Sugar and Grains conference special.

Welcome to the October 2018 edition of the Ghost In The Machine, which as ever covers a broad range of topics, though loosely themed around upcoming conferences: London Sugar Week, LME week, ECE Grains (Rouen) and Global Grain (Geneva).

In this edition we look at what has been driving the world’s sugar markets, which have been in a protracted bear market since the start of 2017. The LME has made a reduction in trading fees permanent in a bid to boost trading volumes, but is there a case for reviewing initial margins.

For all the noise that surrounds the US efforts to re-arrange its trading relationships, above all those with NAFTA, China and the EU, with the pendulum swinging towards protectionism, China’s ‘Belt and Road’ initiative which spans Asia and Europe is the most ambitious economic-operation project that has ever been seen, and is having a very profound impact on Eurasia, particularly in agriculture.

As the January 2020 deadline for the IMO 2020 ruling for the reduction of marine fuel sulphur to 0.5% from 3.5%, how are the various stakeholders preparing for its implementation? October also sees the presidential elections in Brazil; the outcome of which remains very uncertain, and has been overshadowed by the Operation Car Wash scandal. With less than 6 months until the UK leaves the EU, we ask whether Britain’s economy is fated to fail as some have argued.

The polarisation of politics in Europe, UK and the USA begs the question: have we lost the ability to debate? As the Federal Reserve continues its rate hiking cycle and balance sheet reduction, we look at the record run in US stock indices, why the TINA phenomenon of recent years has not died, and whether inflation is getting some traction. Last but not least, we look at Structure Trade Finance.
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SUGAR’S DEJA VU

The biennial London sugar dinner is nearly upon us. As usual the global sugar industry descends on London for several days during the second week of October for meetings, networking and the chance to catch up with old friends. Unsurprisingly, one of the main topics of conversation will be the state of the market and expectations for the next few months.

Sadly, the mood is likely to be rather negative and depressed. Since the last dinner, prices have collapsed. Back in October 2016 the market was at a healthy 23.5 cents. This August prices fell to their lowest level in ten years dipping, albeit momentarily, into single digits, hitting a low of 9.91. Of course the over-riding reason for the fall has been a huge over production of sugar.

The 2017/18 (Oct to Sept) season has been extraordinary in many ways. Unprecedented perfect weather for growing sugar cane and beet was seen right across the globe. Virtually all the world’s major producers; Brazil, India, Thailand, the EU and the United States, produced record amounts of sugar. However, it was the huge increase in India, Thailand and the EU that bamboozled analysts. The EU increase was not entirely a surprise given it was the first season farmers and processors were not encumbered by the constraints of the sugar regime but ideal growing conditions saw unexpected yields. Even more unforeseen was the unbelievable amount of sugar produced by India and, to a lesser extent, Thailand. India easily surpassed their previous record by several million tonnes to hit over 32 million tonnes, with Thailand hitting 13 million tonnes which will see it maintain its place as world’s second largest sugar exporter after Brazil. All this against a back drop of stagnating demand as health concerns over eating sugar filters through to consumption. This has meant that a huge global surplus of around 19 million tonnes has been produced.

Unfortunately, things do not look much better for the 2018/19 season which starts on 1 October. While sugar production in Brazil is likely to plummet and the EU’s production will drop, it is expected that India and, possibly Thailand, will produce another season of record production. Although it is early days, analysts currently see another global surplus of around 4-5 million tonnes. This would mean a combined consecutive two year surplus of a record 23-24 million tonnes.

This excessive production saw prices dive to their lowest level since 11 June 2008 and well below cost of production for all. Needless to say, the question on everyone’s lips is whether there is any light at the end of this long tunnel and when prices will improve significantly.

It should be first remembered that over the past nine seasons (including 2018/19) a surplus has been seen seven times with just a couple of years of deficit. Since 2010/11 it seemed the only factor that governed production was the weather. Consecutive poor Asian monsoons in 2015/16 and 2016/17 were the main reason for the two global deficits. The convention that overproduction of any commodity leads to prices falling to a level which then prohibits further production did not seem to work with sugar. Indeed, it seemed as if Asia, actively, tried to wrestle market share away from Brazil. This is something that could only happen when prices are low. It is virtually a forgone conclusion that in 2018/19 India will become the world’s largest sugar producer for the first time, usurping Brazil by, possibly, 5 million tonnes. This could have happened a season earlier if it was not for the collapse of the Brazilian real in 2015, which meant that Brazilian millers could price at much better levels than had been expected.
Since February this year, prices have collapsed to levels that have put all sugar producers under severe financial pressure. The convention that cane and beet prices in many countries are pre-agreed with farmers well before the crop is grown has exasperated things further. Therefore, for the first time for many seasons, Brazil’s sugar production is being cut because of price (and some dry weather). It is more than likely that their sugar production will fall by over 20 per cent in 2018/19 from the previous record season. However, there is precious little evidence as yet that production will fall elsewhere. The EU will see a drop but this is mainly due to dry and hot weather during the main growing season. Indeed, as mentioned above, sugar production in India and Thailand could hit record levels. These countries surpluses will easily off-set production drops in Brazil – hence the expected global surplus for 2018/19.

So, with another global surplus, it is unlikely prices will improve dramatically anytime soon, especially as the Asian monsoon has passed with adequate rainfall. There is some chatter about El Nino developing during next winter but it is not expected to be anywhere near as severe as in 2014-16. Therefore, it seems likely that the market will have to wait well into 2019, in the hope that a weather issue will develop to cause global production to decline to the extent that it causes a supply deficit, which will see a sizable drawdown in stocks. The worry is that nothing occurs to cause a dramatic drop in production, which results in another small surplus in 2019/20.

However, there is optimism that other factors will help stifle production. Brazil is likely to divert even more cane to ethanol. EU farmers will be paid less for their beet so will produce less. Indian farmers will grow tired of waiting to be paid and substitute cane for other crops, as will Thailand. They will also both start to use cane for ethanol production. Then, perhaps, sugar demand might outstrip supply and prices can improve back to above 20 cents.

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“EU FARMERS WILL BE PAID LESS FOR THEIR BEET SO WILL PRODUCE LESS.”
THE BRAZILIAN PRESIDENTIAL ELECTION 2018...THE FINAL (?)

‘...It’s now become a touchstone and resonates with the fate of past Brazilian Presidents.’

With the approach of London Sugar Week and the upcoming Brazilian Presidential Elections I thought it opportune to write something current about Brazil. In my mind, I initially wished to write a commentary on the Brazilian ‘Operation Car-Wash’ bribery/corruption scandal and how it has gotten us to where we are today with the Elections. Yet on contemplation, I realised my thoughts ought to turn to the wider world and the slow realisation that this was perhaps another result of an aspect of Chaos Theory.

Let me explain...back in December 2010, Mohamed Bouazizi set himself publicly on fire in Tunisia. He committed suicide in frustration and desperation at official’s demanding bribes to allow him to be a fruit seller and sparked what is now known as the ‘Arab Spring’. These events reverberated around the world and I think continue to echo in a way that may still be evident. It was well known the role social media played in spreading the news of these events. They helped break down what some have called ‘pluralistic ignorance’, each individual believing they were alone in their views on such desperation and bribery when really all that happened was they were collectively silenced and isolated. Social media spread (and also fomented) the realisation that where once people had thought they were isolated and alone in dissent, they found they were not and drew strength from each other.

This went on from the Arab world to Asia, Africa, Southern Europe then Northern Europe and then to the Americas...both of them. Many times it was against the paternalistic attitude of the perceived ruling elite or a section of society, sometimes it was on a single issue.

In Brazil at the same start to the decade, there was also a slowly fomenting individual anger and frustration. This was growing everywhere but especially prominent in the state of Paraná in Brazil where it overcame the usual apathy and resignation. The reason...rejection for too long of an dull acceptance of institutionalised corruption.

These three conditions met...

1. a general international grass roots uprising.
2. the maturing and usage of social media and
3. a local apathy that had gone on too long being rejected once certain key disenchanted individuals, who happened to be the right people at the right time and place, led a public awakening.

The result was the outcry, revulsion and uncovering of what is probably the world’s largest ever corruption and money laundering scandal – the Operation Car Wash scandal in Brazil. I’m not going to go into detail because 1) there isn’t enough space here and 2) it is still ongoing. Suffice to say that it currently stands at about USD 10 Billion value with huge consequent investigations leading to significant incarcerations of members of Congress, banks, Senators, Governors and even the Brazilian Presidency. To give you an idea of the size...this is more than ALL...yes ALL...the drug and contraband smuggling that enters Brazil.
Brazilians, as I know very well, are a hugely tolerant people with big hearts. They can and have put up with violence in their society, the lack of education, bad healthcare, National debt, high interest rates, the defeat (at crucial times) of their national football team and coincidentally the most recent assertion by some news sources that they are no longer the world’s largest exporter of sugar (...India’s name has been touted). All of them take strong exception to the root of many of these – the ‘cancer’ of bribery and corruption. It is interesting due to the current strength of feeling in this matter. I’ve asked a number of Brazilians prior to writing about the issues and they saw this as very important, if not the key, to the Presidential Election. It was always echoing the same answer – corruption and the description of it as a ‘...cancer...’ Election polls have shown how this has driven many of the electorate to punish current political leaderships of different parties and of different political ideologies for letting this happen and for the one fault they seem no longer able to forgive.

