The Ghost In The Machine

May 2015

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‘The Ghost in the Machine’ Editorial Team

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Editor's Note
May 2015

Editor's Note

Welcome to the May launch edition of
The Ghost in the Machine

The British philosopher, Gilbert Ryle, coined the phrase 'ghost in the machine' in 1949. The doctrine being a critique of the notion that the mind is distinct from the body. He opined that the body and mind are harnessed together but after the death of the body, the mind may continue to exist and function. Looking at the average age of some of the contributing authorship, we are hoping this is correct!

Perhaps the urban dictionary's definition is more accurate to explain this journal's title: "When software or hardware is made to complete a specific function but a small percentage of the tasks completed have an unexpected result….which cannot be explained." Our job is to disprove the last premise.

At ADMISI, we are very fortunate to have a wealth of experienced and enlightening personnel, across many different asset classes, obviously specialising principally in global commodities. We are also blessed with our highly respected economic and macro strategy team. It is a company of fascinating individuals with a truly global reach. Our own 'Ghost in the Machine' will attempt to bring some of their views and stories to the readership on a monthly basis. We are hoping you will find it not only entertaining but thought provoking.

In this issue we have invited some external friends to share their views as well (and are keen to welcome more of you in future). We are very thankful to them. Hopefully, it is anthology of not only economics and market chat but some gripes and discussions on the changing face of dealing conditions and the difficulties facing us all.

It is our belief that financial analysis should not be dull. It should be interesting, entertaining and principally thought provoking. We will strive to achieve those aims.

Welcome to the first edition of 'The Ghost in the Machine'.

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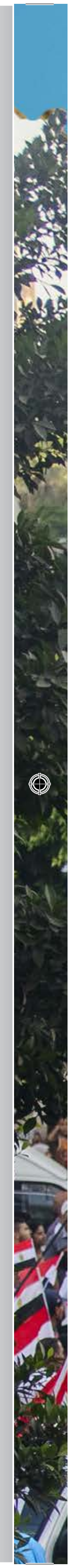

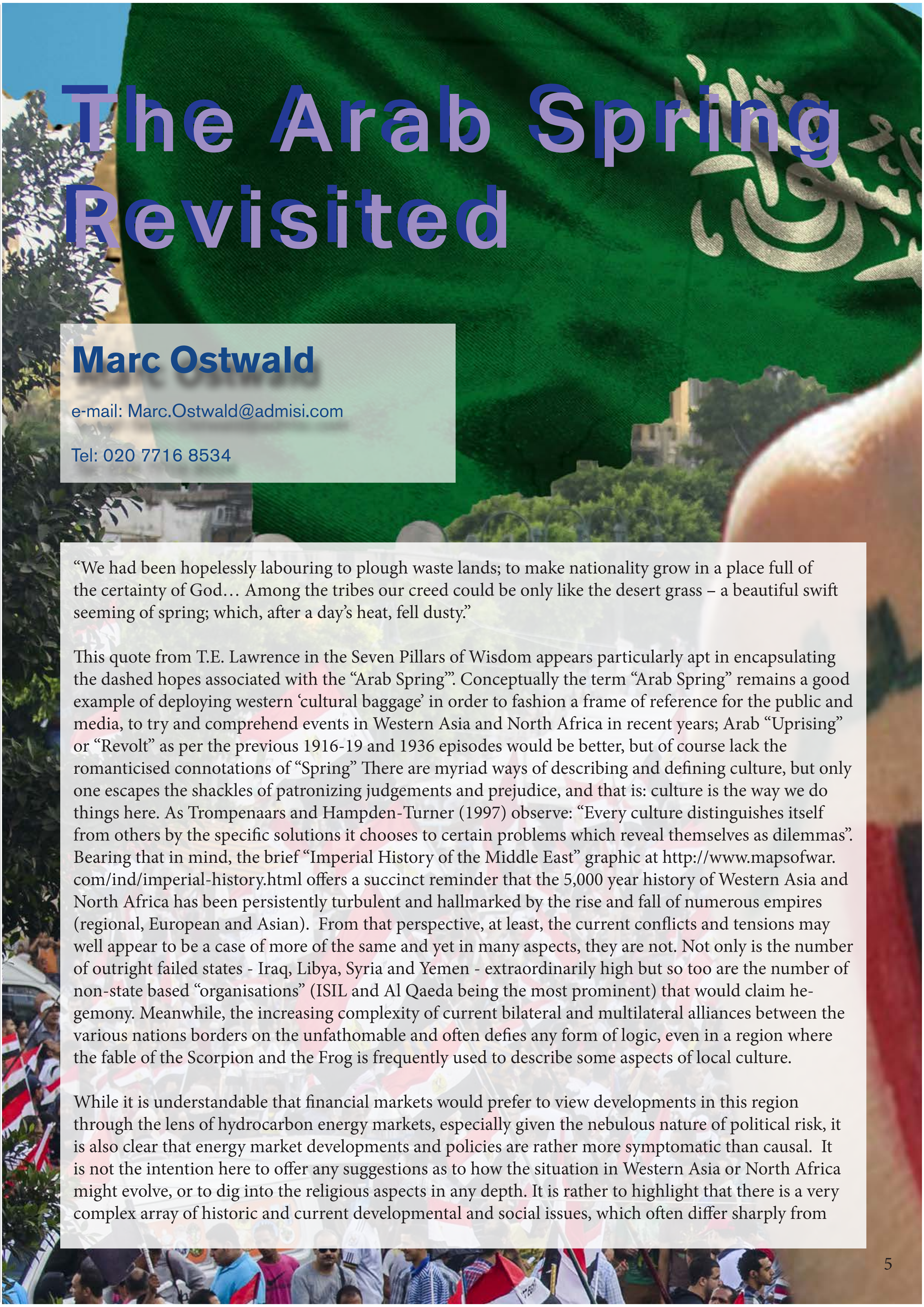

The Arab Spring Revisited

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"We had been hopelessly labouring to plough waste lands; to make nationality grow in a place full of the certainty of God… Among the tribes our creed could be only like the desert grass – a beautiful swift seeming of spring; which, after a day's heat, fell dusty."

This quote from T.E. Lawrence in the Seven Pillars of Wisdom appears particularly apt in encapsulating the dashed hopes associated with the "Arab Spring"'. Conceptually the term "Arab Spring" remains a good example of deploying western 'cultural baggage' in order to fashion a frame of reference for the public and media, to try and comprehend events in Western Asia and North Africa in recent years; Arab "Uprising" or "Revolt" as per the previous 1916-19 and 1936 episodes would be better, but of course lack the romanticised connotations of "Spring" There are myriad ways of describing and defining culture, but only one escapes the shackles of patronizing judgements and prejudice, and that is: culture is the way we do things here. As Trompenaars and Hampden-Turner (1997) observe: "Every culture distinguishes itself from others by the specific solutions it chooses to certain problems which reveal themselves as dilemmas". Bearing that in mind, the brief "Imperial History of the Middle East" graphic at http://www.mapsofwar.com/ind/imperial-history.html offers a succinct reminder that the 5,000 year history of Western Asia and North Africa has been persistently turbulent and hallmarked by the rise and fall of numerous empires (regional, European and Asian). From that perspective, at least, the current conflicts and tensions may well appear to be a case of more of the same and yet in many aspects, they are not. Not only is the number of outright failed states - Iraq, Libya, Syria and Yemen - extraordinarily high but so too are the number of non-state based "organisations" (ISIL and Al Qaeda being the most prominent) that would claim hegemony. Meanwhile, the increasing complexity of current bilateral and multilateral alliances between the various nations borders on the unfathomable and often defies any form of logic, even in a region where the fable of the Scorpion and the Frog is frequently used to describe some aspects of local culture.

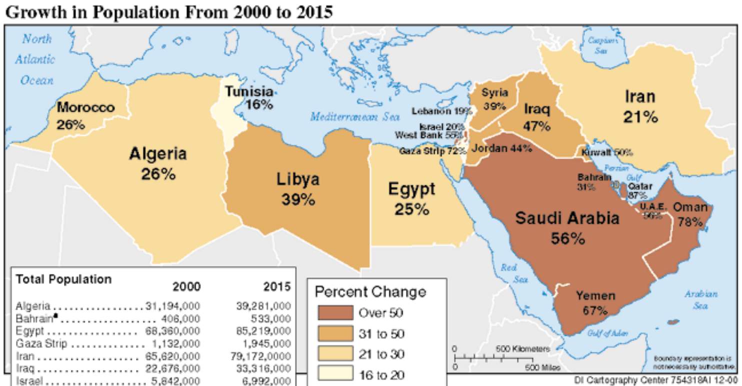
While it is understandable that financial markets would prefer to view developments in this region through the lens of hydrocarbon energy markets, especially given the nebulous nature of political risk, it is also clear that energy market developments and policies are rather more symptomatic than causal. It is not the intention here to offer any suggestions as to how the situation in Western Asia or North Africa might evolve, or to dig into the religious aspects in any depth. It is rather to highlight that there is a very complex array of historic and current developmental and social issues, which often differ sharply from country to country but which also will dictate the extent to which these regimes will survive in the longer run, and by extension informs many of the policy decisions. The evolution of energy and food prices has and will at times play a very significant role.

