# The Ghost In The Machine

NOVEMBER/DECEMBER 2019

ADM

ADM Investor Services International Limited

# EDITORS NOTE

**NOVEMBER/DECEMBER 2019**


## Central Banks, Sugar, Health, Gas, Negative Rates, Railways, Brexit, Agriculture, Law.

Welcome to the December 2019 edition of the Ghost In The Machine, which as ever looks at a broad spectrum of topical issues. These range from the latest round of central bank policy easing, through prospects for Sugar markets in terms of price and health trends, the Dutch/European gas market, post Brexit prospects for UK agriculture, challenges for UK rail freight, and the fall-out from the judge's ruling in the Natixis vs. Marex and Access World Logistics case.

Fed and ECB decisions to ease policy in the face of a weaker global economy once again impart an asset allocation bias to equities, given low fixed income yields, but raises questions over stimulus efficacy, ballooning debt levels and indeed financial stability. The Fed flagged its easing as a 'mid-cycle adjustment', but would it consider deploying negative rates in the face of a sharper downturn?

Sugar markets remain under a large cloud, but with supply forecasts being reduced and a large 'short' position, there may be echoes of 2015. Health concerns have dented sugar consumption trends, but complacency and a failure to challenge false narratives behoves the industry to actively promote its 'healthier' sugar initiatives.

As the Groeningen gas field nears the end of its productive life, what are the quality and cost considerations in sourcing replacement supply? The UK's Agricultural sector faces major challenges not only predicated by Brexit, the question is which subsectors and what factors will determine survival rates.

Anecdotal evidence points to the freight sector creating a lot of stress for the UK rail network, above all via all too prevalent passenger network delays, with a negative impact on the economy. Finally we take a look at Natixis vs. Marex and Access World Logistics ruling, and how it impacts commodity financing, logistics and a broad array of stakeholders.


### THE GHOST IN THE MACHINE

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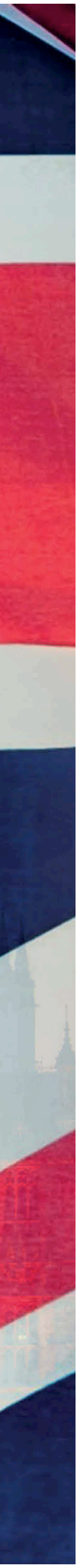
# CONTENTS





# GLOBAL FINANCIAL STABILITY: CHOPPIER WATERS AHEAD?

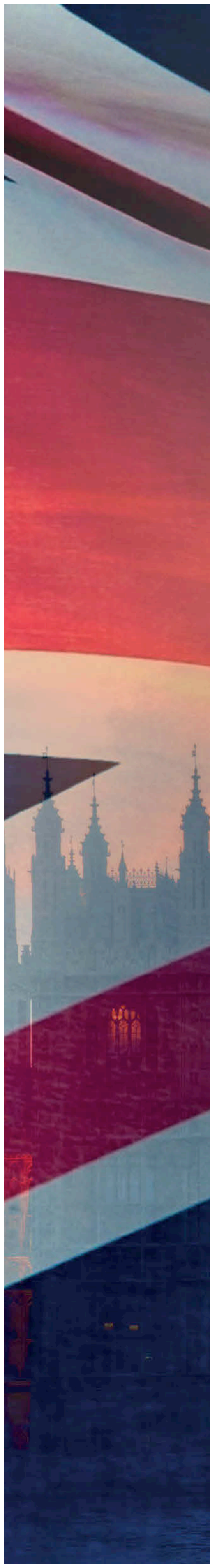
## Financial markets have been fixated for most of the past two years on trade tensions, above all those between the US and China, and the tortured process of the UK's decision to leave the EU, a.k.a. Brexit.

Financial markets have been fixated for most of the past two years on trade tensions, above all those between the US and China, and the tortured process of the UK's decision to leave the EU, a.k.a. Brexit. There is little doubt that both have taken their toll on the global economy, and in turn prompted the 'volte face' in terms of major central banks' monetary policy stance from actually tightening policy (Fed and BoC) or thinking about less accommodation (Europe, Japan) up until the end of 2018, to a round of renewed policy easing currently. It has to be added that while the post-GFC central bank dictum of 'do something' (or Draghi's whatever it takes') which has prevailed in the face of economic headwinds continues to inform market policy expectations, the sharp divisions in policymakers' opinions are all too visible at the ECB, Fed and BoJ, and underline concerns about the 'law of diminishing returns'.

But there is also a realization that, leaving aside the issue of the side effects of zero or negative rates, monetary policy is an ineffective tool in the face of trade tensions or a trade war. It also can do little to mitigate the impact of major structural shifts in key industries (e.g. autos and telecoms/tech at the current juncture, energy in the longer run), and most importantly needs help from governments in terms of fiscal policy measures and structural reforms, most abundantly evident in the Eurozone. By extension, the myth of central bank supremacy in the face of any challenge, which has been allowed to flourish in financial markets since the GFC, has in no small part been due to the all too frequent tendency for financial markets to indulge in 'wishful seeing' and 'wilful blindness'.

In a certain sense, it should come as little surprise that, after such a prolonged period of central bank largesse, financial repression and accompanying capital misallocation, along with zealous regulation of the banking sector, strains are starting to appear in financial markets. But perhaps the more pertinent point is that the divergence between the performance of financial assets in recent years, and the lived reality of the so-called 'real economy' is another element that has fed the fire of rising social tensions. The current wave of popular protests around the world, from Santiago through Barcelona, Paris, Beirut to Hong Kong, suggests that the myths and mirages of the current recovery as seen through the prism of the prices of financial assets are foundering on 'straws that break the camel's back'. These are tipping points amongst a broad swathe of long-standing popular complaints and grievances about inequality, corruption and oppression, in other words variations on the broader themes of populism and anti-globalization. As with the Arab Spring, the escalation from what one might term 'mutterings' to outright disorder and violent protest is frequently sudden and all too often exponential.

*“THE CURRENT WAVE OF POPULAR PROTESTS AROUND THE WORLD, FROM SANTIAGO THROUGH BARCELONA, PARIS, BEIRUT TO HONG KONG, SUGGESTS THAT THE MYTHS AND MIRAGES OF THE CURRENT RECOVERY AS SEEN THROUGH THE PRISM OF THE PRICES OF FINANCIAL ASSETS ARE FOUNDERING ON 'STRAWS THAT BREAK THE CAMEL'S BACK'.”*




"FINANCIAL MARKETS HAVE BEEN FIXATED FOR MOST OF THE PAST TWO YEARS ON TRADE TENSIONS, ABOVE ALL THOSE BETWEEN THE US AND CHINA, AND THE TORTURED PROCESS OF THE UK'S DECISION TO LEAVE THE EU, A.K.A. BREXIT."

The relevance of all this to potential financial stability risks should be obvious from the 2008 meltdown, with a vast array of earlier financial crises also displaying similar characteristics. Context is of course always important, but in any post hoc analysis will all too often show evidence of deep seated 'wilful blindness', and no small amount of hubris. All too often, the proverbial 'plot is lost' when process becomes confused with procedure, in general because as humans we like to think that once we have understood a process, we can then apply procedures to improve our perceived control over a process, primarily in the business arena to allow greater 'rent extraction', i.e. larger profits. However a process in any given arena is never static, it is of needs evolutionary, adapting to an ever changing environment, and thus necessitating procedures, which will very often become dogmatic and static, to be as evolutionary, which is precisely where we find the seed beds for many a crisis, because the focus is on evolving procedures without a reference back to the changing nature of the process. One might say this is what is at the heart of Einstein's famous quote that 'we cannot solve our problems with the same thinking we used when we created them.'

I cannot even vaguely begin to scratch the surface of the myriad of signals suggesting that the procedures that markets have evolved to deal with the forces of financial repression and post-GFC regulation may be headed for stormier waters, the 'rocks' or even an iceberg. But I will try and highlight a few that have flashed up on the radar, some of which I have referenced in daily or weekly commentary.

It was former BIS chief Jaime Caruana who in 2015 noted that monetary 'policy does not lean against the booms, but eases aggressively and persistently during busts. This induces a downward bias in interest rates and an upward bias in debt levels, which in turn makes it hard to raise rates without damaging the economy – a debt trap.' He added that 'systemic financial crises do not become less frequent or intense, private and public debts continue to grow, the economy fails to climb onto a stronger sustainable path, and monetary and fiscal policies run out of ammunition. Over time, policies lose their effectiveness and may end up fostering the very conditions they seek to prevent.' This looks to be a very useful prism though which to consider the latest bout of central bank policy easing.

> *"WE CANNOT SOLVE OUR PROBLEMS WITH THE SAME THINKING WE USED WHEN WE CREATED THEM. ALBERT EINSTEIN"*

For instance there are the niggling truths about the deteriorating profile on non-financial corporate debt service ratios, perhaps no better exemplified than by the fact that according to Goldman Sachs (GS), non-financial cash balances are down $185 Bln over the past year, which according to GS IS the sharpest fall (11.0%) in percentage terms since 1980 (11%)!

Central banks may continue to wax lyrical about how the health of the banking sector is so much better due to regulations introduced since the Global Financial Crisis. But as I have pointed out for many a year, the fact is that bank balance sheet woes in the GFC were a symptom of the malaise, rather than 'a' or 'the' cause, which was financial market instrumentation and the risks which multiplied on bank balance sheets, and which now sit on the balance sheets of a broad array of shadow banking (hedge funds, private equity, venture capital, along with peer to peer and indeed pay day lenders) and non-banking entities (insurance, mutual, pension and ETF funds). Indeed the regulators will doubtless point out that the risks are much less concentrated and better and broadly distributed. But the fact remains that ZIRP, NIRP and QE and all the associated instruments of financial repression have forced, and continue to force ever more money out of the traditional fund sectors into private equity and other shadow banking entities, draining liquidity from the banking sector and regulated markets into the shadow banking sector and into ever more illiquid and untradeable assets in a desperate reach for yield, some of which will turn toxic in a downturn.

While it may be something of an unfair comparison, given the 50% increase in US share buybacks in 2018 due to Trump's corporate tax cuts, the fact is that 2019 share buyback volumes will be lower, and that this will also act as a liquidity drain. The fact that this comes at a time, when US Treasury issuance is skyrocketing and will continue to do so and the Fed is struggling to manage USD money markets, in no small part due to its incessant piece meal tinkering with 'procedures' over recent years, underlines why rather belatedly, the likes of the IMF issued the relatively stark warnings on debt levels in its latest Financial Stability Report.

