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Welcome to our latest Ghost In The Machine. Having covered issues such as ‘BREXIT’, global trade, ‘Big Data’, ‘Seasonality’ and ‘El Nino’ in recent publications, we thought it was time to focus on what is essentially ADM’s core expertise, Commodities.

It’s certainly been a brutal few years.

However, talking with the different trading desks in the London office, we detected a slightly more optimistic tone from a couple of them. This surprised us since speculative flows are such a feature of commodities markets these days and the general theme in financial markets has been one of “risk off” since the New Year.

A focus on commodities also seems timely for a couple of other reasons.

One is the unusual degree to which equity markets, like the S&P 500, have correlated with movements in the oil price in recent months. We are also struggling to remember a time when views on the oil price outlook have been so polarised.

Secondly, Japan has joined the Eurozone, Sweden and Denmark in the NIRP twilight zone for monetary policy. The Federal Reserve has acknowledged that it is something that it will also consider.

Commodities are priced in dollars. If US rates were to go negative, the potential for an increase in demand for zero-yielding commodities via carry trades becomes real.

However, if US rates do go negative, it’s worth pondering what that might imply for the global economy and the financial system. There is only one financial asset which has zero counterparty risk and that’s gold. It also has a zero yield and the combination of the two could begin to look compelling.
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The ECB eased its already highly accommodative policy stance as recently as December. Despite this, Mr Draghi has been speaking in ever more urgent terms of the need for further measures to inject stimulus with a view to ‘delivering the ECB’s mandate’, which is to achieve a consumer price inflation rate below but close to 2%. One of the principal factors bearing down on euro zone consumer prices since December has been a further decline in the prices of oil and of some other commodities, following steep falls in the preceding eighteen months. Though this disinflationary influence affects the advanced economies similarly, there is a striking difference between the ECB’s reaction and those of the Bank of England (BoE) and especially the US Federal Reserve. At his latest appearance before the Commons Treasury Select Committee, Mr Carney said the collapse in the oil price was ‘largely a good thing’ for the UK economy. He did note, nevertheless, that its effects on financial markets had so far been adverse. Later, at her semi-annual congressional testimony, Ms Yellen declared that, on balance, cheaper oil was good for the US economy. The BoE and the Fed have been willing to look through the near-term effect of lower oil and commodities prices on their respective consumer price indices while the ECB has not. Why should there be this difference in approach?

The truth may well be that Mr Draghi is far less confident of the underlying stability of inflation expectations than his counterparts at the BoE and the Fed. It is less than four years since he pledged to ‘do whatever it takes’ to preserve the euro. Since he recognises there is a question-mark over the very survival of the currency which the ECB is managing, it should be no surprise he is hypersensitive to shifts in expectations and less inclined than Mr Carney and Ms Yellen to regard stability as the default position. Perhaps high European taxes on oil products and, therefore, the relative insensitivity of consumer prices to fluctuations in the crude oil market are leading Mr Draghi to exercise caution in attributing unwelcome disinflationary effects largely to the collapse in crude prices. IMF figures show crude prices, an average of UK Brent, Dubai and WTI, down by 73% between June 2014 and January 2016.

Mr Draghi may also have observed that non-fuel commodity prices have, according to some measures, been on a falling trend for more than four years, with no clear signs yet of bottoming out. Thus, the IMF’s index of non-fuel primary commodity prices in January this year was 36% below its 2011 average. The decline in the industrial inputs sub-index, at 41%, was even sharper than for ‘edibles’, which fell 25%. Within the industrial sector, metals prices slumped 55%. From this fairly wide range of variation, it should be clear that, though the trend has been downward in most
commodity prices, any calculation of their effect on an advanced economy must be difficult to justify. While reports often glibly state that commodity prices have risen, or fallen, by some specified amount over a set period, these figures relate to movements in indices. There are several different indices of commodity prices, each of them with a following, but differing in their coverage and mode of construction.

In 1940, the US Bureau of Labor Statistics (BLS) began publishing a daily index of spot commodity prices. This series has been redefined and rebased several times since then, rendering it awkward to use in any long-term analysis of price trends. However, since it includes prices of economically-important commodities, even if they are not traded on futures markets, it is useful as an indicator of shorter-run trends in raw material costs. It is, perhaps, worth noting that this index reached a near-term 'low' on 26 December last year and has since risen by 3.5%. The BLS index is designed to track the impact of commodity prices on the US economy; their impact on other economies will differ from this, reflecting exchange rate movements against the US dollar and differences in the intensity of usage of commodities. Another widely followed measure is the Journal of Commerce/ECRI price index, which focuses on commodities weighted according to their significance to US industry. These weightings are regularly updated. The IMF commodity price series, also a measure of spot prices, attempts to take a global view by weighting commodities in line with their importance in world trade but, of course, this may be just as misleading when gauging the impact of commodity price movements on specific national economies.

The Commodity Research Bureau (CRB) index (now the Thomson Reuters/Jefferies CRB Index) is the longest established of those series that are widely watched in financial markets, having been first published in 1958. It is a measure of futures prices generally reflecting forward deliveries within six months of the current date, with front months being more heavily weighted than back months. However, a minimum of two delivery months is used to calculate the current price of a commodity even if the later of the two is for delivery more than six months into the future. The CRB index now comprises nineteen commodities, with petroleum-based products making up no less than 33% of the weightings. Derived from the CRB is the Thomson Reuters Equal Weight Continuous Commodity (CCI) Index. This accords equal weights to the seventeen commodities that were included in the CRB in 1995. It is regarded in some quarters as a useful indicator of sentiment towards commodities, a factor which has become increasingly important in recent years as these goods have come to be regarded as an asset class for investment purposes. However, since the commodities it comprises are not, in fact, of equal weight in terms of their economic importance, this measure is less useful in economic forecasting.

With the rise of commodities as an investment class, indices have been devised with the primary aim of serving as benchmarks of commodity performance. Those that were first devised base their calculations on near-term futures prices. The S&P GSCI, first published in 1991, was one of the earliest. This index assigns weights to its constituents based on the amount of capital tied up in holding each of them. These weights accordingly reflect the value of world production of the commodities included in the index. However, this measure excludes commodities that lack active underlying futures markets. Compared with some other commodity price indices, it attributes a relatively heavy weighting to energy products. The Bloomberg Commodity Index (until recently, the Dow Jones-UBS index) tracks futures prices of 22 commodities, with weightings reflecting their global economic significance and market liquidity but with ceilings on the contribution that each sector (energy, metals etc) can make to the overall measure. Because these indices are based on prices of front-month futures contracts only, they are not wholly satisfactory as performance measures of commodity funds, which typically invest in futures across the maturity curve. Indices covering a broader range of prices from across the term structure of futures contracts have been devised to meet the needs of the investment community. These include the UBS Bloomberg CMCI indices and the JP Morgan Commodity Curve Index. Even these indices fall short of the requirements of some investors, however. There are investment managers who like to measure their performance on the assumption that it had been possible to optimise investment returns by concentrating their funds in the contract in the term structure that performs the best. Dynamic indices have been devised to satisfy this need. Some fund managers also pay attention to 'oscillators' such as the commodity channel index, to identify the strength of trends and turning-points in
commodity prices.

This has taken us a long way from the central bankers’ problem of assessing the significance of commodity price movements for future economic conditions. But it points to a problem confronting policymakers nowadays that was far less serious for their predecessors. There has long been a speculative element in commodities market activity. Indeed, the liquidity and efficiency of those markets has depended on it. But only in the past twenty years or so have commodities come to be regarded as a suitable asset holding for funds with primarily an investment focus. It should not be surprising, therefore, that the behaviour of commodity prices, including the prices of energy, should no longer be influenced solely by the fundamental factors that used to determine them. Historically, the prices of commodities were established in light of the prospective supply from producers, which was usually relatively inelastic, and the demand from end-users. Typically, there were then only relatively brief deviations from the trend set by underlying supply and demand factors, reflecting the build-up and rundown of speculative inventories. By contrast, investment-related flows, given their scale, are nowadays likely to exercise substantial sway over commodity prices for sustained periods. The force of this effect has probably grown with central banks’ liberation of investible funds through their QE operations. Further, the drawback with commodities as an investment, namely, that they do not hold out the promise of an income stream, is nullified and turned to an advantage as interest rates are pushed down to zero or even into negative territory. Even so, given the dominance of momentum-based styles of investment, the enormous expansion in investible funds does not guarantee the direction in which commodity prices will move. The point is that central banks can no longer count on commodity price trends reflecting the state of the economy, though they are painfully aware there is a feedback loop from these prices to real economic conditions.

Since the prices of raw materials are so important to economic activity, there have been periodic calls from critics of the current financial regime to put commodities out of bounds for fund managers. When the strategies that these investors deploy, often in unison, can have such serious consequences for the real economy, raising the costs of factors of production or throwing central banks’ policies off course, it might seem clear these are dangers to be avoided. All the same, it might be no easy matter to establish rational criteria for deciding who should be permitted to transact business in commodities markets, and who should not. Further, the argument advanced against allowing commodities to figure as an asset class for investors could also be aimed against equities or bonds. In recent years, the prices of those assets, too, have been dissociated from economic fundamentals, yet changes in price-levels in those markets feed back, not always benignly, into economic conditions. As with commodity prices, central banks’ massive asset purchases have played a leading part in this process. Yet to conclude from this that fund managers should not be permitted to operate in equity and bond markets would be absurd. The case for banning commodities as an investment class based on their importance to the economy does not really stack up. An appeal to historical tradition, to an age-old custom that treats only financial securities as the proper targets of investment, also fails. After all, the caravans that criss-crossed the deserts of the Near East in ancient times depended in large part for their profits on expected shifts in the prices of the commodities they were carrying. It would be hard to defend any arbitrary delimitation of the instruments in which a fund manager might be allowed to invest, unless it could be shown that the construction of those instruments was potentially toxic.

The key to stabilising commodity markets, as indeed other markets that have been displaying unwelcome volatility in recent weeks, is in the hands of the central banks. It is to take steps towards the normalisation of monetary conditions. The US Federal Reserve has made the first small move in that direction but Mr Draghi is intent on going the other way. The ECB risks adding to the fragility of confidence in financial markets.
Sugar: Is the future sweet?

Our high energy friend, sugar, has been in the news recently, unfortunately, for all the wrong reasons. Despite being an essential and staple part of our diets it has become the ‘evil’ ingredient of our foods. If the media is to be believed then sugar is causing us to become obese, less intelligent and likely to suffer diabetes and cancer. To be honest, it is surprising it has not been blamed for the banking crisis and poor weather.

Despite the doom merchants, demand for sugar has risen enormously over the past 25 years. Back in 1990 global consumption was running at slightly over 100 million tonnes per year. Much of the increase is down to population growth. However, increasing wealth has also contributed to the jump, along with changing diets in Asia as the likes of China embraces a more Western diet. In fact consumption per head has dropped over the 10 years in Europe and the US.

It is expected that global sugar consumption will be around 183 million tonnes this season. This is slightly above global production which is seen at around 180 million tonnes. This is after five seasons of surplus production. The question many producers, millers, refiners and end-users are asking is what will sugar consumption do over the coming 5-10 years? It is probably safe to say it will increase, but by how much? Additionally, will the world be able to produce enough sugar to satisfy this extra demand?

Assuming nothing but a solid 2.5% increase in consumption year on year because of population growth, it is likely the world will consume around 234 million tonnes by 2026 – some 51 million tonnes more than in 2016. Add in changing diets, increasing affluence on the plus side and health concerns on the negative side, consumption becomes considerably more difficult to predict.