Operation Car Wash led until now, to the removal and incarceration of many in the higher echelons of Brazilian society and for the purpose of this article, it has led to the wholesale culling of the senior ranks of various Brazilian political parties – left, right and centre. We’ve lost a lot of the heirs apparent for political office and likely leaders of the country going well into the 2020’s. The situation is so fractured that a former convicted President of Brazil who is ineligible to run in this Election polled, until recently significantly higher than his nearest rival, a controversial far-right populist. There are at least eight significant candidates polling for President, the highest polled (at the time of writing) just 22%, yet from these will likely come the next President. Do not expect an answer at the first round on 7th October...everyone knows the real voting will be between the two finalists of the first round and will be held on the 28th.

Then there’s the most recent event, the stabbing in public of the now leading populist far-right candidate, thankfully not fatally. Here, this Election has taken on a particular Brazilian turn, almost a scene from history...or a popular TV novela. It’s now become a touchstone and resonates with the fate of past Brazilian Presidents. Perhaps the best way to describe this Election going forward is to use the words a senior executive at one of the TV studios producing novelas used when describing their work ‘It’s a big train that’s hard to stop once it gets going...it is a never-ending story for us.’

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Launched in 2013, the Belt and Road Initiative is the signature foreign policy of Chinese President Xi Jinping. The initiative targets investments in infrastructure and trade cooperation with over 70 countries indiscriminate of politics, cultures, democracies, dictatorships or religion. The simple diplomatic cohesion is all about trade and deeply needed infrastructure across a largely untouched and forgotten stretch of the world. China with it excess capacity in its steel and construction industry is looking to expand its economic footprint abroad at a crucial time of slowing domestic economic growth. Xi Jinping’s long term goal is to strengthen economic trade throughout Eurasia which in turn will secure the needed resources for its own long term future.

Whilst the Silk Road has been part of Chinese empires of old, the New Silk Road signifies the ambitious scale and potential reach of the current regime. For some, China’s Belt and Road Initiative is as much political as it is an economic objective allowing Beijing to exert its soft power and influence over western Asia. Some sceptics see China’s evolution and mission creep filling the gaps left void since the collapse of the Soviet Empire and so, despite the promise of investment, remain politically cautious to its implementation that will see an increasing security and beholding influence.

Taking its name from the ‘belt’ of overland corridors and a maritime ‘road’ of shipping routes that also include key infrastructure pipelines; China’s long term project is said to be a $1 trillion investment drawing together the markets of Europe and Asia. The scheme opens up new customers for China’s exports of consumer goods but also seeks to build upon the bilateral trade that smooths access to the vital resources and commodities China needs to continue its development. China’s western frontiers are home to vast reserves of oil and gas, whilst the former Soviet Empire lands of Kazakhstan and Eastern Russia lie rich with fertile soils prime for investment, new technology, and agricultural revolution.
It is therefore thanks to the Belt and Road Initiative that Kazakhstan has found a new source of economic growth and diversification away from its oil and energy sector dependence. The government has refocused its policies to promote its agricultural sector with a series of subsidies and tax exemptions available. Kazakhstan's Ministry of Agriculture has set new standards to harmonise domestic grades with international standards setting regulation on grain and food safety as well as reaching Eurasian agreements on seed. Investment in rail, locomotives, cargo cars and infrastructure agreements has also opened export opportunities on China's Pacific coast at the eastern port of Lianyungang, demonstrating that China is not their only target. A joint Chinese-Kazakh logistics centre and port side silos facilitated the first export cargo of high protein Kazakh wheat last year to Vietnam with more expected to follow.

China’s Belt and Road Initiative therefore offers a revolutionary game changer to the global grain and agricultural trade and specifically to the prospects and production potential of Kazakhstan and Eastern Russia’s previously landlocked soils.

Sparking a battle of the breadbaskets, Kazakhstan’s Ministry of Agriculture has stepped forward to cement bilateral cooperation for common agricultural development seeing a much needed investment in education, technology, and resources. For years, Kazakhstan has suffered from the high logistical costs, limited access to markets and the lack of direct access to sea ports with a number of neighbouring countries charging import quotas (Iran) or transit fees (Uzbekistan). This has hampered investment in new technologies and farming practices, resulting in repeated monoculture and low yields. Additional policies that run in conjunction with the Belt and Road Initiative see specific agriculture-related policy goals that see China increasing investment in collaborative projects, strengthening science and technology knowledge share, and optimizing agricultural trade.

In the current trade war context, China in particular is keen to exploit the last policy goal, reducing their reliance upon the western world for imported resources. Striking a joint accord, China has vowed to support Kazakhstan’s agricultural sector with increased wheat imports but will also see the increasing flow of higher value agricultural products such as dairy, fruit, vegetables, and processed ingredients. Initiatives such as the China-Kazakhstan Modern Agriculture Innovation Park launched in 2015, have seen the introduction of new varieties and investment from seed companies that is expected to help grain and oilseed yields increase by 30% from 2017 to 2020. The Kazakh Ministry of Agriculture also sees greater diversification in cropping thanks to increased rotations that sees the area of oilseeds grown increase from 2.131mln ha to 3.935mln ha, increasing production by 81% to 3.95mlnt from 2.17mlnt. Despite Ministry forecasts that grain plantings will fall by 1mln ha as a result, the rotational benefit and use of new seeds and technology is forecasted to bring a 22% increase in production from 20mlnt this year to 24.5mlnt by 2020.

*China’s $40 billion Silk Road fund also has a number of other planned investments including an oilseeds processing facility, fruit farms, a bio-starch factory and a tomato processing facility providing Kazakhstan with its largest injection and influence since Soviet years. It is claimed that Kazakhstan’s transformation brings the potential to double its agricultural output and grow its position from a landlocked and under invested sector to a leading Eurasian producer of food and agricultural commodities.*

The New Silk Road and China’s Belt and Road Initiative is driving dramatic change across Eurasia, creating a new world that revives the connections of the past. China’s evolving economy is driving global growth away from the west and in the process, providing growth and dramatic change across Eurasia that is unlocking vast areas of fertile lands. For China; better roads lead to better lives.

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WHAT IS STRUCTURE TRADE FINANCE (STF)?

Structure Trade Finance aims to create innovative financial solutions for banks and corporates in emerging countries leveraging on international trade flows. The structures used by STF provide alternative source of short term financing with more flexible denominators at a competitive rate. The idea is to have one face to trade finance market player, from banks to underwriters and other stakeholders.

WHAT KIND OF TRADE ACTIVITY DOES THAT INCLUDE?

STF covers three main activities:

- Leveraging ADM trade flows to develop and market tailor-made financial products for banks in emerging markets;
- Helping ADM clients & suppliers in all our business units by offering innovative, alternative trade-related sources of financing while mitigating cross-border and credit risk for ADM; and
- Have a consistent approach to Bank Relationship Management, creating a multi-dimensional relation with the different trade finance banks to distribute trade-related assets generated by our business units, mainly via letters of credit.

HOW IS STF PRESENT IN LONDON?

I have recently relocated to London to expand on the relationships with the insurance markets and Customer Solutions, after almost 8 years in Switzerland.

We are growing our team with the addition of a very experienced individual in London: Nehir Kirli Ozel. She will be responsible for handling the distribution banks relationship and related transactions for EMEA with a specific focus on UK based institutions and Northern Europe.

A BIT ABOUT MYSELF:

I have been with the ADM group since 2009 in various roles from M&A to Business Development, including Audit, Controlling and others. Then in 2015, I joined Olivier Boujol’s team in the newly launched ADM Structure Trade Finance department.

With a mixed background in different areas of finance and mixed cultural background (Brazil, Portugal, UK, India, Switzerland), it was a great step in my ADM career.

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CAN YOU TELL US A BIT ABOUT THE TEAM THAT MAKES THIS ALL HAPPEN?

We have a team of over 26 people spread out across Shanghai, Singapore, Delhi, Dubai, Rolle, London, Sao Paulo, New York and Decatur. It is a small but extremely diverse group. These individuals have joined from other ADM departments, from the financial industry and also from other Agri-businesses, making this a mix a great way to leverage on each other’s past experiences to help the department succeed.

WHAT IS NEXT FOR STF?

We do expect to gradually grow the business in 2019 and beyond, managing risks carefully and in accordance with the ADM way. As our international footprint is expanding, we expect STF to become a cornerstone of ADM’s destination-marketing strategy.
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IMO 2020: JUST A RIPPLE OR A STORM FOR SHIPPING AND OIL?

There is no debate that since Donald Trump took over the presidency of the USA, he has ploughed a deep and disruptive furrow in respect of US trade relationships with the rest of the world, above all that with China. However one might evaluate his negotiating tactics, there will be consequences for the outlook for global growth, the demand for raw materials (above all oil) and indeed for the world's shipping industry, which facilitates some 90% of physical goods trade, including energy products.