To be fair, the IMF is something of a 'latecomer' to this party, the BoE, Fed's Brainard, ECB's Lautenschlaeger and BoC's Wilkins (amongst others) have all spoken or written about these risks over the past 12 to 18 months. But the most erudite and prescient exposition on the topic was BoE's Andrew Haldane in his speech 'Half Way Up The Stairs' back in August 2014, when he was still director of financial stability. He noted that 'one of the likely consequences of the crisis, and the resulting regulatory response, is that the financial system will reinvent itself. Financial activity will migrate outside the banking system. And with that move, risk may itself change shape and form. What previously had been credit and maturity mismatch risk on the balance sheet of the banking system may metastasize into market and illiquidity risk on the balance sheets of non-banks.' He continued: 'Risk, like energy, tends to be conserved not dissipated, to change its composition but not its quantum. So it is possible the financial system may exhibit a new strain of systemic risk – a greater number of higher-frequency, higher-amplitude cyclical fluctuations in asset prices and financial activity, now originating on the balance sheets of mutual funds, insurance companies and pension funds.'

*“WHILE IT MAY BE SOMETHING OF AN UNFAIR COMPARISON, GIVEN THE 50% INCREASE IN US SHARE BUYBACKS IN 2018 DUE TO TRUMP'S CORPORATE TAX CUTS, THE FACT IS THAT 2019 SHARE BUYBACK VOLUMES WILL BE LOWER, AND THAT THIS WILL ALSO ACT AS A LIQUIDITY DRAIN.”*

The question would then appear to boil down to 'when' not 'if', both in terms of a renewed crisis, and the end game of some form of 'debt jubilee', i.e. debt repudiation. The broader perspective point is that the central bank regime of financial repression (which is in part also cyclical due to demographics and the vicissitudes of the technological or fourth industrial revolution) was only ever going to work if accompanied by government legislation to limit corporate 'financial engineering', and force investment in structures, research and product development and workforce re-education/re-training - but that would have been heavily opposed by the defenders of 'laissez-faire' and vested interests. As noted earlier, procedures would appear to have divorced or distanced themselves from an understanding of how processes are evolving, and if policy makers fail to grasp this nettle, then the potential for a crisis will only escalate.

It may indeed be the case that if political and trade risks were to dissipate sufficiently (not a forecast), then the potentially euphoric reaction could be the tripwire.

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# THE SLOW DEATH OF THE GRONINGEN GAS FIELD

## Due to growing safety concerns, production from the largest European gas field will cease in the coming years.

**HISTORY**

Following the discovery of the Schoonebeek oil field in 1943 in the North East of the Netherlands, Shell and ExxonMobil decided to create a joint-venture to be active in the upstream sector in the region. The joint-venture called Nederlandse Aardolie Maatschappij BV – better known as NAM – was created in 1947 and is the largest producer of natural gas and major oil producer in the country today.

At that time, the company was mostly looking for oil as the Dutch domestic gas market was saturated by coal gas (a flammable gaseous fuel made from coal)–used for lighting and fuel. Therefore, there was limited enthusiasm when wells Slochteren 1 and Slochteren 2 successively found traces of gas 30km apart in 1959. When well Delfzijl 1 found gas about 20km in the north east of Slochteren the following year, NAM started to suspect that the three discoveries could be linked as all the wells had the same gas water contact depth. Further analysis including interpretation of seismic data indicated that all the gas discovered in Slochteren and Delfzijl were actually all part of the same gas field. The Groningen gas field was born.

**PRODUCTION**

When it was discovered, the Groningen gas field was the largest in the world. The field covered an area of 900km2 which is similar to the size of New York City and Paris combined. The initial recoverable gas reserves are now assessed at 2,800bn cubic meters which is equivalent to the volume of 1.1bn Olympic swimming pools.

Production started in 1963 at a pace of 100 a year for the first decade. During that period, additional pipelines were built across the country and most of the houses and businesses had switched energy source from coal gas to cheaper and cleaner natural gas. The idea was to extract gas from the Groningen field in very large amounts as nuclear was soon to become the main energy source. However, this strategy was reviewed during the oil crisis in 1973. Following that period, most of the European governments were looking for new sources of energy to ensure the continuity and supply for the future generations. In order to extend the life of the Groningen field, annual production slowed down to 35 billion cubic meters per year on average and the Dutch government encouraged E&P companies to look for new gas fields.

The Groningen gas field has been a significant source of income for the Dutch government due to the large proportion of total gas revenues going back to the government as well as the high volume of exportations to other European countries such as Belgium, Germany and France. The Groningen gas field income reached its peak in 1982 at 19% of the total government income. This income has helped the government to improve the general standard of living of the population through better quality and access to education and wealth services.

## SAFETY CONCERNS

As more than 75% of the reserves have already been extracted, the pressure in the sandstone layer of the Groningen gas field has been decreasing; which in turn has increased the chance of earthquakes in the region. The first seismic event occurred in 1991 with a magnitude of 2.4 on the Richter scale but the public opinion really started to change in 2012 when a stronger earthquake of a 3.6 magnitude caused some material damages in the surface.

In response to growing safety and material concerns about seismic activity, a number of annual production caps were implemented and continuously revised from 2014. Following an unusually strong earthquake in January 2018, the Dutch government announced a plan to phase out gas production of the Groningen field by 2030. In September 2019, the Economy Minister Eric Wiebes mentioned gas production could be phased out by 2022 as additional capacity to substitute Groningen gas was available.

## ALTERNATIVES

The main challenge for the Netherlands and the other European countries importing Dutch gas has been to find a different source of Energy to substitute the Low Calorific gas (L-gas) of the Groningen field.

The first alternative is to import gas from exporting countries such as Norway and Russia. However, gas imported is generally High Calorific gas (H-gas) and therefore would require conversion to L-gas (usually through dilution with nitrogen). The Dutch government is already going in this direction as three nitrogen generation plants are currently under construction in Zuidbroek near Groningen.

However, importing gas by pipeline such as LNG would contain a non-negligible transport cost and also includes a significant environmental cost as additional gas is used and lost during transportation.

> *"WHEN IT WAS DISCOVERED, THE GRONINGEN GAS FIELD WAS THE LARGEST IN THE WORLD. THE FIELD WAS COVERING AN AREA OF 900KM2 WHICH IS COMPARABLE TO THE LAND AREA OF NEW YORK CITY AND PARIS COMBINED."*

The second alternative would be to convert the end-user appliance to H-gas specifications. On the short term, this transition would be more expensive than converting H-gas to L-gas. However, on the long term, this strategy may be more cost effective. Belgium, France and Germany have already started in some degree to switch their L-gas system to H-gas system.

The third alternative would be to produce more gas from smaller local fields but they are generally more expensive to explore and drill. More than 250 onshore and offshore smaller gas fields have been developed in the North Sea after the 1973 oil crisis. However, most of those additional reserves available are now in depleted fields in which production have been declining since its peak in 2000. Moreover, those reserves represent only a small portion of the remaining gas available in the Groningen field and therefore cannot be considered as a long term replacement as production from mature fields declines faster than new fields being discovered or developed.

Another alternative would be to accelerate the transition towards green energy by increasing solar photovoltaic and wind capacity or producing green hydrogen from renewable energy.

## CONCLUSION

The Dutch energy market is now at a turning point. 60 years after being discovered, production from the Groningen gas field will cease at some point in the near future. After being a gas exporter for decades, today the Dutch energy market is reliable on exportation to remain balanced.

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# GOOD AND SWEET

**Sugar prices have been in the doldrums for more than two years. What was once a daily move in price is now only seen during a month. Traders and analysts usually point the finger at the likes of India and Thailand as the villains by increasing their sugar production to a level that has meant that over the past ten years all, but for two years, global production has been more than needed. However, the other side of the equation, consumption, is another problem.**

The concerns over sugar intake and health and its impact on consumption is the elephant in the room for the sugar industry. They know about sugar taxes, they are aware that processed food manufactures have cut the sugar content of thousands of their products but it is rarely discussed. At conferences and seminars the issue is rarely discussed in depth and precious little action has been taken by the industry to counter many of the false claims and news.

Initially, the industry believed the hype over sugar consumption and health would soon be forgotten as another lifestyle fad emerged. They comforted themselves that the few fitness fanatics in the US and Europe who cut down on their consumption would have very limited impact on the continuing global consumption growth fuelled by population growth and changes in the Asian diet. To a certain extent they are right. Consumption has continued to grow but well below the linear 2% per year seen for decades. However, the health concerns have spread across the world with the likes of India, Colombia, Saudi Arabia and South Africa introducing some form of sugar tax. More countries are considering introducing taxes some fairly draconian. Therefore, it would seem it is an issue that the industry needs to address and not ignore.

There has been much written about the perils of eating sugar from the, frankly, spurious to the mildly logical that too much of anything is bad for you. In this day and age of social media, blogs and twitter it is nigh on impossible to refute every piece of false news that details the havoc that consuming sugar will wreak on the human body.

Of course even the most wizened of sugar traders will concede that the consumption of too much sugar, normally combined with fats, can contribute to becoming obese and suffering from type two diabetes. Global obesity rates have nearly tripled since 1975. Currently, worldwide, over 650 million people are obese. Global diabetes rates have nearly quadrupled in the past 40 years. More than 7.2% of the Indian population are diabetic and 1 million Indians die due to diabetes every year. So the cost to the world's health services is enormous hence it is hardly surprising governments are keen to introduce measures to reduce these two conditions. Whether targeting just sugar is debateable but that is an argument for another time.

> *"MORE THAN 7.2% OF THE INDIAN POPULATION ARE DIABETIC AND 1 MILLION INDIANS DIE DUE TO DIABETES EVERY YEAR."*

*“A 10-15 POINT REDUCTION ON THE GI MAY NOT SEEM HUGE BUT IT COULD MAKE A DIFFERENCE TO SOMEONE TRYING TO LOSE WEIGHT OR CONTROL THEIR DIABETES.”*

Therefore, it would seem the next logical step is to develop and sell the idea of a 'healthy' sugar. Many would say this is an oxymoron but others would argue that some sugars are healthier than others. This is down as to where they are ranked on the Glycaemic Index (GI). The GI is a relative ranking of carbohydrates in foods according to how they affect blood sugar (glucose) levels. Carbohydrates with a low GI value (55 or less) are more slowly digested and absorbed so slows the rise in blood sugars and insulin levels. Therefore, foods with low GI are thought to be beneficial to the control of diabetes, weight control, the reduction of cholesterol and blood pressure. The GI of sugars range from a very low 19 for fructose (found in fruit) to Maltose (found in malt) at 105. In the middle at 65 is sucrose (found in cane and beet) which is used in processed foods and fizzy drinks.