As the world gets wealthier it eats more sugar is a true tenet to a certain extent, but income quickly reaches a level where sugar consumption becomes static. Sugar is a comparatively cheap commodity so demand is generally pretty inelastic in most developed economies.

Nevertheless, consumption is likely to increase considerably across Asia and, to a lesser extent, across Africa. This will be because of the continuing adoption of a Western diet in the former and likely improving wealth in the latter.
It is much harder to predict the impact on consumption because of health concerns in the US and Europe.

Currently, there are widely contrasting views on the impact of excessive sugar consumption. Some eminent medical experts are adamant that sugar is one of the major reasons we are seeing a huge increase in childhood obesity and a surge in diabetes in adults. Other equally renowned experts say sugar has no impact on obesity or cause of other diseases. One thing is for sure, the arguments will continue. But the chances are that these grim warnings will fall on more and more fallow ground.

Sugar consumption is more likely to be cut if prices increase substantially. For some it will be unaffordable, substitution with HFCS (High Fructose Corn Syrup) will increase. (There is rather more medical evidence that HFCS has much more negative impact on health than sugar but that is for another discussion). It was noted that, when sugar prices jumped to over 36 cents per pound in 2010, shipments of small container loads to many African countries dropped as many of the importers decided the cost was too high and the profit margin too low.

So can the world increase sugar production by over 20% in ten years’ time? Probably. However, it is likely that production will become more and more impacted by weather issues. Over the past 10 years Brazil has increased sugar production by a third (25.5 million tonnes to around 38 million tonnes in the 2015/16 season). If it were to increase another third in the next ten years, it would equate to another 12.5 million tonnes. Production costs (in BRL) have fallen as Brazil’s currency collapses which aids expansion. However, it is very unlikely there would be the necessary investment available. The Brazilian sugar cane industry is suffering more than most as the country’s economy slumps. Ethanol production could also impact negatively on sugar production. Currently, larger margins are to be had on sugar but that will not always be the case. Although, in 10 years’ time who is to say that sugar cane will still be a viable feed stock for Ethanol – if not, then their ability to produce sugar would be significantly higher.

Both Indian and Thai production has jumped over the past 10 years – 35% and 45% respectively. Again, if repeated over the next 10 years it would result in another 16.25 million tonnes. Without doubt, this is a rather too simplistic calculation not taking into account crop substitution/competition. Nevertheless, both producers are aware that the greatest consumption growth will be in their part of the world so are keen to expand to take
advantage.

China will also aim to increase production as they may well see the biggest increase in consumption. Other Asian countries will also look to increase output as their own internal consumption increases and to take advantage of the porous Chinese border for legal and illegal imports.

Europe is one area of uncertainty. Next year the EU’s sugar regime comes to an end with deregulation. Some have said, without subsidies, sugar beet production will quickly die. Others are much more optimistic, believing that sugar production will increase as European producers are well placed to compete in the international market at the expense of other smaller producers who have antiquated infrastructure and sky-high production costs.

Other producers will increase production given the right incentive – a decent return. The US market is likely to remain ring-fenced import-wise but will probably expand in line with any US consumption increase. Mexico, Pakistan, Australia, Russia, Guatemala, Philippines and Ukraine (in descending order of global production) can all increase production but will need a healthy profit margin.

Therefore it is probably safe to conclude that over the next 10 years any increase in sugar consumption can be matched by an increase in production. However, better prices will be needed to encourage growers. It is very unlikely that there will be another five-year period of surplus production. It is also very probable that average prices over the next few years will be considerably higher than the current price.

That is, assuming, sugar is not banned in the meantime!
2015/16 world grains markets saw an increase in production and ending stocks. This dropped prices back to near 2007 lows. At the same time, concern about growth in world economies, especially Europe and China, hit world equity markets. Most commodities saw an increase in production and supplies but a large increase in crude oil supplies and slower demand dropped crude oil prices sharply, which also weighed on commodity prices. Traditional managed funds turned short sellers in 2015 and have a large net short position on heading into the 2016 crop year.

USDA estimates world 2015/16 soybean end stocks near a record 80.4 million tonnes versus 77.1 million last year. Brazil is estimated to produce a record 100.0 mmt crop. Argentina's crop is estimated near 58.5 mmt versus 61.4 mmt last year but some feel the final crop could be above 60.0 mmt. China 2015/16 soybean imports are estimated at a record 80.5 mmt. Early estimates of the US 2016 soybean crop is near 3,945 million bushels and a carryout near 550 million bushels. This should be negative for prices. USDA recently suggested that by the year 2025, US soybean yield could reach 51.0. They suggest demand will increase to offset the higher crop but if demand does not increase US farmers may be forced to plant 7 million fewer acres than in 2016 owing to the increase in yields.

USDA estimates world 2015/16 corn end stocks near a record 208.8 million tonnes versus 206.2 last year. Brazil is estimated to produce another 84.0 mmt crop. Argentina's crop is estimated near 27.0 mmt versus 27.0 last year. China 2015/16 carryout is estimated at a record 111.5 mmt. Early estimates of the US 2016 corn crop is near 13,805 million bushels and a carryout near 1,900 million bushels. This should be negative for prices. USDA recently suggested that by the year 2025, US corn yield could reach 185.8. They suggest demand will increase
to offset the higher crop but if demand does not increase, US farmers may be forced to plant 8 million fewer acres than in 2016 owing to the increase in yields.

USDA estimates world 2015/16 wheat end stocks near a record 238.8 million tonnes versus 214.5 million last year. EU is estimated to produce a record 158.0 mmt crop. FSU crop is estimated near 117.5 mmt versus 112.7 mmt last year. China’s 2015/16 carryout is estimated at a record 93.6 mmt. Early estimates of the US 2016 wheat crop is near 2,035 million bushels and a carryout near 1,000 million bushels. This should be negative for prices. USDA recently suggested that by the year 2025, US wheat yield could reach 49.0. They suggest demand will increase to offset the higher crop but if demand does not increase, US farmers may be forced to plant 6 million fewer acres than in 2016 owing to the increase in yields.
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Gold has enjoyed a small resurgence in price and investor interest as concerns emerge that central banks’ unconventional policies might not actually work in a sustainable way.

The inevitability of that outcome was clouded by the undoubted success for the Fed, ECB and BoJ in extending the current cycle after it suffered its biggest post-GFC test during 2011-12.

It’s possible that the recent BoJ move to negative rates will be seen as a “crossing the threshold” event in terms of central bank ZIRP-QE-NIRP policy.

The BoJ was pursuing the most aggressive ZIRP/QE policy and its credibility was already damaged with Japan flipping in and out of recession. Kuroda’s denial regarding any desire to implement NIRP just days before the announcement has hardly helped. More importantly, however, the post-NIRP strengthening of the Yen and fall in the Nikkei contrast starkly with previous responses to globs of additional stimulus.

The only viable investment strategy in gold for some time has been to gradually accumulate undervalued physical bullion and (patiently) wait for the revaluation - so long as the investment case for gold remained valid of course.

Realistic maybe, but it’s not been very satisfactory.

The “price of gold” on your screens today is a hybrid price consisting of largely (unbacked) paper gold claims which have become disconnected from fundamentals for the actual physical bullion.

For physical gold, the four major identifiable sources of aggregate net supply and demand are

- Central banks;
- Shanghai Gold Exchange withdrawals;
- Indian imports; and
- All known gold ETFs.

The first three have been (obviously in two cases) dominated by EM nations. The fourth used to

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Source: ADMISI, Bloomberg
represent a major part of western demand, but has seen net disinvestment in recent years.

In aggregate, these four sources alone have been exceeding the output of all the world’s gold mines in the majority of months since mid-2014 as shown in the chart below.

While the data can be relatively volatile on a month-to-month basis, anything from 150-450 tonnes, the aggregate net demand from these sources is on a rising trend. In addition, the chart understates the real picture due to Indian smuggling and PBOC purchases before July 2015. It obviously excludes ALL other sources of Asian and western retail and institutional gold demand.

However…

In order for a fractional reserve system like the current gold market to break down, we are likely to need a “run” to develop on physical gold – and we are not there yet.

In gold’s case, it might require an escalation of geopolitical/economic tensions between the US and China/Russia, for example.

Or…

It might require the vast pools of western capital to actually dip their toes into the gold market.

To say that gold as an asset class is under-owned by the vast pools of western capital is to understate the situation in the extreme.

Across the centuries of financial history, western prejudice towards gold is a recent and a typical phenomenon. The prejudices which have built up in the minds of the modern day custodians of western capital essentially parallel the era of hyper-interventionist central banking since the 1980s, when Greenspan took over the Fed.

Our view is that we are travelling a long and winding road – certainly longer than we expected when we first began analysing the gold market in 2005 - which sees gold recover its former role as an investible asset for western investors.

An increase in the currently tiny allocation of the vast pools of western capital into physical gold would have a disproportionate impact on the market.

But we need catalysts.

One catalyst for western capital to enter the physical gold market could be some exhaustion of buying in other major asset classes due to a combination of one or more of:

Deteriorating fundamentals;
Overvaluation; and
Unacceptable credit risk.

The fact that even consensus thinking is suddenly beginning to express doubts about central bank policies is potentially very significant for gold.

Over the centuries, periods of gold outperformance have tended to coincide with periods of financial/economic mismanagement in one form or another, including rising inflation (obvious), deflation (gold is money) or periodic fears about the financial system (safe haven/counterparty risk).

A key theme in financial markets is the re-pricing of credit risk as credit markets are bifurcating between the “bad” and “good” ends of the credit spectrum.

High yield and numerous indicators relating to the banking system are flashing warning signs about the sustainability of the central banks’ ZIRP – QE - NIRP driven bubble. The CCC high yield ETF, for example, has been in free-fall.
In European sovereigns, the spread on Portuguese 10-years versus Bunds has widened the best part of 200bp.

This has broken almost two years of stability which followed more than two years when spreads narrowed dramatically on threatened and actual ECB action.

Japan has joined the Eurozone, Sweden and Denmark in the NIRP zone which, as our Chief Economist, Stephen Lewis argued, could prove to be counter-productive both for bank earnings and economic growth.

The most obvious problem arising from a negative rate regime is that it tends to squeeze bank profits. Mr Kuroda was right to point out that BoJ’s measure would affect only a small proportion of Japanese banks’ assets, and would, therefore, have only a minor impact on their earnings. However, when bank managements feel themselves under the regulators’ cosh, as they do at the moment, even a small additional penalty may have a disproportionate impact on their willingness to take risks. In other words, there is a real danger that the BoJ’s negative rate on banks’ excess reserves will turn out to be counter-productive in terms of its effect on bank lending.

Japanese bank stocks have fallen more than 40% since last Summer.

We first heard faint rumblings about solvency issues at Deutsche Bank 2-3 years ago. The market is starting to take them seriously, although the situation remains largely opaque to outside observers.

One might liken Bank sector analysts to the inhabitants of Plato’s Cave – and that is not meant to be a derogatory remark, more an empathetic one. It’s not just DB as markets are significantly re-pricing credit risk across the banking system in general.
Gold, and we are specifically referring to physical bullion – not the multitude of paper gold alternatives - is the only financial asset which has zero counter-party risk.

The oft used push back against investing in gold down the years has been “Gold has no yield”. This argument is losing its validity as rates for the highest quality move towards and into negative territory.

There is currently some US$7 trillion of government bonds now trading with negative yields. Swiss rates are negative out to ten years and German out to seven years.

