Investments Banks' Perspectives on Commodity Super Cycles

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CIBC

Not Everything Fits Into A Neat, ‘Cycles’ Package

- Some elements of the contemporary commodities markets are cyclical, but some are unique.

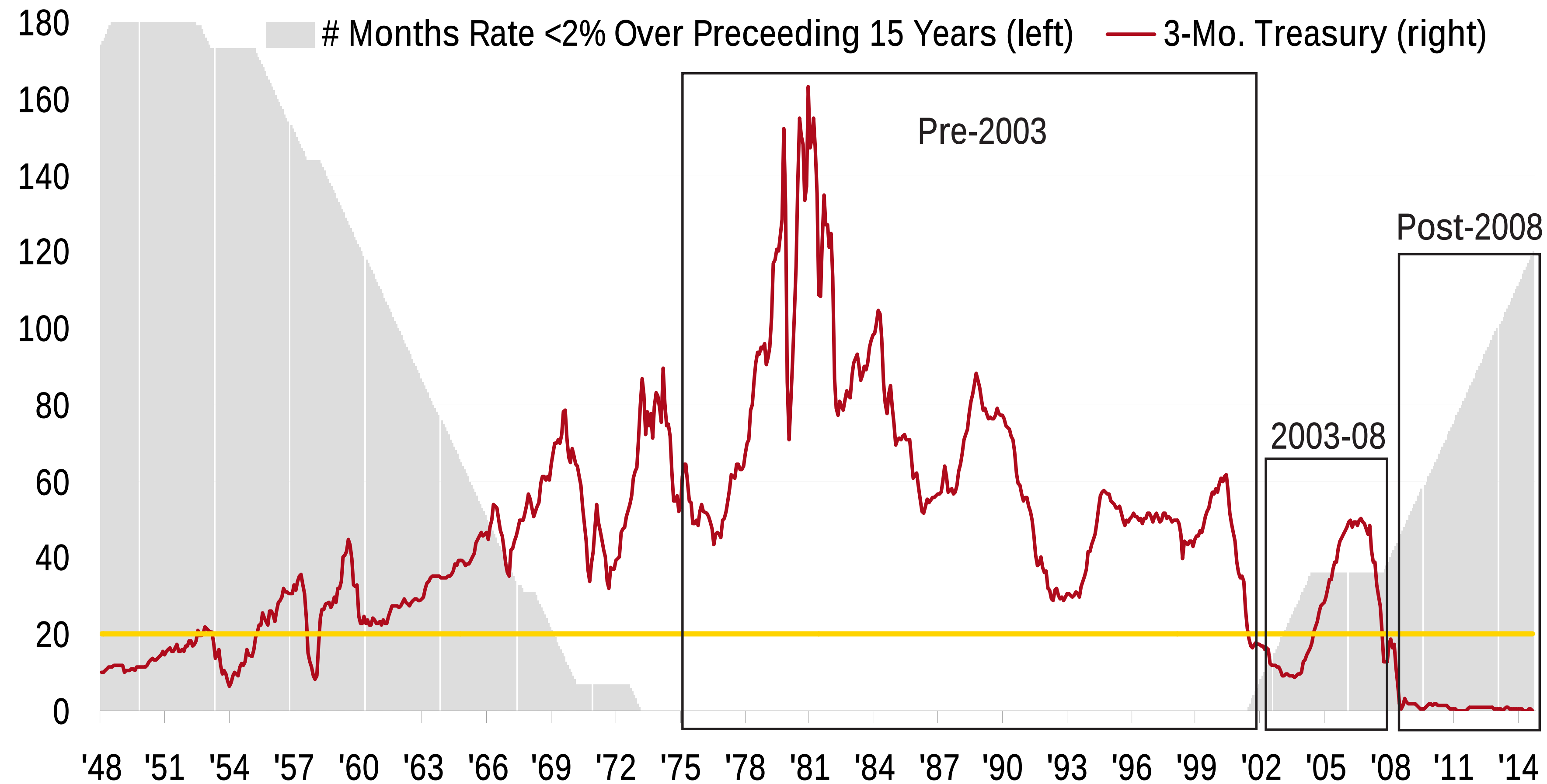
- Cyclical: (1) Boom bust cycle of over- and under-investment in resource development, processing, and transportation; (2) Commodity demand in line with economic growth cycles, stages of development.

- Unique? The evolution of the financial trade of commodities (and maturation of capital markets in general) and the over-capitalization of resource development in a persistent low-interest rate environment.

- Some of the market features we have observed over the past fifteen years can be explained with traditional metrics, but some can’t. The 2003-08 period in commodity markets and the post-2008 period were distinct from each other and from what had come before. Are these “flukes” or new types of market cycles?

- Banks do seem to demonstrate a cyclical tendency when it comes to their role in commodities trading if not lending...