Over the past few years there has been a lot of work done into producing sucrose with a lower GI but remaining commercially viable. Several sugar companies now produce either under licence or through their own development sucrose with a GI of between 50 and 55. Carbohydrates are considered to have a low GI if below 55.

A 10-15 point reduction on the GI may not seem huge but it could make a difference to someone trying to lose weight or control their diabetes. Of course the possible benefits of using low GI sugar will be mitigated if the overall diet remains poor.

Whether the use of low GI sugar will be adopted wholesale by global food processors and drink manufactures remains to be seen. There will be an additional licencing cost but there should be little need to re-formulate the ingredients.

Getting the adoption of low GI sugar is hardly game-changing but it is a step in the right direction for an industry which desperately needs some good press. At least it suggests that the industry is trying to be pro-active as opposed to hoping the health issues associated with sugar will just, eventually, fade away.

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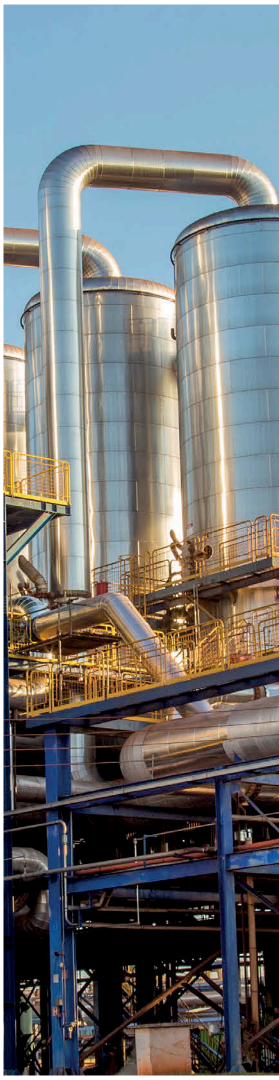

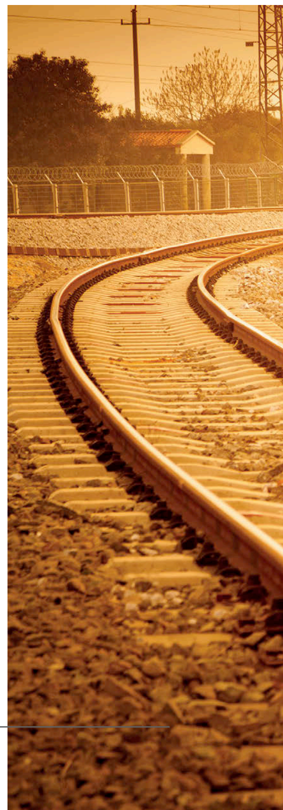

# FREIGHT TRAIN, FREIGHT TRAIN… GOING SO FAST…!

## Sheldon Cooper likes trains!

Sheldon Cooper likes trains! He doesn't like airplanes! He's OK with cars…as long as someone capable is driving (he can't seem to grasp driving himself) and he hates scooters and mopeds. He has issues with buses (hygiene and wishing to use bungee cords to strap himself in). Why start with this? Well, partially it was to get your attention…Sheldon Cooper is the much loved fictional character from the TV Series The Big Bang Theory initially made popular by Jim Parsons. Part of it was to introduce a subject and situation I came across a few months ago.

I take the early train into work from the heart of the County of Essex, to the East of London. It's a very popular commuter station and one of the busiest in the UK. One day in August I arrived at the station and had a chance to chat with some of the station staff as the train was delayed, the third consecutive time that week, due to '…points failure…'. I found it a little hard to believe as they'd been replacing the points for ages (…years…but I'm biased). I mentioned this to some of the station staff. He knew me and was sympathetic…but couldn't do anything about it. I then looked across the rails to the 'Country Side'… the one heading away from London and pointing said something like '…it couldn't be related to THAT?'. He looked at me, said nothing…yet his silence spoke volumes.

On the other side, at the platform, was a stationary bulk carrying, diesel/electric powered freight train. To my mind, the size of the whole train for the UK rail network was huge! I can't remember how many wagons…but many…and they were all heavily loaded with aggregate. This seemed to originate from the West of England or somewhere similar and looked to be heading East. I see such a freight train every day and it was then that I put the two situations together. Partially I think it was because I'd recently read a story about '…the heaviest 'jumbo' train currently running in the UK[1].' A trial run of a huge train weighing 4,624mt for the same train company as the one sitting in my station. All these made me think of the competing needs of freight and passengers to run at speed, over points, on the same two skinny pieces of steel rail.

Now I'm not against freight on rail, far from it. If the locomotion units are from overhead electric lines, the electricity is green in origin and there's hardly a more environmentally friendly way to move people or freight around. The problem as I see it, is not just that freight is moved by diesel/electric units… many passenger services are also powered in such a way. Rather it's the weight of the trains at speed and the conflict/competition between freight and passengers.

For example, a typical UK commuter train weight in around 45 - 48mt. It is a hollow tube that realistically carries very little weight in passengers. A freight train wagon weighs on its own at least 23mt and has a carrying capacity of another 77mt. A heavy total of around 100+mt when laden with aggregate. The locomotives pulling them can also be up to 127mt…though I appreciate the larger number of axles. Meanwhile, my commuter trains are rated up to 100mph though I suggest most of the time they travel up to about 75mph. I've found out freight wagons unladen can travel up to 75mph and still up to 60mph when laden. Maybe I am just doing simple maths wrong…but wouldthese freight wagons not, at speed, have a greater impact on points, rails, etc…?

1 Dry Bulk magazine

This of course sets up the age old argument of for whom are the railways there to serve – passengers or freight? In some countries one can see this has already been settled. In the US one understands that freight dominates (though the double decker freight cars there seem to travel at a much lower speed) whilst many European countries prioritise passenger traffic with some highly subsidised passenger rail networks. I've always thought of the UK as a mixture…or perhaps one that can't make up its mind. Data from 2017[2] shows that only 9% of UK domestic freight travelled by rail. Most was by road… even waterborne freight accounted for more (13%). In 2000, the largest sector of UK rail freight had been coal.

**2** DOT Freight (TSGB04)

*"THIS OF COURSE SETS UP THE AGE OLD ARGUMENT OF FOR WHOM ARE THE RAILWAYS THERE TO SERVE – PASSENGERS OR FREIGHT?"*

Metals, construction materials (aggregate!) and oil/petroleum combined were just about matching coal[3]. However, by last year the shift had seen a dramatic drop in coal whilst construction took the lead with metals also increasing and oil/petroleum now about the same as coal. This looks linked to the change in UK electricity generation and new 'intermodal' freight transportation methods. At roughly the same time (2002 – 2016) UK passenger rail trips had increased by 56%. Interestingly, 64% of passenger rail journeys started or ended in London. I quote 'The UK rail network is one of the most heavily used in terms of train kilometres in the European Union[4].'

Recently, there has been a greater interest in climate friendly mass passenger transportation whether it is the HS2 line in the UK, HyperLoop in the US or maglev trains in China. This is all good! Though until those days become reality, in my corner of Essex I just wish to say (…and I am biased) how are we going to get my passenger train to arrive/depart on time, not be held up by '…points failures…' and deliver me to my London destination in a safe and timely manner? There is a finite limit to capacity determined by those two simple steel rails and their associated, seemingly delicate, crossover points. Which is more beneficial to the economy of the UK (and in your own part of the world…)? Is it passengers generating growth through a service economy…or freight building new infrastructure and/or transporting finished goods? What is the balance?

I still look at the freight train full of heavy aggregate early every morning…and I sometimes hum the old skiffle tune sung by Nancy Whiskey…'Freight Train… Freight Train…going so fast…'. When I see one at speed, I shudder…and think…so fast over all those points! I wonder if Sheldon Cooper would like that image…It may prompt this fictional character to use his vast intellect on deciding choices. I hope it may also prompt you!

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**3** DOT Rail Stats Dec 2019
**4** DOT Rail Factsheet/Eurostat

# STOCK INDEX FUTURES - DON'T FIGHT THE FED

## "Don't fight the Fed" is a rule of thumb that, based on historical averages, investors may gain an advantage by investing in a way that aligns with the current monetary policies of the Federal Reserve, rather than trading against them.

However, there are times when the "Don't fight the Fed" rule of thumb must be ignored and fighting the Fed is the exact right thing to do. The bulls correctly ignored this rule when the Federal Reserve was hiking its fed funds rate all through the December 2015 to the December 2018 period. During this span the Federal Open Market Committee increased its fed funds rate from a target range of zero to 25 basis points to 2.25%-2.50%. Traditional thinking this is when the Federal Reserve is increasing interest rates, stock index futures should normally decline in price. So why did this rule of thumb fail so miserably, as stock index futures advanced to a series of record highs?

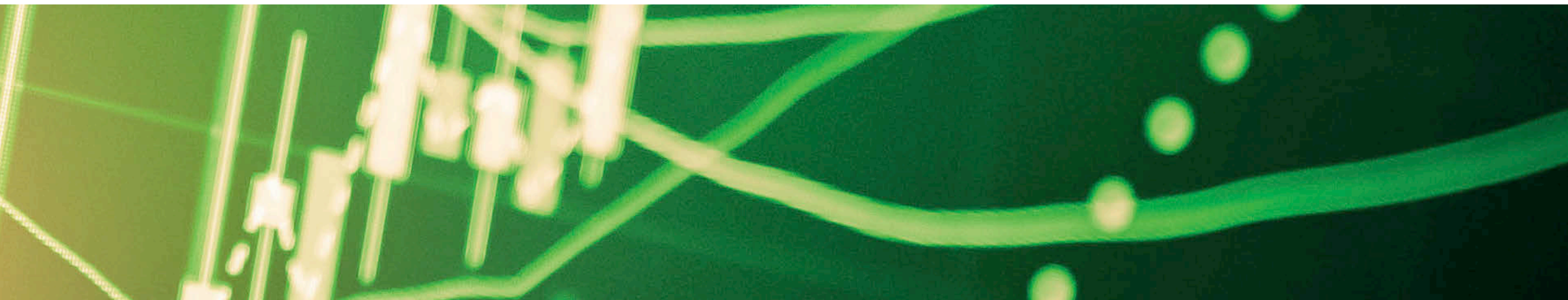
One very important factor to keep in mind is that while the Federal Reserve was steadily hiking interest rates, by historical standards interest rates were still extremely low, and in spite of the nine rate hikes from the Fed, the fed funds rate was still very accommodative. Remember that the fed funds rate was as high as 20% in 1980 and averaged close to 10% in the 1980s. European central banks in the late 1970s and early 1980s had correspondingly high interest rates, as well.