This is the artificially bizarre financial system courtesy of today’s central bankers. It is creating the remarkable situation in which investment in physical gold can increasingly be justified on a yield basis relative to the highest quality sovereign and (European/Japanese) corporate borrowers.
Having gone from being the darling of the speculative commodity investment world, the stand out major commodity gainer of 2015, Cocoa futures have plummeted in the New Year, apparently being caught up and overrun within the early New Year malaise of sharply declining commodity and equity markets brought about amidst a general pessimism and an expectation of a significant downturn of the global economy.

However, the recent sharp decline cannot necessarily be laid at the feet of external macro influences. Indeed, the seeds of decline may have already been sown in recent weeks and months. In my previous article for ‘Ghost in the Machine’... ‘Hot Chocolate’ I alluded to the fact the market was at a confluence of factors which would instigate the next trend leg, where having rallied for several months due to an array of bullish supply factors ranging from strong global demand, less than optimal rainfall patterns within the main crop growing season with the prospect of the strongest El Niño seen in years. This was likely to ravage the West African main and mid crops, which provide 60% of the global supply of beans. But guess what? It didn’t quite work out that way.

Subsequent to the highs seen in early December 2015, Cocoa has lost some 18 percent to establish recent February lows of 1971 basis second month. As they say, when you are at the top, there is only one direction you can go! Easy with the benefit of hindsight.
Well not quite entirely. The fact is that the West African main crop was not as significantly impacted as was expected. Indeed, the bellwether of supply prospects, the Ivorian weekly bean port arrivals has managed to sustain a reasonable pace and, most significantly did not fall off a cliff as some presumed. It didn’t even taper significantly and currently stands at 1,173,000T compared to that of the same period last year. Essentially, the prospect of a significantly impacted main crop for West Africa never really occurred. The obvious consequence of this has been a significant decline of the speculative long position built up into the end of the year, which stood with a combined long of 81,225 lots and is now currently standing at 37,421 lots. Essentially the markets went from a Hot Chocolate rally into meltdown!

The rapid decline was hallmarked with significant and violent increased volatility with significant long liquidation and deferred buying interest, which has continued with what appears to be a developing basing action, with Cocoa appearing to find a level balanced range between the rump of weak liquidators and new short system fund sellers and profit takers to tentative industrial bargain hunters? However, creeping back into the market psyche has been the renewed enthusiasm for bullish supply concerns which may now impact the mid-crop development.

Certainly a recent focus of interest is now the West African mid-crop which has been very influential in recent years in determining the overall annual output. After the main crop was essentially maintained despite less than optimal conditions, concern is growing for the mid-crop development which is seemingly influenced by a perceived strong local Harmattan, a seasonal dry and potentially damaging wind out of the Sahara. Most likely in concert with the El Niño phenomenon, the current Harmattan is perceived to be strong and resolute, such that we are seeing a notable lack of rain currently in Cocoa growing areas.

The current difficulty is knowing whether there is any real impact already. Essentially it is very difficult at present to know, as the crops transition from main to mid. Putting aside the daily woes of farmers as reported in the media, the real difficulty is assessing whether or not the lack of rainfall is still within the realms of seasonality. Up to this point we only have circumstantial evidence to allude to arrivals still coming in at a reasonable pace at the tail end of the main crop which will, in turn, taper on a seasonal basis. Whereas anecdotal reports of high bean counts and poor quality at this early stage of the season may indicate a potential bean or product deficit in the pipeline.

I dare say that we will not need to wait too long given the juncture we are at within the crop season, as well as the rumoured small army of trekkers now apparently in the bush looking at pod counts and potential damage? However, given the recent movement up, which appears as a break higher from a recent congestion zone in a technical sense, the possibility of better values to come looks intriguing. However, at the end of the day, to ferment a new upside trend, we will still require some reasonable and confirmed bullish supply concerns to get going. We suspect that anything less will not convince the trade or industry to extend further cover whilst suspicions that forward demand may well be less than experienced historically, given the external global economic outlook and weakening of key emerging market growth. Indeed, additionally, we still suspect that there may well be an ongoing overhang of local African shippers still rumoured to be holding on to unsold stock which may yet impede any significant advances.

So, once again, Cocoa may yet go back to being ‘hot’ if we have an impacted mid-crop!
The stage is set for what is arguably one of the most significant public debates on the European Union. As the political posturing ramps up a gear in Westminster, with party divides deepening, the ‘In’ and ‘Out’ campaigns will be gathering strength in their attempts to sway the pendulum of public opinion ahead of the critical vote on 23 June 2016.

Current opinion polls suggest the British public sits firmly on the fence collecting splinters as we evaluate sovereign national pride against life in the afterlife, but what would the impact be on a key corner stone of agriculture?

Opinion in the farming community without doubt first speaks of fear when it comes to Brexit, with the immediate dependence on EU subsidies acting as a lifeline to many rural communities. Whilst many may desire independence from handouts, the reality is that European intervention runs deep, highlighted by data from the Farm Business Survey 2014/15 showing that 56% of total UK farm income across all farm types derives from European payments. The common agricultural policy represents 40% of the EU’s budget and, in its current format, contains a number of ‘greening proposals’ in the form of ‘pillar one’ payments aimed at protecting the environment, thereby increasing habitats and diversity which has essentially transitioned some farming businesses into ‘custodian enterprises’ from traditional farming roots.

Agriculture and food production is arguably one of the most significant sectors when it comes to Brussels-led policy and trade. The UK has a £20 billion trade deficit on food, drinks and animal feed, of which 70% of imports and 60% of our exports are all within the European bloc. The EU is therefore the UK’s biggest Agri-trading partner and also the world’s biggest agricultural trader overall, with the free market movement of goods, people and quality standards directly benefiting the safety and security of our food supply chains.

The EU Commission is responsible for numerous pieces of legislation that protect animal welfare, the control of diseases, diversity, water quality, food standards, the fair and accurate labelling of goods and provenance on regional produce.

These numerous acts facilitate the freedom of trade and movement. However, many claim they add ‘Brussels Bureaucracy’ and complications as the one-size-fits-all policy forces the ‘square peg in the round hole’. Differing levels of compliance and conformity are claimed by many in the UK to undermine the
expense and resources required to produce under the regulations.

So what are the alternatives? Well, suggestions of joining the European Economic Area in a similar capacity to Norway are simply not realistic. This is despite the carrot offering of a 30% reduction in contributions to the EU budget (HM Treasury estimates) in return for continued free movement of goods, services and people. We’d still be hit with the same stick on policy, only this time with nails in it given our reduced influence and representation, without resolving many central themes of Cameron’s renegotiation. It would also be naïve to think that the UK could snub EU agriculture legislation despite the manifestation of higher costs and bureaucracy. This is because World Trade Organisation rules state products imported into a country must be treated no less favourably than products domestically produced, meaning that the same legislation covering welfare, food safety and labour rights must still be observed if we wanted to continue trade. Furthermore, our own domestic consumers set the European standard as a minimum and in many instances request additional welfare and husbandry requirements to help build trust and loyalty with consumers.

A simple free trade agreement with the EU and independent treaty is likely to be the UK’s favoured position with immediate benefits to public expenditure, saving £8.5 billion from EU budgetary contributions. Life freed from the EU shackles would allow the UK to negotiate its own terms with trading partners, with the UK in arguably a strong position when it comes to EU trade given its deficit and importance to Europe as a trading partner. A vote to leave, however, would initiate a very intense two-year negotiation period for UK diplomats to secure post-Brexit deals securing an open trading economy covering the ground of the EU’s 48 international trade agreements already in place and the additional 84 agreements currently under negotiation.

Divorced life, free from the EU’s grip, would undoubtedly benefit consumers with the removal of EU tariffs, opening the door to cheaper produce and imports. Critics of the current CAP, of which there are many, will be given the opportunity to amend the inefficient support mechanisms that offer poor value for public money which allow some enterprises to ‘milk the cream off the top’. The capitalists and supporters of free markets however will be disillusioned to think Brexit would see the end to subsidies, as removal of the Common Agricultural Policy (CAP) would undoubtedly be replaced with a ‘British Agricultural Policy’ more focused on the environment. Pulling the carpet from underneath the most in need would result in a bloodbath for rural communities. However, it may do more to reduce land prices removing the artificial floor in the market of a guaranteed return.

From an agricultural perspective it’s very clear that Brexit provides some major uncertainties and wouldn’t be plain sailing. UK exports into Europe would likely be subject to the import levies as those of the rest of the world, requiring producers to compete. The closing of borders would undoubtedly increase the cost of trade. Higher prices and more bureaucracy for exporters would exert downward pressure on prices to producers.

Other than assessing the current environment and picking holes in the bureaucratic process and procedures of our current policy, it’s very difficult to fully project exactly how the future would play out. I don’t doubt that, with time, UK agriculture will be in a stronger position benefiting from innovation in the face of adversity. But to what detriment to our environment and rural communities?

From a UK agricultural point of view, I don’t see much room for manoeuvre within Europe and, given our dependence on trade and security of supply, access to seasonal labour and critical integration of environmental and animal welfare the mountain may well appear too high to climb.

Ultimately, the backdrop in the weeks before the referendum will pose the biggest influence on how the opinion polls will swing influencing the noise we may make with our feet. However, come 23 June, will the electorate have the confidence to jump into the void or will they stick to the known beast that protects the livelihoods of many and safeguards our food security?
A few weeks ago I had the great privilege to speak on FX at the 12th Platts Kingsman Sugar Dubai Conference. I’d made my FX presentation (well received I’m glad to say) and was making notes on other areas presented to pass onto ADMISI and customers. On the last day there was a presentation by a Bangladeshi sugar mill pointing out the virtues of their sugar industry – its location close to India, other Asian markets...all good...and then it was pointed out how stable the U.S. Dollar was compared to the Bangladeshi Taka. This was where I took issue...but kept my peace. The reason was I’ve had many enquiries from customers who had currency exposure to many Emerging Market/Frontier currencies, including BDT and I’ve tried on many occasions, without success, to find a counterparty to quote a Non-Deliverable Forward (NDF) in the USDBDT...could I find one – NO!

It’s appropriate to mention my history in NDFs and EM Currencies. I did my first NDF trade back last century around 1994. It was then a new thing that enabled many to have EM currency exposure without the need of delivery or any tedious EM Central Banks (CBs) paperwork. My first trade was a small one in USDMXN (yes – it was that long ago that MXN was an NDF) of USD 100,000 hedging against a local bond. It went brilliantly and so we did more. The NDF market grew and we grew with it adding additional currencies, ones we’d never have dreamed of being able to trade. So by the late 1990s I even quoted a customer USD versus BWP one month NDF. The New Century saw further growth as we and others had customer demand for a EM/Frontier Currency then the banks – in case they had no interest – would speak to their in-house hedge fund/prop desks and make a price...acting as a proper liquidity provider to their customer(s).

The world turned and went through The Great Recession brought on by excessive risk taking. Though not directly attributable to FX as a cause, FX nevertheless suffered in the resultant counterblast. Banks’ management turned against anything ‘risk’ enhanced...including EM FX. Instead of being warehouses of liquidity in FX markets, an obligation if not written then implied in their relationships with CBs, FX banks started to pass through risk. Capital was better used elsewhere and FX – which could always be commoditised – became less important. At the same time, two other things happened. First, consolidation of FX banks.
A whole level of mid-tier FX banks either exited or were swallowed up by larger competitors. Secondly, growth of non-bank liquidity providers who filled a gap left by the FX banks. Initially welcomed by many they nevertheless do not have the obligation FX banks traditionally had of always making markets to customers...mind you, after SNBomb, FX banks have given that up as well.

