in Financial Instruments Directive review might classify carbon credits as financial instruments even though, at the moment, they are treated differently in each EU country.

After lunch, Tim Greenwood from the European Energy Exchange (EEX) expounded on how power could be traded as an alternative asset class. While investors had been scared away in the past by the extreme volatility and special characteristics of power markets, there was an increasing number of financial participants on EEX, he said.

Wind generation was having an unpredictable effect on short-term power markets, Greenwood said, and through the tight link between spot and futures prices, it has impacts on long-term price signals as well.

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ETF effect

The effect of exchange-traded funds on broader commodity markets is a hot topic nowadays. Speaking on this was John Hyland, chief investment officer at US Commodity Funds – manager of the popular US Oil Fund and US Natural Gas Fund.

Hyland said it was ridiculous to assert that physically-backed gold ETFs were 'hoarding' gold, when they were the only market participants who were obliged to sell you some of their gold holdings whenever you wanted.

After a coffee break, Jason Lejonvarn, strategist at Hermes Fund Managers, took an analytical look at how well commodity investments work as a diversifier. He said, as a rule, commodities performed well late in the business cycle, while equities did well early in the cycle. In 2008, commodities had a six-month lag before they were brought down by the financial crisis, Lejonvarn said.

Result of regulation

The day was rounded off by a lively panel discussion on how new regulation would change trading and investment.

Homayoon Arfazadeh reminded participants that new regulation on market manipulation didn't require proof of intent, just proof that a position was causing distortion. This would make it much easier to prosecute for manipulation.

Hyland said airlines and every other end-user would argue for an end-user exemption, even when it didn't make sense. However, he had serious doubts about the timeline for implementation, which was causing serious uncertainty for market participants. "We'll be back here in June 2012, and we still won't know what the rules will be," he said. ■

Gerd Stuhlmacher, E.ON Energy Trading; John Hyland, US Commodity Funds; Homayoon Arfazadeh, Python & Peter; and Gregory Mocek, Cadwalader, Wickersham & Taft, discuss the effect of regulatory changes on commodities trading