Interest Rates (& Duration) In 3 Commodity Eras



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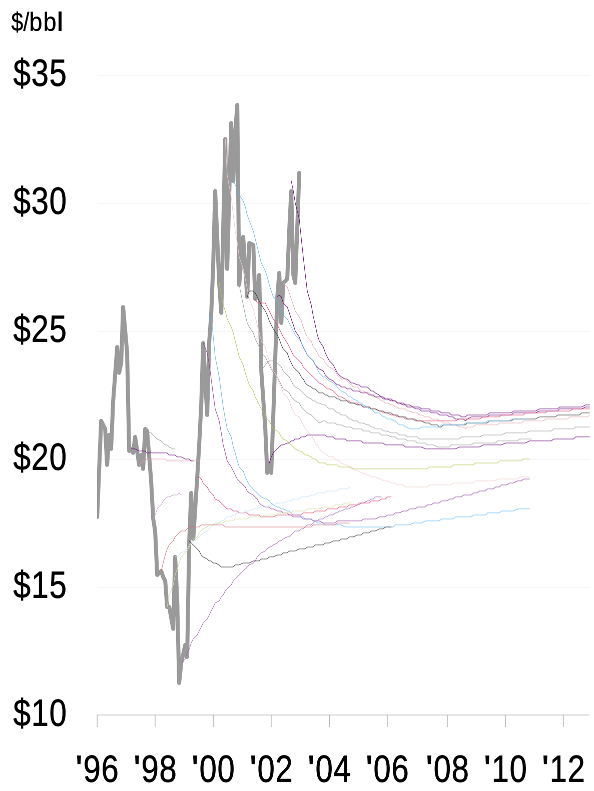
View #1: Curve Behavior In Three Eras

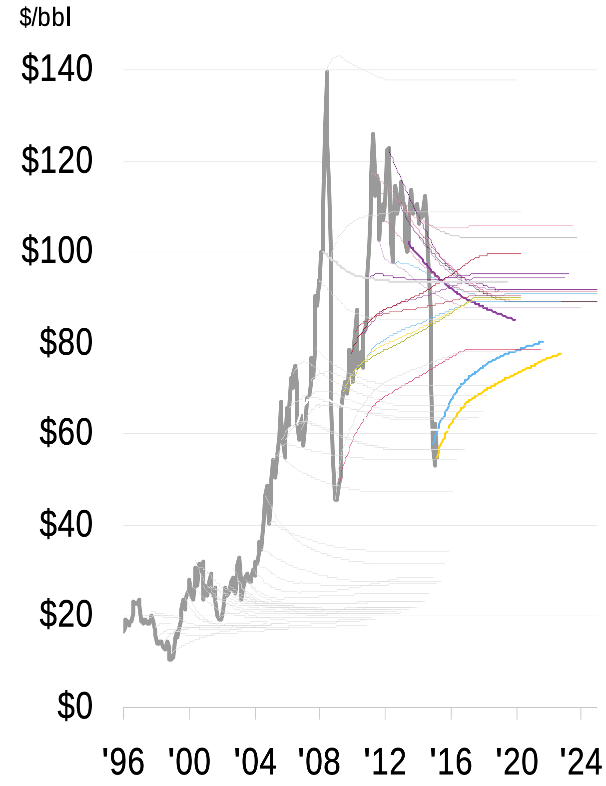
Price History With Snapshots In Time Of Forward Curve