Now, in a reversal of the Federal Reserve's hawkish monetary policy, the Fed has embarked on a new path of easier credit conditions, starting with the July 31, 2019 quarter point cut in its fed funds rate to 2.00%-2.25%, followed by a second rate reduction of 25 basis points to 1.75%-2.00% at its September 18, 2019 meeting.

In addition, the Federal Reserve recently said that it would begin buying approximately $60 billion per month in Treasury bills to ensure "ample reserves" are in the banking system. This program will continue at least until the second quarter of 2020. While the Federal Reserve said the program is "technical" and is in response to recent disruptions in short-term money markets and is not a change in the "stance" of monetary policy, many market participants believe it should be considered an additional form of accommodation. The still historically low global interest rate environment and now the Federal Reserve expanding its balance sheet remains a major tailwind for the bull market in U.S. stock index futures.

**Chart 1: S&P 500 Futures - Monthly**


Source: Chart from QST



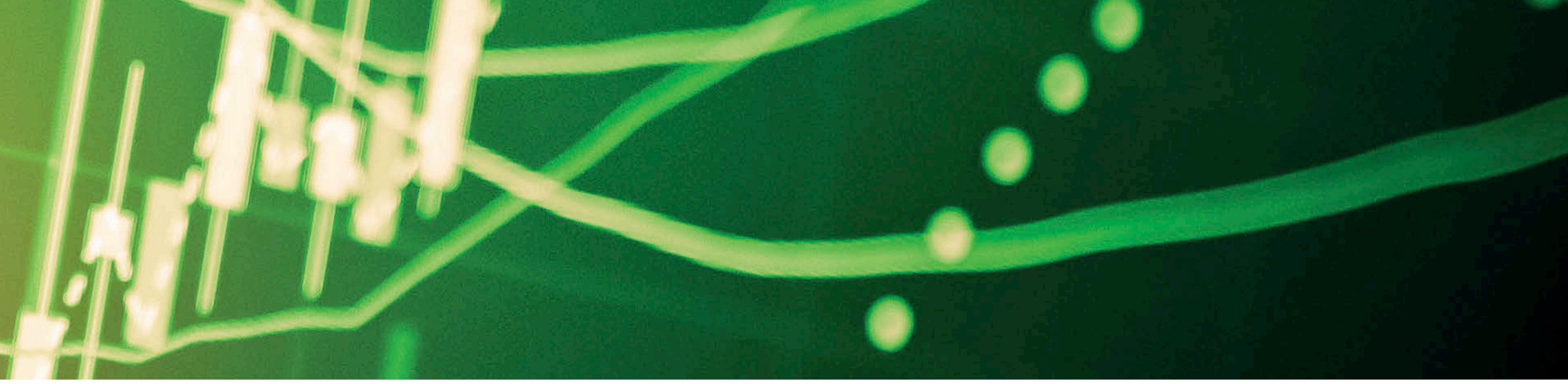
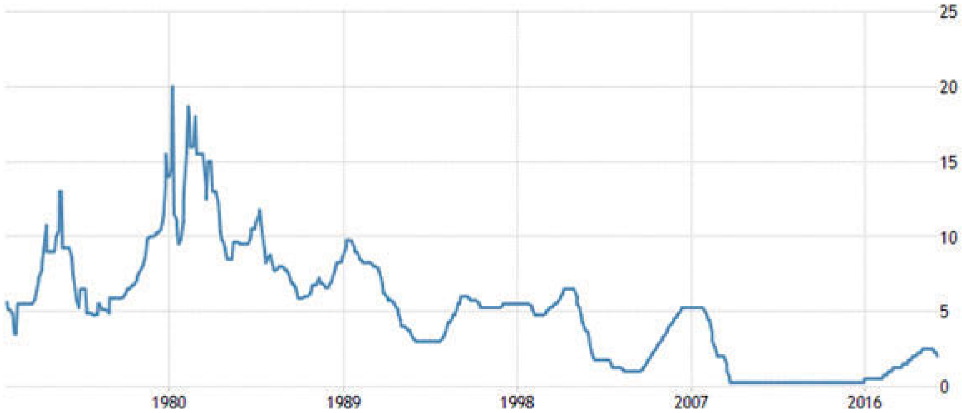


**Chart 2: U.S. Fed Funds Ratea**




Source: Tradingeconomics.com, Federal Reserve

### GLOBAL CENTRAL BANK POLICIES ALSO ACCOMMODATIVE

It is estimated that over $16 trillion worth of the global debt market has negative yields, which means some investors are becoming so risk adverse that they are willing to pay to hold bonds. And it appear that these negative yields are likely to become even more negative, as additional stimulus is needed in Europe and Japan. Also, countries that have positive interest rates are lowering them to varying degrees, or are in a frame of mind to do so.

The European Central Bank at its September 12th policy meeting reduced its deposit rate by 10 basis points to a record low negative 50 basis points and promised that interest rates would stay low for longer. Also, the central bank of the euro zone is restarting a quantitative easing program that it just phased out last December by restarting bond purchases at a rate of 20 billion euros a month ($22 billion) starting on November 1st =. The new quantitative easing program will "run for as long as necessary," according to the ECB. Officials recently said the central bank won't hesitate to "consider" easing, if the economy loses momentum towards hitting its price target.

The Bank of Japan also has a negative interest rate policy rate and its interest rates are likely to become even more negative. Bank of Japan Governor Haruhiko Kuroda recently said it could "certainly" cut rates again, if needed. In addition, the Bank of Japan deputy governor said the central bank must "patiently continue" its powerful monetary stimulus to maintain momentum toward achieving 2.0% inflation, as the downside risks from overseas economies mount.

### LOW GLOBAL INTEREST RATES REMAIN A MAJOR TAILWIND

The fed funds rate and interest rates overseas never got high enough to reverse the bull market in stock index futures. The rule of thumb about not fading the Fed did not work when the still near record low interest rates in the U.S. and overseas was taken into consideration. With some overseas interest rates remaining near or at historical lows and in many countries interest rates are becoming more negative, there is plenty of accommodation in the domestic and international banking systems.

The Federal Reserve is now on a path of easier credit conditions with two fed funds rate cuts already taking place in 2019, and probably one more before the end of the year. With global interest rates remaining at or near historically low levels, my view remains that the global reflation scenario is on track and easier credit policies from most of the world's central banks, including the Federal Reserve, are coming and will be the dominant fundamental that supports U.S. stock index futures in the long term.

Therefore, in light of the global accommodative interest rate policies, including the Federal Reserve's newly found need for more accommodation, I am now fully on board with the rule of thumb of "Don't fight the Fed."

Higher prices are likely for U.S. stock index futures .

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# AGRICULTURE, IT'S CURRENT ECONOMIC CLIMATE AND THE B-WORD… A TOXIC COMBINATION

If you put the simple search 'farming after Brexit' into Google the first result that comes up is the government website for the Department for Environment, Food and Rural Affairs.

Click on this and you get guidance on 'Prepare your farming business for a no-deal Brexit'. In theory as and when a withdrawal has been ratified by parliament deal, then all I would need to know is summarised for me. Then you see a contents split into 12 sections, and then you click on the second section and it provides you with two links, and then you click the first of these links and that takes you to 12 links and so it goes on. By this point you are lost in a bureaucratic minefield and you are still none the wiser on what is going to change and what isn't. After all this line of links ends up on how to claim the Basic Payment Scheme (BPS), and that is the biggest of the EU's rural grants for the farming industry. Great, apart from I started this search on farming after Brexit, which its whole purpose is to leave the EU, I somehow don't think this is going to be very helpful to me.

If you are to look at the current statistics on UK farm income over the past 9 years split roughly by agricultural sector you would be shocked. Cereal farms, general cropping, and grazing livestock farms actually lose money by producing what they are in existence to produce. In fact, a large majority of their income is made up from BPS/SPS (EU subsidies) that we are set to no longer have access to following the split from the EU. If you dig into this further and look at the Farm Business Survey datasets for £'s output per £100 of input, you see historically that around 50% of farms don't break even which you would expect to become a higher percentage following the previous statement.

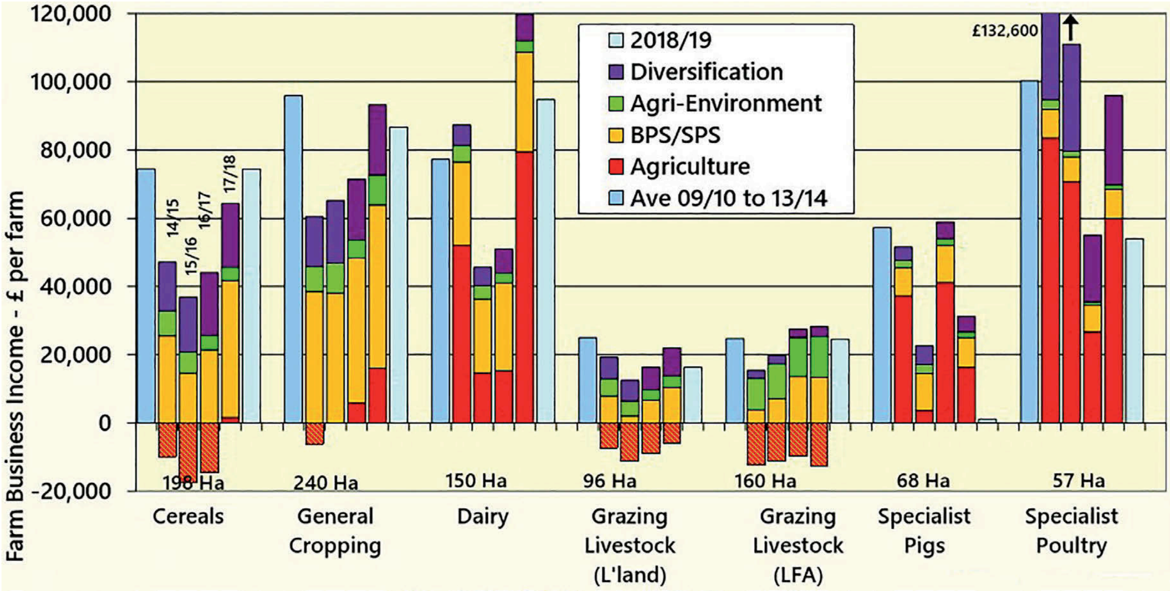
It all appears pretty damning for the future of UK agriculture. It therefore comes as no surprise that AHDB has reported a dramatic decline in dairy farm producers over the past 10 years and sheep flock numbers in the past 4 years despite the UK's continually growing population. The old saying in the industry 'no matter what people have got to eat' somehow seems to be bypassing the UK or maybe it should have tagged on the end 'but not from the UK'.