However, in the first instance, it is important to consider a critical difference in the evolution of nation states in the region. In contrast to European nations, where the various tribes evolved over more than a thousand years into nations with common cultural, linguistic, religious and geographic characteristics and via a long succession of wars, before they became "political" states, much of the post-colonial Arab speaking world was organised into states (primarily by Britain and France with the assent of Russia), which were expected to evolve into nations. Unfortunately the ensuing history highlights incessant and often very inconsistent interventions not only by the US, the EU, Russia/USSR and China but also many of the regional actors, above all Iran, Saudi Arabia, Turkey and latterly Qatar. There is some irony in the fact that, outside of Bahrain (which has perennially been a focal point for proxy confrontations between Iran and Saudi Arabia), it has been the republics which were established by military elites steeped in anti-colonialism, who also espoused so-called "Arab socialism" (Egypt, Iraq, Libya, Syria and South Yemen) in the post-World War II era, which have seen the most turmoil since the demise of the USSR. This is testament both to the usual failings when socialist central planning falls victim to corruption and to the post-Soviet collapse in so-called mutual support systems. The long running tensions between this group and what has been termed the "colonial assimilators", whom they had overthrown, did not help. By contrast the monarchies in the region have fared rather better, with little in the way of unrest, perhaps suggesting a greater 'ability' to both suppress and 'buy off' popular resistance. It can certainly be argued that rather shallow economic reforms (above all post 1990) were adopted in much of the Arab world, which benefited a select few (generally closely associated with the political elites). Deeper reforms that diversified economies into new industries, which tend to create more, better skilled and generally better paid employment, were neglected. This, allied with a hefty flow of foreign direct investment into Central & Eastern Europe, while FDI into the region was negligible, helped to sow some of the seeds of discontent and frustration at growing social inequality.

The framing of the western discourse about the "Arab Spring" in terms of a popular desire for greater political freedom and liberal market reforms is also incorrect. It was rather more a case of prolonged economic mismanagement and its consequent economic misery, combined with a desire for greater commercial freedom and a more equitable social development, which served temporarily to unify otherwise very disparate tribal, religious and indeed ideological forces to overthrow incumbent political regimes. But far from providing the catalyst towards establishing some form of political nation-state in the various countries, the divergent tribal, ideological and religious forces merely reasserted themselves, with the vacuum left by the dismantling of some or all of the law and order apparatuses of previous regimes, allowing in some cases the already burgeoning forces of "political Islam" to gain even greater traction. It also has to be observed that in contrast to central and eastern Europe, where the West had actively sought regime change, there was perceived to be little benefit in facilitating such change in many Arab countries, on the basis that regimes were deemed to be "friendly" to their so-called "interests". History suggests that democracy is rather less necessary in the formation of cohesive nation-states and rather more the will to establish a consensus which recognises the need to establish a social contract between government and citizens, which can then be maintained by stable institutions (military, legal/court and general public administration) to ensure the principles of the social contract between the various tribal, ideological and religious interests are upheld. Given the economic and social complexities of the region, this will be a very long drawn out process, fraught with turmoil. This gargantuan initial task faces even greater challenges ahead, above all in terms of addressing demographic trends and the attendant developmental socio-economic needs.

The array of challenges is so immense, complex and disparate that we can only scratch the surface here but demographics make a good starting point. In contrast to every other region of the world except Africa, population growth in the Western Asia and North Africa region has been very rapid at 32%, as the country chart below highlights (N.B. the GCC data are exaggerated in percentage terms as they exclude non-citizens). While population growth is expected to ebb in coming decades, a yawning socio-economic gap has already opened up in in terms of youth unemployment, as the right hand chart below highlights. The dangers of long-term youth

Growth in Population From 2000 to 2015



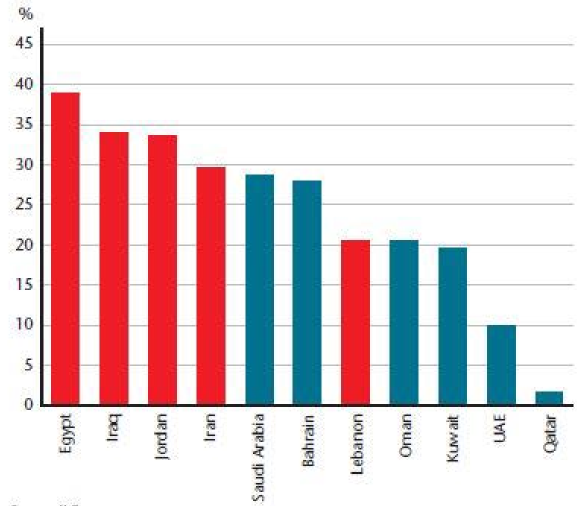
Total Population	2000	2015
Algeria	31,194,000	39,281,000
Bahrain[a]	406,000	533,000
Egypt	68,360,000	85,219,000
Gaza Strip	1,132,000	1,945,000
Iran	65,620,000	79,172,0000
Iraq	22,676,000	33,316,000
Israel	5,842,000	6,992,000
Jordan	4,999,000	7,199,000
Kuwait[a]	814,000	1,218,000
Lebanon	3,578,000	4,252,000
Libya	5,115,000	7,115,000
Morocco	30,122,000	37,832,000
Oman[a]	1,961,000	3,507,000
Qatar[a]	168,000	314,000
Saudi Arabia[a]	15,879,000	24,789,000
Syria	16,304,000	22,697,000
Tunisia	9,593,000	11,174,000
United Arab Emirates[a]	793,000	1,237,000
West Bank	2,020,000	3,128,000
Yemen	17,479,000	29,165,000
Total for Middle East	**304,055,000**	**400,085,000**

Percent Change
- Over 50
- 31 to 50
- 21 to 30
- 16 to 20

Total growth for the Middle East is 32 percent.

[a]Population numbers for the Gulf Cooperation Council (GCC) states exclude the noncitizen population.
Source: US Bureau of the Census.

Figure 2: Youth unemployment rate (% of labour force aged 15-24), 2013



Source: ILO

unemployment are well documented in terms of the resultant detachment from the labour force and erosion of skills, and are all the more acute given the rise of the extremist sections of political Islam, and its potential 'siren call' to the socially disaffected.

While this problem is clearly more acute in the non-GCC countries, the proper distinction seems to be more between higher population countries and the smaller countries, where oil revenues and by extension GDP and National Savings per citizen (i.e. excluding migrant workers) are much higher. One only has to contrast the extraordinarily high rates of (2013) National Savings as a % of GDP in Qatar 59%, Kuwait 55.2%, with a still very high 47.6% in Saudi Arabia as against a much lower 30% in Iraq, 20% in Egypt and 18% in Jordan. But even with such huge savings and oil wealth, and as but one example, Saudi Arabia still has a youth unemployment rate of 29%, despite having a female labour force participation rate of just 20% (Iraq and Jordan are in fact lower at 16% and 18%, but the UAE rate stands at 47%). Unsurprisingly, the key is how high National Savings are deployed in spending terms, above all how it is or is not used to foster private sector non-energy investment, or less usefully in public sector administration. For a country such as the UAE with a small indigenous population, the fact that 61% of employed UAE citizens work in the public administration or defence sectors is unsurprising, but the fact that 37% of Saudi citizens work in these sectors hints strongly at an outsized public sector crowding out private sector job creation.

Per se, and as part of the processes of establishing that social contract between government and citizens, there also needs to be a focus on economic diversification into the non-oil sector. High National Savings rates will need to find a balance between improving public services, such as health and education, and transport to improve basic living standards, It will need to increase commercial freedom, and thus boost private sector opportunities and employment, which should feed through into higher wage growth. This should also allow a reduction of very costly public sector subsidies for food and energy, above all in countries such as Egypt. In turn, this will also diversify and in theory at least improve the fiscal base, above all with a long-term focus on decreasing dependency on hydrocarbon revenues.

Economics & Politics

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CENTRAL BANKS HOLD THE KEY

Global investors appear less anxious now at the prospect of US Federal Reserve rate rises in the months ahead than they were two years ago after Mr Bernanke had intimated the US central bank might phase out its QE bond-buying. Then, the so-called 'taper tantrum' saw a sharp fall in the S&P 500 index and marked weakness in the currencies of some emerging economies. To be sure, in recent months there have been moments when pieces of news seeming to raise the chances of an early hike in US rates have prompted a downtick in prices of risk assets. But these occasions have not changed underlying trends; market sentiment has remained positive. Why should this be?

Investors may not be wholly convinced the Fed will raise rates any time soon. Though the minutes of last month's FOMC meeting record that 'several members' believed rate rises should begin in June, two of them thought the FOMC should wait until 2016 before initiating rate increases. All the same, given this is the split in opinion on the committee, it seems unlikely the Fed will delay a rate increase until December, as the money market currently discounts, unless weaker data change the views of FOMC members. There are no compelling reasons, however, to expect the data to be so weak as to lead the FOMC to draw back from raising the funds rate target at some point in the next six months. The March non-farm payrolls figures revealed only a small increase in jobs but that could be readily attributed to temporary factors. Meanwhile, core inflation is edging higher. If, as seems likely, job growth rebounds in the April payrolls report, financial markets could well have to face up to the possibility that a Fed rate rise might be only weeks away.

Perhaps, though, investors believe a rise in US rates would be less damaging to market prospects than the 'tapering' of Fed bond-buying might have appeared. For one thing, a rate move would signify that the US economic upswing was further advanced and maybe more firmly established than it was when the Fed was tentatively cutting back its bond purchases. Accordingly, the risk that a tightening in monetary policy might seriously damage economic prospects could seem to be less than in 2013, when the Fed started to 'taper' QE.