Pre-2003



2003-2008

Post-2008



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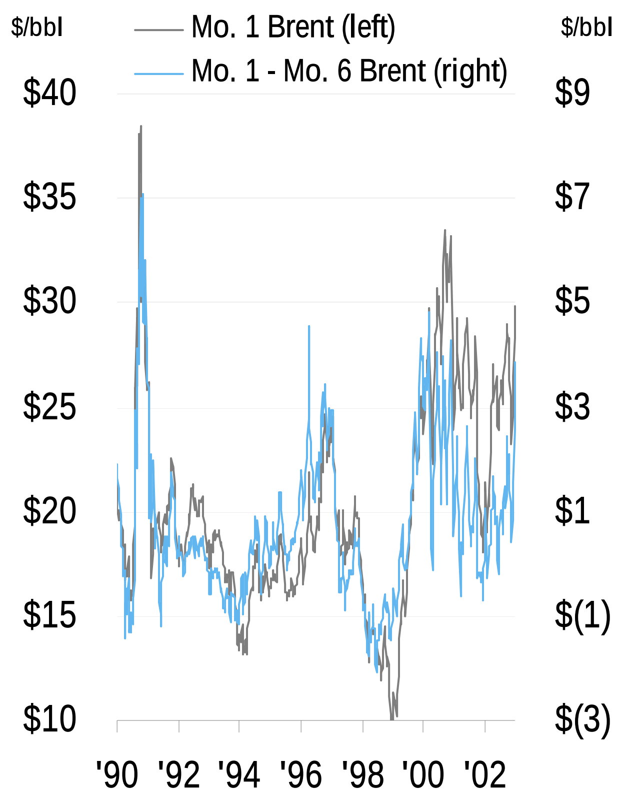
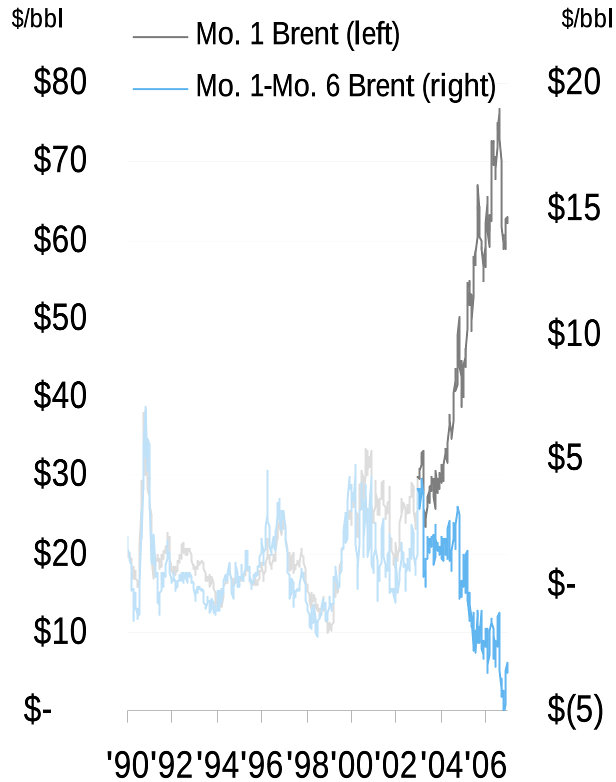
View #2: Three Eras of Curve Behavior