It can certainly be argued that the ultimate outcome of the various trade tensions and associated negotiations relegates other considerations to subordinate roles. However there is rarely anything that pertains to global trade that is one dimensional, and as a rule the bigger picture is an array of complex inter-dependencies, where a single factor can have an inordinate influence, even that proves to very transitory with the benefit of hindsight. The International Maritime Organization's (IMO) ruling to reduce the sulphur content cap for bunker fuel from 3.5% to 0.5% from 1 January 1, 2020 will entail a major overhaul for the shipping industry, with major implications for all those in the sector's value chain, including refiners, as well as trading, logistics and ports operators.

Via way of an overview of key aspects, it is worth noting the following. High sulphur fuel oil (HSFO) accounted for ca. 70% of the world's bunker fuel us in 2016, and these will be non-compliant as of 2020. The marine sector consumed 3.8 million bpd (barrels per day) of fuel oil in 2017, and thus was responsible for roughly of all global fuel oil demand. By way of a contrast the marine sector also used ca. 1.0 mln bpd of marine gas oil, which a lower sulphur content distillate, but this amounts to just 5% of global gas oil and diesel demand (the bulk of which is consumer by the heavy duty trucking sector). While vessels which install 'scrubbers' (allowing vessels to continue to burn cheaper HSFO by washing the exhaust gases to reduce the SOx emissions) can continue to HSFO post 2020, the cost of investing in these scrubbers is estimated at $1.0-10.0 mln per ship (depending on size). It is hardly surprising that the marine industry, which is struggling to claw its way out of a low margin environment, is very reticent to make such investments, particularly as it is hardly environmentally friendly. That said, there are some short-term attractions, in so far as the upfront investment on 'scrubbers' can be recouped much more quickly, than for example replacing them with compliant vessels, and on current price differentials, once the investment has been recouped, there would also be a unit cost advantage.

So what are the options to comply with IMO 2020 that are viable both in business and environmental terms? There are a plethora of options, but the industry preferences appear to be crystallizing around two: low sulphur fuel oil (LSFO) and liquefied natural gas (LNG) bunkering. However the challenge for vessel and port operators along with refiners is to try and gauge prospective demand for LSFO and LNG, particularly as it will also require investment in supporting infrastructure (port & floating) above all for LNG (which is better suited to fixed maritime routes), and indeed a need to address the issue of minimizing LSFO differences in so-called ‘blend quality’ between suppliers around the world. The latter is to a certain extent subordinate to the broader topic of compliance with IMO 2020, and establishing a regulatory framework that work towards full compliance, and has to recognize that full compliance will certainly not be immediate, even with the prospective introduction of a so-called ‘carriage ban,’ which expressly forbids ships from carry non-compliant fuels in their bunker tanks, with port authorities tasked with enforcing regulation.
Before looking at the question of how this might impact market prices of the various fuel types, there is a further higher order question to address, which, to a certain extent, is proving to be something of a ‘game of chicken’ on between the refiners and the marine industry in terms of investment to meet the new rules. As noted above, installing ‘scrubbers’ is very much the quick fix, which would sustain a higher level of demand for HSFO than a wholesale switch to LSFO, and by extension allow refiners (and port authorities) a longer lead-in time for investment in equipment, and, where necessary, facilities, to refine and store LSFO. Given that upfront investment for all concerned will be high, and possibly very difficult to recoup in the short-term, it is little wonder that both sides are taking a ‘wait and see’ attitude to what other stakeholders will do. But with the 1 January 1, 2020 deadline already looming very clearly in the headlights, the scope for considerable volatility in market prices for related products, regardless of what happens to crude oil prices, now looks to be very high.

According to a Wood Mackenzie estimate, compliance with the new IMO regulations is anticipated to be around 80% in 2020, and by extension that implies a drop of ca. 2.0 million bpd in HSFO demand from the bunker sector. Leaving aside the observation that refiners have traditionally seen the bunker fuel market as a ‘sink’ to dump residual high sulfur material, thus eschewing the need to avoid the investment in much higher cost upgrading and hydro-treating facilities, the question is what happens to the excess HSFO. As with anything, there are alternatives of course, it could be re-blended to produce VLSFO (very low sulphur fuel oil), but such VSLFO would need to be priced at a premium to crude oil, rather than the discount that applies to HSFO, in order to be economical. Alternatively it could be processed within the world’s extant spare residue upgrading capacity, though this would imply a bigger discount to crude prices in order to make using such spare capacity viable in business terms. The same Wood Mackenzie study also assumes that the demand for marine gas oil will rise by ca. 1.0 Mln bpd, which by extension implies that its current premium to crude prices would need to rise, both due to the fact that its production requires higher refinery utilization, as well as to compensate for the revenue shortfalls from lower HSFO prices. Again by implication such a shift in the prices of refined products also suggests that there will be a shift in crude oil differentials, primarily assumed to involve a substantial widening in the discounts for sour and heavy crude grades to Brent, as well a perhaps less obvious shift in sweet/sour crude differentials.

While this article only scratches the surface of the complex economic interactions involved, it should be obvious that considerable disruption is on the horizon for all of the stakeholders. In the very near term, the primary risk is that refiners reduce stocks of high sulfur fuels in anticipation of 2020, potentially rather too quickly. The latest reported drop in Singapore fuel oil inventories has taken them down to their lowest levels since 2009, in other words back to levels not seen since the maximum disruption point to global trade as a consequence of the global financial crisis.

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“INSTALLING ‘SCRUBBERS’ IS VERY MUCH THE QUICK FIX.”
IS BRITAIN’S ECONOMY FATED TO FAIL?

At the end of 2015, less than a year before the fateful date of 23rd June 2016, the OECD was projecting that the UK economy would overtake Europe’s largest, Germany, by 2032. This would make the UK the 4th largest in the world. Then the British public voted to leave the European Union and we experienced an event at first hand, about which much will be written in the history e-books for generations to come.

There is now a continuing debate on what the British economy may look like in a post Brexit world, with many predicting a very bleak future. Yet many of the older generation, who were a significant element in the demographic who voted for the UK to leave, hold a memory of a Britain which they argue functioned perfectly well prior to membership the EU. So why are we all so worried about the future of the British economy outside of the EU?

In 1972, when the decision was made for the UK to finally join the EEC, Britain was known as the sick man of Europe. The UK lagged far behind its German and French peers whose GDP per capita had risen 95% (compared with just 50% in the UK). The UK also had very high inflation, topping out at an unhealthy 20% twice during the 70’s. Looking at these facts it is easy to see why in 1975 when the British public was asked if they wanted to stay in the ‘Common Market’, the result was ‘yes’. From these poor beginnings, Britain had risen by 2013 to become more prosperous than its peers. In GDP per capita, the UK economy grew 103% from 1972, edging out Germany at 99%, and well ahead of France at 74%. On this basis the EU appears to have been an economically positive factor.

In 1972 the UK was not the only economy that lagged its peers. Italy’s economy also suffered, but it was a founding member of the EEC. But while the UK began to show a small recovery in the latter half of 1972, Italy saw no business recovery, something that could be attributed to the continued recurrence of labour unrest in the country. The UK also struggled with labour unrest during the 70’s, and days lost to trade union strikes were at all-time highs. Like its Italian peer, it is believed that poor industrial relations were a key factor in holding back British industry. British manufacturing profitability had been in a slow decline since the late 1880’s hence the boom in financial services with Britain being home to 50% of the world’s capital investment by 1913. However there is a strong correlation between a noticeable dip at the end of World War II and a peak in trade union membership in the post war era. Economic advisors such as Ruth Lea of Arbuthnot Securities believe the change in the UK’s fortunes was in fact due to ‘a certain lady from Finchley’. Margaret Thatcher deliberately reduced the power of the trade unions in the UK during her time in power, and it has not recovered ever since. Many years after Maggie’s time in office the principle features of Thatcher’s economics still remain and are still viewed by many as positive attributes of the UK’s current economic structure: privatisation, deregulation of monopolies, and deregulation of the financial sector. One of the key impacts of this was the strong growth in the UK’s services sector.
The services sector now dominates the UK Economy, making up around 80% of GDP. London is classed as a major centre for international business and commerce. It is one of the three ‘command centres’ of the global economy, alongside New York City and Tokyo. Along with the obvious banking services, London also houses four of the six largest law firms in the world. The result of this is the following UK Trade Balance:

Recent PMI reports indicate that despite the uncertainties related to EU negotiations, the UK’s dominant service sector continues to show solid growth according to Chris Williamson, chief economist at IHS Markit, which casts some doubt over Brexit’s actual impact. This is positive news considering that since 1973 the ratio of UK trade to economic output has increased from 48% to 67%. It is all the more remarkable for the fact that 44% of UK exports go to other EU member countries, and of the UK’s current top 10 trading partners, EU member countries account for 63% of total trade. These facts may lead us to believe that the UK leaving the EU is possibly an uninformed decision. But one only has to look at Germany to see that even though a country is a member of the EU, its economy is not beholden to it. In 2016 Germany recorded the highest trade surplus in the world worth $310 billion; its service sector contributes around 69% of its total GDP, which is not far behind the UK and its largest trading partners are not members of the EU. Germany’s successful economy is more complicated than just its apparent non-reliance on the EU, as it is a leading advocate of European economic and political integration, and there are also factors such as its incredibly strong manufacturing industry. But it nonetheless serves as an interesting example.