It is not all doom and gloom though, as seen in the previous table, the intensive livestock market is booming. Intensive farms by nature also do not rely on EU subsidies and are thus far less directly affected by the UK's departure from the EU.

No matter what category of agriculture a farm falls under, those that prosper tend to have two very clear attributes. High performance of livestock or crop, and most importantly a strong control over their costs. The largest components of these costs across the whole sector are animal feed 23%, paid labour 11%, seed and fertilisers 10%. All of these are directly affected by the UK leaving the EU and what agreements/deals are made in the coming months. After all, 73% of all UK agricultural imports are from the EU and 61% of its agricultural exports are to the EU. These figures are based on a 3 times trade deficit.

To be able to excel in cost structure management, you need to be able to plan for the future. So what does this mean for our farmers on the day we finally cut all ties from the EU? Although the UK will be able to negotiate new trade deals once it has left the EU this will take time. For example, the EU / Canada trade deal (CETA) took 7 years; and as for the TTIP between the EU and the United States which started in 2010, the EU declared the negotiations obsolete on the 15th April 2019. A whole 9 years of negotiations which have so far resulted in nothing.

Figure 1: English Sector Profitability - Farm Business Income - 2009/10 to 2018/19




Source: Defra/Andersons *real terms, 17/18 prices – Copyright © The Andersons Centre - Andersons

As such I wouldn't hold out for anything monumentally positive happening in terms of trade relations between the UK and the world in the foreseeable future. Although we will not crash out of the EU there is still a finite time scale on our time in the customs union. Once this time is up, we will no longer have its benefits and will be expected to be trading on our own agreements. At the time of writing, there is much talk in that timeline ending in 2021. Your maths does not have to be very good to realise that that is nowhere near 7 years. The average trade deal takes around 2.5 years to complete is also longer than current proposals.

Once we are officially departed from the customs union you could see negative pressures on the prices of cereals, oilseeds and meat. As demand for feed in livestock sectors and grains for the ethanol industry create surpluses, and exports become uncompetitive, while import tariffs stay low to feed the trade deficit, this will create even more competition. It all provides a perfect recipe for eroding margins. But where the real challenge will come is when the industry loses its support payments from the EU.

The story for farmers' support goes like this. Currently subsidies work on a basis of the larger the number or hectares, the larger the sum received and this is not set to change. What will change is the sum made per hectare is expected to erode. Currently a large proportion of this is made up of EU subsidies (BPS/SPS) with a small amount made up of the Countryside Stewardship Scheme (CSS). In 2020 the BPS/SPS will be simplified from a EUR sum to a GBP sum at an unknown conversion rate. It will then be slowly phased out from 2021. It is speculated that the reduction in 2021 could be anything from 5% to 25% depending on the size of farm.

However, CSS will continue to run as it has previously as this is a UK government lead subsidy. From 2021 new funding is set to come in known as the Environmental Land Management Scheme (ELMS) on a pilot basis with only 1250 farms being selected and building to 15,000 at the end of 2024. But there is little known about what the selection criteria will be at this point. It will then be rolled out from 2025 onwards and BPS and CSS will no longer exist. Its main criteria are set to be improved air, water and soil quality, increased biodiversity, climate change mitigation, cultural benefits and better protection of historic environments. It is important to point out though that this bill has not yet gone through parliament and could be amended or even scrapped by a new administration. Since it looks likely that we are heading for a general election again, the certainty in ELMS becomes questionable.

If that doesn't leave you scratching your head on how the agricultural landscape will prosper once we fully divorce our EU neighbours, then please put yourself forward for Minister of Agriculture. For me the only thing that is clear is that those who are not in control of minimising their overhead costs, do not have the ability to review their business model from an unemotional distance, do not understand where their biggest profit centre is in their business and focus on this, and do not thoroughly comprehend what consumer trends or requirements are in their markets will struggle to weather the storm that is about to come.  I am expecting intensive farming to continue to grow, and grazing livestock to continue to decline and with this the number of agricultural businesses. Those with bigger bank balances will wait out the problems and smaller family run enterprises are likely to be swallowed up.

**Lauren Judd**

# WAREHOUSE RECEIPTS IN FOCUS – IF THE DEAL LOOKS TOO GOOD TO BE TRUE…

**The Commercial Court (Mr Justice Bryan) recently handed down judgement in a case which has important implications for commodity financing, warehousing, logistics and more generally in relation to a service provider's reliance upon limitation provisions.**

The decision:

I. Affirmed that estoppel can only be used as a shield and not as a sword

II. Included an insightful analysis as to the relationship between the holder of a warehouse receipt and the warehouse

III. Considered what is required by way of notice in order to permit a party to rely on its standard terms and conditions to limit its liability in negligence

IV. Contained a detailed discussion of the reasonableness requirement contained in UCTA

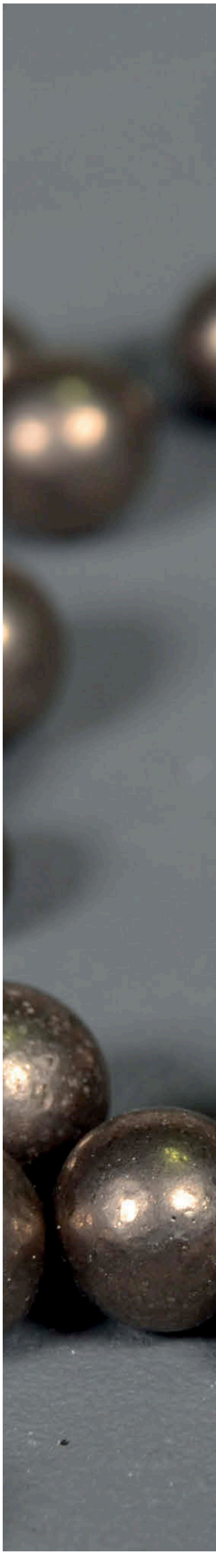
In Natixis -v- Marex and Access World [2019] EWHC 2549 (Comm), the Court considered a four handed dispute. The background can be summarised as follows. Marex Financial ("Marex") entered into various purchase and repurchase contracts with a Chinese company, CHH, for the sale of various parcels of nickel. Natixis agreed to buy the nickel from Marex pursuant to further spot purchase and re-purchase contracts (referred to as PC1 to PC5). The nickel was stored at warehouses owned by Access World and both purchases involved a set of transferable warehouse receipts which had originally been issued by Access World. By the time of the trial, it was common ground that the warehouse receipts provided by CHH to Marex which were in turn provided to Natixis were counterfeit. Following this discovery, Natixis closed out its futures position and claimed the sum of US$32 million in damages from Marex. Marex in turn brought claims against Access World in contract and for negligence and against its marine cargo insurers for an indemnity under the terms of its insurance policy.

In a wide-ranging judgement, the judge considered each of the claims in turn, save for that against the insurers, Marex's claim against them having been compromised following cross examination of its witnesses. As a result, the judge did not need to consider (for the first time) whether there had been a failure to present the risk fairly under the new Insurance Act 2015. However, he did consider a number of other important issues.

Natixis succeeded on its straightforward case that Marex had breached its purchase contract in various respects, notably because Marex had failed to pass title in the nickel to Natixis. Marex's construction argument, that it had simply promised to deliver whatever warehouse receipts Marex had been provided with, even if (as was the case) they were forgeries, was described by the judge as contrary to the ordinary and natural meaning of the clauses, uncommercial and unbusinesslike.

He found that, on the wording of the contracts, the obligation was to provide genuine warehouse receipts and that since Marex had failed to do so it was in breach of contract.

The judge also rejected Marex's argument that the contracts should be avoided on the grounds of common mistake. Having decided against Marex on the issue of construction, the Court found that it bore the risk and assumed responsibility for any forged documents.



Accordingly, in accordance with the principles set out by the Court of Appeal in The Great Peace [2003] QB 679, which confirmed that before a plea of common mistake can succeed, it must be shown that the contract itself does not already provide for one party to bear the particular risk, Marex's reliance on the doctrine was stillborn.

Accordingly, the Court awarded damages to Natixis in the full amount of its claim, namely $32 million.

In its claim against Access World, Marex brought claims in contract and in tort. Its primary claim was one based on alleged contractual warranties and associated alleged estoppels which were said by Marex to give rise to an obligation on the part of Access World to deliver up the nickel the subject of two of the transactions which Marex had entered into. In this context, Marex argued for the existence of a contract in a number of ways and, in particular it relied upon emails from Access World in which Access World had incorrectly confirmed the authenticity of two of the relevant warehouse receipts. The Court rejected this argument and in so doing, considered the nature and status of the relationship between a warehouse and the holder of a warehouse receipt. Perhaps surprisingly, as the Court observed, the status of such receipts has not received a great deal of attention from the English courts. However, the judge was clear that they do not constitute a document of title in the common law sense and that the relationship between the warehouse keeper and the relevant person who has the right to possession of the goods is that of bailment. As the judge observed, where there is a warehouse receipt there is a bailment of goods between the first order party (in this case a company called Straits) and Access World, that bailment being contractual in nature and at least evidenced by the terms of the warehouse receipt. When another party presents a duly completed original warehouse receipt to Access World, the latter may attorn to that party. However, there is no relationship between a warehouse keeper and any buyer from the first order party unless and until the warehouse keeper attorns to the buyer, the warehouse receipt not being a document of title within the Sale of Goods Act 1979. A fortiori, presentation of a false warehouse receipt could not give rise to an attornment.

Marex also sought to argue that a genuine warehouse receipt would give rise to a unilateral contract between its holder and Access World on the basis that it contains a statement by Access World to whoever may become endorsee (that is, the person to whom the first order party (original holder) transfers the warehouse receipt to) that Access World will deliver the goods to the endorsee upon presentation of the original warehouse receipt. The judge considered this to be fundamentally flawed. First of all, it failed to have regard to the fact that the relationship between Access World and Straits was one of bailment, to which neither Marex nor Natixis was party and the fact that it is only upon attornment on presentation of a genuine warehouse receipt that any relationship is created between Access World and the endorsee. It also failed on the facts because no genuine warehouse receipt had ever been presented.

The Court also rejected an argument that there was a warranty in the form of a collateral contract, there being no evidence of any intention to create legal relations nor any contractual offer.

A further point of note is the Court's consideration of Marex's arguments on estoppel. Marex had argued that Access World's confirmation of the authenticity of the PC4-5 warehouse receipts and Marex's reliance upon such representations estopped (i.e. precluded) Access World from later denying the authenticity of the receipts, with the consequence that Access World was obliged to deliver up the metal described in the warehouse receipts to Marex upon the presentation of the counterfeit receipts.