All this has led to a more risk adverse view of FX. Though right and appropriate given past excesses, it still manages to disenfranchise EM/Frontier FX. Whereas in the past banks would price such currencies as potential revenue and/or service to customers, the obligation to make prices with the greater fragmentation of FX into bank, non-bank plus other liquidity recyclers has seen a greater move to safer main currencies...or those politically inspired by both domestic and international governments – such as the CNY/CNH.

So we have a situation whereby currencies such as the BDT...or even the previously mentioned BWP are not fulfilling their potential as the next new wave in the growing alphabetical soup of the FX market. We’ve seen since the late Noughties, a gradual relinquishment of the need to bring EM/Frontier FX markets to worldwide investors’ attention despite the race for yield. This has led to two things, one not surprising and the second the worse for FX compared to Commodities.

There is the disenfranchisement of domestic and international participants within the local EM/Frontier markets. There are the local players – local banks for the main part – who dominate their market and who now have at least a large breathing space and, at most, a guarantee they can run the market to their advantage. To draw an unseemly but perhaps appropriate analogy – there is no large superstore being built just outside of town that can challenge local shops...to extend the analogy, if you drive to the next town you’ll find you can’t buy exactly what you wish anyway - they don’t have it.

Next, Commodity markets have developed and we’ve seen finessing of original contracts. Once you could only choose WTI/Heating Oil/Gasoline or Brent/Gasoil – now there’s a multitude of exchange traded/OTC Cleared contracts helping hedgers and specs. Great - as it’s lowered Beta risk of lopsided hedging. Now look at FX – this has gone the other way with fewer players willing or interested to go outside the comfort of majors plus a few larger EMs.

Anyone who compares the growth of New Century Commodity markets to changes in FX, especially EM/Frontier markets can see the difference couldn’t be starker. As earlier - you could say...I have stability in my EM currency...see...it hasn’t moved against the USD for years. Or you could say what I believe to be true – do not mistake stability for a lack of liquidity...a lack of participants gives perhaps a truer picture on how a currency is doing.

Now – any answers? Probably not! We live now in a world so risk adverse to risk ‘appearance’ that it may not see or deal with pent up forces. I wrote last month on how the SNBomb blew up Switzerland and others, so I don’t think I need repeat myself. However, I do find it offensive that many CBs have seemingly exited their responsibility to FX...once they gave FX banks a privileged position on the understanding they’d always be there to provide markets...that’s now gone...in the unlikely event CBs come back and fulfil their role...well, that would be nice...late...but nice. Then there is the Third World...does anyone think not providing sufficient FX arenas for Commodity hedgers...and there are plenty in EM markets...is a suitable action for banks, CBs, governments, etc...to take? Speculators, those who take on hedgers’ risk, are also owed the ability to participate...they need liquid markets. I heard this story many years ago. In great human discoveries, man first discovered fire...then the wheel...then banking! Perhaps hedgers and specs are owed participation in EM/Frontier FX as they’ve had the wheel for a helluva long time already.

Finally - alternatives? We carry on using the USD as an international trade currency but that doesn’t help dealing with Taka risk in Dhaka! Bits of Africa now use Chinese Yuan as a proxy for Dollars and local currency. Fine, but you don’t have monetary control and you are subject to another country’s actions. Some even use Bitcoin for local payments, they’ve found it useful especially where the USD isn’t welcome...but that’s got a long way to go. I’ll paraphrase a famous activist elsewhere who’s had their efforts largely come about...the thing to look forward to is hope, hope that all who are disenfranchised in EM/Frontier FX will one day have Non-Deliverable Forwards. (Sorry to all who recognise it...).
The Reality Perception Divide

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“We know - intellectually - that confronting an issue is the only way to resolve it. But any resolution will disrupt the status quo. Given the choice between conflict and change on the one hand, and inertia on the other, the ostrich position can seem very attractive.” Margaret Heffernan - Wilful Blindness: Why We Ignore the Obvious at Our Peril (2012)

The disconnect between the financial and the real (non-financial) economy is anything but a new phenomenon, but the fact that it has become larger since the global financial crisis is perhaps not only counterintuitive, but should also be a major concern. The following makes no pretense to be a thorough evaluation of causes and effects, let alone solutions, but is rather a series of observations about certain aspects, which are worthy of consideration. As Heffernan's quote above underlines, the disconnects are in no small part attributable to a deep-seated human yearning for stability, in which the familiarity of the 'status quo' is generally perceived as preferable to the uncertainty of change. This is known as 'stasis' or 'inertia'. As I have previously noted, Hirschman's 'Hiding Hand' argues that creativity is the key problem-solving tool when we face unexpected situations; and that it is only via the experience of impotence when faced with the unexpected that we develop the innovative knowledge to solve problems, and that 'rational choice' often stifles innovation and creativity. Alternatively one could also look to Einstein, who correctly observed that 'we cannot solve problems with the same kind of thinking that created them'.

Be that as it may, Japan's 'lost decade' is often seen as 'the', prima facie example of how not to respond to resolving a 'balance sheet crisis', primarily due to the resultant period of very weak growth and bouts of disinflation in Japan. But the critique focuses primarily on 'what Japan did wrong' post-crisis, rather than on the antecedents to it. The latter have been well documented, but are all too often swept aside, or ridden over roughshod, more than likely owing to the embarrassing aspect that nothing was really learnt from the 'zaitech' (financial engineering) bubble. It is worth briefly recalling a few of the key drivers: deregulation of the financial services sector in Japan in the 1970s, which gave Japanese banks 'free rein' to seek out a new and broader customer base; the BoJ's very loose monetary policy in the mid-1980s, which fuelled a corporate credit bubble, little of which was deployed for genuine capital investment, and much of which was spent on speculative activities in the capital and property markets, the profits of which were used to 'enhance' corporate earnings to the point where such 'non-operating income earnings' far outweighed those from many of the companies' actual business activities. It does not require a great stretch of the imagination to see that these antecedents and consequences are also identifiable in the formation of the 'global financial crisis'. As but one example, it is estimated that just $1 in every $20 of credit that was created in the USA in pre-crisis years found its way into the 'real' non-financial economy, while the rest was 'recycled' in financial market instruments, with a 'race to the bottom' encouraging an ever greater level of 'reaching for yield', that is hunting down higher income returns at the expense of credit quality, or rather of due diligence about potential credit risks,
above all in the banking sector. Ironically, central bank policymakers’ post-crisis response has sought to encourage the same type of behaviour from fund managers and ‘end investors’ in response to zero (ZIRP) or even negative interest (NIRP) rates, and ‘unconventional’ ‘quantitative easing’.

This lack of what might be termed ‘joined up thinking’, both in respect of crisis cause and crisis remedy, may prove, with the benefit of hindsight, to be ‘primus inter pares’ in the ‘Reality Perception Divide’. But a quick recap of the rudiments of why the remedy was expected to work is necessary; above all from the aspect that most theories and many phenomenological investigations falter on their assumptions about what is a constant and what is a variable. In theory, ZIRP, NIRP and a deluge of liquidity should dis-incentivize saving and incentivize spending, while low debt servicing costs should facilitate and encourage borrowing for investment of all forms, as well as extending existing financing for longer periods with significantly lower debt servicing costs. However, as has been the case with psychology’s yearning for recognition as a ‘science’, the empirical directive too often attempts to ‘iron out’, even exclude, the contextual ‘noise’ which, later in the post hoc historical evaluation, frequently proves to be the element that is highlighted as (often politically expedient) wilful blindness, or dogmatic wishful seeing, predicated on the comfort of a stability born of inertia, and rejecting change and above all conflict.

There is some irony in the fact that the NIRP, ZIRP and QE policies are very closely associated with the other market thematic of the moment, namely ‘Currency Wars’. However the suggestion which is rarely made is that, from a broad perspective, current developed world central bank rate and ‘unconventional liquidity’ policies are in fact not so different to the foreign exchange intervention regimes of the 1980s and 1990s, which were ultimately rather ineffective. A closer examination of export and import trends in both the UK and Germany in the post-Bretton Woods era, in which the pound sterling and the Deutsche Mark (latterly the Euro) have been very volatile, highlights that exports from both countries have neither benefited nor suffered significantly from these fluctuations. However, the cost of sometimes very sharp changes in import prices has on a number of occasions delivered quite sharp economic shocks to businesses. Yet the mainstream (financial sector) discourse insists on focussing on the benefits to exporters of a weaker currency, rather than the much broader impact on an economy of higher import costs, in so far as economies are inevitably far more dependent on domestically-oriented demand.

There has also been insufficient discussion about the impact of what Carmen Reinhart among others has termed QE0 (see: https://www.project-syndicate.org/commentary/foreign-holdings-treasuries-impact-by-carmen-reinhart-2016-02). Reinhart is specifically referring to foreign central banks’ purchases of US Treasuries which ‘really took off in 2003, years before the first round of quantitative easing’, and make it ‘difficult to determine the extent to which the Fed’s QE1 during the crisis owed its success in bringing interest rates down to the fact that it was being reinforced by what foreign central banks worldwide – notably in Asia – were doing simultaneously’. Reinhart adds that ‘the Fed’s next two policy instalments, QE2 and QE3, were not matched by large foreign purchases and appeared to have only modest effects in financial markets.” This does however need to be seen in the broader context of the EM FX reserve accumulation in the aftermath of, and as a result of, the 1997/98 Asian/Russian ‘debt’ crises. While this was understandable in the first instance as a way of attempting to ensure that the excessive and rapid accumulation of external liabilities would not be repeated, it soon started to operate in precisely the opposite direction. Thus global FX reserves grew from just $2.0 Trln in 2000 to a peak of $12.03 Trln in August 2014, which saw a rapid accumulation of US and G7 assets, which then put immense downward pressure on long-term G7 interest rates, which in turn assisted in fuelling the credit boom in the USA and Europe, and the ensuing ‘credit crisis’, latterly renamed the ‘global financial crisis’. In passing, it is worth noting the discursive distinction that was made between the Asian/Russian ‘debt’ crisis, and the US and European ‘credit’ crisis. The latter echoes the distinction that I have previously noted about the Arab ‘Uprising’ or ‘Revolt’ as per the previous 1916-19 and 1936 episodes, and the romanticized connotations of the ‘Arab Spring’, which has proved to be anything but.
Be that as it may, the rapid EM FX reserve accumulation up until 2014 was all too often justified by concerns that, if all the proceeds from net exports were allowed to flow into many of these economies, they would result in rapid currency appreciation, which would ultimately make these economies uncompetitive, both in terms of labour costs and goods export prices. The more significant aspects only moved into the mainstream discourse, once capital flows and export revenues to many of these countries started to reverse, in no small part due to the aspect that they were rather ‘inconvenient truths’ during the EM ‘boom’ years. Many of the pitfalls were evident prior to the onset of the current crisis, and are numerous and require far more in-depth analysis than the scope of this article allows.

However, there are some fundamental issues which can be briefly identified. First, while the rapid accumulation of FX reserves may appear to enhance a country’s ‘wealth’, it also effectively deprives a developing economy of income which could and should be deployed to ‘develop’ its local economy in domestic infrastructure terms, be that roads, utilities, hospitals, education or other public service facilities, in turn offering a degree of protection in those times when external demand falters. One can argue that diverting such earnings abroad subsidizes other countries at the expense of the local economy and population. Equally, it typically encourages the international financial community to arrange external borrowing facilities (i.e. liabilities) on the premise that the accumulated external assets offer security to foreign investors, though it will in many cases ensure that the process of developing domestic financial markets in such countries is impaired. Such domestic financial markets would again (in theory) offer a buffer in times of weak external demand. The failure to develop local financial and non-financial sectors has left many economies, above all those that are reliant on exports of primary resources, brutally exposed.

