

July 31, 2014

“There is a tide in the affairs of men, when taken at the flood leads on to fortune... We must take the current when it serves, or lose our ventures.”
 — **William Shakespeare**

There is a “forced sale” going on in principal risk trading businesses. Banks and other traditional traders are rapidly exiting and selling entire business lines even though trading volumes are growing. The combination of new regulations, oversight and technology are drastically disrupting the landscape.

Pressure from the government and regulators is increasing. A recent Reuters article described banks as being in the “Senate’s crosshairs” and the results of a two year investigation are expected out of Washington imminently¹. Banks want out of the firing line as soon as possible.

Headline after headline confirm the ongoing saga:

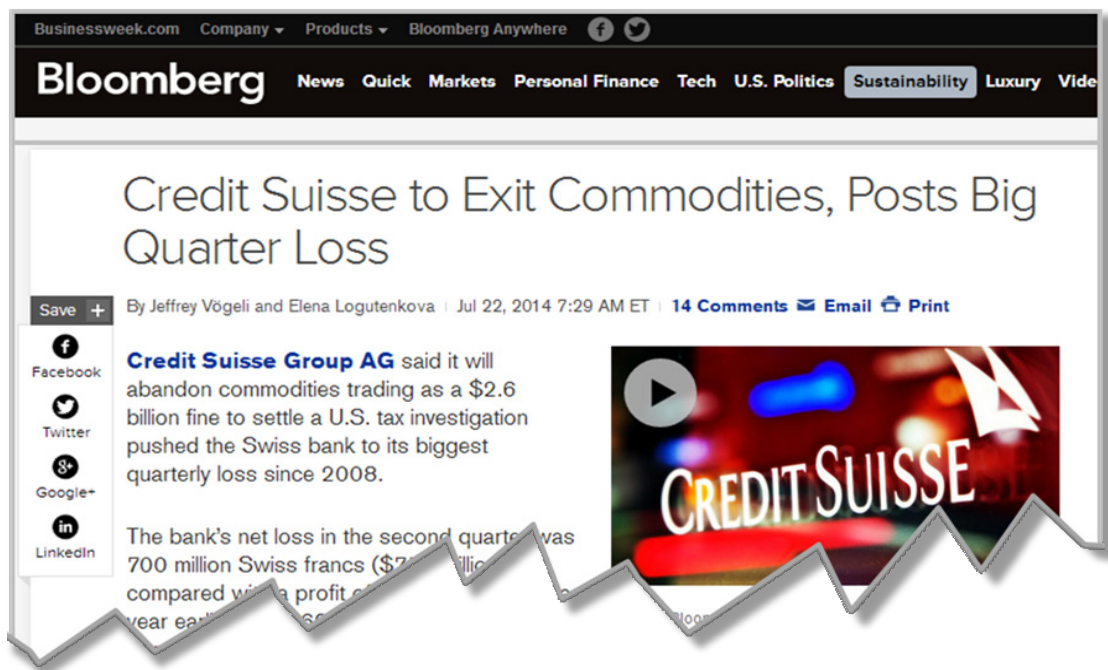


Figure 1: Source - Bloomberg News article clipping²

¹ <http://www.reuters.com/article/2014/08/08/us-usa-commodities-levin-exclusive-idUSKBN0G80EK20140808>

² <http://www.bloomberg.com/news/2014-07-22/credit-suisse-posts-biggest-loss-since-2008-after-u-s-fine.html>

Global investment banks are pulling back from commodities trading as regulations tighten and revenue slides. Deutsche Bank AG said in December that it would exit dedicated energy, agriculture, dry bulk and base metals trading. Barclays Plc said in April it would withdraw from most of its commodities activities. JP Morgan Chase & Co. agreed to sell its physical commodities unit...

Figure 2: Source - Bloomberg News article clipping³

The bank exodus from commodities markets is a topic we have covered and it continues to be relevant across the industry.⁴ While most of the articles point to regulation, conflicts of interest, and higher capital requirements, another theme is developing beneath the surface.

Without the banks and other traditional players, one might expect liquidity and volumes in futures and options markets to dry up. On the contrary, they are *increasing*. Hedgers want to avoid bank counterparty risk, opaque pricing and decentralized clearing that comes with trading over-the-counter with banks. Their preference has shifted to listed products and their appetite is growing.