Price History With Snapshots in Time Of Forward Curve

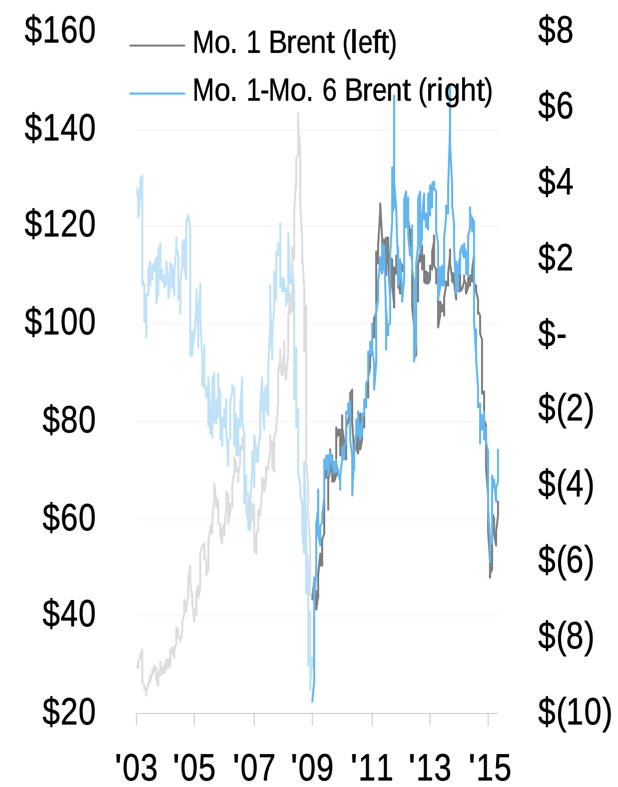
Pre-2003



2003-2008



Post-2008



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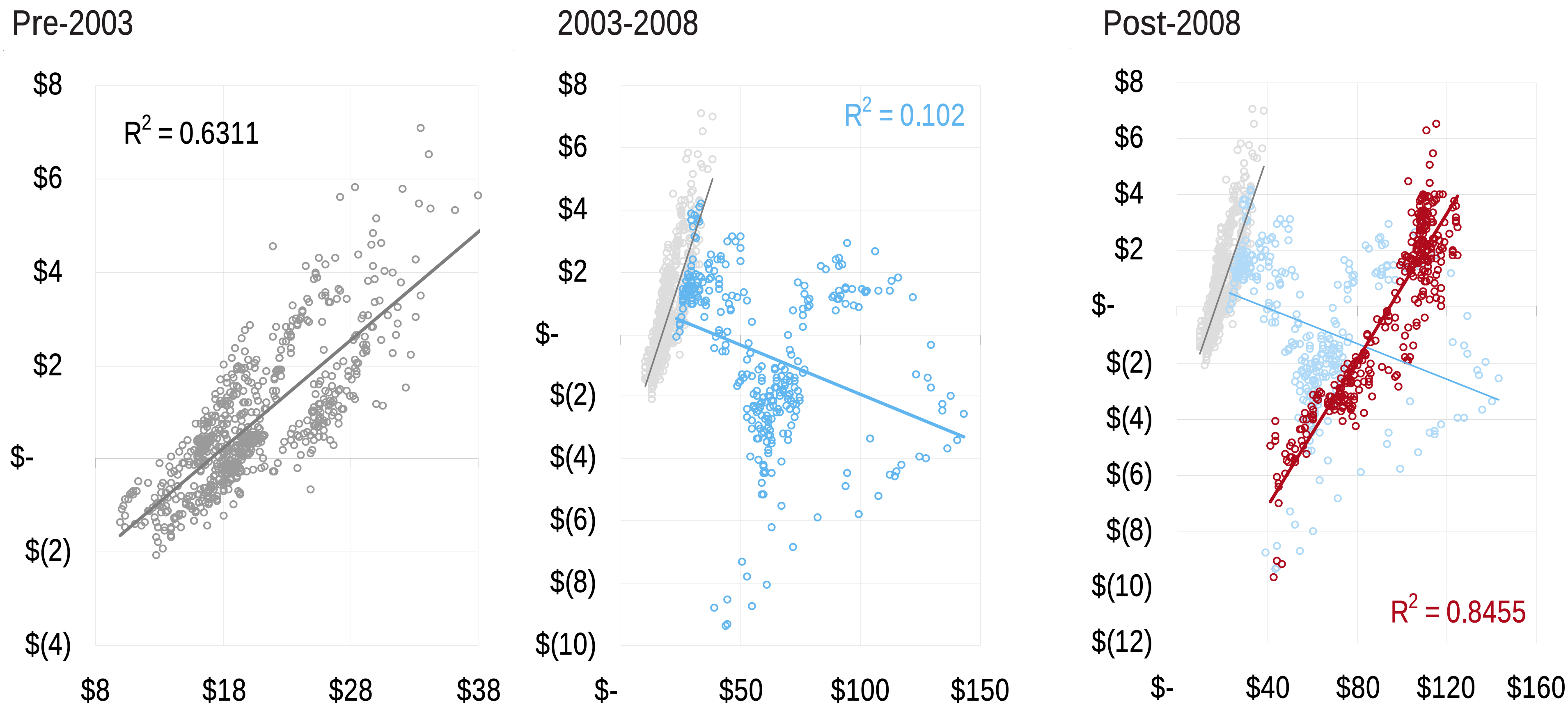
View #3: Three Eras of Curve Behavior

Brent Flat Price (x-axis) Versus Mo. 1-Mo. 6 Brent Spread (y-axis)



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A Closer Look At The Three Eras

Pre-2003:

- Derivatives market dominated by producers and consumers hedging exposure to commodity price risk, and the market makers (banks, merchants, and majors) who facilitated that business.
- Producer hedging was the dominant market flow.
- Backwardation was the natural state of the market.