The final observation relates to price formation and debt. ‘Financial market participants’ are ex-ante always more interested in the demand side of any economy, rather than the supply side, outside of the obvious interest in supply/demand mismatches. These mismatches are however primarily seen through the lens of demand ‘growth’ and (maximizing) ‘pricing power’ in the hope of high levels of returns. All too often, and above all at the current juncture, this results in insufficient attention to the changing dynamics of supply, above all with respect to production (in all sectors). There can be little doubt that what has been termed the ‘fourth industrial revolution’ or the marvels of the technology (in the very broadest sense of the word) boom is having a very profound effect on price formation. Situationaly it is similar to the profound shift in underlying processes that was seen in the late 19th century, a period in which the economies at the forefront of the then industrial revolution experienced protracted periods of deflation. It can be observed that this technological boom has a much lower demand for capital, raw materials, facilities and labour, than previous boom cycles associated with the arrival of trains and motorized vehicles, (and it is also true that many of the associated new products very often have a short business cycle). The key problem that policymakers, investors and, indeed, academic economists face is that with total global debt having reached three times global GDP, and with much of that debt associated with older industries that are capital, raw materials, facilities and labour ‘intense’, these new industries may prove to be so ‘disruptive’ as to leave the older capital intense (i.e. debt-laden) industries staring down the barrel of a gun, with very profound consequences for price formation, the financial sector and the global economy.
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UNITED KINGDOM

Cardiff University on Monday 1st sold £300mn 40yr bonds at 3.10%. They were sold at a discount to achieve a coupon of 3% - a record low for the sector. Leeds University followed a day later, pricing 15bps wider. Hitachi followed Toyota's lead last month and said that it would continue to invest in the UK even in a Brexit scenario. Construction PMI on Tuesday 2nd was softer at 55.0 vs. 57.5 survey. Mortgage lending remained robust at £18bn in December – this compares to £14.7bn a year earlier and £18.7bn in November 2015. The average interest rate on outstanding UK mortgages fell to 2.99%, the lowest since BoE records began 16 years ago. The >15yr BoE APF operation on Tuesday 2nd was 1.35x covered with 46% (£642.8mn) of the Bank’s accepted purchases comprising UKT 3.5% 2045 – a bond in line for auction the following week (£1.5bn on Thursday 11th).

British independent research institute, the NIESR, pushed back its forecast for a rate increase by six months – to August, from February, this year. Simon Kirby of the Institute said that, in light of the expected Brexit referendum in June, the MPC were likely to hold off so that ‘they don’t have to reverse course in the event of an exit’ and that, without a referendum, they would have looked to move in May. He added that the current market pricing, which indicated the first rate rise would occur in 2018, was unlikely and warned of the ‘transmission lags inherent once tightening begins.’ The NIESR forecasts two rate rises this year to stand at 1% by December and 1.5% by the end of 2017.

The Halifax House price index came in stronger on Thursday 4th at +1.7% MoM for January vs. survey +0.1%. The December figure was revised up to +2.0% from +1.7%. The 3m YoY comparison was +9.7% vs. survey +9.0%. The MPC voted unanimously to leave rates unchanged on Thursday 4th vs. 8:1, previously. It saw downside risk to near-term inflation forecasts, where sub-1% CPI is expected until the end of the year, and cut its 2016 GDP growth forecast to 2.2% from 2.5%. At the Inflation Report press conference later that day, Carney stated that there was not enough tightening in the market path to meet the 2% CPI target. When questioned, he said that the whole of the MPC thinks that the next rate move will be upward.
Jon Cunliffe of the BoE on Tuesday 9th voiced concerns about rapid growth in consumer credit and buy-to-let loans which could warrant moderating action by the central bank. Also on that day, the UK’s Automotive Council released a report using research it conducted in the middle of 2015. It highlighted an ongoing skills shortage in the UK automotive industry. It found up to 5,000 current vacancies due to this shortage – the majority in engineering. Of the 2,500 vacancies classed as ‘difficult to fill’, 19% were identified as critical, unfilled for three months or more, and ‘impacting productivity now’.

December Industrial Production (-1.1% MoM/-0.4% YoY) and Manufacturing Output (-0.2% MoM/-1.7% YoY) both came in below market expectations on Wednesday 10th. Both were also subject to downward revisions to the prior month’s figure. The DMO auctioned £1.3bn 0.125% 2026 index-linked on Tuesday for a cover of 1.9x. The 10yr B/E at the time was 2.32%. On Thursday 11th it auctioned £1.5bn 3.5% 2045 conventional for a cover of 2.08x.

HSBC announced on Monday 15th that it has decided to stay headquartered in the UK after ten months of deliberation. Those cheering the move as a sign of confidence in the UK despite Brexit risks were disheartened later that day when CEO Stuart Gulliver said that the bank would probably relocate 1,000 front office staff to Paris in the event of an exit. The unemployment rate was unchanged on Wednesday 17th at 5.1%. Earnings data came in modestly higher than expectations. Retail sales surprised on Friday 19th with a strong +2.3% MoM (+0.8% forecast) headline reading driven by clothing and computing, pushing the YoY comparison to +5.2% (+3.6% forecast). PSNB disappointed on the same day as receipts came in below forecast and the previous month’s borrowing was revised higher. On Saturday 20th, David Cameron concluded days of negotiation in Brussels with a deal he felt sufficient to secure a British vote to stay within the EU at a referendum he called for 23 June.

The small sterling rally that ended week three on news of PM Cameron’s EU deal was swiftly reversed on Monday 22nd as the possibility of Brexit weighed, following influential Mayor of London Boris Johnson’s announcement that he is to campaign for exit, further dividing the Conservative Party. Rating agency Moody’s warned on the same day that a vote for Brexit would be a net negative for the UK and would result in a negative credit outlook. Sterling suffered – cable broke down to new lows not seen since March 2009 on Wednesday 24th, touching 1.3879.

Mark Carney and other MPC members faced Parliament’s Treasury Select Committee on Tuesday 23rd where the BoE head confirmed ‘no intention and no interest’ for negative interest rate policy. Trade association Oil & Gas UK the same day released its annual Activity Survey. It noted that, should current oil prices prevail through 2016, 43% of the UK continental shelf oil fields would likely be operating at a loss, despite significant cost reductions. The British Bankers Association on Wednesday 24th reported a surge in UK mortgage lending, up 38% in January compared with the level a year earlier. Mortgage approvals were up 33% using the same time comparison. This was attributed to buy-to-let investors rushing to complete before an additional BTL tax takes effect from April. GDP data for Q415 were released on Thursday 25th where the headline figure was in line with forecast at +0.5% QoQ and +1.9% YoY. Business investment showed a marked fall whereas there was higher than expected government spending. Private consumption remained robust. Chancellor George Osborne warned on Friday 26th that worsening economic conditions may warrant further cuts in the upcoming budget on March 16th. Consumer credit increased to £1.6bn in January, from £1.1bn in December, equating to a 9.1% YoY increase. Lending secured on dwellings increased to £3.7bn, from £3.2bn in December.
The Treasury Department's borrowing estimate for Q1 2016 was raised by 51.5% on Monday 1st to $250bn. Federal Reserve data on Tuesday 2nd showed that, since 2009, foreign investors accounted for 7ppt more (to 31%) of US corporate bonds in issue, a move attributed to hunt for yield. The Republican Iowa Caucus on Monday 1st was split, where Ted Cruz took victory with 28% of the vote. Donald Trump took 24% and Marco Rubio surprised to the upside with 23%. The Democratic vote was also a close-run affair, where Hilary Clinton just pipped Bernie Sanders to victory. The Fed Vice Chairman Fischer said on Monday 1st that it was difficult to judge the implications of global volatility and how it will affect the March FOMC meeting. Kansas Fed's George followed on Tuesday 2nd saying that the US is in a 'good spot' and the recent volatility was not 'necessarily worrisome'. The ISM Non-Manufacturing index, weaker at 53.5 vs. 55.1 survey, caused a stir on Wednesday 3rd despite an upward revision to the previous month's number. The 10yr Treasury briefly made new highs not seen for a year and the USD weakened as investors appeared to further flatten the Fed's rate rise trajectory. Oil and equity markets were suitably encouraged, where switching out of equities into bonds (Dow Jones Dividend Yield vs. US 30yr Treasury) worsened to -8bps; once again, terms not seen for a year. Kaplan, in keeping with a united Fed tone, said on Thursday 4th that they are 'focused on removing excess accommodation because zero rates create distortions'.

In a surprise turnaround given the previous week's results, Hilary Clinton (38%) suffered a heavy defeat to Bernie Sanders (60.4%) in the New Hampshire primary on Tuesday 9th. Republican Donald Trump (35.3%) emerged well clear of second-placed John Kasich (15.8%). Janet Yellen addressed Congress in her semi-annual report on Wednesday 10th. She reiterated that the Fed expects to raise rates gradually while taking into account incoming economic data. The 10yr Treasury yield was driven lower all week on flight to safety flow, briefly reaching 1.53% on Thursday 11th before closing at 1.66%. Support was found here, as a yield of 1.625% represents a 100% retracement from May 2013 and also January 2014. On the same day, 30yr fixed rate mortgage rates dropped to 3.53%, the lowest level since May 2013. Retail Sales on Friday 12th were stronger than forecast across all measures and the previous month was also revised higher. The core control figure was +0.6% MoM vs. +0.3% forecast. The Treasury Department sold $24bn 3yr (0.844%), $23bn 10yr (1.73%) and $15bn 30yr (2.50%) bonds in the week. The 30yr sale was at the top of the market YTD.

January FOMC minutes out Wednesday 17th showed no new material developments. Initial Jobless Claims out Thursday 18th were solid at 262k vs. 275k forecast. Continuing Claims were a moderating factor, rising 30k to 2.273mn. CPI data were 0.1ppt higher than forecast across all measures on Friday 19th; core YoY reached 2.2%. Hilary Clinton prevailed against Bernie Sanders at the Democratic Caucus in Nevada on Saturday 20th with 52.6% of the vote. On the same day, Donald Trump won (32.5%) in South Carolina, where Marco Rubio (22.5%) narrowly pipped Ted Cruz (22.3%) to second place.

Consumer Confidence came in far lower than expectations on Tuesday 23rd at 92.2 (vs. 97.2 forecast) led by a drop in 6-month consumer expectations. The prior month's figure was also revised down to 97.8 from 98.1. Donald Trump on Tuesday 23rd took a third consecutive Republican Caucus win with 45.9% of the vote in Nevada. His closest competitor was Marco Rubio (23.9%). In South Carolina on Saturday 27th, Hilary Clinton (73.5%) trounced Bernie Sanders (26%). The candidates head to their next major test – 'Super Tuesday' on March 1st – the first multi-state day.

A flurry of primary issuance from investment grade corporates rounded off February. Among them, a $7.5bn multi-tranche sale from rare AAA-rated Johnson & Johnson in a revival of last year's theme, selling debt to fund share buybacks instead of drawing down cash. GDP was stronger than expected on Friday 26th with a 1% annualised gain beating forecast of 0.4%. FOMC voting member Loretta Mester said the same day that the next meeting, on the 15th and 16th March, 'should be on the table'.
for the next rate increase. Later on Friday, inflation measure core PCE posted a forecast-busting 1.7% increase YoY. The USD strengthened on rate rise expectation given the upward revision to the previous month's PCE level and Q4 GDP and Mester's comments earlier in the day.

**EUROPE**

The ECB reported a return to maximum pace of QE following its Christmas liquidity break with €62.4bn of purchases, up from €50.3bn in December. Nowotny noted in response to the mini-tantrum following December's ECB policy disappointment that the markets 'clearly expected too much and I think that should give them a certain lesson'.