Marex's argument faced many difficulties, including the long-standing principle that 'an estoppel does not found a cause of action'. Having found there was no contract between Marex and Access World, the court concluded that the estoppel on which Marex relied could not exist as otherwise estoppel would be used as a sword and not a shield. Even if there had been a contract, the estoppel could not have resulted in an obligation to deliver the metal, owned by third parties, as an estoppel is personal and does not establish title against the world.

Turning to the case in negligence, the Court found that Access World owed Marex, but not Natixis, a duty of care in authenticating the receipts and that it had not exercised reasonable skill and care in its authentication of the receipts presented to it for this purpose, which related to the PC4 to PC5 transactions only. However, the Court also found that Marex's conduct in the transactions that it had entered into with CHH constituted contributory negligence which should lead to the recoverable damages being reduced by 25%, but rejected the argument that it was sufficient to break the chain of causation.

Nevertheless, the Court also held that, notwithstanding the gratuitous/non-contractual nature of the authentication exercise, Access World was entitled to rely on the limitation of liability contained in its standard terms and conditions. In this regard, Marex had argued that if (as the judge found) there was no binding contract between Access World and Marex there was no proper basis for holding Marex to be bound by Access World's terms and conditions. Secondly, it argued that if those terms and conditions applied the limitation of liability provision did not meet the reasonableness requirement within the Singaporean equivalent to the UCTA 1977.

In rejecting these arguments, the Court found that what was required in order for there to have been an effective disclaimer of liability was reasonable notice of that disclaimer. That in turn depends on the consideration of related issues. First, are the relevant provisions particularly onerous or unusual and secondly did Marex have sufficient notice of those provisions. As the judge noted, these are interrelated issues because the more outlandish a particular clause is, the greater degree of notice required. In this context, the judge found that the terms in question were neither onerous nor unusual and that, Access World having (amongst other things) issued thousands of warrants to Marex over the course of 10 years, each of which expressly referred to its terms and conditions, and Access World having also issued invoices to Marex containing a similar reference, and reference to its terms and conditions appearing on every email sent by Access World, sufficient notice had been given.

With regard to the argument that the terms and conditions did not apply to gratuitous services as opposed to contractual ones, the Judge held that the reasonable person in the position of Marex would have understood that the terms and conditions, on their wording, applied to extracontractual services such as the authentication services provided by Access World.

Finally, having weighed up all the relevant factors, including the fact that Marex was a commercially sophisticated LME broker with access to legal advice, the judge had little hesitation in finding that the limitation provisions in Access World's terms and conditions were reasonable. In fact, the provision reflected similar clauses in the industry, which the judge considered were appropriate in circumstances where the warehouse keeper generally has no knowledge of the commercial considerations and risks that are in play, in contradistinction to the customer who can assess those risks and take other steps to ameliorate risks that it faces. Interestingly, the judge also found that the inclusion of a limitation clause is an integral part of the very assumption of responsibility which Access World was prepared to undertake and that any intervention by the Court would be to disrupt the equilibrium of the very circumstances in which an assumption of responsibility arose, which, he said, the Court should be extremely reluctant to do.

The judgment is of particular interest not only to the global warehousing industry, but also to those in any sector which regularly rely upon limits of liability in their dealings with their customers and suppliers, including freight forwarders, carriers and customs brokers, who trade on their own bespoke trading conditions or industry standard terms such as BIFA or RHA.

Adrian Marsh and Iain Kennedy, together with Robert Thomas QC and Nicola Allsop of Quadrant Chambers, represented Access World Logistics.

**Adrian Marsh**
T: +44(0)161 817 7217

*“TURNING TO THE CASE IN NEGLIGENCE, THE COURT FOUND THAT ACCESS WORLD OWED MAREX, BUT NOT NATIXIS, A DUTY OF CARE IN AUTHENTICATING THE RECEIPTS AND THAT IT HAD NOT EXERCISED REASONABLE SKILL AND CARE IN ITS AUTHENTICATION OF THE RECEIPTS PRESENTED TO IT FOR THIS PURPOSE, WHICH RELATED TO THE PC4 TO PC5 TRANSACTIONS ONLY.”*

# IS THE US HEADED FOR NEGATIVE RATES?

In the search for higher economic growth and a desire to create some inflationary pressure, in the last several years the European Central Bank (ECB) and the Bank of Japan (BoJ) have pushed their short-term policy rates into negative territory. If the US were to enter a recession, what would the Federal Reserve (Fed) do? Would the Fed follow the lead of the ECB and BoJ into negative rate territory?

First, let's be clear that a US recession is not our base case. We put the recession probability for 2020 at only around one-third. The US is, however, in the longest economic expansion on record, and business cycle theorists worry that all good things must eventually come to an end. Our perspective is that economic expansions are dynamic processes that do not end due to old age. If one only looks through a rear view mirror, then it appears that there might be predictable economic cycles, but that would be an illusion. Looking forward, something has to cause a recession, and it is usually related to too much debt in one or another sector of the economy, such as mortgage debt in 2007-2008 or high yield debt in 1990-1992. So, when an over-indebted sector can no longer service its debts, there is the possibility of an economy spiraling into recession. While debt levels are on the rise, it is not our view that they are so high that the trade war or some other cause would tilt the US into recession in 2020.

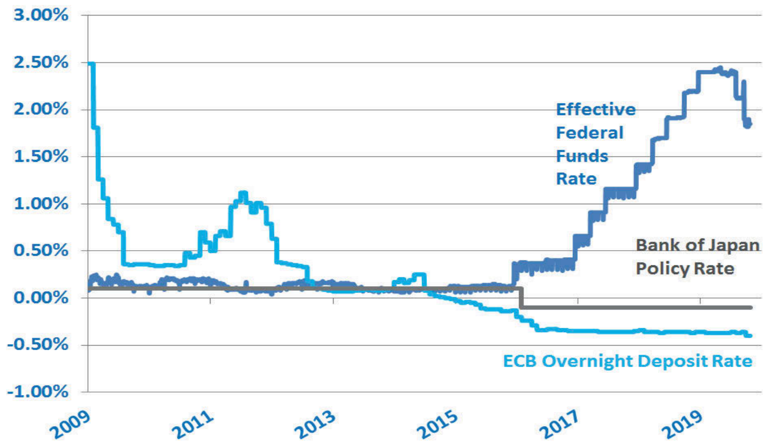
Yet, eventually, the US economy may experience another recession, and so the question we are analyzing here is how would the Fed react, and specifically would the Fed adopt a negative rates policy as some other major central banks have done. Our short answer is "no"; the Fed is unlikely to adopt a negative rate policy. The analysis is a bit more complicated.

## NEGATIVE RATES AND NEGATIVE-YIELDING DEBT

Negative rates refer to the deposit rate set by central banks for overnight deposits held at the central bank. Negative-yielding debt refers to notes and bonds that that have a sub-zero yield to maturity. Please note that negative overnight deposit rates do not necessarily cause markets to price debt with negative yields. Negative yielding debt is encouraged by the combination of a negative overnight central bank policy rate and aggressive central bank purchases of sovereign debt (that is, quantitative easing or QE). The ECB and BoJ have combined negative rate policies with massive asset purchases and the result is some $13-$15 trillion of negative yielding debt in Europe and Japan.

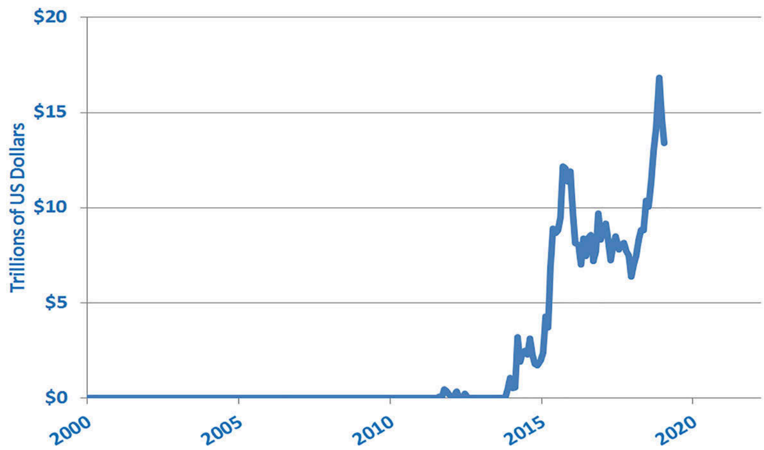
Both the ECB and the BoJ adopted negative rate policies to stimulate banks to lend more for business investment and consumer spending. They billed negative rates as an accommodative policy, which was certainly their intention. Unfortunately, it has not worked out that way. Negative rates are a tax, pure and simple. Banks holding deposits at the central bank are penalized, that is, taxed. In many cases, the banks cannot pass this tax on to their depositors, although that may not matter. What does matter is that within the economic system, the tax gets paid, and it has worked to discourage banking activity because financial sector profits have been stressed by the tax. In turn, the financial sector has been less able to expand lending, which might have encouraged business or consumer spending. Of course, this is not an interpretation accepted by the ECB or the BoJ.

**Figure 1: Fed, ECB, and BoJ Overnight Rates**




Source: Chart Created by CME Group Economics
Bloomberg Professional (FEDL01, EUMIOD, BOJDPBAL)

**Figure 2: Negative-Yielding Debt**



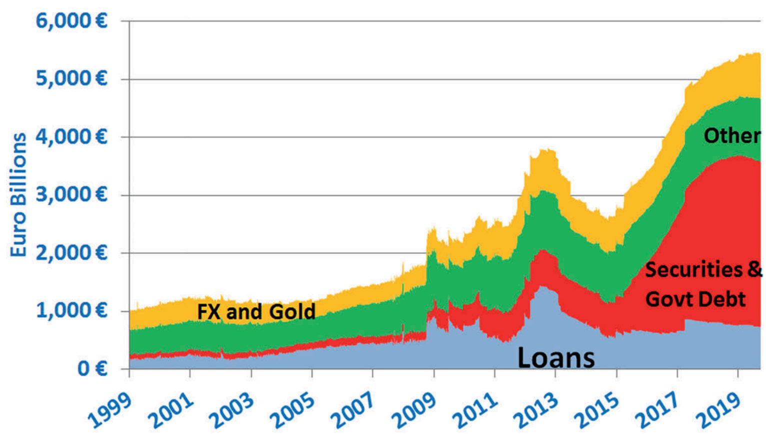

Source: Chart Created by CME Group Economics
Bloomberg Professional Bloomberg Professional (BNYDMVU).