- Financial trade concentrated in the front two years of the curve.
- Poor correlation between commodities and other asset classes.

2003-08:

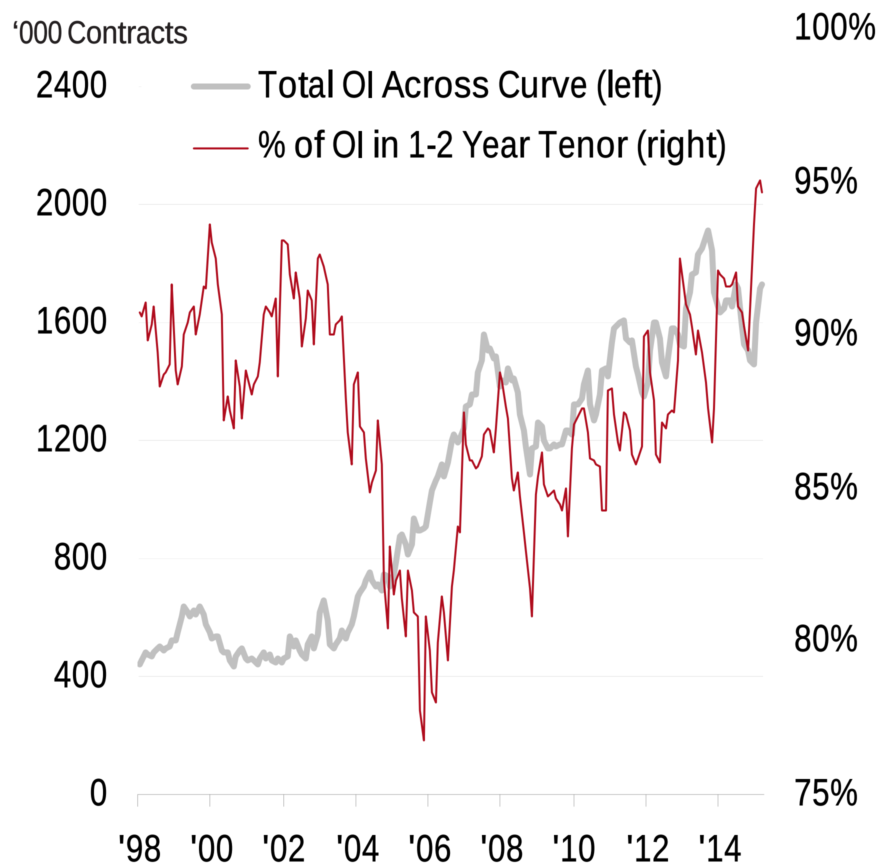
- Characterized by the balance of *buyers versus sellers*.
- Contango in a bull market.
- Merchants out, banks in.
- Trending market discouraged producer hedging, encouraged both active and passive investors.
- Cheap money searching for yield results in new investment vehicles.
- Banks use credit as loss leader to facilitate commodities business.
- Financial trade becomes more long-dated.
- Rise of asset class correlation.
- Petrodollars are major source of liquidity for capital markets at large.