It is also possible that investors do not see higher short-term interest rates as presenting as serious a threat to capital market values as a shift towards restraint in a major central bank's quantitative support. The Fed's QE worked primarily by making more funds available to investors to deploy in buying risk assets. The prices of such assets were bid up to levels above, perhaps far above, where they would have otherwise stood on fundamental considerations. Less QE meant fewer buyers at the artificially elevated market levels and a prospective downward adjustment in asset prices to tempt in marginal buyers responding only to fundamentals. So it was fairly clear that the phasing out of QE carried serious negative implications for asset markets generally. It is less clear what the implications will be of a gradual rise in interest rates. Long-dated Treasury yields may be historically low but they are, nevertheless, well above the near-zero funds rate. If the funds rate were to begin rising, it might take an appreciable time before the yield-curve flattened to a degree that would make investors uncomfortable holding long-dated bonds. To the extent that the valuation of risk assets depends on comparisons with yields on supposedly risk-free government bonds, there might be little effect on the markets for risk assets from the early stages of a rate-hiking policy.

That at least is one theory in which investors might find comfort. But, in the real world, however vehemently central bankers might protest that rate hikes would be small and gradual, long yields would probably try to discount the end-point of the tightening cycle as soon as the first in the series of rate increases was implemented. Accordingly, a Fed move to raise the funds rate might trigger a significant rise in long-dated yields. At present levels, a rise in yields does not have to be very large to be significant in terms of the capital performance of asset markets. In such circumstances, there might be a substantial risk that market dynamics set up negative momentum in asset prices and maybe not a little structural damage to markets. But investors are probably not taking this risk fully on board because they do not believe the impact on risk markets of central bank policies will, in aggregate, be negative. The Fed may be tightening but the ECB and the Bank of Japan are still highly accommodative.

It is on the assumption that the ECB has taken up the baton of monetary accommodation from the Fed that investors are probably grounding their confidence that firm trends in risk markets will persist. The ECB hinted when it first presented its QE plan that the bond-buying programme's end-date of September 2016 was provisional. ECB policymakers subsequently indicated that the central bank would be prepared to do more if that were needed to meet its objective of restoring inflation to the targeted rate. Market participants have regarded the €1trillion of bond-buying consistent with the current schedule as the minimum support to expect from the ECB. It is important to note, therefore, remarks of Mr Mersch, now a member of the ECB's Executive Board, widely publicised in the European press. He did not say the ECB would do more if necessary. Indeed, he affirmed that the ECB could do less if it saw it was 'overdoing it'. He interpreted 'overdoing it' as reaching the ECB's economic objective faster than expected. But behind his comment may lie recognition that the

scale of the ECB's bond-buying pledge is impractical. If so, Mr Mersch may have been laying the foundations for an ECB defence, should it decide to buy fewer bonds than the market currently expects. It will point to the stronger economic growth and an end to the deflation threat, claiming a quick victory that eliminates the necessity for more QE. For global markets in risk assets, though, that could well splinter the last prop of monetary support. It could precipitate a jolting downward adjustment in the prices of high-risk assets.

Global Metals Comment

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Fourteen years ago the LME witnessed its first electronic trade on LME Select and it appears never to have looked back since! In February 2001, LME member firms signed up to use Select as a means to transact with each other but also, perhaps inadvertently, they signed up for a new future for metals trading. LME Select is the main venue for trading the LME's benchmark 3-month metals contracts. Clients now connect directly through a member, by-passing a voice broker for some of their executions (LME Select was originally closed to outside clients and was for LME members only), something that was possibly overlooked when members signed up. However, a perennial question has lingered ever since its launch; with the screen now a permanent fixture, is the City's famous 'LME ring' under threat of extinction? As it moves from its historic location at the centre of the Square Mile, we look at what the future holds for the LME and how the 'screen' is moving things on.

When compared to other futures exchanges around the world, there's no denying that the LME has been reluctant to move to a fully electronic offering. The complexity of the market, most notably the 'date structure', affords the LME some argument. However, despite some voices of dissent against the 'screen' from within the broking community, there exist strong arguments for its benefits. Electronic trading vastly improves the speed of price discovery as well as outright flat-price execution, Clients can connect their own proprietary systems which can observe markets independently and execute vastly greater volumes than any human can possibly hope to manage. The increase of speculative firms has driven a demand for direct market access and straight-through processing, limiting both manual order entry and reducing human input errors, further driving volumes higher.

On several occasions LME Select has been a proving ground for new contracts. However it is interesting to note that it is rarely the sole venue for such an enterprise. In the past, any new contract launch has been carried out in conjunction with the floor. The LME has made a number of interesting changes recently that are aimed at improving the chances for a successful 'monthly' LME contract. A number of market makers are presently making prices for small volumes on monthly contracts on LME Select. Trading monthly contracts, more akin to futures contracts on other exchanges, might seem fairly innocuous, however its potential is huge for the LME. A number of prior attempts to "future-ize" the LME market haven't been all that fruitful, mini contracts and an Asian mini are but a handful of notable failures.

Nevertheless, a successful monthly contract could dramatically increase the number of participants who trade the LME, especially those who have in the past been deterred by the complexity of the date structure. If it were to become successful, a monthly futures contract might well overtake the LME 3-month contract as the benchmark price. Indeed one might go so far as to say it would spell the end of the dominance of the 3 month contract and the date structure that underpins much of the business transacted on the floor and inter-office. Such a change would be hugely beneficial to new entrants and potentially to existing clients.

Nonetheless, it is important to recognise that as things evolve at the LME the significance of human interaction in this market remains, chiefly on the LME floor. The date by which its new Chinese owners were likely to change things has been and gone; the floor is still here and it is visited by thousands as a spectacle to witness all year round. Despite the closure of trading floors around the world, it appears it's not good to bet against the LME floor! It continues to add a dimension to trading that clients like, actively make use of and are prepared to continue to support.

Additionally, the benefits of electronic trading need not be argued: increased transparency, liquidity, anonymity and lower costs all aiding a market that has an ever-growing number of systematic and speculative trading houses. To all appearances it would seem then that the floor and LME Select are an unlikely partnership but their respective strengths continue to differentiate each to their end users – the clients – and it will be the clients that decide where this business goes. As the LME prepares to move for the fifth time in its 138-year history, it would seem naïve to forecast the demise of the 'floor' as it looks set to survive for some time to come, (maybe).

COFFEE in the MIX

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FILTERING THROUGH 2015

The coffee market entered into 2015 off the back off a story line that dominated the year before, Brazilian drought. At the beginning of 2014 the coffee market was trapped in a two and a half year bear market following the 2011/12 commodities boom. A comfortable supply and demand picture had led to the market becoming heavily oversold so when a genuine supply side issue formed in late January 2014 the market took off like (only coffee can), a rocket. The latter half of 2014 was a fight between fundamental bulls and bears as crop surveys split opinions throughout the trade and managed money sectors and lead to massive swings in supply and demand forecasts.

NY Arabica Coffee

The result was a coffee tug of war between 165clb and 210clb that only broke mid-February 2015. The cause of the break was a combination of fundamental news and the general macro sell off affecting commodities.

The fundamental news was no shock however, more steadily increasing rainfall that relieved soil moistures and slowly weighed down on the stubborn bulls in the market, who took so long to

NY Coffee in BRL

get out. The COT showed industry long cover at record highs so we can't only look at these managed money bulls as the only market participants from the long side continuing to increase throughout the year . Since mid-February the managed money net long reduced too and became a net short as the gross shorts outweighed a core long that remains almost index-like in its lack of movement. This swing pushed the market back to a 130clb/145clb range last seen in February 2014. The range has continued since the beginning of March and to be honest, seems likely to stay here with little fundamental news and a macro environment that seems to have stabilised. The final caveat to highlight of 2015 has been effect of the weakening Brazilian Real. Political uncertainty has weakened the currency and dollar denominated Brazilian exports have received a currency internal boost. This has helped weaken coffee and other commodities and is particularly visible looking at the chart below showing NY coffee prices in BRL. The chart shows much less of a dramatic decline compared to the outright.

Robusta comment

Well financed farmers in Vietnam, the biggest Robusta producer, have held their nerve in a balanced supply and demand market through 2015 so far and as differential widens, in a falling market, supply ahead of the Indonesian and India crops has thinned to an almost stand still and at present the ICE Robusta certified coffees look likely to see a new owner in the coming weeks. Unlike NY Arabica London Robusta hasn't quite had the daily rollercoaster journey in 2015 starting the year circa. $1900 and although we did see a push through $2000 origin, selling has never been too far away capping any major gains.

Through Q1 Robusta futures slipped lazily lower and although some fund support, adding to longs, kept values nearer the year's starting point, it was probably NY's weakness that eventually triggered a bout of long liquidation taking values lower, Arb N/N mid 55 area. Looking ahead there is still a belief of higher Robusta prices but with new crops on their way, we wonder whether the hope of a rally is more about sellers wanting higher prices than from a technical or fundamental stance.