The ECB and the BoJ have also been very aggressive in their asset purchases. The BoJ started its asset-buying program in 2013, and has grown its balance sheet to equal the size of the whole Japanese economy and the BoJ owns about half the outstanding government debt. At the start of the Great Recession of 2008-2009, the ECB did not expand its balance sheet by purchasing securities. Instead, at the beginning, the ECB lent trillions of euros to the financial system to insure that banks remained liquid. The ECB ventured into asset purchases in 2015, and the ECB now owns as much as 30% of some key government bond markets, such as Germany and the Netherlands, and a little less of a percentage for markets such as Italy or Spain.

There is growing evidence that the ECB and BoJ have pushed the limits of QE or asset purchases. The problem is that once a central bank becomes the major buyer of government securities, liquidity in those markets dries up. Liquidity to an economy is like oil is to an automobile internal combustion engine. Liquidity reduces market frictions, allows for effective interest rate risk management, and enhances the ability of an economy to grow more robustly. Without liquidity in fixed income markets, economies simply do not function as smoothly and, thus, they grow more slowly. Put another way, at some point the advantages of lower bond yields are more than offset by the disadvantages of a lack of liquidity.

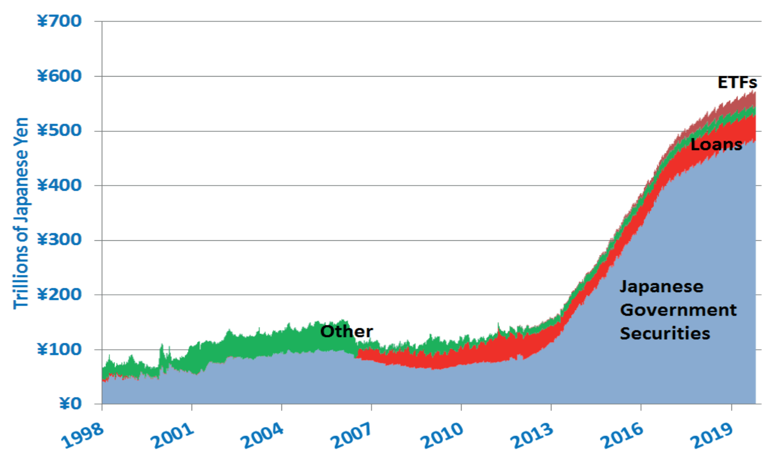
As an aside, we note that the US Treasury market has been influenced in no small way by the massive asset-buying programs of the ECB and BoJ. The existence of trillions of dollars of negative-yielding debt in Europe and Japan exerts a powerful downward influence on US Treasury notes and bond yields. As German Government Bond 10-year yields have declined, investors have sought higher yields from the US Treasury market. As German yields declined, and brought US yields down, the spread of US 10-Year Treasury Note yields relative to German Government 10-year Bonds (Bunds) has traded in a relatively narrow range in the territory of 2.20% or a little more since negative-yielding debt started piling up in Europe.

**Figure 3: European Central Bank Assets**




Source: Chart Created by CME Group Economics
European Central Bank Monthly Bulletins, obtained through the Bloomberg Professional

**Figure 4: Bank of Japan Assets**

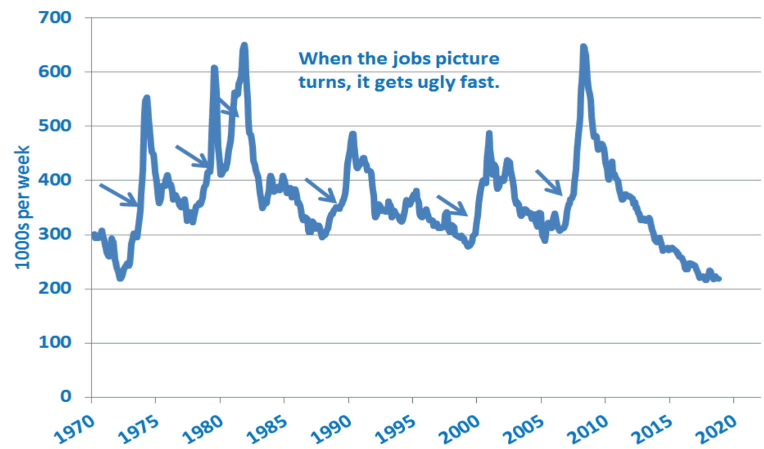



Source: Chart Created by CME Group Economics -Bloomberg Professional

> *"WE NOTE THAT THE US TREASURY MARKET HAS BEEN INFLUENCED IN NO SMALL WAY BY THE MASSIVE ASSET-BUYING PROGRAMS OF THE ECB AND BOJ."*

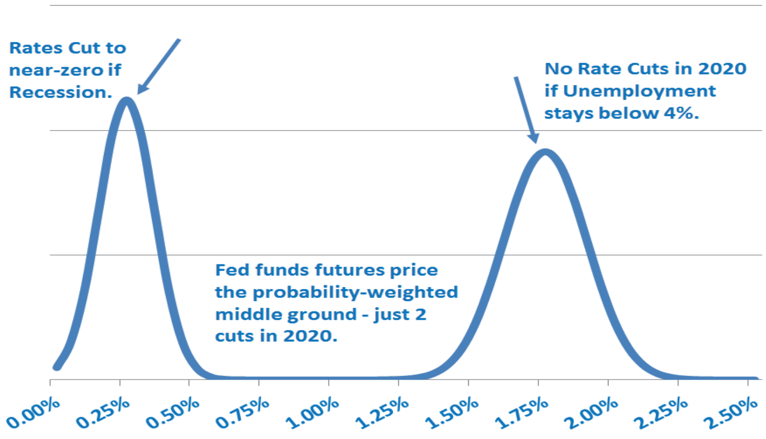
> ## “THE TRIGGER FOR A CHANGE IN FED POLICY WOULD MOST LIKELY BE A RISING UNEMPLOYMENT RATE.”

**Figure 5: New Unemployment Claims 3-Month Moving Average**




Source: Chart Created by CME Group Economics -Bloomberg Professional (INJCJC)

**Figure 6: Conflicted Probability Distribution for where the Federal Funds Rate will end 2020**




Source: Chart Created by CME Group Economics

### THE FED'S POSSIBLE RESPONSE TO A RECESSION

With this background on negative rates and negative yielding debt, it is now time to turn our attention to the Fed and what it might do if a recession developed. Would the US Fed follow the ECB and BoJ into negative rates for overnight deposits held at the central bank? Not likely.

The trigger for a change in Fed policy would most likely be a rising unemployment rate. The unemployment rate ended Q3/2018 comfortably below 4%, at 50-year lows. If, for whatever reasons, the unemployment rate started to climb above 4% and appeared headed higher, we think the Fed would move abruptly to cut rates to 0% to 0.25% in just one or two big moves, and the Fed would also probably re-start its buying program of long-dated US Treasury notes and bonds. As most economists know and the Fed appreciates, once the job market turns in a negative direction, the recession has already started and the job losses come thick and fast. Unlike the slow grind of rates on the way up as an economy recovers from a recession and starts to expand again, when an economy enters a recession, the Fed typically moves quickly. Although, one of the challenges is that by the time the labor market is in turmoil, the economy is already 3-6 months into the recession.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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.**

> “THE END OF THE AUSTRALIAN HARVEST IS APPROACHING AND WILL LIKELY RESULT IN A 10% DROP ON PRODUCTION GIVEN THE LOWER RAINFALL, PERHAPS CLOSE TO 4,1 MLN M/T.”

# THE BITTER SIDE OF SUGAR, BUT CONSUMERS ARE NOT COMPLAINING!

## The price for Sugar in the World Market (export/import market) has been trading on average at UScts/lb 12,25 in the past 10 months, which is just slightly better than the average of UScts/lb 12,18 in 2018 and much lower than UScts/lb 15,56 in 2017 and UScts/lb 18,42 seen in 2016.

**World production vs. demand is expected to yield a deficit of 5 mln m/t R.V. (which is up from 4 mln m/t deficit estimated in Aug) as many large producers are or will be producing less than earlier estimates.**

With Thailand, Australia and the EU experiencing less than ideal weather, production will be down in comparison to last year. Current Sugar prices have also caused poorer cane and beet husbandry as well as a reduction in acreage for some producers including India, Pakistan, Thailand, and the EU.

So, with a deficit year, one would expect Sugar prices to recover - and perhaps they will. However we still need to deal with Sugar stocks being released into the World Market, these are mainly coming from India with some volumes also from Thailand and Mexico.

**The Indian Government** have decided to help Cane Farmers (+/- US$ 147 per m/t) for the second year, by helping Sugar Millers export 6 mln m/t of their stocks at the current depressed World Market prices. The intended exports will reduce the pressure on the domestic market and allow Sugar Millers to pay the agreed cane prices (+/- US$ 41 per m/t). This will also improve the value of Sugar Refineries especially the ones listed at their Stock Market value.

The Indian domestic market has been trading around INR 3167 per 100kg (around US$ 464 per m/t) this year and is worth around INR 3303 per 100kg (U$ 479 per m/t) allowing Millers to clear 11/13% margins, which is not great. So, based on the current Indian Government incentives and the domestic market, the breakeven would be around US$ 330/335 per m/t fob which is not far from where the World Market (white sugar) is currently.

The harvest is about 4 weeks away and the crop is expected to be lower however estimates are still quite wide ranging from 27,5 to 29 mln m/t, which is still higher than domestic needs at 26 mln m/t. So, Indian export policy is not facilitating the World Market to reflect the 18/19 deficit as Indian exports are making up the difference at 'attractive prices'. It seems the Sugar World Market prices are not going after the Indian stocks but it appears that Indian stocks are going after the World Market demand.

**Sugar production in Brazil** will once again be on the lower side, given that Ethanol prices return better than Sugar. The cane crop may be marginally better than last year and the Sugar mix marginally lower, therefore we are heading for a crop similar to last year around 26 mln m/t.

Ethanol prices in Brazil are still rising i.e. 4% in October after a 4% rise in September. As the Real improves after the Pension Reform approval, Ethanol prices are 7% higher equivalent to UScts/lb 14,36 for Hydrous and Uscts/lb 16,08 tell quell for Anhydrous. Ethanol prices have been stronger than Sugar since August 2017 and the average price in 2019, after the start of the harvest in April, has been UScts/lb 13,85, which is about 13% higher than Sugar.

**The Thai harvest** which is about 6/8 weeks ahead is expected to end lower given the poor rainfall throughout the year, lower cane prices (poor husbandry) and reduced acreage. Cane estimates range from 111 to 115 mln m/t of cane (some expect 120 mln) vs 131 mln m/t of the last crop.

The EU crop is also expected to disappoint given the lower acreage (+/- 5% lower) despite a modest improvement on Agri yields (+/- 5% higher) so total sugar production may end under 17,5 mln m/t leading to strong imports and still lower exports, likely less than 1,8 mln m/t. The EU current sugar stocks are similar to last year, about 2 months of sugar demand.