Post-08:

- Characterized by the balance of *users versus providers of liquidity*.
- Return to “normal” curve behavior.
- Banks out, merchants (and private equity, and debt investors) in.
- Low vol market discourages producer hedging *and* investors (particularly hedge funds).
- Clearing lowers barriers to entry for commodity traders but also creates “phantom” liquidity.
- Cheap money searching for yield results shifts attention from financial products to physical ones.
- Banks price credit more explicitly.
- Financial trade returns to front of curve

Three Eras of Tenor Concentration, Volume, & OI

Concentration of OI In Front Of WTI Curve



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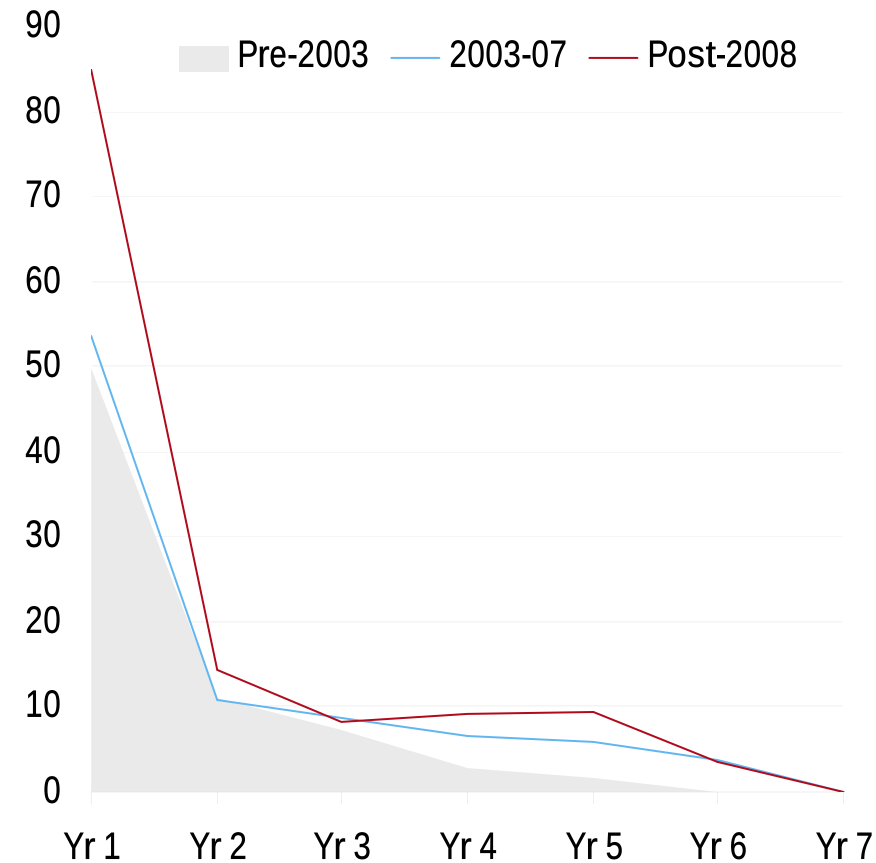
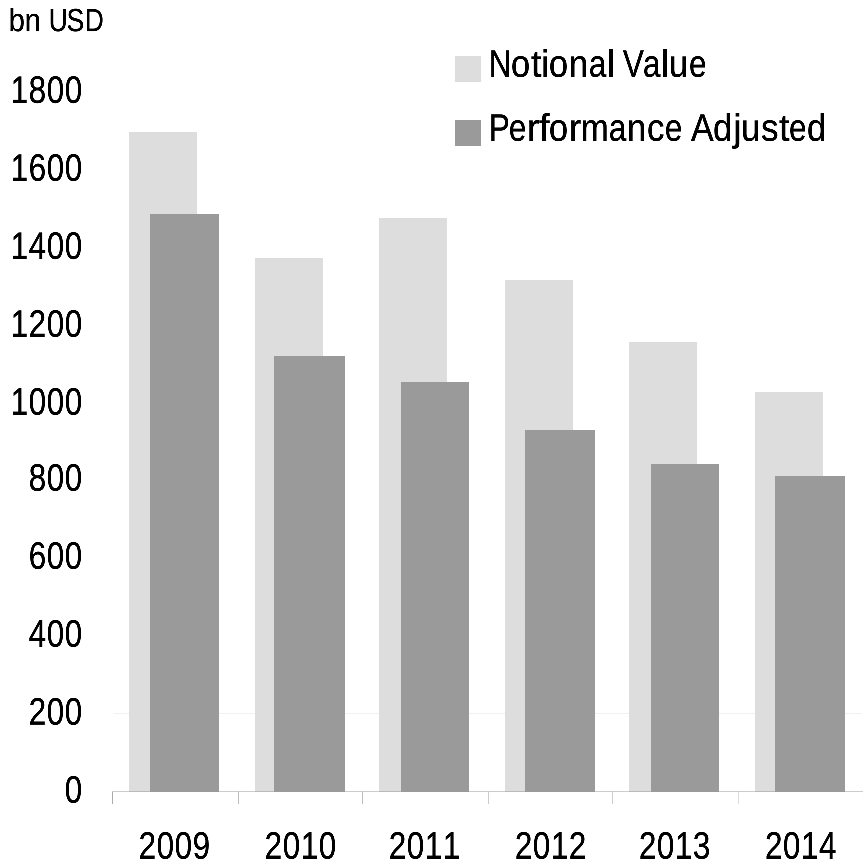
Ratio of Volume:Open Interest Across WTI Curve