In light of this, it could be time to revisit the legacies of Britain’s history. The Commonwealth is vast – accounting for almost a third of the world’s population at 2.4 billion and includes countries that range in size from India with 1.26 billion people to Tuvalu (with just 100,000). The Commonwealth far outstrips the size of the EU which is estimated at 512 million in comparison. It represents an opportunity not open to our other EU peers, and its London based administration estimates that trade between its members is already 19% cheaper than global trade, due to soft efficiencies such as shared language, laws and standardized consumer products. However the Commonwealth will not be an easy saving grace. It currently makes up a very small proportion of British trade and there is the further issue of Commonwealth countries such as India and Pakistan having specially negotiated access to the EU market due to Britain’s membership. As such maintaining this access may be the Commonwealth’s priority rather than making new trade deals with its old master.

Although the future of the UK economy does appear to be uncertain and certainly not that easy to negotiate, this does not necessarily mean that it is bleak; and if there is a lesson from the UK’s recent history, it is that the UK once again needs to get creative. It is always important to look outwards, but the Thatcher years showed that getting your own house in order first tends to be a very good place to start. There are indeed examples from the UK’s EU peers from which it seeks to distance itself, that could provide answers to a future that is not so closely linked with them. In the modern world service economies do not require old trading routes, nor are they held hostage by freight spreads. Maybe the OECD predictions of 2015 may not be as ‘lost’ as they appear to be.

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LME INITIAL MARGINS, TIME TO REVIEW?

The London Metal Exchange has made a reduction in trading fees permanent, after the unpopular fee increase in January 2015 to help recoup the costs of buying the exchange at a multiple of 180x earnings, not a bad sale for a business founded in 1877.

In the interests of boosting volumes, perhaps the LME could review the high levels of LME Initial Margin, especially for spread trades?

Since the global debt collapse of 2008, when some banks were exposed as incapable of pricing or managing their risk exposures, financial regulators have forced banks to give up proprietary trading and massively increase regulatory capital above the previous thresholds of Basle 1 and 2.

Regulators have also pushed OTC products onto Exchange and expanded reporting requirements, increasing market transparency, and replaced the web of bank counterparty credit risk with trades booked at clearing houses.

Margin is the accepted way of reducing counterparty risk but, if margins seem excessive and deter users from the normal business of hedging, then volumes can drop and the market and customers will lose out.

Variation Margin covers negative MTM exposures, and may be applied basis end of day or intra-day, whereas Initial Margin covers the credit exposure due to adverse price moves from the time that a client has failed to post Variation Margin until the position is stopped out, typically 2 or 3 working days.

According to the LME website, the purpose of Initial Margin is “for the Clearing House to be holding sufficient funds on behalf of each Clearing Member to offset any losses incurred between the last payment of margin and the close out of the Clearing Member’s positions should that Clearing Member default”, with the LME using a 2 day liquidation period at a 99% confidence interval.

Most common measures apply historical price volatility and a high confidence level, and can generate surprisingly high risk numbers. LME Initial Margins are dependent on metal and type of position, with outright positions more risky and calendar spreads calculated using the SPAN margining system.

Metal traders know there are different risks to being long or short calendar spreads.

If you’re long a spread, you are exposed to the contango steepening. However, an LME contango can never exceed the full finance (i.e. carry cost of rent, finance and insurance), because riskless arbitrage kills any contango excess over full finance.

If you borrow a spread at full finance, you can only lose on the position if there is a rise in rent, financing costs or insurance during the period (rents are fixed for 12 months), but will fully benefit if the curve moves from contango to backwardation.

However, if you lend a calendar spread you benefit from a steeper contango which is limited to full finance, but you are fully exposed to a backwardation which makes this a much riskier position, especially when lending wider contangos.

“IF YOU’RE LONG A SPREAD, YOU ARE EXPOSED TO THE CONTANGO STEEPENING.”
With this in mind, Initial Margin rates for LME calendar spreads are surprising (see table): The recent LME valuation spread is highlighted in green, being the difference between the Dec/Dec prices (+ve for contango, -ve for backwardation), and the other figures show the Initial Margin in US$/Mt for:

- a long spread ("Borrow"),
- a short spread ("Lend"),
- a borrow at $100 Contango, i.e. Forward price is +$100 higher
- outright position on the front month

![Chart 1: US$/Mt basis 14 Sept' 18](source: ADMISI Risk / ION Margin Direct)

<table>
<thead>
<tr>
<th>AL</th>
<th>CU</th>
<th>NI</th>
<th>ZN</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEC18-DEC19 VAL SPREAD</td>
<td>$32</td>
<td>$41</td>
<td>$288</td>
</tr>
<tr>
<td>BORROW</td>
<td>$89</td>
<td>$54</td>
<td>$133</td>
</tr>
<tr>
<td>LEND</td>
<td>$89</td>
<td>$54</td>
<td>$133</td>
</tr>
<tr>
<td>BORROW AT $100 CONT</td>
<td>$89</td>
<td>$54</td>
<td>$133</td>
</tr>
<tr>
<td>OUTRIGHT DEC18</td>
<td>$169</td>
<td>$493</td>
<td>$1292</td>
</tr>
<tr>
<td>DEC19-DEC20 VAL SPREAD</td>
<td>$32</td>
<td>$35</td>
<td>$195</td>
</tr>
<tr>
<td>BORROW</td>
<td>$96</td>
<td>$103</td>
<td>$359</td>
</tr>
<tr>
<td>LEND</td>
<td>$96</td>
<td>$103</td>
<td>$359</td>
</tr>
<tr>
<td>BORROW AT $100 CONT</td>
<td>$96</td>
<td>$103</td>
<td>$359</td>
</tr>
<tr>
<td>OUTRIGHT DEC19</td>
<td>$165</td>
<td>$478</td>
<td>$1258</td>
</tr>
</tbody>
</table>

Note how the Initial Margin doesn't change if the spread is borrowed or lent, or if the spread is borrowed at $100 contango rather than at the market valuation. Indeed, a low-risk borrow at full finance requires the same Initial Margin as high risk spread lending at full finance.

Also note that the outright position for Dec19 Zn requires less IM than the Dec19–Dec20 Zn spread.

**Short dated carries:**
The previous Initial Margin rates showed no differentiation between the risk of borrowing or lending contango spreads or the spread rate used, but IM rates for short dated carries look even stranger.

The following table shows the IM rates for one day borrows across 18–19 September and also 26–27 September, with the table showing:

- the valuation spread (basis COB 14 Sept 2018),
- the IM per Mt, on a borrowed position
- Full Finance (FF) for that period basis maximum rent and 3% interest, and
- the Risk on the borrowed position, being the difference between FF and Valuation, (ignoring the potential impact of light/heavy warrants on LME Tom-Next due to a sharp price move)

![Chart 2: US$/Mt basis 14 Sept' 18](source: ADMISI Risk / ION Margin Direct)

<table>
<thead>
<tr>
<th>US$/MT BASIS 14 SEPT 18</th>
<th>AL</th>
<th>CU</th>
<th>NI</th>
<th>ZN</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 SEPT TO 19 SEPT VAL SPREAD</td>
<td>$0.50</td>
<td>$0.25</td>
<td>-$0.50</td>
<td>$0.75</td>
</tr>
<tr>
<td>IM PER MT, BORROW</td>
<td>$23.00</td>
<td>$13.04</td>
<td>$12.00</td>
<td>$30.00</td>
</tr>
<tr>
<td>FULL FINANCE (FF) AT 3% INTEREST</td>
<td>$0.74</td>
<td>$1.04</td>
<td>$1.64</td>
<td>$0.74</td>
</tr>
<tr>
<td>FF MINUS VALUATION (BORROW RISK)</td>
<td>$0.24</td>
<td>$0.79</td>
<td>$2.14</td>
<td>-$0.01</td>
</tr>
<tr>
<td>26 SEPT TO 27 SEPT VAL SPREAD</td>
<td>$0.56</td>
<td>$0.75</td>
<td>$1.04</td>
<td>$0.42</td>
</tr>
<tr>
<td>IM PER MT, BORROW</td>
<td>$25.00</td>
<td>$14.04</td>
<td>$11.00</td>
<td>$30.00</td>
</tr>
<tr>
<td>FULL FINANCE (FF) AT 3% INTEREST</td>
<td>$0.74</td>
<td>$1.04</td>
<td>$1.64</td>
<td>$0.74</td>
</tr>
<tr>
<td>FF MINUS VALUATION (BORROW RISK)</td>
<td>$0.18</td>
<td>$0.29</td>
<td>$0.60</td>
<td>$0.32</td>
</tr>
</tbody>
</table>
With Initial Margins ranging from $11-$30/Mt against Borrow Risks of up to $2.14/Mt, these Initial Margin rates greatly exceed the risk to a borrower and appear difficult to justify.

**TAKING AN OPTION BASED, IMPLIED VOLATILITY APPROACH TO INITIAL MARGIN FOR OUTRIGHT POSITIONS**

Outright LME positions tend to have more scope for movement and risk than calendar spreads, so you expect to attract a bigger IM.

LME Initial Margin is calculated using historical price volatility and a 99% confidence interval, but how do these margin rates compare if options theory and market implied volatility is used to estimate the margin required for a 2 day price move at 99% confidence?