**The end of the Australian harvest** is approaching and will likely result in a 10% drop on production given the lower rainfall, perhaps close to 4,1 mln m/t.

We are seeing higher production in **Russia**, perhaps close to 6,8 mln m/t, which is putting pressure on the domestic market and we may see higher exports in the coming months, perhaps beyond the usual CIS markets.

We can see that lower Sugar prices in the past 2 years and weather are leading to lower Sugar production, a drop of 7 mln m/t YoY, and given that Sugar consumption is 1,8 mln m/t higher, **we are heading to a deficit of 5 mln m/t vs a 4 mln m/t surplus the year before.**

What may happen beyond April 2020 is yet to be determined, as based on prices, acreage and assuming reasonable weather, we may have another deficit year. We do, of course, have time to erase that possibility giving the ability for Brazil to switch back to Sugar from Ethanol, however prices need to improve.

On a different note, it is also good to highlight the 'desire' the Funds had to position themselves short in Sugar since May 2017.

Looking back to 2015, Sugar prices were falling and reached an average of UScts/lb 11,56 during Q3 2015 just ahead of the Brazilian Sugar Dinner. The average net short position of Funds was 65k lots during July 2014/Sept 2015.

At that time (due to lower prices and weather) there was talk of a possible large deficit and Funds started covering shorts and going long. Well, we know what happened, by Oct 2016 during the Sugar Dinner in London, prices had already reached UScts/lb 23,00 cts (the high for the year and the highest price since). The Funds net position was 164k lots net long during Oct 15 to April 17.

The current net average position is 108k lots short since May 2017 and the current net short is at 186k lots. Just food for thought!

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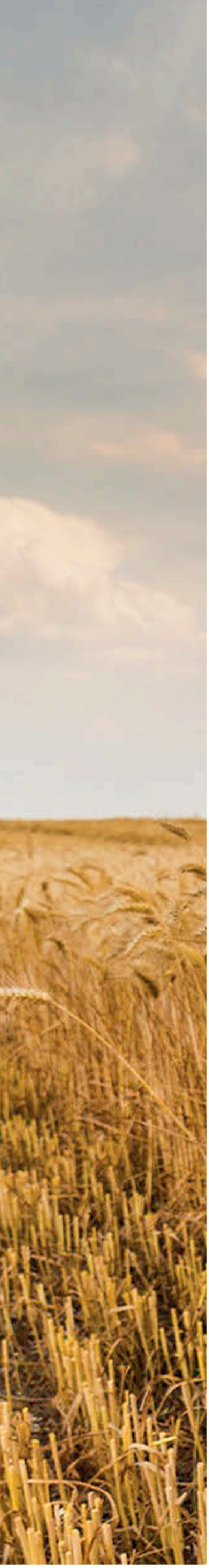


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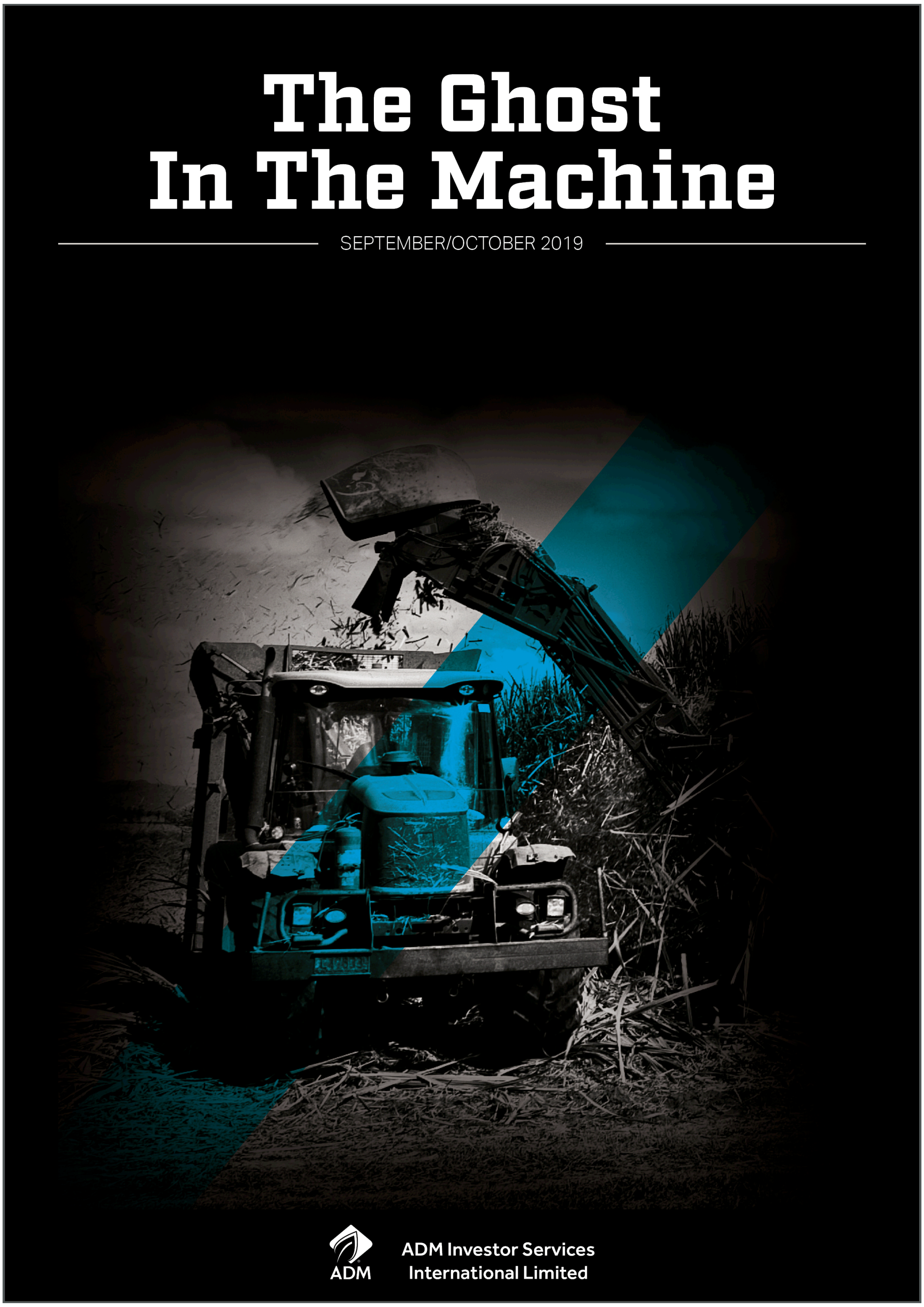


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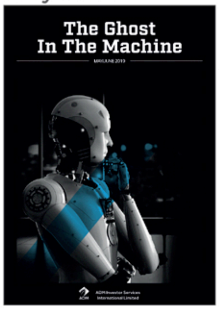


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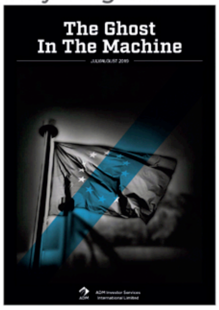


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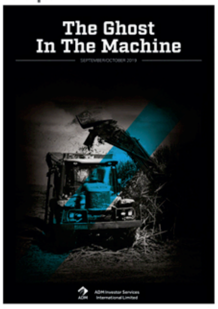


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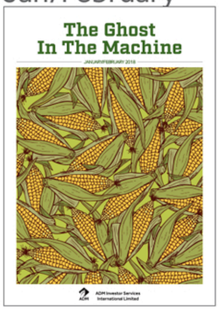


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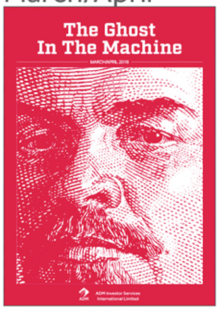


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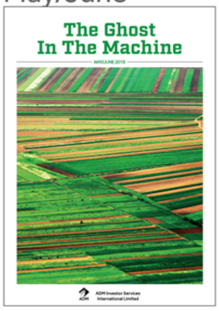


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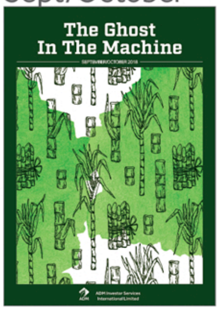


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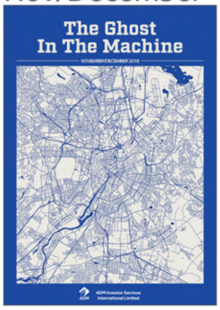


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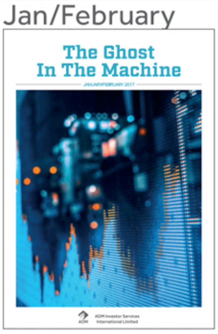


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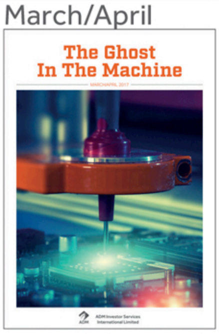


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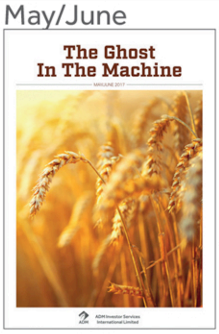


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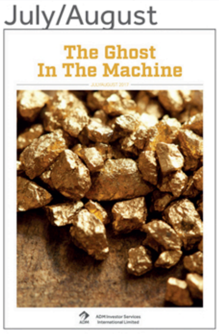


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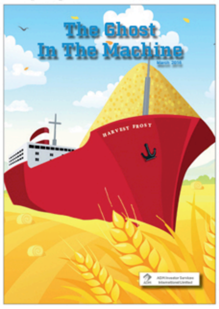


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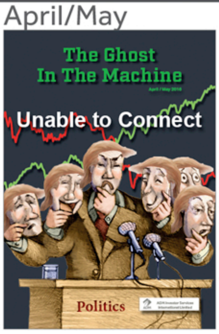


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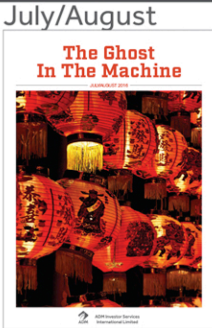


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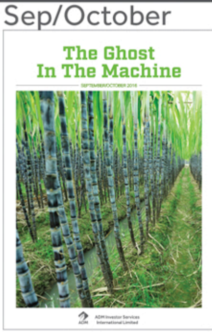


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# The Ghost In The Machine

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