Draghi on Monday 1st stated that monetary policy was working and, along with other Board members, reiterated January comments that the ECB will review and may reconsider policy in March. In an apparent nod to the challenges ahead, Coeuré said at a conference in Budapest that 'we will need new political convergence to accompany new economic convergence'.

The ECB's Weidmann appeared uncharacteristically dovish in his comments from Paris on Tuesday 9th when he said that inflation would rise later than forecast and the economic outlook was weaker than a few weeks ago given global market events. Some interpreted these comments as paving the way for another deposit rate cut at the 10 March ECB meeting. The Swedish Riksbank surprised markets with a rate cut from -0.35% to -0.50% on Thursday 11th. In a well-signalled move, Deutsche Bank on Friday 12th announced a tender offer for €3bn and $2bn senior unsecured debt. It confirmed that there would be no change to its 2016 funding plan.

The OECD released its latest Global Interim Economic Outlook on 17 February, revising down global growth forecasts and warning that global demand cannot be sustained solely by the US recovery. It called for 'a stronger collective policy response'.

Deutsche Bank announced the result of its euro-denominated debt tender on Tuesday 23rd, where the bank accepted €1.27bn of the €1.75bn bonds tendered. Given the €3bn target, the exercise was presented more as a communication/marketing tool to demonstrate investor ease in the bank's bonds than a real desire to retire debt. The US dollar tender remains open until 11th March. The European Banking Authority released on Wednesday 24th the methodology it will use for its latest stress test, covering 51 banks within the EU. Testing with a negative interest rate scenario was notable by its absence. The number of banks under scrutiny marked a significant reduction from the 123 tested previously in 2014 and the 90 tested in 2011. Furthermore, there will be no threshold 'pass' criteria this time around. Results are expected early 3Q16.

On Wednesday 24th an unintended consequence from Sweden's foray into negative interest rates came to light. The Swedish Debt Office reports a surprise expectation for a SEK 3bn budget surplus for 2016 (revised substantially by SEK 35bn from its previous forecast for a SEK 32bn deficit) as companies and households have overpaid the Tax Agency in the form of preliminary tax, receiving interest on their excess deposits in the process. Hans Lindblad, Director General at the Debt Office, remarked that 'the Tax Agency can be described as some form of parallel debt office here, which is paying for borrowing whereas we're paid to borrow'. The loophole is to be closed.

Ireland looks unlikely to have a new government formed in time before parliament reconvenes on 10 March after elections on Friday 26th resulted in no clear majority. The ECB's Weidmann spoke at the G20 meeting on Saturday 27th. He remarked that the ECB should 'look through' the slump in energy prices and that the economic outlook is better than markets suggest. He added that he doesn't expect big revisions to ECB forecasts in March. The Eurozone headline CPI inflation estimate for February, released on Monday 29th, contradicted Weidmann's comments, coming in below expectation at
-0.2% (vs. 0.0% forecast) with core CPI rising 0.7% (vs. +0.9% forecast).

**JAPAN**

The first JGB sale following the policy change occurred on Tuesday 2nd with ¥2,198.5bn 10yr supply sold at 0.078%, down from 0.254% previously. A 10yr sale to retail investors was cancelled in light of an expected negative yield - the same circumstance which led to the cancellation of a 2yr retail sale in 2014 where broker fees would have outweighed the return on offer. The JPY strengthened to touch 117.06 on Wednesday 3rd in the fallout from a disappointing US ISM Non-Manufacturing figure before settling in the 118.00 area – this completed, after just three trading sessions, a reversal of the yen weakness that was triggered by the BoJ easing.

**Ministry of Finance** data on Monday 8th showed that Japanese investors bought a net ¥13.852tn (approx. $118.6bn) long-term and ¥323.6bn (approx. $2.8bn) short-term US Treasuries in 2015, both highs since records began in 2005. In contrast, **US Treasury Department** records for the year to November 2015 show that Japanese holdings in general declined by $93.7bn to $1.145tn.

The **Summary of Opinions** from the **Monetary Policy Meeting** where negative interest rates were introduced was released on Monday 8th. Opinions are not attributed to individual members, but they shed light on the slim 5:4 majority for negative rate implementation. Critical views included 'given the current accommodative financial conditions, additional easing measures are not warranted' and 'maintaining the current pace of increase in the monetary base and introducing a negative interest rate at the same time lacks logical consistency'. The yen appeared to be on course to strengthen through 110.00, reaching 111.00 on Thursday 11th before rumours surfaced that the BoJ was checking FX rates. The interpretation by the market that intervention was on the table was enough to stem the flow and weaken the yen to end the week in the 112.50 area.

An auction of 2yr JGBs on Thursday 25th was sold at -0.183 vs. the previous sale in January at -0.018. Interbank overnight lending rates meanwhile have struggled to push below zero as banks assess the situation from the sidelines. **Inflation data** out on Thursday 25th showed January national CPI at 0.0% with the ex-food and energy measure at +0.7%. Both were in line with expectations.

**CHINA**

Given the extra strain from capital outflows this year, the PBoC had to inject 4x as much cash ($50bn) into the economy to maintain liquidity ahead of the Lunar New Year holiday compared to what had been required last year. The Bank's head of research Lu Lei said that there was not much room left for more policy easing and that rate cuts spur flows to risky assets and fuel financial risks.

Much of the Far East was out on Monday and Tuesday (8th and 9th) for Lunar New Year celebrations while China, Taiwan and Vietnam were out for the whole week. We welcome in the year of the monkey.

The January **trade balance** came in at CNY 406.2bn vs. CNY 389.01bn forecast on Monday 15th; exports fell 11.2% whereas imports fell 18.8%. After increasing the frequency of its open-market operations to daily from twice-weekly around the Lunar New Year holiday, the PBoC announced on Thursday 18th that it would make the change permanent as it seeks to improve the effectiveness of these operations.

Chinese stocks rallied on Monday 22nd after it emerged over the weekend that the Chairman of the China Securities Regulatory Commission, Xiao Gang, was removed from his position in a bid to restore investor confidence following recent market volatility. Liu Shiyu, former chairman of the Agricultural Bank of China, takes over the role. On Wednesday 24th, the PBoC announced
measures to further liberalise its domestic interbank bond market. Effective immediately, it will allow and encourage more overseas qualified institutional investor access, scrap quotas for medium and long-term investment and simplify management processes. Also on Wednesday 24th, and following Donald Trump's Nevada Caucus win, a spokeswoman for China's Ministry of Foreign Affairs was asked at a regular press conference whether China was concerned about Trump's proposed foreign policy – specifically the threat of a punitive Chinese import tax given Trump's accusation of Chinese currency manipulation. She responded that China hoped the US 'will pursue a positive policy toward China in a responsible manner'. In its latest easing measure, the PBoC cut the cash reserve ratio required for major banks by 0.5ppt to 17% on Monday 29th.

**CRUDE OIL**

It emerged Monday 1st that both Angola and Nigeria had held separate talks with the World Bank for potential support in the wake of weak oil revenues. Oil sector corporates reported results following sector-wide downgrades. BP suffered a large earnings miss Tuesday 2nd – profit was $196mn vs. $815mn estimate. WTI broke down through a fledgling YTD support level of $31.45 on Tuesday 2nd. As it reached $30/bbl, general sentiment, Treasury yields and equity indices were all sent lower. It bounced Wednesday 3rd on the back of a weakened USD following softer US data. Royal Dutch Shell reported poor results on Thursday 4th as it had previously forewarned. It announced a plan to cut 10,000 jobs.

The IEA said in its monthly market report on Tuesday 9th that 'it is very hard to see how oil prices can rise significantly in the short term', citing oversupply as producers battle for market share amid tepid global demand. The US Energy Information Administration on Wednesday 10th released weekly crude stockpile data which showed a surprise dip (-754k barrels vs. forecast +3.6mn barrels) following record highs previously.

Saudi Arabia, Russia, Qatar and Venezuela met to discuss oil on Tuesday 16th. They disappointed the market, which had been hoping for a pledge to cut output, by agreeing a preliminary deal to maintain production at January levels. The production freeze was stated as contingent on agreement by other producers to implement the same. Venezuela and Qatar went on to meet Iran and Iraq on Wednesday 17th to discuss the freeze. Iran, seeking to boost production after the recent lifting of international sanctions, voiced its support for measures to stabilise the market, but did not itself commit to the plan. Iraq towed a similar line.

Oil was nevertheless boosted as it was announced on Thursday 25th that Russia, Saudi Arabia and Qatar would meet once more in March to further discuss the production freeze.

For the WORLD addendum report please contact the authors.
As a rule, I am always sceptical of people who have personalised car number plates. To disguise the age of a car might be acceptable but it also carries the higher risk of being seen as ostentatious. Some plates might simply show how owners have made their money to afford such a plate. Such as ‘1 BET’ or more often simply the initials and a low number such as ‘AMS 1’; one assumes that this is purely to remind the owner, in the event of them forgetting their name. I have the same apprehension towards companies that have associated stock exchange tickers symbols. I am not referring to a ticker like BP, for BP, that’s entirely logical. I mean tickers that attempt to be narcissistically humorous.

The most annoying seem, ironically, to be tied to companies whose share prices fare poorly. Majesco Entertainment, which not so long ago traded at $20, and are now languishing at a lowly 78c, use the moniker of ‘COOL’ (yuk). Dynamic Materials, a maker of explosive bomb stuff, unsubtly uses ‘BOOM’, which their shares have not done. In fact they have drifted in two years from $24 to $6.20. Sotheby’s use ‘BID’ for their stock exchange symbol, which their stock price has not seen much of, falling from $47 to $20 in less than a year. The art market has been a tricky place recently. It is not cool and certainly not booming.

Conversations I have with many modern art buyers impart a similar feeling of giddy misgiving. The art market is strongly correlated to financial markets and, because of that relationship, it draws the ‘wrong’ type of buyers in to it, those hunting monetary gain rather than aesthetic gratification. Not surprisingly the majority of buyers are from financial investment backgrounds.

In the first two weeks of February, the art market’s alarm bells started ringing. After the frenzied buying of last year, Phillips, Sotheby’s and Christie’s all had disappointing results at their eagerly awaited contemporary art auctions. Sotheby’s and Christie’s sold a total of $184.7 million of art, far below the $364 million from the same sales last year. Christie’s sold 89% of 61 lots for $84.3 million, just above the low level of their presale estimate of $72.7 million. Sotheby’s sold 78% of 55 lots.

It appears the downturn in equity markets has had an instantaneous effect on contemporary art buying. Interestingly, like stock exchange flotations
and placings that can get ‘pulled’ at times of high volatility, a worrying amount of lots were withdrawn, including, minutes before the sale started, a star lot of Gerhard Richter’s, all-embracingly titled ‘Abstract Painting’ and estimated at $25 million. The conspiratorial whispering in the room was evidently very audible!

However, the internet favourite and Bloomberg columnist, Barry Ritholtz, thinks the art market, being dominated by a financial elite, does not relate to stock market valuations. ‘There are more than 7 billion people in the world. There are almost 320 million people in the U.S. How many of these folk can afford to spend almost $200 million on a Picasso? There are 2,300 billionaires in the world. That pretty much defines the size of the market for these sort of collectibles. That means that record breaking art auctions may say something about the rarefied world occupied by the super-rich, but their informational value is of little importance to market sentiment.’ He wrote this prior to last month’s art market wobbles. The top of the equity market was at the end of May in 2015 and in the same month, Pablo Picasso’s Women of Algiers (the ‘O’ version) sold for $179 million, the most expensive work sold at auction ever. A nude Modigliani, well actually a nude painted by him, sold to a Chinese collector for $170.4 million. Over the course of nine days $2.3 billion of art was sold in New York alone. An amount described by the press as an ‘art buying frenzy’. May 2015 was also the year when we started seeing some of the largest ‘orchestration’ in auction history. As Sotheby’s BID price faltered on the stock market, increased competition between the big three auction houses intensified and increasingly barmy financial sweeteners were offered to sellers. Sotheby’s laid out an underwriting guarantee of $515 million for its former owner Alfred Taubman’s estate. Phillips guaranteed half the works of its November auction, while Christies were active constantly offering ‘third party guarantees’.