If you assume that the delta of an option is comparable to the probability of the market price reaching the strike price in a given time period, then the US$/Mt price gap between the strike price of a two day, 1% delta call option (priced basis current ATM volatility) and the underlying market would suggest the maximum upside price move with 99% confidence (i.e. 1% chance of that strike price being reached, so 99% chance of the price remaining below).

Using this option based method, the following table shows the price move at 99% confidence for trade day+1 through +8, compared to the current LME Initial Margin requirement for outright positions (left column, highlighted in blue):

<table>
<thead>
<tr>
<th>LME IM</th>
<th>US$/Mt Position Loss to 99% Confidence Basis LME Implied Vol%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$170</td>
<td>$170 AL - $56 - $80 - $100 - $115 - $131 - $144 - $156 - $167</td>
</tr>
<tr>
<td>$494</td>
<td>$494 CU - $153 - $216 - $273 - $312 - $351 - $393 - $425 - $455</td>
</tr>
<tr>
<td>$123</td>
<td>$123 NA - $31 - $45 - $56 - $64 - $72 - $78 - $85 - $91</td>
</tr>
<tr>
<td>$1299</td>
<td>$1299 NI - $490 - $702 - $854 - $1001 - $1135 - $1253 - $1361 - $1462</td>
</tr>
<tr>
<td>$188</td>
<td>$188 PB - $64 - $90 - $112 - $131 - $148 - $163 - $176 - $189</td>
</tr>
</tbody>
</table>

Source: ADMISI / LME Desk
This option method suggests aluminium has an $80/Mt risk over 2 days (compared to an IM of $170/Mt), and copper has a risk of $216/Mt (c.f. LME Cu IM of $494/Mt).

However, some back testing of actual LME 3m aluminium data between Sept 2008 and Sept 2018 suggests that the current LME IM of $170/Mt is a better, more prudent measure of historical 2 day risk at 99% confidence.

The chart uses daily LME 3m Aluminium data (Open-High-Low-Close) for the 10 year period 18 Sept 2008 to 17 Sept 2018 (covering 2525 trading days) and shows two day data as follows:

- Cumulative histogram for a Rising Market, being the D+2 High minus D Low
  - 99% of the 2 day rise is <= $160/Mt, i.e. more positive on 25 days
- Cumulative histogram for a Falling Market, being the D+2 Low minus D High
  - 99% of the 2 day fall is <=-$160/Mt, i.e. more negative on 25 days
- Histogram for all data, being D+2 Close minus D Close
  - 98% of the data is approximately within +$100 to -$100 (i.e. 1% higher, 1% lower), reflecting lower Close/Close risk compared to the daily High-Low range.

Based on 2525 days of data, a 99% confidence level suggests that the IM is effective on 2500 days and is exceeded on 25 days. Applying this criteria to the historical data suggests an approx. range of +/- $160/Mt (area inside the blue box), which is in line with the current LME Aluminium Initial Margin of $170/Mt.

Applying this analysis to LME 3m Copper over the same period suggests a 99% range circa -$650 to +$650/Mt for the volatile 2 day High-Low data (blue box), above the LME’s $494/MT Initial Margin, or +/- $350 range basis two day Close–Close data (green dashed box).

Analysis of the historical data undermines the case for lower Initial Margins for outright LME positions suggested by an implied volatility/options based approach, certainly over short 2 day periods, (although an options based approach has merit for use in longer dated Potential Future Analysis (PFE) as an alternative to binomial expansion models used currently).

However, there appears to be a good case for reviewing Initial Margins on spread trades, to better reflect:

- Differences in risk between “borrowing” or “lending”
- The level at which the spread is traded compared to the market and limit of full finance.

In summary, although LME margins need to be conservative to protect against occasionally volatile markets, a review of margins on spread trades could help the LME attract more business.

Sir Bobby Robson (the late, great football manager) once said that “the margin is very marginal”, but margins could be crucial in the LME’s fight to increase trading volumes.

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Rohan Ziegelaar
SOMEONE LEFT THE TAP ON...

A few years back the phrase TINA (There Is No Alternative) was omnipotent. Every saver was trying to buy into yield of some sort, to temper the ill effects of zero interest rates. It was a logical time, driven by illogical circumstances. The central banks had left the world awash with cash and borrowing money had never been cheaper.

Let us envisage investment as a very large ornate pot, sitting outside a magnificent house at the top of a hill. It looks great. Beneath it is the cobbled street, which leads down to a drain that is covered with moss. If you now see this pot as an overall investment pool in which the liquid level rose more and more, as people dispensed their cash into it indiscriminately. With zero interest rates abounding anything that has had a yield has been dumped into this large pot. As more liquid poured into the investment pot it dampened the volatility within. The volume of water flowing in, meant that the pot was getting heavier and heavier, with hard leaden assets, also increasingly ever fuller of liquid and thus harder and harder to shift.

We assumed that with any seismic change in economics or politics, once the pot became unbalanced by some liquidity exiting it, the pot would fall over and all the liquid would run down the street into the drain. It didn’t. The pot has wobbled but the weight of the vast amount of liquid within it, has stabilised it quickly; like an investment weeble.

Perhaps it will still topple and the pot is so big and full, that the disused moss drain might not be able to take the deluge; but recently we have been reminded how heavy and full of liquid the pot really is. As emerging markets have hit the skids, with investors realising that the excessive borrowing these countries did in the last ten years, in dollars, potentially causes a vicious downward spiral whenever the dollar rises, the liquid has not left the pot it has simply displaced into another area. Investors withdraw their investment from EM but leave it in the pot. This time mainly flowing into US assets and primarily the S&P.

Does the pot need liquid to come out of it to destabilise it or will the increased currents from the liquid moving around more violently inside the pot (with a little bit flowing out of the top) be enough to destabilise it and send it crashing? If the liquid inside gets considerably choppy we will lose increasing amounts over the lip but at the moment TINA has shown what a powerful force it still is. Asset flows simply move around looking for another less volatile investment haven.

At the centre, the liquidity inside the pot is and always has been the US dollar. As more turbulence works up the inside walls, the more liquid gets moved into the dollar centre. The more this happens the more a vertex is formed. Liquid splashing up the inside walls and splashing out of the top but the inside remaining relatively calm (by the way, I am not a physicist or an expert in Grecian Urns… the answer being that whatever a Grecian earns, it is borrowed euros).
Recently, the conversation has been turning to why US treasuries and other bond markets have been so soggy in performance, especially considering the apparent record trading ‘speculative’ short. Is this also a flow phenomena?

The answer is, as ever, not a single factor. Recent CPI data was lower than expected but remains very clearly above the Fed’s target and with wages finally showing signs of acceleration, markets have belatedly come to the realisation that the Fed is very much intent on raising rates to its short-term trajectory (3.25%-3.50% in 2020), rather than the medium-term neutral rate (2.75%-3.0%) and it was not as if the Fed had not told them. Ms Brainard did so again in mid-September. However, perhaps most pertinently, especially with our urn filling analogy, is the typical high seasonal levels of corporate issuance. Investment grade bonds had issuance of over 125 bln $ for the first three weeks of September. In addition the front loading of US Corporate Pension fund purchases of Treasuries due to tax advantages that expired that on 15 September, being a positive flow has ebbed to a close. The Fed is upping its balance sheet reduction programme to the assumed peak pace of $50 billion per month (selling bonds), while the US Treasury ups its borrowing volume, and EM central banks look to defend their currencies reducing their FX reserves and by extension their holdings of Treasuries. Last but not least the inflows to the US as a result of the corporate tax earlier in the year have not been vaguely close to the $1.0 Trln plus that Trump keeps on talking about, so less repatriation of funds into treasuries than had been expected.

The demand for bonds has been lower than would have been estimated, the flows bigger, so Treasuries have gone down. As they fall, rates go up. However, very recently the dollar has not benefited from this. That is concerning. The pot is wobbling again.

During the last few years as the pot has gotten (that’s American speak) fuller and fuller, the flow dynamics in the pot have been reinvented with the advent of increased technology. Now the flow decisions are primarily automated. Decisions are made by computers and consequently, there is no real human emotion rocking the pot from outside; even the retail investor has his money locked into the low cost tracker network. Not knowing any computers intimately enough to chat with, the question still remains to what it is that will eventually destabilise the pot.

Logically, one would assume it will be an algorithmic trigger: Calculative Loosening in Mathematical Algorithmic eXposure - ‘CLIMAX’ as it is known, but without whimsicality, it might simply be that the pot is not big enough now to take any more liquid. It is full and the liquid simply runs over the top constantly with the tap still on. Soon people notice that the pot is not wobbling but not actually increasing in liquid worth any more. What is being poured in is actually just going straight down the drain anyway.

Now the pot is full and the drain is active, the situation becomes increasingly dangerous if all the flows within the pot change direction.

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The financial crisis of 2007-2009 stunned the country and the world. Stock markets plunged, shedding more than half their value, as companies battled for survival, and on March 9, 2009 the S&P 500 hit a measly low at 666.8.

Way back in 2009 there were very few people that were predicting a stock index recovery, let alone such a long-lived advance. However, in nine years, five months and 13 days, it more than quadrupled.