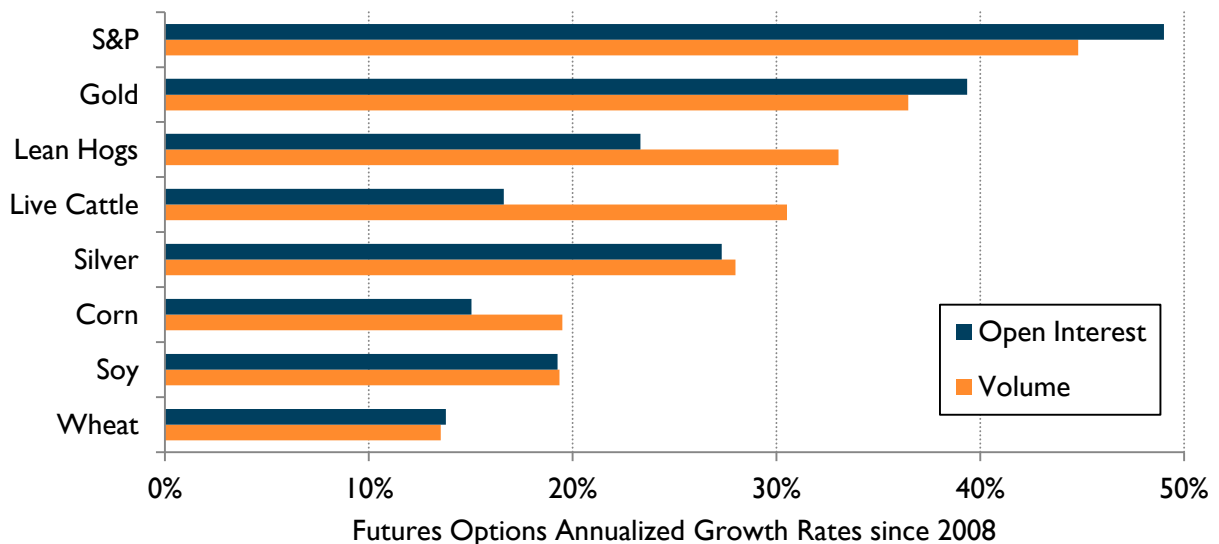


Figure 3: Futures options annualized growth rates since 2008. Data obtained from CME Group.

³ <http://www.bloomberg.com/news/2014-07-22/credit-suisse-posts-biggest-loss-since-2008-after-u-s-fine.html>

⁴ "Banks are exiting commodities" – Lake Hill Capital Management Research and Press http://lakehillgroup.com/files/Lake_Hill_Capital_Management_January_2014_blog.pdf

In addition, the percentage of volume traded electronically is exploding across the board. These numbers are on the rise since exchanges introduced electronic access, and the process of converting from manual open outcry trading pits to electronic marketplaces continues to accelerate.

For instance, less than 10% of WTI crude oil options traded electronically on the CME in 2009. This year, the proportion traded electronically has been consistently more than 50%. This trend is observable across commodities, equities, FX and rates and is not a coincidence.

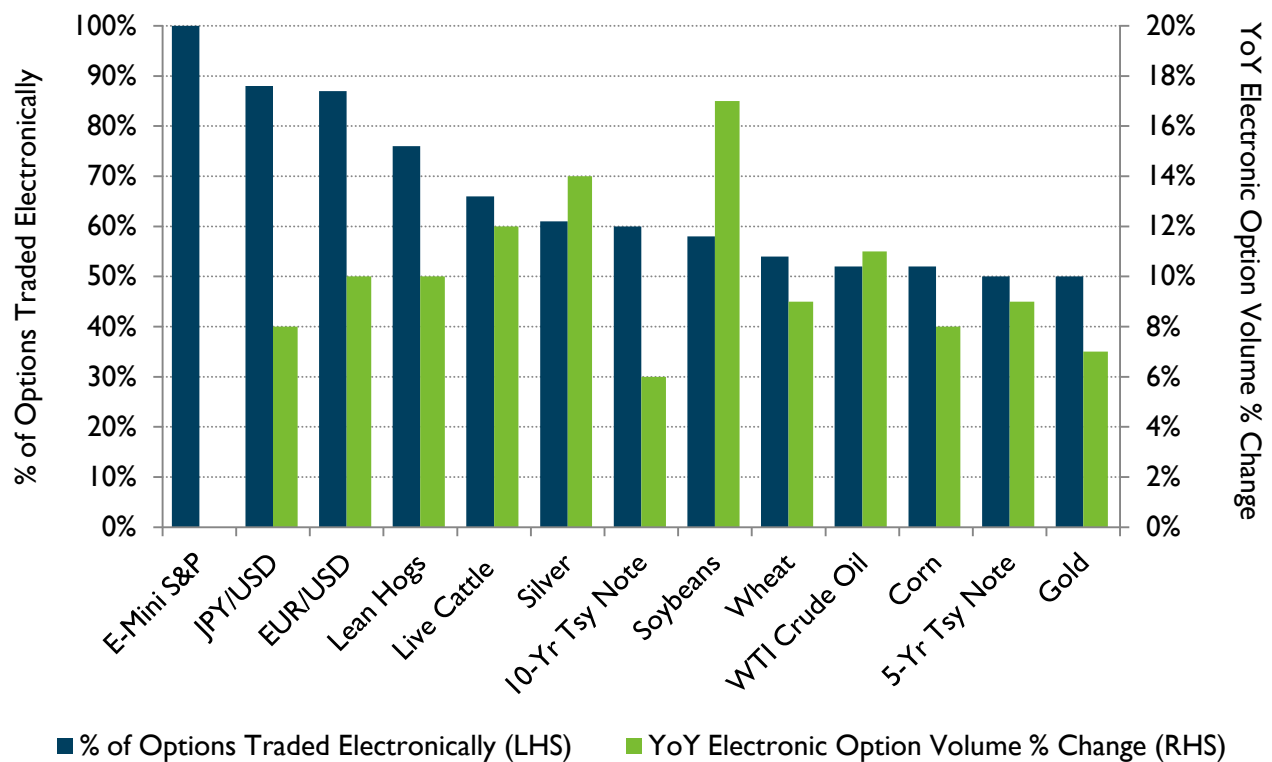


Figure 4: Data compiled from CME Group Electronic Options Spotlight⁵

The supply side is down: Banks and traditional players are leaving the industry and no longer providing liquidity to hedgers.

The demand side is up: Volumes in listed hedging products are growing and electronic trading has become the lion’s share of the volume.

Who is profiting from these shifts in supply and demand? Answer: Specialized trading companies

⁵ <http://www.cmegroup.com/education/files/electronic-options-spotlight-2014-q2.pdf>

Private investment companies are picking up the slack. These include some hedge funds, proprietary trading firms and technology-focused trading groups. Electronic capability has leveled the playing field, allowing hedgers and speculators to access liquidity providers directly via exchange-traded products. Hedgers and speculators are trading more but much less with banks.

The traditional players are out of the loop and the new landscape has created tremendous opportunity.

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