By the end of 2015, the old masters market was already looking very jaded and the previously buoyant Russian market only saw $25.9 million of sales in December, across four London auctions. The contemporary, modern and impressionist art auctions, in November, had all failed to hit low estimate levels.

The momentum buyers of art, the ones who show you the painting and then tell you how much they have paid and how much it is now worth, also started to waiver as the year came to a close. The little known ultra-trendy art sub-set of ‘zombie formalism’ (yes, honestly), had attracted a lot of the ‘greater fool’ financial investors; the greater fools wearing Emperor’s clothes. Non–household names like Christian Rosa, Parker Ito and Lucien Smith, which were selling for roughly $10,000 in 2013 and were evidently changing hands for $250,000 in late 2014 have now fallen firmly back down to earth. It creates an obvious comparison with some racy priced internet stocks. The key to trading all assets is not only to buy well but, as importantly, to sell better. Many financial investors, who excel at that when trading markets, seem to have no grasp of the same technique in art markets. Art history shows how many leading ‘artists of the day’ simply become firewood and kindling for the next generation. Very few artists command the same inflation-adjusted prices after their deaths as they did during their lives. No more than a handful of each oeuvre and stylistic development will stand the test of time at all. The impressionists and cubists are the only art genre to have been the exception to that rule. No doubt investment buyers of ‘zombie formalism’ will be confident that ‘this time it will be different’. My own personal ‘hero’, Caravaggio, presents a fine example. From being the world’s foremost celebrated artist in the seventeenth century, he went on to being totally unknown and his art virtually worthless, until rediscovered again in the early twentieth century. 2015 was also the year when we started seeing some of the largest ‘orchestration’ in auction history. As Sotheby’s BID price faltered on the stock market, increased competition between the big three auction houses intensified and increasingly barmy financial sweeteners were offered to sellers. Sotheby’s laid out an underwriting guarantee of $515 million for its former owner Alfred Taubman’s estate. Phillips guaranteed half the works of its November auction, while Christies were active constantly offering ‘third party guarantees’.

In the recent February sales we saw the curious appearance, as buyers, of ‘Art Agency Partners’. The partnership which had been formed by Phillips and Sotheby’s was recently acquired by the latter for a potential $85 million. No-one seems to know who they are bidding for and with what money and all a spokesman would proffer was, ‘……retained AAP clients will be bidding in our sales and they were bidding tonight’. The market seems to be becoming less and less transparent and more and more underhand.

Part of me wants art buyers who are governed purely by financial interest to be burnt. Unfortunately, it is likely they will be. Even over a shorter time frame the bastions of contemporary art can hit significant road bumps in pricing. Jeff Koons, who is famed for his
gigantic balloon animals, sold ‘Balloon Dog (orange)’ in 2013 for $58.4 million, the highest auction price achieved ever for a work by a living artist. I like the fact that Koons was once a commodities broker for Smith Barney and the candidness he no doubt learnt there allowed him to state openly that there is ‘no hidden meanings in his work’, which for $58 million, has to be worrying. In 2009, the value of Koons’s art at auction fell by an estimated 50%, to price levels that were still financially rewarding for him but perhaps not so good for someone who had just paid $58 million for a blow up dog. In November 2007, ‘Hanging Heart (magenta)’ was sold for $23.6 million. By 2009, ‘Hanging Heart (violet)’ changed hands at only $11 million … whoops!

The stock market, despite its recent wobbles, seems an eminently sane investment world compared to contemporary art.

Judson B. Schumacher

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By viewing the current stocks to use grain charts below and corresponding price chart below it, one can see the non-correlated nature of future price direction to current inventory levels.

- Could it be that burdensome stock levels cause policy changes necessary to draw down stocks?
- Are macro money flows (forward looking) more important than inventories (backward looking)?
- By the time visible stock levels have increased (or decreased) have price levels already factored it in?

Answers: Yes, Yes & Yes
“Catwalks Across Global Central Banks Highlight US Dollar As Top Pick For Spring 2016 Collection”

What stands out here?

1. Chinese Yuan devaluation worries, Commodity markets faced with increasing supply, and softer US economic data spooked markets at the start of 2016 and caused dislocations and unwinds in Currency markets (short Yen trade) that impacted other asset classes as well.

2. After the latest 10-25% rally across Oil, Copper, Iron-ore and even Gold, nothing has changed in their fundamental picture. Prices will continue to trade lower in search of an equilibrium until either supply cleans up or demand picks up aggressively...
1) What is the best way to explain what happened to markets in January 2016?

Imagine the positioning of all funds and investors across all asset classes linked to a very long elastic band. As the days go by, facts confirm and reinforce the elastic band being pulled in one direction. Imagine that band being pulled further and further until the positioning is stretched so far, it reaches the limit of its maximum resistance level. What happens when that tension gets too strong to hold on any longer? It snaps and yanks right back to a level of no stress. Other than instigate a very fond and nostalgic memory of my first physics experiment in kindergarten, this analogy helps explain why we have experienced such violent moves in just one month across all asset classes.

In January, US and European markets fell 10-15%, Commodities rallied ~ 25%, Yen fell back to 112 vs. the USD after touching a high of 122, reversing the moves seen following Bank of Japan’s aggressive easing policy stance. What gives? The elastic band in this case was the long USD trade against most G10 currencies with a bias of long developed markets growth in 2016 offset by emerging market weakness. After saying otherwise, China blind sided the market by devaluing the Yuan aggressively at the start of the year, leading Chinese indices to sell off. Investors worried that perhaps Chinese growth was much weaker than the officials wanted to admit to. In 2016, the US economy was seen as the beacon of growth with the market willing to shrug off manufacturing weakness as long as the labour market held up as per Fed’s guidance. The Fed was the only central bank that was leaning towards higher interest rates this year. When weak US data spreads to non manufacturing side as well, investors were convinced we were about to enter a global recession. Together with falling Commodity prices, talk of deflation cornered the market.

The short Yen carry trade has been one of the most powerful driving forces for a host of investments given the Bank of Japan’s one-way stance to weaken the Yen. It was a “no brainer” to borrow the Yen to fund investments in other risky assets. As the Yen reversed course in January, this led to a domino effect across all asset classes. Investors had to buy back their short Yen positions and sell their holdings in other asset classes, even safe ones like European and US Equities. No one bothered to ask why some markets were falling but painted everything with the same doom and gloom brush without logic. As Commodity prices fell dramatically on increased supply prospects, this impacted the sovereign wealth fund holdings as well since their wealth is linked to oil. Lower petrodollars compelled them to unwind other holdings to make room for the shortfall.

Painful as they may be, unwinds are necessary to recalibrate and reset the markets from time to time. Emotions aside, after fund managers have been busy putting fires out in January and February, a few thematic opportunities have now emerged in the background.

In recent months, the decline in PMI surveys led to worries about global economic growth. The ISM non-manufacturing index fell to 53.5 in January from the high 50’s in 2015. The index is now at its lowest level since February 2014. Consumer stocks in the US have been hit extremely hard on back of this weakness along with other domestically exposed sectors. However the markets seem to be pricing in a much worse scenario than actual economic data may suggest (seen in Chart 1 below).

**Chart 1: Market’s Perception Of US Growth vs. Real US Economic Data**

![Chart 1](source)

Chart 1 above shows US Current Activity Indicator (CAI) based on current economic data plotted against the market’s perception of growth via an index that tracks a basket of US growth and cyclical stocks. The US CAI is trading much higher than the basket of stocks think where it should trade. This trend is also evidenced in the forward 5yr-5yr break-even US inflation rates where the market’s view is that rates will stay a lot lower for longer than currently guided by the FOMC. Falling Commodity
prices and every central bank looking to devalue its
currency against the USD, with over $6 trillion worth
of global bond markets trading at negative yields,
investors are now really worried. These slowdown
fears have fed through to the European banking
stocks as well, given their credit exposure to bad
loans and negative yields.

But who is right, fund managers or the Fed?

As usual, trading is dictated by human emotions
at times of stress. This tends to exaggerate moves
in either direction. There is no doubt the Fed can
perhaps delay rate hikes in March 2016 but hikes are
still on the table. The market from pricing in four
rate hikes this year, is now pricing in less than a 50%
chance of one rate hike! In its recent commentary,
the Fed maintained its data dependent approach.
At the time of writing, the last Friday US Core CPI
posted its largest gain in over four years. Core CPI
increased 2.2%, largest increase since 2012. The Fed
has a 2% inflation target and there are tentative signs
of an underlying increase in base inflation. This is
important to monitor as data in the US may not be as
bad as everyone thinks outside of seasonal factors.
If the labour market continues to be resilient, the Fed
may still hike, which means the USD will regain its
upward trend vs. rest of the pack.

Outside of central banks’ race to get their currencies
as close to the bottom, let’s see what this means
for Commodity markets. Commodity markets are
plagued with excess supply given the years of over-
investment finally paying off. On the other hand, if
global growth is weakening across the board, then
Commodities will see lower demand as well. With
the supply side showing no signs of restraint, the
USD on an upward path vs. rest of emerging markets,
Commodity prices at best are capped here with risks
to the downside.

2) Are Commodities really cheap or can they go
lower still?

Oil:

After the 27% collapse of Brent Crude since the start
of the year, front month futures reached a low around
$28/bbl. to then rally 25% in February. Meetings
between Venezuela, Russia, Saudi Arabia and Qatar
led to hopes of production cuts. What sounded like
an idealistic scenario turned out to be just wishful
thinking? Unless all members of OPEC are on
board, the cuts will never materialise. At the OPEC
meetings in 2014 and 2015, Saudi Arabia went to
some lengths to convince the market of their ‘free for
all’ strategy to maximise revenue and market share.
Chart 2 shows how their strategy has worked as US
production has come off since then.

Chart 2: US Crude Oil Production

The EIA has revised down its end 2016 crude output
production from 9.7 million bpd in July 2014 to just
8.5 million bpd February 2015, and expect another
800k bpd to be removed from the market by the end
of this year. Oil production in North Dakota, one
of the biggest shale regions, fell to just 1.15 million
bpd in December 2015 from all time highs of 1.23
million bpd in December 2014. Meanwhile Saudi
market share has been rising (see chart 3 below).
Saudi Arabia is now pumping above 10 million bpd,
up from 9.64 million bpd in Nov 2014. So why cave
in and cut now when the tide and revenue share is in
their favour?

Chart 3: World Producers Crude Oil Production
(million barrels per day)

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The oil price is costing the kingdom about $100bn per year in terms of extra borrowing and lower foreign reserves, which, according to S&P rating agency, will lead them to have a budget deficit of close to 9% of GDP between 2016 and 2019. The government has already budgeted for a deficit of 13% in 2016 based on oil prices of $45/bbl. It has enough foreign reserves to fight this one out for the next 3-4 years, but can US shale afford the same luxury?