On Wednesday, 22 August the bull market in S&P 500 futures turned 3,453 days old, surpassing the previous record of 3,452 days that took place between October 1990 and March 2000. This milestone makes the current bull market the longest such streak on record. It is widely accepted that the bull market started on 9 March 2009, which marked the low of the financial crisis. Many analysts consider this to be the birth date of the current bull market, since that was the absolute bottom for the prior bear market, which ended that day.

A bull market is defined as a 20% rally on a closing basis that at no point is derailed by a subsequent decline of 20%. This market is considered to still be a bull market until it falls 20%, which generally defines the end of a bull market. Since the 2009 lows were made, there have been a multitude of geopolitical problems that temporarily adversely affected stock index futures, and every time stock index futures were able to recover.

<table>
<thead>
<tr>
<th>Bull Market Peak</th>
<th>Months</th>
<th>S&amp;P 500 Return</th>
<th>Annualized Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>08/02/56</td>
<td>86</td>
<td>267%</td>
<td>20.0%</td>
</tr>
<tr>
<td>12/12/61</td>
<td>50</td>
<td>86%</td>
<td>16.2%</td>
</tr>
<tr>
<td>02/09/66</td>
<td>44</td>
<td>80%</td>
<td>17.6%</td>
</tr>
<tr>
<td>11/29/68</td>
<td>26</td>
<td>48%</td>
<td>20.0%</td>
</tr>
<tr>
<td>01/11/73</td>
<td>32</td>
<td>74%</td>
<td>23.3%</td>
</tr>
<tr>
<td>11/28/80</td>
<td>74</td>
<td>126%</td>
<td>14.1%</td>
</tr>
<tr>
<td>08/25/87</td>
<td>60</td>
<td>229%</td>
<td>26.7%</td>
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<tr>
<td>07/16/90</td>
<td>31</td>
<td>64%</td>
<td>20.9%</td>
</tr>
<tr>
<td>03/24/00</td>
<td>113</td>
<td>418%</td>
<td>19.0%</td>
</tr>
<tr>
<td>10/09/07</td>
<td>60</td>
<td>101%</td>
<td>15.0%</td>
</tr>
<tr>
<td>08/21/18</td>
<td>113</td>
<td>323%</td>
<td>16.5%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>63</strong></td>
<td><strong>165%</strong></td>
<td><strong>19.0%</strong></td>
</tr>
</tbody>
</table>

Source: LPL Research, FactSet, CFRA  08/21/18
SHOULD YOU CELEBRATE OR FADE THE LONGEST BULL MARKET IN HISTORY?

The latest geopolitical worries, including global trade tensions, Brexit uncertainties, the political and economic upheavals in Turkey, a less steep yield curve and inflation concerns will probably only negatively affect stock index futures for a short time. The U.S. economy and the stock index futures market rally have plenty of fuel left in the tank. While this bull market and economic recovery may very well be old, the still relatively low global interest rate environment suggests U.S. equity markets have plenty of upside both in duration and in price. We should celebrate and not fade the longest bull market on record.

Higher prices for U.S. stock index futures are likely through this year and well into 2019.

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The bears on U.S. equity markets cited several reasons why stock index futures shouldn’t have advanced this high and why they cannot go any higher. They refer to the fact that debt levels have been rising in the U.S. and in China, the world’s two largest economies, along with the expanding U.S. budget deficit, prompting some commentators to predict an imminent demise of the bull. In addition, analysts that are negative on this market argue that emerging market foreign exchange disruptions will be the catalyst for an imminent bear market.

In spite of the multitude of bearish arguments, this bull market has thrived thanks in part to the still accommodative interest rate policies, hosted by the Federal Reserve and other major central banks. Even though the Federal Open Market Committee has raised its fed funds rate seven times since December 2015, the central bank of the U.S. is still by historical standards very accommodative.

The bulls on this market have cited a variety of other reasons for these historic gains in stock index futures. They range from everything from earnings growth, share buybacks and $1.5 trillion in tax cuts that brought overseas cash flooding back into the U.S.
ADM Investor Services International Limited (ADMISI) is a full service multi-asset brokerage company with an 80-year corporate history in London and extensive experience in the international investment markets, offering clearing and brokerage services into all major investment markets.

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EU was also blamed!

pressure, especially in the Northern Countries. So, the domestic market in the EU is weak, under down somewhat, perhaps 500k m/t lower. Having said time Beet needed rain. Exports for 2018/19 may be from 1,2 mln m/t one year ago. The coming EU crop is mln m/t being exported, as of September 2018, up large crop of around 34/36 mln m/t, well in excess of the domestic market estimated just under 26 mln m/t.

We have seen the EU scrapping their export limits and therefore pressure on the market. The India Government is “encouraging” Millers to invest in any products mentioned by ADM Investor Services International Ltd. (ADMISI). In particular, it does not constitute an offer or solicitation in any jurisdiction where it is unlawful or where the person making the offer or solicitation is not qualified to do so or the recipient may not lawfully receive any such offer or solicitation.

THE SUGAR MARKET VS. MACRO/WORLD INTERVENTIONS

The Sugar market is challenging to say the least. Low sugar prices benefits consumers but not producers. We see a strong push towards Food Manufacturers to change blends aiming to reduce sugar intake and many Governments are not asking nicely but implementing a “Sugar tax” to make sugar it gets done.

In the short term, we have a World surplus for April/March 2018/19 estimated at 4,2 mln m/t R.V. (following a surplus of 11,8 mln m/t R.V, last year) and very large stocks in India with a prospect of another large crop of around 34/36 mln m/t, well in excess of the domestic market estimated just under 26 mln m/t.

We are living a world of greater government interventions and India is well familiar with it. The main issue is that India sometimes tends to let things get too bad before acting and their actions sometimes are not enough to solve the problems, in this case high stocks of sugar and a larger one as we go along.

The India Government is “encouraging” Millers to export 5 mln m/t from October 2018 but will the market need all that? As we speak, we would need Sugar near 11 to trade in excess of UScts/lb 15/16 cts, ahead of the main harvest, to get some Raw sugar exports going. So, India is blamed for the low sugar prices. Anyone else?

We have seen the EU scrapping their export limits from October 2017 which is leading to around 3.6 mln m/t being exported, as of September 2018, up from 1,2 mln m/t one year ago. The coming EU crop is expected to be lowered due to the long dry spell at the time Beet needed rain. Exports for 2018/19 may be down somewhat, perhaps 500k m/t lower. Having said that, the domestic market in the EU is weak, under 400 euros and exports seem necessarily to reduce pressure, especially in the Northern Countries. So, the EU was also blamed!

We also have seen Pakistan “incentivising” exports and 2 mln m/t were exported from September 2017 until August 2018. For the time being, further exports are unlikely but Pakistan will once again produce more than they consumes despite the crop will be down somewhat, perhaps around 6,6 mln m/t. Will the Pakistan Sugar Government look at exports again? Well, Pakistan was also blamed for lower sugar prices.

Thailand Sugar exports are stronger this year. Raw Sugar exports, as of August 2018, were 1,6 mln m/t higher and White/Refined Sugar 564k m/t higher but as the crop ended 4,5mln m/t higher, stocks are higher. Thailand has benefited from Chinese Raw sugar policies (leading to greater White Sugar exports) and a strong demand from Indonesia in Q2 and Q3. It is likely Thailand will have a similar crop to last year and a higher carry over; therefore, more sugars would be available in 2019. So, Thailand also contributed to greater supply and therefore pressure on the market.

In Brazil the market situation is quite different as Brazil has a great Sugar/Ethanol flexibility. The long dry spell allowed for a fast harvest and a higher sugar content, but low sugar prices vs. domestic Ethanol prices, throughout the harvest, encouraging millers to maximize Ethanol production. The crop in the Northeast is likely to be similar to last year and a stronger mix, therefore the NE will also not increase sugar production. Brazil overall is likely to produce as much as 8 mln m/t less sugar during April 2018/March 2019 ending their respective crops earlier. The Sugar mix in the Centre–South may not exceed 36% vs 46% in 2017/18 therefore a large drop of 10% YoY.

Does it matter?
What seems to be holding back the market is the bearish view on the Brazilian Economy and the currency which is trading at 25% lower than back in December. Brazilian elections are encouraging a bearish market view on Brazil. So, Brazil hasn’t really been helping to prop up the market.

The world is a bit stressed with the various “trade wars” like USA vs NAFTA, China and the EU (which will all be solved soon) as well UK/EU and not to mention the OPEC/Russia “pact” on OIL supply. So, overall weaker EM currencies and trade wars are not helping Commodities.

Coming back to Sugar prices, Funds/Specs took a bullish view from October 2015 until October 2016 pushing the market from US cts/lb 10 to 24 cts. Towards the end of 2016 into early 2017, Funds/Specs decided to liquidate longs (on a nett basis) and by May 2017 they started going short. During the past 14 months, Funds/Specs have “played” the Sugar market from the short side, with weekly average Nett Shorts of 100k lots (164k lots short as of 11 September) while Index Funds remain largely long at an average of 216k lots (258k lots as of the 11 September 2018).