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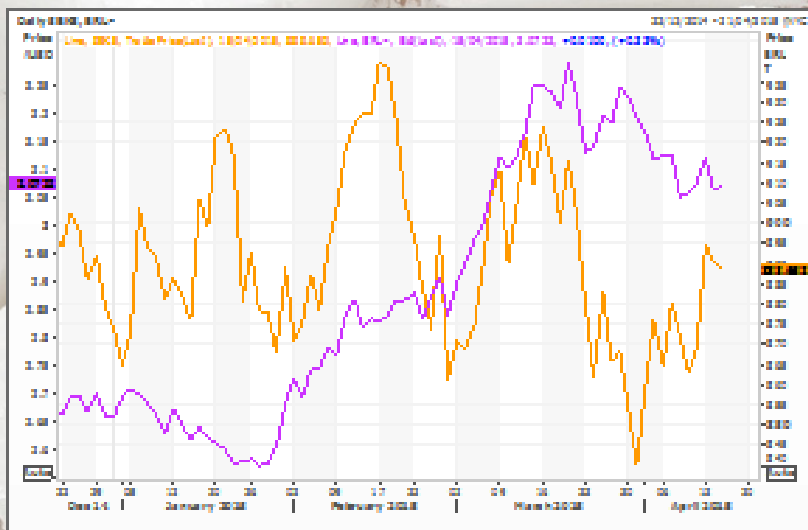
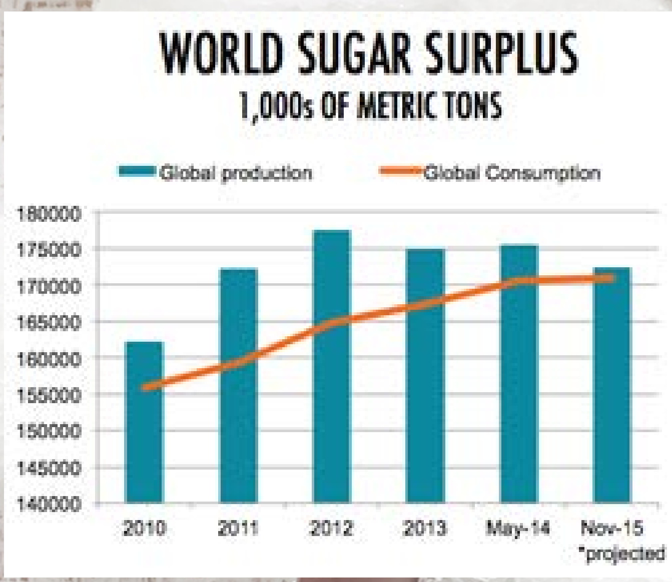
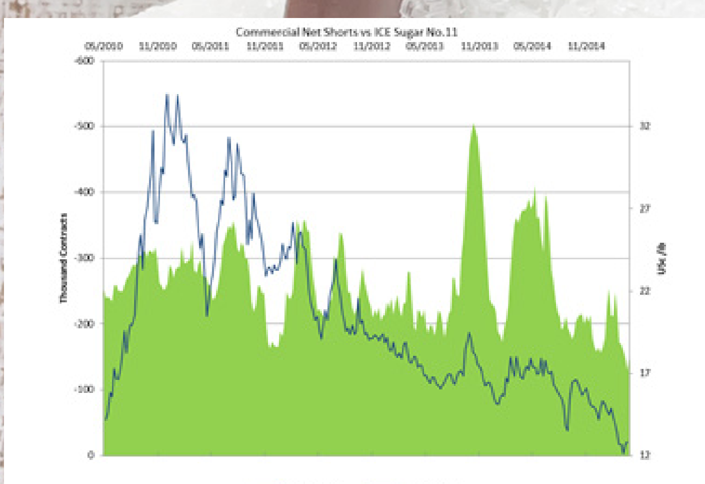
Bearish times for ICE raw sugar

According to the Supplemental COT report, as of the end of March, the funds held a record net short position of 121,692 lots. Their massive gross short position at 265,681 lots was also a record. What main reasons for the funds taking this view? Primarily, because the US dollar is strong (the Brazilian real is weak) which has encouraged the funds to build short positions in most of the US Dollar denominated contracts. The chart shows how raw sugar prices (in real) have improved as the real collapses against the US dollar.







Secondly, sugar fundamentals are resolutely bearish. 2014/15 is likely to see another season of a global production surplus – the Fifth in a row – albeit somewhat smaller than the previous four but still likely to be nearly two million tonnes.

The current commercials (trade) net short position is historically small at only around 130k. Previous 5 years, the average was closer to 295k. This can probably be explained by the historically low prices. Prices have not been under 12 cents since Jan 2009.

Consequently, end destination have priced commitments and probably taken a longer term view in fixing some cover further out than normal. The trade, generally, see prices as cheap and are reluctant to go short at current levels especially as the funds remain heavily short.

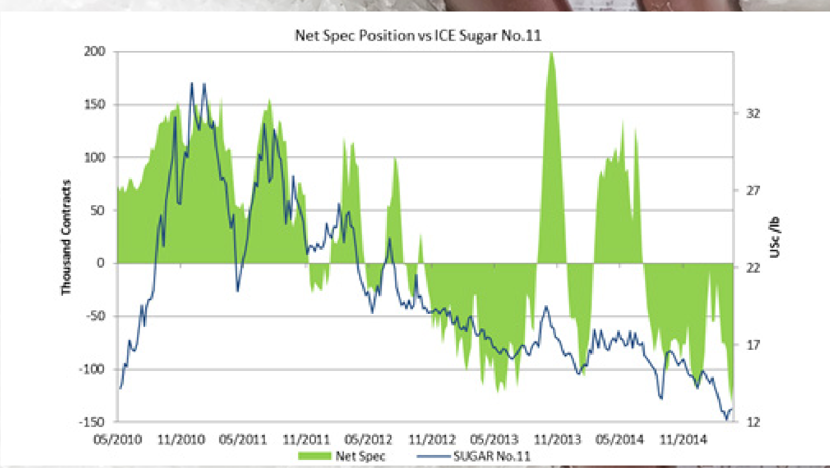
Finally, as is generally the case, with low prices producers are poorly priced. Trade sold in January as the Brazilian Real collapsed but have bought back as prices have dropped and Real has begun to stabilise a little.

The latest COT report showed the funds had cut their net shorts by less than 9k despite prices rallying nearly 100 points during the reporting period. With the May expiry looming attention has now

shifted to the July contract. Producers generally panic on time as oppose to price.
With all their May pricing done they have a two month period before next expiry, during which, they will be hoping for higher prices so will not be aggressively selling at current levels.

ICE NY No.11 SUGAR							
	Supplemental Futures & Options COT Report				Changes From Previous Week		NET SPEC POSITION
	Net Position	Wkly chng	Open Interest	% total Open Interest			non-commercial + non-reportable
Non Commercials					Longs	Shorts	
07/04/2015	-112820	8872	436367	38.23%	659	-8213	
31/03/2015	-121692	-14155	437995	39.47%			
Index Traders					Longs	Shorts	-110309
07/04/2015	263723	2231	148590	13.02%	1821	-410	
31/03/2015	261492	1739	147884	13.33%			
Commercials					Longs	Shorts	
07/04/2015	-153414	-24401	475759	41.69%	23896	48297	
31/03/2015	-129013	19114	439663	39.62%			
Non-Reportable					Longs	Shorts	22170
07/04/2015	2511	13298	80580	7.06%	3122	-10176	
31/03/2015	-10787	3220	84107	7.58%	Change In OI from	31/03/2015	31649
Total OI Futures & Options		1141296				1109647	

The funds remain heavily short so downside looks limited and they will be vulnerable to being forced to cover due to currency movements.



However, the bearish fundamentals continue to cast a dark shadow over the market. With Brazil's centre south region expected to produce around 2 million tonnes more sugar than last season (34 mln t) and current Thai stocks at record levels, current price levels are beginning to look a little high. So who will prevail? The technical or fundamental traders?

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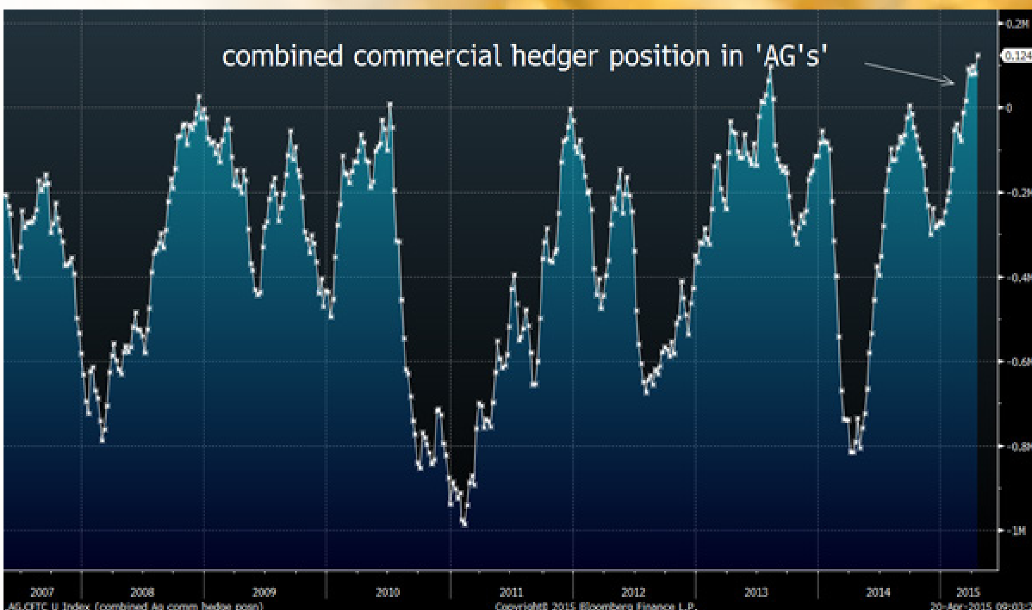
Longing for Wheat