The latest round in the oil saga suggested a ‘production freeze’. Call me a skeptic but it seems an extremely opportune time for Russia and Saudi Arabia to call for a freeze when they are producing at their highest levels ever (chart 3 above). A freeze is not the same thing as a cut, it still means there needs to be enough demand to soak up the existing supply or supply needs to come off the market fast enough for the market to find price support. After years of sanctions finally lifted on Iran, why would they give up the opportunity to make some money back?

Any mention of production cuts can lead to spikes in the oil price. But what the market fails to understand is that if there was a cut, that would only be followed by a bigger sell off after the fact as it would mean there was more (spare capacity) oil stored that could easily come back on line if prices ever rallied! The rally will not be sustainable nor will it be a healthy one. Wishful thinking can still lead to massive short covering rallies, especially when markets are so heavily shorted. Violent rallies and falls are daunting. It is easy to call a buy to a market that has fallen over 50% in a year, but cheap can always get cheaper. Volatility and greed aside, the fundamentals will still dictate price action in oil. With total crude and product inventories trading in excess of 5-year averages (even gasoline is now building aggressively), there is still too much supply.

**Copper:**

According to Goldman Sachs, global copper demand growth will slow to 0.5% in 2016, well below trend of 2.5% p.a. and against their previous forecast of 2%. Refined supply growth is set to pick up 2% in 2016! Chart 4 illustrates how the current rate of growth is much below the average of the past few years.

**Aluminium:**

This market displays one of the most bearish trends compared to other base metals. Chinese supply has been resilient in face of subsidies granted by the government despite falling prices. Production curtailments are yet to be seen in size before even suggesting some price support. Cost deflation from lower energy and coal prices plus infinite storage options are all delaying the re-balancing of the market. Only a demand pick-up can save this market, but even that looks unlikely given global economic growth prospects. According to Wood Mackenzie and GS numbers, the aluminium market has about 1.3-1.5mln tonnes per annum of excess surplus over the next two years.
After trading as low as $40/t, Iron ore has also rallied in sympathy with the rest of the complex trading close to $45-48/t now. Perennial “value” bulls are using this as an opportune time to call the bottom, presenting arguments as to why the rally happened in the first place. As always a story comes after the move, never before.

Chart 6 opposite shows the increase in supply for the next few years according to company guidance following their Q4 2015 earnings reports. BHP Billiton announced an increase of 6% y-o-y for 2016 to 247 million tonnes. Rio Tinto guided for 350 million tonnes for 2016 and more to come in 2017 due to productivity improvements. Vale S11D project, biggest Iron-ore expansion project currently under progress, can be a game changer, as it will increase VALE’s capacity by 90 million tonnes per year to 450 million tonnes, expected to come on line in late 2016. Based on supply additions from company mines and new projects, the total supply for Iron ore is estimated to increase by 200 million tonnes from 2016-2018.

Gold:

Gold was the least preferred asset class coming into 2016. As all asset classes unwound on back of deflation and growth slowdown fears, and US rate hikes were pushed back, Gold benefited as the ‘safe haven’ trade. It is the best performing Commodity and asset class year to date, up 17%. There is no fundamental reason for Gold to be up other than the fear factor. There is no economic evidence of a recession and if underlying inflation trends are higher and central banks adamant to reach their inflation goals by more quantitative easing, then the USD will maintain its trend higher.
YTD PERFORMANCE:

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>% YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPX YTD</td>
<td>-6.00</td>
</tr>
<tr>
<td>Eurostoxx YTD</td>
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</tr>
<tr>
<td>SXPP (Basic Resources Index)</td>
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<tr>
<td>SXEP (Oil &amp; Gas Index)</td>
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<tr>
<td>EEM (Emerging Markets)</td>
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<tr>
<td>S&amp;P GSCI Commodity TR Index</td>
<td>-9.89</td>
</tr>
<tr>
<td>MBCC Net Return YTD</td>
<td>2.95</td>
</tr>
</tbody>
</table>

Maleeha Bengali - Founder, MB Commodity Corner

Maleeha Bengali graduated from Cornell University with a Bachelors of Science degree in Engineering in 1997. For the past 14 years, she has worked as a Portfolio Manager/Trader for various Hedge Funds and Proprietary Trading desks across both US and Europe including UBS O'Connor, Goldman Sachs J. Aron, Merrill Lynch Commodities and Noble Group, where she launched and managed their Commodities and Equities investment funds specialising in Energy and Basic Resource Equities and the respective Commodities. Over the past 8 years, her strategy has generated a compound annual growth rate (CAGR) of 12% using systematic delta neutral investment trading strategies; minimising market and directional risk while maximising returns, focusing on alpha generation.

After the recent elastic band adjustment, it is time to start pulling it once more in the direction of short Commodities on fundamental demand vs. supply factors. As rate hike expectations normalise, Gold should start to trade lower once again.
In addition to the ridiculous notion that falling oil prices are a proxy for future economic activity, the market herd is also sure that the deflationary train is set to drive prices down through the end of 2016. Those calling for the end of the commodity cycle must not be aware of how many physical commodity markets are trading at or below their cost of production, and they probably haven’t considered that a prolonged slide in prices will begin to significantly injure supply capacity. Furthermore, the chance of inflation is seen as so minuscule that the talk of zero interest rates is becoming more ubiquitous than quotes from Donald Trump. While there is currently more evidence of deflation than inflation, the draconian easing measures that so many central banks are considering could not only cure deflation but also rekindle inflation.

The ‘experts’ are calling for oil prices to remain south of $35 a barrel until the end of this decade. But with 34 years in the markets, I have learned to be skeptical when forecasters are so sure and so similar in their outlooks. There is evidence that crude oil supply is already reacting to lower prices, with a pattern of declining US rig counts, rumblings of a deal to reduce oil production within OPEC, and a seasonal upswing in Northern Hemisphere energy consumption. Still, there is a difference between the end of a downtrend and the beginning of an uptrend, and getting rid of the deflationary psychology will probably require stable or even slightly higher oil prices.

Edible Oils - A Key Food Component of Little Interest to the Markets as a Whole

While some nations are trying to dictate healthy diets for their citizens and are leading protests against GMO, the consumption of palm oil, with its saturated fat and high number of calories, continues to grow. Palm oil represents 35% of global vegetable oil consumption, soybean oil 29%, with the balance consisting of sunflower, rapeseed (Canola), flaxseed, cottonseed and others. Furthermore, palm oil represents 61% of all vegetable oil exports.

El-Niño: Fact or Fiction for Commodity Prices?

After a slow start, El Niño started in earnest in mid-2015, and at its peak this past autumn, it was measured as one of the strongest in history. These events typically bring hot and dry weather...
to Southeast Asia, and this year was no exception. Malaysia and Indonesia experienced hot and dry conditions starting last June. It usually takes about six months before the effects show up in palm oil production, which means that we could be just starting to see the results in February, half-way through the 2015/16 marketing year. What this means is that palm oil production shortfalls may only be just getting started and could continue well into the 2016/17 marketing year.

A prominent palm oil analyst recently predicted a 3-5% decline in Malaysian palm production, and there are similar concerns about Indonesia. Furthermore, there is still a great deal of uncertainty as to how long this El Niño will last. The Oceanic Niño Index (ONI), which is the key measurement for El Niño's strength, peaked last fall, but after declining for a couple of months it has recently started to climb again. We are still in a strong El Niño and the worst may not be over.

Key Palm Oil Producing Areas Affected

Together, Indonesia and Malaysia represent 85% of global palm oil production. In addition, the palm oil they produce represents 30% of global vegetable oil production and consumption! Clearly, a sharp drop in output from these two countries would have a major impact on global vegetable oil supplies. Global palm production has increased for 18 years straight. The last time production fell was in 1997-98, which followed the “moderate” El Niño pattern of 1996-97 and coincided with the “very strong” El Niño of 1997-98. Previous declines occurred in 1986-87, which coincided with a moderate El Niño pattern and in 1982-83, which coincided with a very strong El Niño. Palm oil production has been in an expansion mode for almost 50 years, and the only time it has had a setback has been either concurrent with or immediately following an El Niño pattern. Over the years, the importance of Malaysia and Indonesia to global output has grown. They represented 74% of global production in 1986-87, 80% in 1997-98, and are expected to represent 85% in 2015-16.
As global palm oil has increased, so has global demand. The fast-growing economies in India, China and other developing countries have enabled broader, richer diets for their populations. If palm oil production does decline 3-5% in the coming year (and it could be worse if El-Niño intensifies), the world will have to look to other vegetable oils to meet demand.

Palm oil may satisfy 35% of global vegetable oil consumption, but it represents a whopping 61% of vegetable oil exports. This could make the market a lot more volatile if production declines sharply. Palm oil exports out of Malaysia and Indonesia are expected to reach 42.6 million tonnes in 2015/16, while soybean oil exports out of the US and Argentina are only supposed to reach 6.8 million tonnes. That could mean a lot more people will be fighting over a much smaller pie!

**Markets Already Sensing Something Going On**

Malaysian palm oil prices have already risen 9.9% since September, and the nearby futures have reached their highest level since May 2014. US soybean oil futures prices managed a 23.4% rally between August and December, as El Niño finally appeared.

If El Niño doesn’t worsen and conditions in Southeast Asia stay dry, nearby soybean oil futures might be expected to rise from the recent lows around 30 cents per pound back toward the highs from 2011, when the market peaked at 60.41 cents. If El Niño strengthens, we could see soybean oil prices approaching the early 2008 high of 71.26 cents.

Past inflationary cycles have been fostered by crude oil, gasoline, corn, wheat, soybeans, monetary policies, wars and drought, but the next inflationary event might start with a significant appreciation of one of the basic building blocks in the global food chain, vegetable oil.

**David Hightower** is a founding principal of The Hightower Report (www.HightowerReport.com), a commodity research and information firm specialising in high quality futures research and analysis for individual investors, brokers, commercial producers, farmers and end users. The Hightower Report publishes one of the most widely read daily commodity wires in the world and has become a highly utilised industry consulting service with many brokerage firms turning to it for their primary commodity research coverage. The Chicago Mercantile Exchange (the world’s largest futures exchange) has sent Mr. Hightower to Europe, South America, India and China to promote Agricultural futures trading, to introduce electronic trading and to educate foreign governments and traders on advanced risk management techniques. Mr. Hightower is also a keynote speaker favourite for Futures Clearing Merchants. Seed, implement and food manufacturing companies also turn to Mr. Hightower for his high-impact analysis of current market conditions. In almost every instance, Mr. Hightower earns a return invitation from his speaking venues.

A keen eye on the complex interaction of the world markets insures that Mr. Hightower thoroughly examines the financial, agricultural and geopolitical situations around the globe. This, in turn, allows his company to provide analysis and commentary on a wide variety of markets, ranging from grains, livestock, precious metals, stock indices, bonds, currencies and the energy complex.

Prior to the inception of The Hightower Report, Dave was the Director of Research at what was then the world’s largest commodity brokerage firm. In total, he has over 30 years’ of experience in nearly every aspect of the futures industry.

Mr. Hightower is thoroughly versed in the complex interaction of the world markets and global businesses, and his closeness to the markets is evidenced in his direct and insightful analysis. Because of his expertise, Dave has regularly appeared on CNN, Bloomberg Television and ONN.tv and is often cited in Wall Street Journal, Futures Magazine, Reuters and many other industry publications. He has conducted extensive work with regulatory agencies, exchanges and other industry players on a wide range of research and trading projects and is often called upon by the CME Group to provide their expertise on the markets. Dave’s infectious enthusiasm shines through and has made him a highly sought-after speaker for industry events. Some of his recent speaking engagements have been for ADM Investor Service, Charles Schwab, RJ O’Brien & Associates, Global Grains Inc., HighQuest Group, and the US Grains Council.
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