We estimate that producers priced in excess of 26 mln m/t in the past year (current and forward contracts) at an average not far from US cts/lb 13,40, basis October, while consumers also priced similar tonnages an estimated average of US cts/lb 12,75. We have seen Funds/Specs buying from producers and selling to consumers and the market seems trapped in the low end of a “sensible” market range, assuming no further market interventions or weather problems.

It is fair to say that most other Commodities are also under pressure as the dry weather this year which spoiled the prospects for some crops in Argentina, Europe and the CIS, wasn’t enough to propel the market to higher levels, given the stronger Dollar, Trade Wars and weaker EM currencies.

The Sugar market is trading at historical low levels and below cost of production for Brazil and India to say the least. Cost of production in many other Nations are also well above the current market. Is the market too low? Yes, it is.

Sugar prices under US cts/lb 14/15 is not conducive to investments, husbandry and expansion, therefore, the current market is forcing production to suffer while we still have some consumption growth and prospects for strong Fuel prices and EM currencies to improve, somewhat, in the near future.

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THREE TELL-TALE SIGNS OF A RECESSION

The nearly decade-long U.S. economic expansion may look a little long in the tooth, but it is not about to end due to old age. Economic expansions need a catalyst that triggers a downward spiral of consumer and business retrenchment.

In the United States, the most common catalyst has been the collision of rising interest rates and heavy debt loads, corporate valuations that appear to have run ahead of free cash-flow generation, or both. Add trade tensions and geo-political uncertainties, which may work to slow global growth, and we might have a scenario that could trigger a recession, at least at first glance.

While the current environment ticks off all the items on this list, that does not mean a recession is in the cards. Indeed, equity markets have been placid thus far in 2018. After a brief volatility spike in January, implied volatility has subsided to near record lows for equities, many related financial products and precious metals. So far, neither markets nor U.S. macroeconomic data for labor markets or consumer confidence are flashing any signs of concern. We want to examine the recession risk signals and evaluate the probabilities of a downturn coming in the next year or two. Our conclusion is that recession risks are steadily rising, with about a 33% probability of a recession in the next 12-24 months.

RISK #1: RISING RATES AND FLATTENING YIELD CURVE

The Federal Reserve (Fed) has been raising rates in its desire to shift growth, and we might have a scenario that could trigger a recession, at least at first glance.

Figure 1: More Rate Hikes Risk Taking the Fed Past Neutral.

Fed Funds Futures 1Y and 2Ys Out

The metric most clearly signaling that the Fed may go beyond neutral and into the high tightening gears is the shape of the yield curve. As the Fed has lifted short-term rates, longer-term Treasury bond yields have hardly moved, resulting in a major flattening of the yield curve. Economic theory argues that a neutral monetary policy is associated with a modestly positive yield curve. The logic for a slightly positive neutral curve is that short-term rates have less inflation risk than longer-term yields, so risk premiums rise with maturities. As short-term rates rise relative to long-term yields, financial institutions can no longer earn profits from borrowing short and lending long. Commercial businesses depending on short-term credit will face higher interest payments. Consumer debt is not particularly interest rate sensitive, but home mortgages are. Rising short-term rates make floating-rate mortgages less attractive, reducing mortgage choices and decreasing the affordability of buying a new home. All of these impacts are exacerbated if the yield curve actually inverts – short-term rates higher than long-term yields. And, inverted yield curves are an especially good indicator of future recessions 12 to 24 months down the road.

It does not matter why the yield curve flattened or inverted, it only matters that the shape is no longer positively sloped. The cause of the yield curve’s shape change does not matter because economic agents – governments, businesses, consumers – face the change in interest costs and have to react no matter the reason. Aside from the Fed pushing short-term rates higher, this time around, one reason the yield curve has flattened has been that long-term yields did not shift upward with the Fed rate hikes. Long-term yields were constrained due to competition from low yields in government bond markets in Europe and Japan helped by their central banks’ asset-purchase policies. This is certainly true, but just because the cause was different does not mean the outcome will be too.

Then, there is debt. Debt levels have been rising in the U.S. and China, the world’s two largest economies, although not in Europe. Rising debt does not mean an impending recession. Indeed, moderate increases in debt fuel sustained economic expansions. The issue is that higher debt loads mean higher interest payments when interest rates do rise. So, as debt loads increase, the fragility of an economy to rising interest rates increases. Telling just about the U.S., the biggest increases in debt are coming from the Federal government, rates increases. Talking just about the U.S., the biggest increases in debt are coming from the Federal government, which means that as interest rates rise the interest expense item in the government budget is going to grow quite rapidly. Consumer and housing debt was way too high in 2007-2008. Consumers cut back for a while but have now returned to the debt loads of 2008. We expect slowdowns in both US auto and home sales due in no small part to rising interest rates hitting high debt loads.
RISK #2: EMERGING MARKET FX DISRUPTIONS

Plunging emerging market currencies should not come as too much of a surprise. Emerging market currencies often have problems following the Fed’s tightening. Most famously, Latin America was plunged into a deep, decades-long economic depression following former Fed Chair Paul Volcker’s massive rate hikes between 1979 and 1981. Following the Fed’s 1994 rate hikes, the Mexican peso wasted no time in collapsing and was followed a few years later by the Thai baht, many other Asian currencies, and then the Russian ruble. Currency disruptions in emerging market countries are growth killers. Existing borrowings in U.S. dollars or other hard currencies become extremely hard to service. Domestic businesses and consumers pull back spending in a downward spiral. Political uncertainties, often already high, get even more convoluted as emergency policies are enacted and interest rates go sky high. As emerging market countries have taken an increasingly larger share of global economic activity over the last few decades, their impact on global growth and the knock-on effects to the major industrial countries has increased.

Between 2009 and 2016, investors grew accustomed to financing long positions in emerging market currencies with interest-free loans in the U.S., European, Japanese or other zero-rate currencies. Now that the Fed has hiked repeatedly and plans to increase rates even more, these currency-carry trades are unwinding in a hurry.

Moreover, high debt levels exacerbate emerging market stress. China has taken on extremely high levels of debt that resembles those of developed nations and is currently trying to deleverage. The problem for China is that its deleveraging plan is not a deleveraging plan at all. Basically, China’s so-called deleveraging plan moves debt from point A (the shadow banking system, non-financial corporations and local governments) to point B (the official banking system, the central government and, indirectly, household balance sheets). Moving debt from one place to another doesn’t achieve deleveraging but it can make debt more manageable. The government is trying to stave off an economic slowdown with an upcoming tax cut, scheduled for September, while the People’s Bank of China is reducing its reserve requirement ratio to spur lending. Given China’s debt burdens and the cost of the trade war, the Chinese economy and exacerbates the slowdown in growth. The U.S. economy may look quite healthy in the near-view mirror, appearing more than able to withstand some trade challenges. However, with economic risks already rising from rate hikes and emerging market FX disruptions, the next bump on the road could prove critical. And, the trade war may simply be the straw that breaks the camel’s back.

Corporate profits are likely to come under downward pressure. Falling corporate profits do not necessarily doom the equity bull market, at least in the short run. The previous two bull markets went through two phases. In the first phase (1990-97 and 2003-2005), earnings and equity prices rose together. In the second phase (1997-2000 and 2006-2007), earnings fell but equity prices rose anyway (Figure 4). Earnings essentially have plateaued since 2014, before being goosed up by the corporate tax cut. With the tax cut impact fully priced into the market, earnings may begin to decline in the second half of 2018. Even so, the actual peak in the equity market might not come until 2019, 2020 or later, depending on whether a recession materializes.

A clear consequence of economic disruption and slowing growth in emerging market countries is the plunging prices for industrial metals. Copper prices fell by almost 20% in June and July 2018. Oil demand has held up so far, but downward pressure on prices is typical in an emerging market currency disruption period.

**Figure 2: Is the Next Emerging Market FX Crisis Underway?**

<table>
<thead>
<tr>
<th>Year to Date versus USD: January 1, 2018 = 100</th>
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<tbody>
<tr>
<td>China: Offshore RMB</td>
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<tr>
<td>Russian Ruble</td>
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<tr>
<td>Brazilian Real</td>
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<tr>
<td>Turkish Lira</td>
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<td>Argentine Peso</td>
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*Source: Bloomberg Professional (ARS, BRL, CNH, RUB and TRY)*

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**All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the authors and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.**
It is almost impossible to click onto a social media link relating to a current affairs issue, listen to a phone-in talk show on radio, or even just skim the first few pages of a national newspaper without observing the decline of rational debate.

It seems more often than not we are confronted by the two sides of an argument that involves all parties simply shouting ever louder in an attempt to reinforce their stated view and drown out any opposing ideas.

There appears to be a lack of respect, caring, kindness and compassion in these discourses and, without any rules or restraints within these exchanges, the conversations tend towards anger, impoliteness and intolerance.

Is this a function of a changing society, a lack of ingrained civic skills, or is this type of behaviour led by the growing dominance of social media as the primary platform of news for many people, in a world where time pressures mixed with a seeming inability for users to maintain a focus on a subject matter for any length of time?

While people still trust traditional media sources more than that garnered from social media, there has still been an overall decline in the trust of all forms of media. Many people have started to ignore or avoid the news.