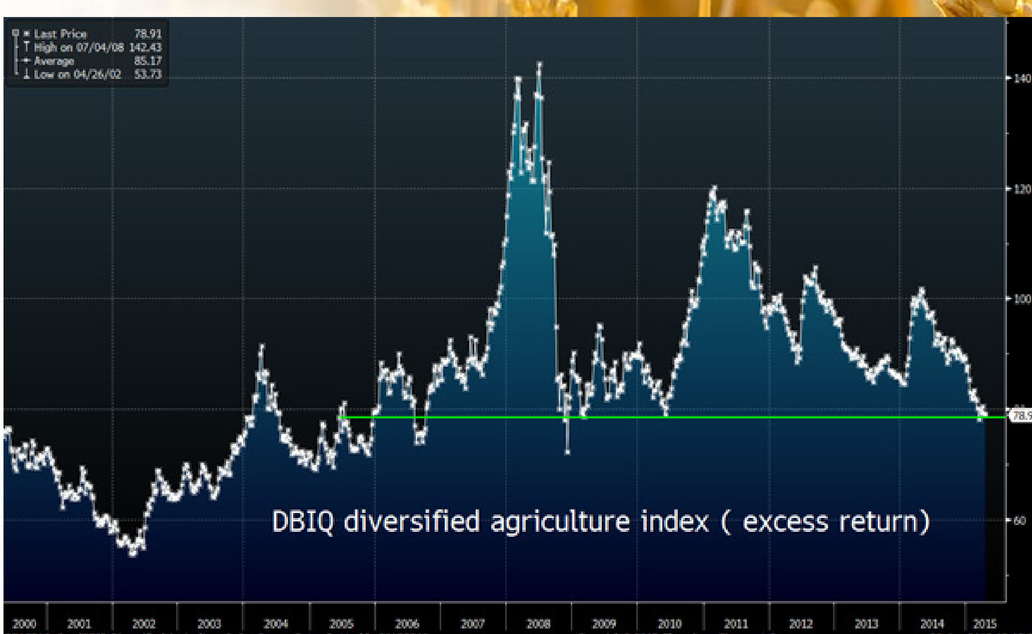
LOOKING AT THE SERIOUS MONEY

In the mocked up chart (right), I have included the commercial hedgers long position on most of the major agriculture products: Sugar , Coffee, Cocoa , Wheat , Corn , Soybeans , Hogs and Live Cattle. I haven't weighted them in any way ….just added them up!



There are mainly four interesting stats we can get from the CFTC data, broken down into speculative positioning, long and short (this is known as dumb money !) and commercial hedging , long and short, (this is known as smart money) . So the above chart shows smart money long positions across all the main agriculture contracts added together. It's a bit basic but shows the point. The smart money is very long, in fact as long as it has been since 2007.

The chart below shows the diversified agriculture index. In fact it says it clearly on the chart! This chart is since 2000 so you can see what an attractive level we have now got back to .

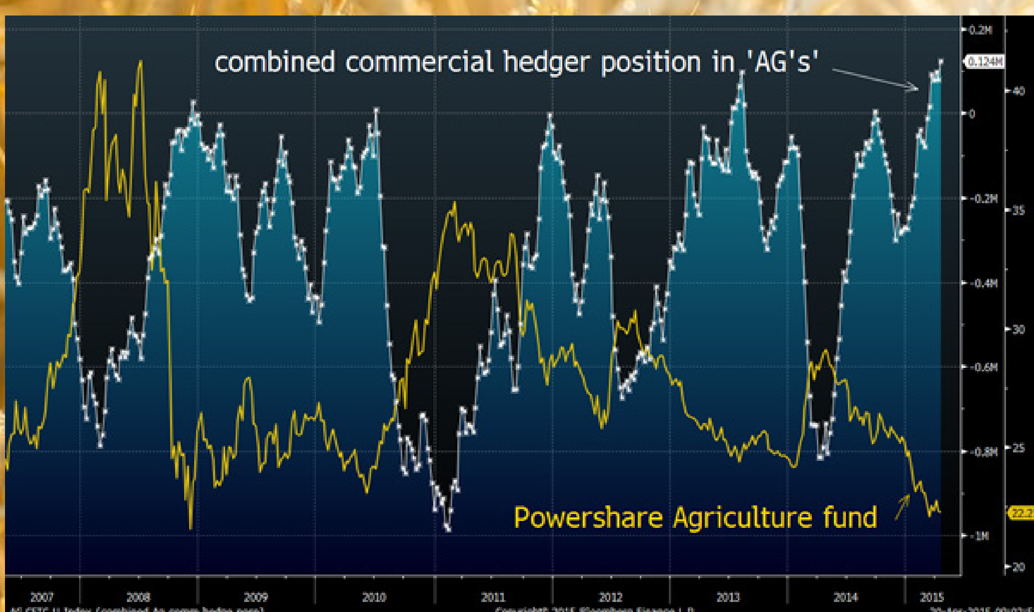


As you can see , whenever the commercial hedgers have been, this combined long it really hasn't been too long before the agriculture indices start rallying ….strongly !
The drought conditions are well known from the startling reports from California but its important to realise it is becoming an 'across US ' problem:

Residents of other states should take a lesson from California, Ben Chou, a water policy analyst in the Los Angeles office of the Natural Resources Defense Council, an environmental group said, “Attention on California is due to the size of the state and the fact that we grow about half of the nation’s produce” he said. “Other states have started looking at it.”

Volume starting to pick up …need to see more of that but if and when it comes, a rally from this level could be very interesting with very cheap limited downside risk that calls offer you.

I used the powershares ag fund in the last chart for a reason! The options on it seem pretty cheap to me. The July 2015, 23 calls at priced at 40 cents. A volatility of under 14.5. If I put the strike price on plus the premium on a chart we’ll see how tempting it looks.



Equities Are Awesome

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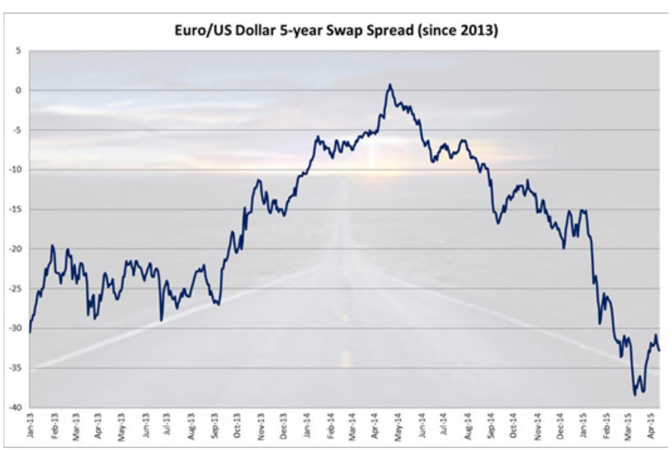
Still awesome, but for how long?

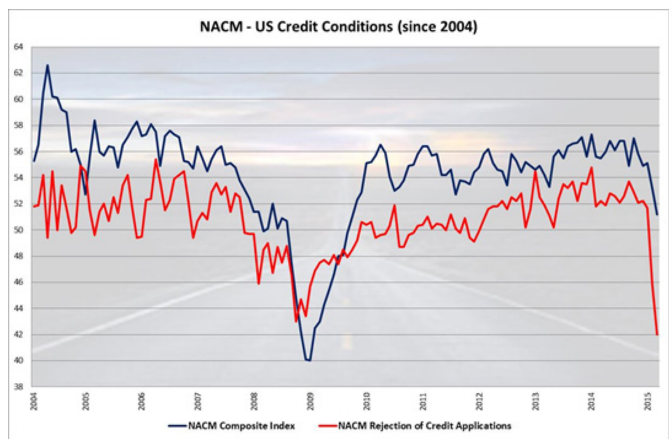
Volatility bottomed in the currency markets in July 2014 and has more than doubled since. Volatility moved fairly quickly from currencies to the bond and commodity markets, especially in the case of crude oil. Our gut feeling is that the tsunami of global speculative capital is starting to become nervous and is increasingly seeking safer havens.

There are emerging signs of stress in some wholesale funding markets, or what could be described as the financial "plumbing." The failure of Lehman and Bear Stearns were basically repo events. Fails to deliver in the repo market and repo rates are on a rising trend. This is something to keep an eye on for now, rather than indicating any immediate risk of market dislocation.



The Euro/US dollar 5-year basis swap has plunged from effectively zero to -32.8bp during the last twelve months signalling significant tightness in dollar liquidity.

When we switch from wholesale funding to corporate credit conditions, there are signs of deteriorating conditions in US corporate credit. The National Association of Credit Managers' Composite Index has fallen to its lowest level since 2009, while the "Rejection of Credit Applications" is the worst on record.



Our recent report, "Selling Time", argued that central banks' policies of ZIRP and excessive credit creation have artificially lengthened time horizons in the real economy and financial markets. However, the key conclusion from our work is that time horizons are shortening and this is raising risk, although it is unappreciated for the most part. Evidence we cite includes the weakness in capital spending and its substitution with share buybacks (i.e. short-term financial engineering), flattening yield curves and increased capital flows into the most marketable assets (e.g. the dollar, high quality sovereign bonds and physical gold). The signs of stress in funding and credit markets described above are consistent with this.

Equities have certainly been awesome, but what's next? The valuation of equities incorporates very long-term time horizons (e.g. capitalising cash flows to infinity), so our gut feeling is that they could be vulnerable to a continued shortening in time horizons.

The two indicators which gave (as far as we can work out) the most well-timed sell signals on the S&P 500 at the peak of the last two equity bull markets (in 2000 and 2007) were.