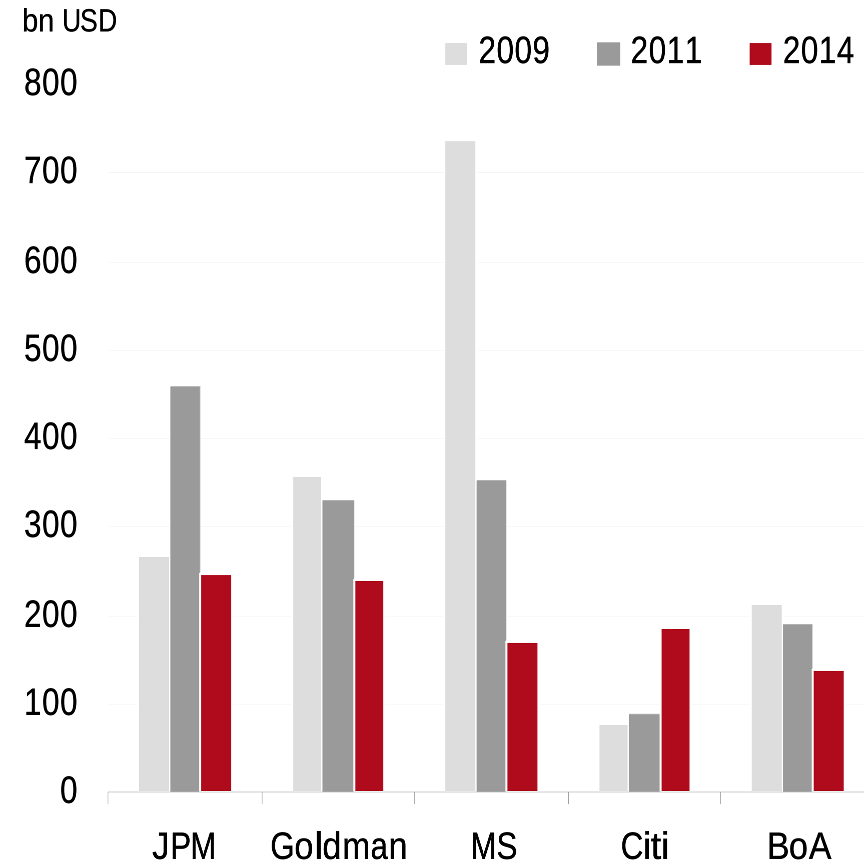


Most Banks Reduce Commodities Risk Post-2009

Notional Commodity Derivative Positions: All US Banks



Notional Commodity Derivatives Positions: 'Large' US Banks



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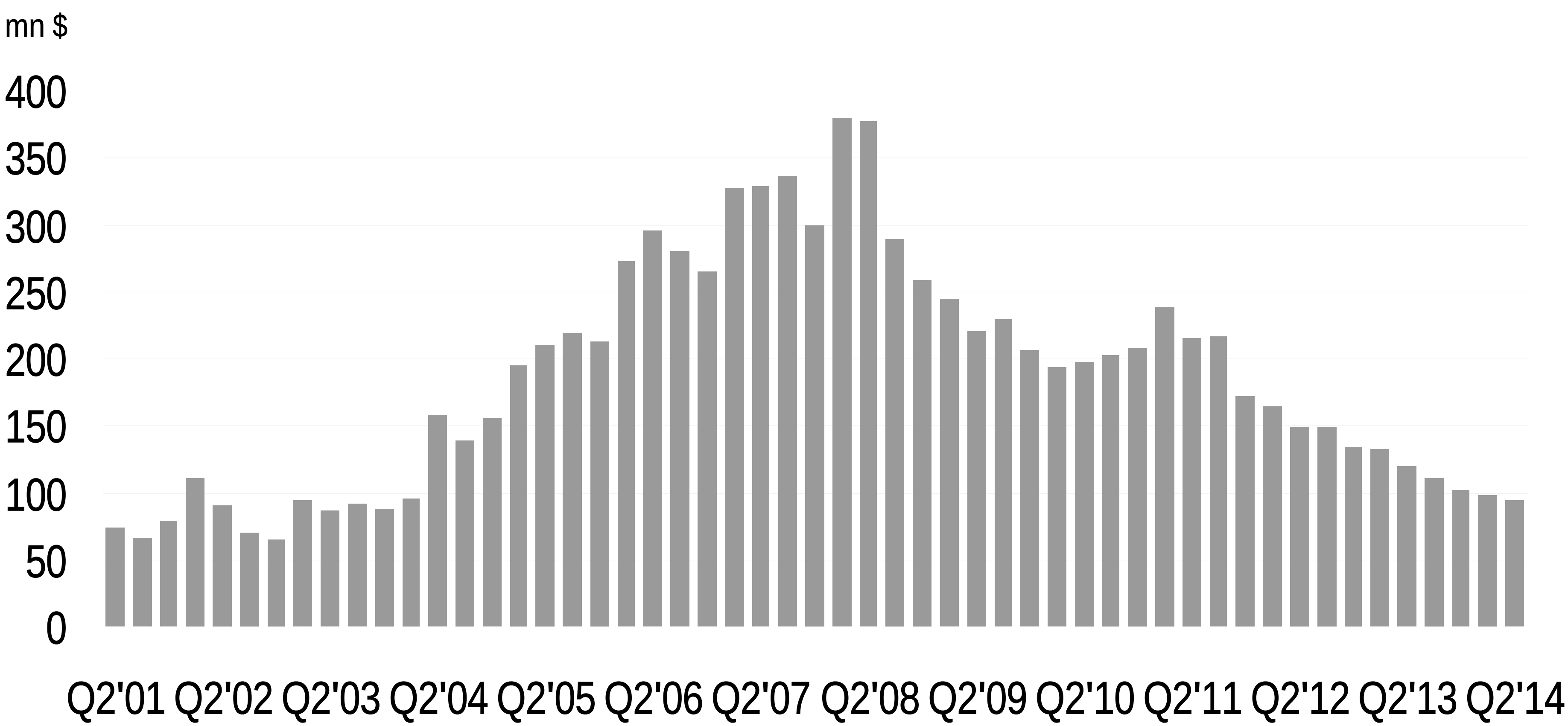
Banks As a Group Reduce Commodity Risk