Individuals often engage in subliminal strategies to navigate this new complex social space. Their personalised searches will tend to reinforce existing views and polarise debate. This might then be exaggerated by the inbuilt algorithms within these social media platforms that create ‘filter bubbles’, further refining the information the users see, limiting diversity of opinion and reinforcing any ‘confirmation bias’ that the individual may have.

Whilst it is possible to ‘break out’ of these filter bubbles, this requires the user to make a conscious effort to evaluate the information they are exposing themselves too, recognise there could be an issue and a bias in the first place, and open their mind to a broader set of sources. People can also make a conscious decision to avoid web sites that are known to carry unverified or weakly sourced news information.

Another problem that is often exacerbated by online media is that of gossip and rumour. If there are questions raised over the integrity of the traditional media outlets, the online media can be even harder to trust. The root of this issue lies in everybody wanting to be the first and the fastest. In trying to spread news stories quickly, many sources are not referenced or checked before publication. As such, the facts might not be facts, they may be partially true, outdated, or just rumour. Veracity comes second to being first and getting the views and clicks.
We are a ‘headline’ reading generation. As traditional news organisations find themselves competing for the attention of an audience, they too are tempted to post articles with inflammatory headlines in order to get individuals to view them. The tone is set by our media. In an age of ‘skimming’, people rarely read beyond the headline. Whilst some might read as much as 25-30% of any article, these are the minority. Not only that, but in the race to be first, people will ‘share’ that headline and story, without having questioned it, further fuelling any misinformation and potential antagonism. They will ‘comment’ on the story without having read the content, often losing context in the process, and sparking angry interchanges. Immediacy is prioritised over comprehension and thoroughness.

So, we often have complicated subjects compressed into small soundbites, we are distracted by headlines, we fail to digest information, we do not search and check other sources of information and, as the volume of information expands seemingly exponentially, the audience begins to ‘tune out’. It becomes too easy for people to ‘shout’ and repeat headlines, even shouting ‘fake news’ repeatedly, until it overwhelms the audience and can start to appear as a fact in itself. This lack of conversation divides people. It makes them puff out their chest and scream the loudest in order to assert dominance in an argument. This achieves little and just destroys possible relationships. People enter ‘broadcast mode’ where the superficial appearance of conversation is actually two people simply stating and restating their views with ever-intensifying fury.

Where might we look to find some kind of reaction to this polarisation of argument and debate? Normally we might think that the schools and universities would be the places that the younger generations coming through might learn the civic skills of debate and reasoning, based on a mutual respect. Yet, at present, when we look towards the university campuses do we find a hotbed of political and social debate? No, instead we often find the abandonment of academic freedom in the name of the right not to be offended. This has been described in some corners as the intellectual betrayal of our time and a dangerous development. We cannot outsource our conscience and/or delegate moral responsibility away. There is a risk that we inflate the expectations of people as to what is achievable in terms of their social and personal rights and any failure to deliver against this raised bar leads to a society that becomes angry, disappointed and resentful.

The danger then, as we have seen through the lens of the UK/EU BREXIT discussions and reporting, and the daily machinations from the Trump administration and its opposition, is that individuals and groups take refuge in ideologies that are dressed up as solutions to their perceived problems. That might be the far right, which references an idyllic past that never existed, the far left, which promises a utopian future that is unattainable, religious extremism that preaches salvation through terror and aggressive secularism, which believes if we remove religion from society we can attain peace. All of these are mere fantasy, yet they draw people in and make them intolerant of any opposing view. There is no attempt to understand the position of the other party and each dogma comes with a convenient and handy suite of aggressive put downs, that can be repeated ad infinitum.
As we have become ever more reliant on social media to connect and remain informed, we also fail to engage in face-to-face conversations that require us to read our counterparty’s reactions, see the impact of statements on others, gauge the tone of an argument and possibly nuance our replies. Social media lacks an emotional connection and allows people to be hurtful as if their on-screen counterparty is not actually a real person.

So, while global social media allows us to connect with people around the world it doesn’t turn us into neighbours and fellow citizens, unless we make a concentrated effort to achieve this.

The risk is that the internet and Social Media can therefore become an atomising form of public discourse. Unless carefully structured, online discussions can soon turn rude and vulgar. There is a lack of cross-party/idea dialogue and even within like-minded groups, true rational debate rarely happens.

The hope must be that we learn to reason together. Can we create, appreciate, and embrace true open access public debate and will this require us to move away from the existing platforms or adapt them to allow for multi-person structured argument?

As with most things in life, any change will likely be in response to a demand for that change. We must want things to change for the better and that will require a marked effort by everyone; both those wishing to engage in debate and those providing the platforms and means for those discussions.

But, at the root of things is a need to educate and teach the ability to debate. A skill that appears to have been lost to so many. This needs to start young, in our schools, and to be reinforced rather than suppressed, during further education.

"ULTIMATELY, WE CANNOT AFFORD TO LET THE TRUTH BE UNDERMINED BY OUR OWN LACK OF SOCIAL AND CIVIC SKILLS."
We as a society gain when we listen to the views with which we disagree. We need to learn to:

• Question everything and seek alternative sources.
• Listen to extreme opposing views.
• Think – promote deep level thinking from that which we have listened to.
• Respect the views of others and try to understand why people might hold those views.

Ultimately, we cannot afford to let the truth be undermined by our own lack of social and civic skills. Only then can we as a society start to mend the fractures and build bridges towards a more tolerant world. In doing so, we close off the avenues exploited by extremists from all corners and possibly regain control of the political and social agenda.

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https://www.bbc.co.uk/radio/play/p06k4y85
https://www.theodysseyonline.com/society-lost-ability-debate
https://www.rootsofaction.com/disadvantages-of-social-networking/
INFLATION - NO LONGER A LONGSHOT

Given that the last significant inflation period was decades ago, it is not surprising that the marketplace has become convinced that a return to inflationary conditions is extremely unlikely. Given that the last significant inflation period was decades ago, it is not surprising that the marketplace has become convinced that a return to inflationary conditions is extremely unlikely. In the wake of the subprime debacle, many economists suggested that a return of inflation would be decades in the making. But looking at current events, it would appear that a classic prescription for such a return has already been written and that it is coming to fruition quicker than many would have expected.

Cheap goods and cheap labor from China have been the primary deflationary impetus over the last 15 years, but the recent series of events suggests that China could become the inflationary spark in the futures. China continues to consume ravenous amounts of commodities as it modernizes and pushes toward an economy more reliant on domestic consumption. Business as usual on trade relations no longer seems acceptable by China’s largest trading partner, the United States. Consequently, both countries have launched into a cycle of tariffs that will not only raise costs to US and Chinese consumers but will also result in international prices rising to match the tariff-adjusted levels of Chinese and US goods. Increased raw material prices should lead to higher wholesale prices, higher retail prices, and should eventually put upward pressure on wages.

Furthermore, China has recognized the potential threat to their economy from the cycle of tariffs and is moving aggressively to expand infrastructure activity, which should add to wage pressures and to physical commodity demand. However, China’s ability to contain inflation has moved beyond its borders and has become difficult for them to control.

CHINA HAS RECOGNIZED THE POTENTIAL THREAT TO THEIR ECONOMY FROM THE CYCLE OF TARIFFS AND IS MOVING AGGRESSIVELY TO EXPAND INFRASTRUCTURE ACTIVITY.

Chart 1: Major Chinese Commodity Imports: January-August 2018 / Net Change from 2017 in % Terms

While trade tensions with the US are impacting soybeans, Chinese imports of major commodities remain strong well into the third quarter of 2018!
Another issue that could contribute to the inflation environment is recent evidence that key foreign investors of US Treasuries are beginning to reduce their purchases. This has pushed certain US mortgage rates up to their highest levels in several years. The importance of foreign investment to the US Treasury market is magnified by the fact that US debt continues to expand. Evidence of the rotation away from US Treasury holdings was seen last month, when Japanese holdings of US Bonds fell to their lowest levels since October 2011. Even a slight removal of foreign buying in the face of expanding supply should mean US Treasury yields will have to increase that much further to attract buyers.

Furthermore, China has recognized the potential threat to their economy from the cycle of tariffs and is moving aggressively to expand infrastructure activity, which should add to wage pressures and to physical commodity demand. However, China’s ability to contain inflation has moved beyond its borders and has become difficult for them to control.

The record US debt is mirrored around the world, as many nations loosened money and borrowed heavily to survive the subprime crisis and have yet to work it off. A slight rise in US yields would likely result in wave of higher yields in non-US debt as well, as governments and central banks are forced to compete.

While the energy space isn’t a glaring inflationary force yet, it should be noted that US oil production continues to post new all-time highs at the same time that US crude stocks in the US have maintained a sizable, 78.6 million barrel deficit relative to year ago levels. Record US production is being swallowed up by domestic demand and by expanding exports. US and China refinery throughput levels continue to operate at record levels, which suggests the demand for gasoline and other petroleum products remains high. Demand for energy worldwide is such that extremely low prices in corn and soybean oil are ramping up biofuel production. This may soon provide a floor to grain prices.

The classic definition of inflation is “money chasing money,” and the cycle of tariffs, rising energy prices, rising developing-world wages, and rising interest rates sets the stage for the start of something.

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