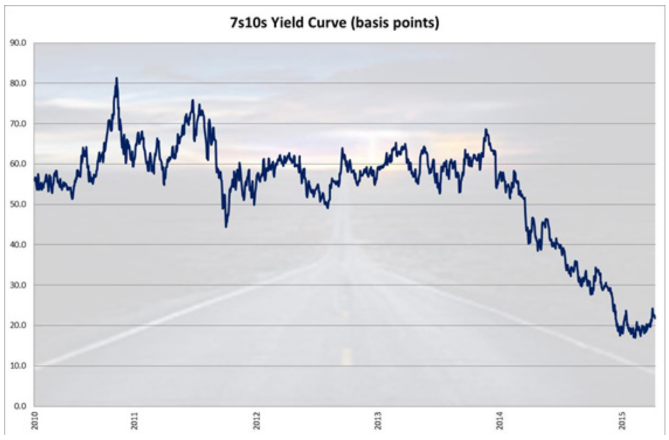
- A negative reading on the "adjusted" MACD (using 25, 26 and 9 day exponential moving averages instead of the default 12, 26 and 9) and
- Inversion across the yield curve on maturities from 2 to 30 years.

They are both closing in on registering their first sell signals for more than 7 years.

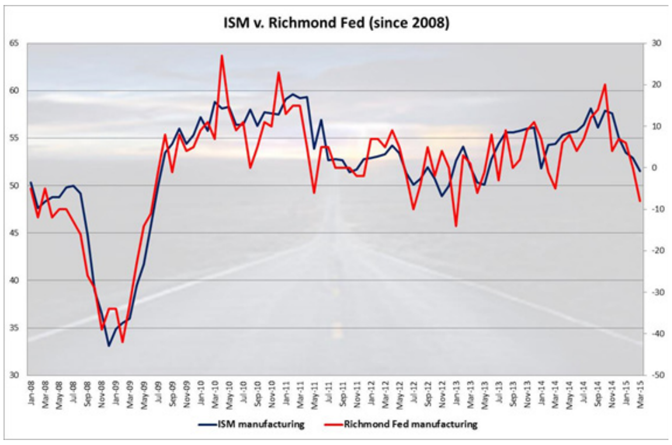
The adjusted MACD is closer to registering a new negative crossover in the moving averages than at any point since 2000 and 2007.
While ZIRP and QE have undoubtedly distorted

yield curves, we still think that a yield curve inversion in relatively close maturities, e.g. the 7s10s, could be a potential warning signal for equities. The 7s10s spread is currently trading at 21.9 bps.

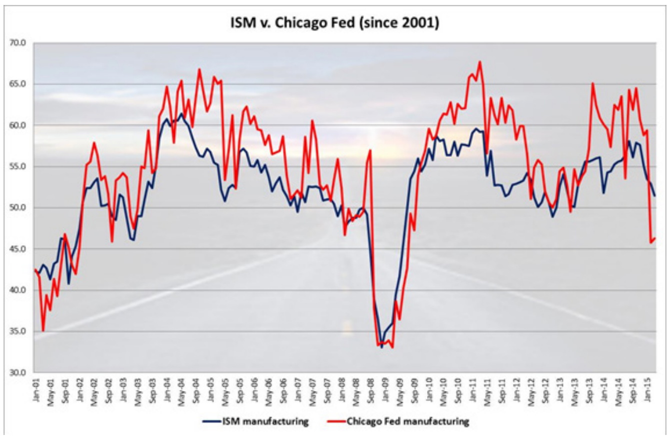
On both occasions, the sell signals given by the adjusted MACD and yield curve inversion were confirmed by the ISM manufacturing index moving down through the 50.0 level. The ISM manufacturing index for March was reported as 51.5.
Regional Fed surveys, such as Richmond and



Chicago, are suggesting that the ISM is at risk of moving below the 50.0 level in the coming months. Here is Richmond:



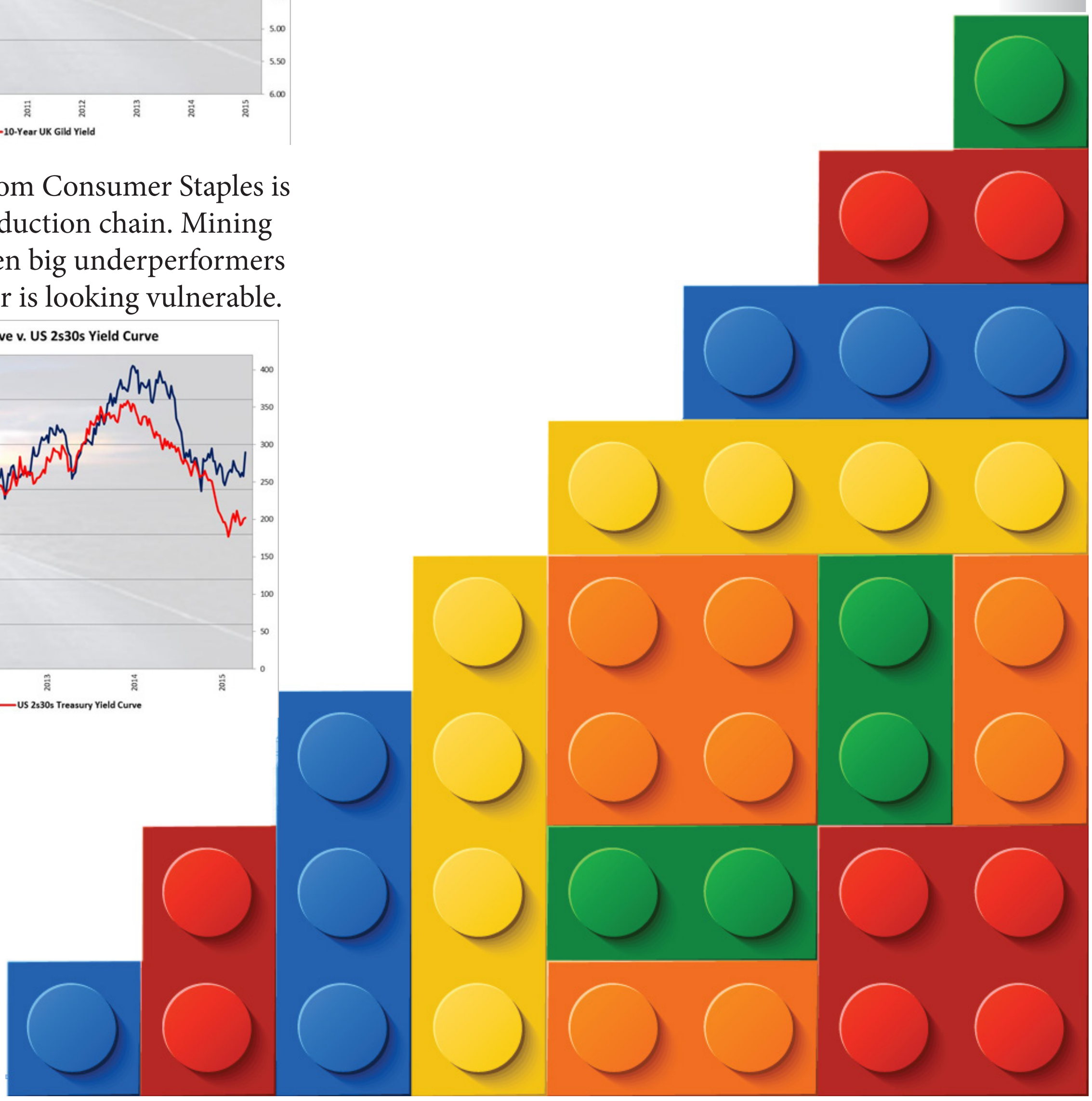
And Chicago:



One statistic that is making us nervous about the US is the surge in the ratio of wholesale sales to inventories since mid-2014. We have not seen the current ratio of 1.29 since we were in the midst of the last crisis. It's not just the weather because that was an issue last winter. The port strike may have played some part but there is a growing risk from a wave of destocking flowing through the US economy later this year.

Not surprisingly, our stance towards equities is defensive. We would highlight sectors where outperformance is positively correlated towards lower sovereign bond yields and flattening yield curves, such as Utilities and Consumer Staples.

The other side of the coin from Consumer Staples is the upstream end of the production chain. Mining and Energy have already been big underperformers and the Capital Goods sector is looking vulnerable.



View from under a toadstool

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THIS CHAP STAN DEVIATION HAS A LOT TO ANSWER FOR

The idea that indexation has taken an utter stranglehold on equity and bond investment is not as bewildering as the fact that active managers who compete against this thundering juggernaut have been so pitiful in their own performances and consequently have failed to stage any realistic response.

As interest rates have collapsed, the fees the investment community charge have been more visible and open to scrutiny. That has shown them rather wanting. But like any great seismic shift in long term investment style, the unintended consequences are much greater than the herd realise.

The premise of investing one's money into a basket of stocks purely by their market capitalisation, which is what passive investment is, while ignoring each companies fundamental qualities, is blatantly perverse over the longer term. As index buyers push up the share price of an individual company, more index buyers have to buy it, consequently the larger the market capitalisation becomes then even more people have to buy, causing a virtuous circle. Essentially indexation leads to a primal form of momentum investing.

Perhaps we should cheer not jeer, as momentum investing continues to be the best investment style out there by far. However, the consequences to the outside world are even more damaging. If capital is allocated only according to market capitalisation and not on the basis of the return on capital a company can achieve, the deserving smaller or recovering companies become starved of capital, whereas the big monolithic behemoths get excess capital purely on the basis of their size.

In the US equity market, nearly all the corporate free cash flow is now being used to buy back companies' own shares, also reducing market liquidity and squeezing equity markets higher (not the same in the rest of the world to that extent). The US equity market is on the cusp of seeing $1 trn returned to shareholders in dividends and share buybacks this year. So the biggest companies get bought heavily purely due to being big and buy back their shares sending their share prices even higher, owing to their ability to borrow at extremely low QE induced interest rates, which smaller companies cannot do. As a blueprint for free market capitalism, it is not a good one.