Collective Commodities VaR at 18 Major (Global) Banks



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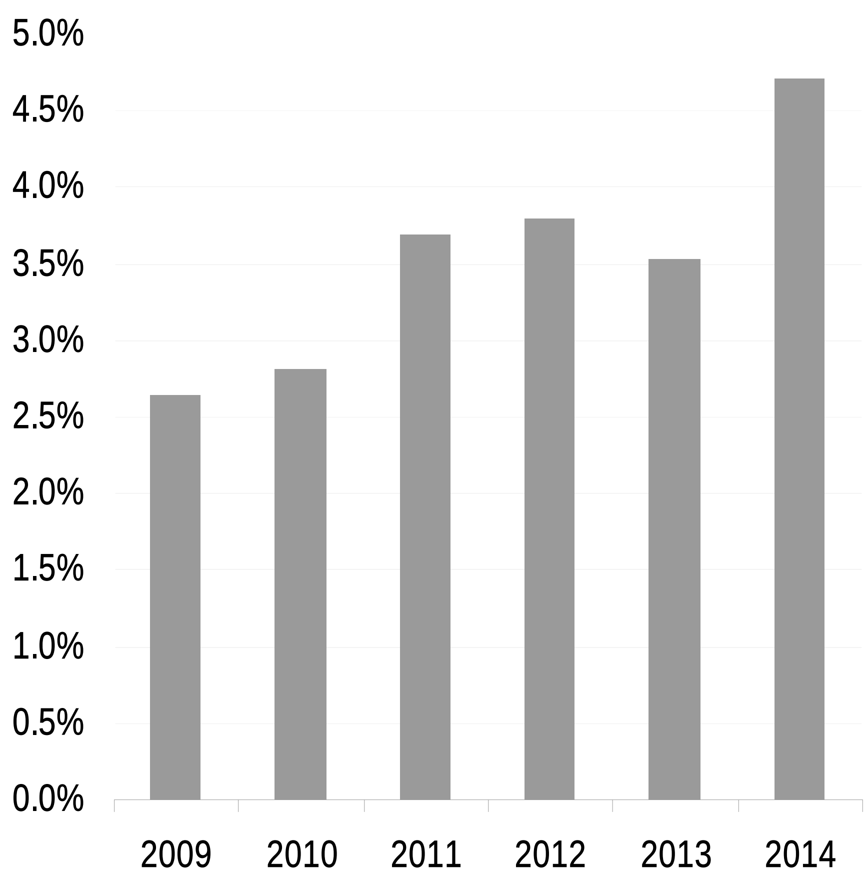
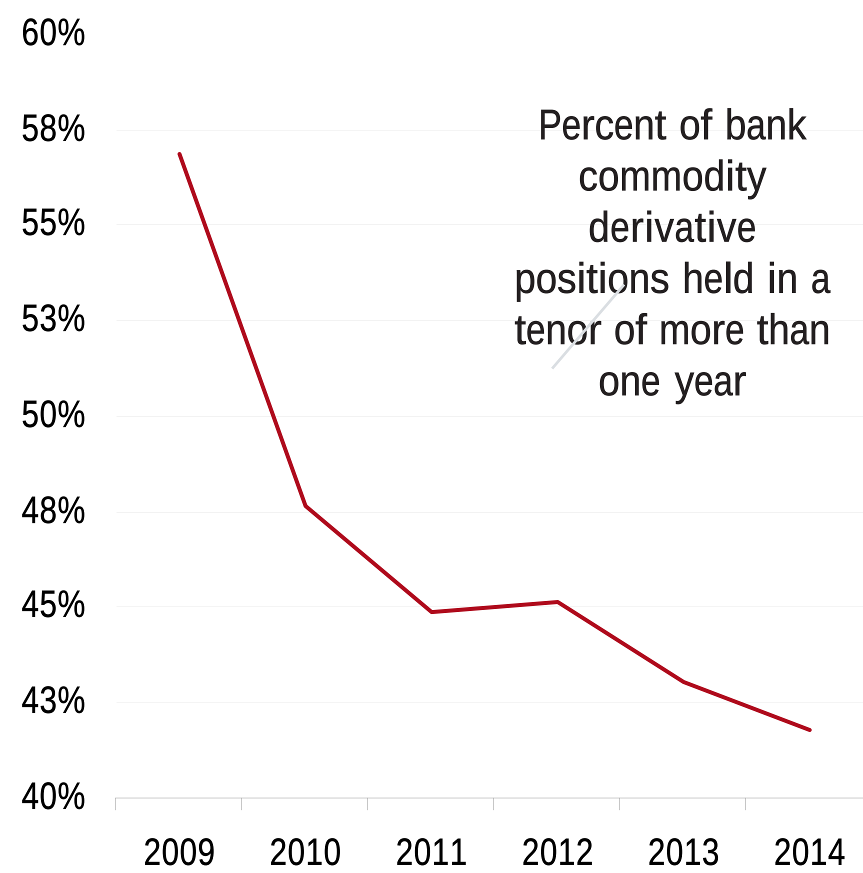
“Small” Banks Rise, Risk Moves to Front of Curve

% of Commodity Derivatives Held By ‘Small’ US Banks



Banks Hold Shorter Dated Commodity Derivatives



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Who Pays For Commodity Production Growth?

Does It Matter?

- The most familiar “commodity cycles” concept is that the industry alternates between periods of over- and under-investment because of the lags between market (price) signals and the physical results of increased spending.

- Does it matter that the majority of today’s production growth is being financed in a different way than the majority of historical production growth was? In other words, does it change the nature of the traditional investment cycle if oil majors and national oil companies are contributing a smaller percentage of growth, and a larger percentage of growth is being contributed by companies that access capital markets to finance E&P?

- While banks still play a meaningful lending role in the industry, capital is increasingly provided by merchants, sovereign wealth funds, private equity, and institutional investors via debt instruments.

- Accessing capital markets to support growth implicitly comes with a risk management requirement, that may be more expensive in a credit- and liquidity-constrained derivatives market.

- Is this a permanent shift or a temporary phenomenon? Does it change the nature of the commodity investment cycle? Does it change the duration of the commodity investment cycle?

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