One would hope that active fund managers could resolve this passive dominant dilemma and exploit it to their own benefit; it appears not. John Authers from 'Smart Money' elucidated: "Take the Russell 1000 index of US large Cap stocks and divide them into quintiles. The top 20% of stocks by performance, measured this way averaged a return of 44.3 %. The fifth quintile (the 20% with the worst returns) lost an average of 16%. The Russell gained 11%". This was a very low dispersion year (one of the lowest on record due to indexation), so stocks were seen as not straying much from the overall index performance but as you can see, the opportunities were still abundant. It is well documented how many active fund managers simply look to track the index with the bonus of higher fees. But this is getting silly!

If one continues to buy the bigger companies in larger weightings than the smaller ones, the investor buys high (and higher and higher) and relatively sells the weaklings lower and lower. Now call me old fashioned …or just call me old ….this was not the way I was taught to invest. 'Buy high, sell low', 'buy expensive, sell cheap' might appear to be a good short term prospect but it is definitely not a good long term one. A UK survey of small and mid-cap fund managers last week found bulls at a record low.

A whole industry of ETFs has been spawned out of indexation (certain ADMISI personnel were structuring sector ETFs back in the mid 1980's way before anyone else invented ETFs !) and it is massive. Only last week, data from ETFGI suggested global ETF assets had hit an eye watering $ 3 trn. In February alone, $30.4 bln went into equities and albeit that some might be switching out of actively fund managed products, the flows are highly significant. At the same time investors rush towards indexation and apparent safety in ETFs but liquidity everywhere is drying up perilously.

Underlying liquidity in most asset classes has been destroyed by central banks, especially in sovereign bond markets.

Furthermore, asset-liability matching in pension funds, with ageing populations, has caused a lot of 'irrational' bond investment that is both very long term and fully locked up, thus lowering the overall tradable volume. Admittedly, the irrepressible nature of actuaries makes pension funds very unwieldy investment vehicles but global QE has made a bad situation disastrous. The holdings of their own sovereign bonds that most major western central banks now have, are generally a quarter to a third of all their bonds in issuance. The Fed, towards the end of QE3 were buying virtually all the US government's new issuance. If you lower the free float of any issue to that extent, you will create liquidity problems.

A lack of liquidity in a rising market simply causes an excessive squeeze. This 'pleasurable' outcome is obviously greeted with applause. ETF indexation, drives the larger market cap issues higher while at the same time, the central banks lessen liquidity. Central banks have not envisaged, or realised the market liquidity problems they have caused , the over-regulation (fair or not fair) of banks and investment houses has meant those institutions now need much greater capital to take on risk positions as well as being suffocated by regulatory scrutiny. Because of it, the investment banks have curtailed trading operations sizably.

In some corporate bond markets, for example, the retail investor, mainly through ETFs, has bought into totally illiquid issues in the primary issuance market (via investment banks) and the banks are then not supporting any secondary market at all. Although we see highly liquid ETFs in these assets -like high yield corporate bonds-the liquidity in the underlying bonds, in which the ETF invests has been obliterated; a dangerous scenario.

On 14 April Simon Potter, a senior Fed official told a gathering of primary dealers, who underwrite the regular debt sales, that sudden swings in bond prices would become more common. Rather disingenuously he suggested that his audience "has the responsibility to help support market function and liquidity". John Brady, MD at RJ O'Brien said that, thanks to Fed QE, (backed by the tax payer!) liquidity in the Treasury market had been compromised. He opined "I think Mr Potter is saying it's OK to stand in front of a runaway train". It certainly implies the Fed has little appreciation that it is they who have caused a major part of the liquidity problems through a
combination of QE and regulation.

In April last year, we had a single day where Japan, the world's largest bond market, had its benchmark 10 year bond not trade once. None, zip, nada! That was a strong warning of the illiquidity danger developing but while markets rise, no one needs to care. In the last fortnight, along with JP Morgan, Blackrock, Prudential and a number of other 'big-hitters' have sounded the alarm though.

Lack of market liquidity becomes noticeable on downward moves. Jamie Dimon, the outspoken CEO of JP Morgan wrote, in his early April letter to shareholders, albeit in a self-interested attack on regulation: "Treasury markets were quite turbulent in the spring and summer of 2013, when the Fed hinted that it soon would slow its asset purchases. Then on one day, October 15, 2014, Treasury securities moved 40 basis points, statistically 7 to 8 standard deviations — an unprecedented move — an event that is supposed to happen only once in every 3 billion years (the Treasury market has only been around for 200 years or so — of course, this should make you question statistics to begin with). Some currencies recently have had similar large moves. Importantly, Treasuries and major country currencies are considered the most standardized and liquid financial instruments in the world."

The FT commented whimsically on the spectacularly nonsensical predictive powers the computer driven risk models adopt. Matthew Wittman at hedge fund Christoffereson Robb says the bond event on 15 October was an eight standard deviation event; this should happen just once if the bond market started at the beginning of time and the Universe lasts 300 times longer than it has so far. Wow! Good to get that out of the way. The move on the severe liquidity vacuum in the Swiss Franc in January was a 300 standard deviation event evidently. If a lottery picked a single atom a trillion, trillion, trillion times a second since the universe started, picking that one single atom out of all those in the universe would be less than a 30 standard deviation event. No wonder the normal investor just craves the simplicity of indexation.

Option Sleuth

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Welcome to the first instalment of Option Sleuth. The objective of this piece is to identify trends in volatility and to try and recognise potential catalysts that can have a dramatic impact on such trends. The style of many of the recommendations will likely be short dated and close to expiry in order to keep premiums low with the prospect of a quick payoff.

All sounds very promising but being a bloodhound in this kind of market is tricky at best. European QE is boosting equity markets on the Continent to new highs and it is probably still safe to assume that the allocation to Europe is far from complete. We could argue all day as to whether QE will improve the economy….and even longer as to whether that fact actually matters. At the moment the main impact of the European policy has been to weaken the € and therefore any "growth" is at the expense of someone else, a fact that has not been lost on the US Treasury market. Eurozone purchasing surveys are improving incrementally but GDP is still about 2% below its pre-crisis level and some tailwind dynamics may soon start to fade. Chiefly among these is the fall in the price of oil and with the US economy now faltering along with the rest of the World, it's hard to envisage a significantly weaker € from these levels. But capital flows in European equity funds on the basis that things are improving, however slowly, remains the dominant theme as we march in to the second quarter. Looking for clever little nuanced counter trades would seem churlish. However I'll kick on, lest this be a very short first instalment. Another impact of Eurozone QE has been to see a reduction of volatility in the banks. Mr Draghi announced his PSPP plan on 22nd January. The chart below illustrates the impact of that policy statement. The chart also highlights the three US QE announcement dates.

There are those that believe that the all-encompassing bear hug from the ECB results in bank implied volatility falling further still. But already we are seeing a reversal of the post-Draghi effect and justifiably so in my opinion. This is a chart of the SX7P three month implied and historical volatilities. It is interesting but unfortunately barely visible, that the spread between the two is at a two and a half year high. That dynamic normally foretells a big move. So where are the bombs going to be going off?

Well, I feel we are on the cusp of widespread restructurings at many big banks, forced either by regulators or shareholders. Banks in Europe have a new single supervisor and while this may be good for governance within the Eurozone, it may not be so great for banks hoping to avoid repairing their balance sheets. The US regulator, mainly in the guise of Ben Lawsky at the Department of Financial Services, is still like a 'dog with a bone' as he feverishly chases foreign banks for their former misdeeds. Will he eventually chase some out of town? Bank shareholders are urging them to improve returns, although most of the cost buttons have been pressed and a bigger shake up would appear to be required. As Goldman Sachs argued recently, the approach now has to strategic rather than operational. I'm interested in DBK and HSBC. One would think that the cat is well and truly out of the bag concerning DBK's restructuring however such is the disparity of the options discussed that there is sure to be a significant move in the shares on 29 April when an update is scheduled along with Q1 numbers. The way the bank will be structured in the future may also command a higher volatility level. Eschewing a retail wing, if this is the chosen route, leaves the bank's fortunes purely dependent on IB flows, be they good or bad, and removes a cheap source of funding. Both these dynamics would likely lead to an increase in DBK's cost of capital. HSBC is further down the restructuring road, having already indicated a retreat from some emerging markets - but this has to be the tip of the iceberg. The UK general election and the question of domicile are key issues and should not

be dismissed (See Flint speech 21/04/15 in HK). I also like the look of owning CBK options. Volatility is very low, it reports Q1 295 results soon, on 7 May and, more importantly, it has long been considered a takeover candidate. Maybe mergers will have to be internal. The ECB (as single regulator) has yet to lift restrictions on capital movements between jurisdictions which can make cross border tie ups ultimately expensive. However, consolidation and shrinking of operations looks inevitable in the sector.

Key dates :

- Apr 24th DBK Executive and supervisory board to decide on strategy options
- Apr 29th DBK Q1 numbers – strategy to be made public
- Jun 9th HSBC Investor Day
- Recommend being long DBK May calls against stock
- Recommend exposure to HSBC June volatility

Earnings reports will be a major feature during the next month. For example, most DAX companies will have reported by mid-May. Earnings growth for European companies is expected this year to outstrip those in the US. Earnings will thus be closely watched as it is a bulwark of the asset allocation argument for European shares. As we went to press, the main feature among most early releases was beats to estimates helped by the forex tailwind. Dividends will also be a feature for the next month as European companies announce their annual payouts. It would seem to be a strange time to suggest selling this market but a case can be made. Using the SXXP as a proxy - it is noticeable that on average most of the year's returns have occurred in the period between November and April since 1987. Indeed returns during this period outstrip those for the whole year. The returns since last November have been the most on record excluding the years that encompassed the dot com boom. We may be done for the year.

- Recommend: inexpensive downside protection via buying a put spread and selling calls

If your stock is called at a higher price, it may prove to be an attractive level in terms of the year as a whole. The events of Friday 17 April, encompassing China and Greek worries, have however raised the cost of hedging. For example VSTOXX rose some 40% at the end of that Bloomberg blackout week. The rise is being sold but for now we will keep a watching brief.

We are expecting a Tory surge in the opinion polls but when is it going to come? It had been expected last October, then in January, then after the budget and finally after recent stellar employment data… but it still fails to materialise. The Tories now seem to be losing their composure with unfunded promises and giveaways and personal jibes about Ed Miliband that having stabbed his brother in the back, he wouldn't hesitate to do the same to Britain. Those seem desperate measures.

They also seem to still have a "brand" problem. There are many stocks nervously awaiting the outcome of the election but no other stock seems to have suffered as much from being a political football than Centrica. May '15 options are not cheap but for a very good reason. In fact, call volatility is very expensive. At one stage in the week ended 17 April it was as expensive as put premium. However, I don't think this should deter us. Nominally the May 280 and 290 calls are fractions of a penny. A Tory surge would be welcome but not, I think, totally necessary for Centrica's share price to see a sharp rally.

- Recommend – owning the Centrica May 270 calls vs stock 23 delta

Until next time.

Lost Generation

Eddie Tofpik

Head of Foreign Exchange

Tel: 020 7716 8201

POISONING THE WELL FOR A GENERATION

June 1914, Gavrilo Princip fired a shot that was heard around the world! The ripples led to WW1, WW2 and eventually to our current world, cataclysmic events for Europe and beyond. I do not diminish the sacrifice of all the generations since but rather wish to draw attention to a financial event earlier this year that was analogous in shock, terror and pain.

On 15th January the Swiss National Bank (SNB) removed the 'Swiss Franc Cap' defence of EURCHF at 1.2000. It had been in operation since 2011. +47 seconds and the market traded down through 1.2000! +56 seconds on and spreads widen, liquidity starts drying up from big FX banks as prices drop below 1.1700! +1.08 minutes and prices are below 1.1100! +1.43 minutes and prices are anywhere from 1.0050 to 1.1550. EBS, the wholesale trading platform quotes 1.0000! +2.41 minutes and the first quotes come in sub-par with EBS quoting over 1.0800! +3.32, the market has its liquidity shot and is dysfunctional with quotes below 0.6400 & over 1.1200 simultaneously! +5.16, EBS ceases valid quotes and the FX Market is effectively not fit for purpose! The market quotes under 0.5700 and over 1.1000. +12.28 minutes and EBS quotes 0.9550, 0.5000 and 0.9600 within seven seconds! +25.40 minutes, prices trade back over par ranging between 0.8700 and 1.0000. +53 minutes, some consistency from banks and liquidity providers' returns, an estimate of liquidity at this time is at 5% of normal levels!

These stark details are the dark, dry events that led to what some have called tsunami, flash crash…or my personal favourite – the SNBomb! But why the title 'Poisoning the well for a generation…'? Well, that's what I think has been the longterm consequence of the action – please note, I'm not arguing for/against the SNB policy, just the results of its action.

On the surface you can see casualties and victims straight away. In FX we've names such as Alpari UK, Liquid Markets, Boston Prime… all ceased operations. Swiss corporates from watchmakers to pharmaceutical companies, chocolate makers to cheese producers have all suffered and still suffer… and that's without mentioning the repercussions this will have on the Swiss people individually and collectively. Then there's the shrapnel of consequences showering out - from the wholesale FX industry and Switzerland. We have the 'Swiss' mortgages popular in Hungary, Poland, Croatia, etc… and the 'retail' FX industry internationally that's seen great growth over the last couple of decades. This last category is the one I refer to in my title.

Retail FX has seen great growth with electronic developments, standardised trading sizes, relatively lax regional regulatory oversight and promotion of such business by international FX banks. FX banks have seen this as a great source of potential income – retail FX traders lose money at a far higher rate than professionals such as middle tier banks, funds, CTAs, HFTs, etc… the big FX banks like the flow as it is seen as less toxic and over the last ten to fifteen years has replaced and added to general liquidity in the FX markets that was once the preserve of many middle tier or regional banks who've cut costs by closing or farming out their FX business.

> ‘the Swiss let off the bomb and poisoned the well

Everybody had it good for quite a while, except Retail of course. Their average lifespan was about three months but there was so many of them coming in and growing up that, like wildebeest in Africa, it really didn't matter losing them.

It didn't matter until Retail FX and its participants got hit and badly by the SNBomb. The individuals trading saw not only margin deposits wiped out but also found themselves being pursued for more. Additionally, after 15th January, various international FX banks decided to ‘adjust’ traded prices to reflect the force majeure state of the market. Personally, I have issue with this! I grew up in this industry in the era where the motto of ‘My word is my bond’ was sacred, anyone trying to ‘adjust’ - or welch on a deal - was a pariah. I well remember one incident mid 80's when a bank tried it on with one senior dealer where I worked at the time (I was just a junior). The dealer, after telling him in no uncertain terms what he thought of the bank, slammed the phone down, pulled out of the board the direct line button to the bank and posted it to them as a sign their relationship was at an end! This doesn't happen now of course because prices can and were adjusted by many over the following day(s) and worse – banks cancelled trades, even ones previously adjusted! This led to Retail FX taking action in various forms from class action suits (benefiting attorneys more than the litigants) to mob-storming the offices of Retail FX brokers in anger. This is where the ‘poison’ has taken, it's turned off and away, many who've been the best source of liquidity in FX markets for many institutions! It will not be just for a few years! In February following the SNBomb, the Chinese search engine Baidu reported a drop of 10% in searches for FX word search variations.

So many have been turned off FX, I fear a whole generation of traders and liquidity providers will not be there because they don't trust the industry, wholesale participants and definitely NOT the SNB! That's where the crux is. You'd think the Swiss and their National Bank could be trusted to manage an orderly market – but no! By extension, could you trust other Central Banks - the ECB, the BOE (remember Soros, ERM and Black Wednesday) and even the Fed? The ripples will carry on for many years, I fear this ‘lost generation’ of Retail will remember these and NOT ever trust Central Banks… or FX. FX and perhaps other markets will rue the day the Swiss let off the bomb and poisoned the well!

EVENTS CALENDAR 2015

Events Worth Noting

ADMISI attend and participate in selected global events across commodities and macro economics. Should you require more information regarding these events please do not hesitate to contact your Account Executive.

Event:	Location:	Date / Month:
FFA Brokers Assoc : Dry Derivatives Forum	London	May 2015
Cocoa Week and Dinner	London	11 – 15 May
NY Sugar Dinner	New York	May 2015
LME week Asia	Hong Kong	20 May 2015
GAFTA	London	9 June 2015
FARO	Milan	2 July 2015
Brazil Sugar Dinner	Sao Paulo	15-17 September
LME Week	London	12-16 October
ICA International Cotton Industry	San Francisco ICA	October 2015
Sugar Dinner	India	October 2015
Coffee Dinner	Basel	October 2015
Coffee Dinner	London	November 2015

Information from External Sources

A special thanks to the following non ADMISI contributors in the subsequent pages for their thoughts and analysis. We are truly grateful for their efforts. ADMISI would like to extend the opportunity to receive additional external contributors' analysis for inclusiion in subsequent editions of The Ghost in the Machine. Please contact Andy Ash for further information. Tel: +44 (0) 20 7716 8520 or Email: andy.ash@admisi.com

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Maleeha Bengali

Our Commodity Fund Specialist

"Forget Chasing the USD / Commodities Correlation Trade; Interesting Opportunities Exist at The Stock Level"

What to do now?

Buy a select basket of US refiners; Valero Energy (VLO US Equity), Tesoro Corp (TSO US Equity), and Phillips 66 (PSX US Equity) to play a secular rerating on back of cash flow and midstream earnings growth.

So where are we now?

Markets have been anything but boring since the much talked about FOMC meeting held on 18th March '15. Equities, FX and Commodity markets have been whipsawed from one end of their trading range to the other as macro players decide the fate of the US dollar heading into q2 '15.

The Fed commented on hikes being dependent on "further improvement" in the labour market and when the committee becomes "reasonably confident" that inflation is on track to return to its 2% target in the medium term. Beyond the language itself, the Fed's economic projections had an even more dovish feel with tempered growth and inflation expectations. This shift was consistent with a September "lift-off" instead of June but with risks tilted towards an even later start date. As the markets digested these headlines, it immediately went into reverse gear; USD fell, Euro rallied, European markets fell, Commodities rallied. It was hardly surprising to see a complete mirror image of the performance of all asset classes since the start of the year, as all trades have been dependent on the "USD call" recently.

But what is the macro data telling us about US Growth vs. Europe?

Over the past few weeks, financial conditions in the US have been tightening whereas they have been easing in Europe. Since January '15, US economic data has shown signs of slowing. Some blame it on weather, some seasonality. The jury seems to be out still. Europe on the other hand is showing signs of growth evidenced by the regional PMI's seen recently. Together, with the help of ECB's quantitative easing program, it is entirely reasonable to see European markets outperform their US brethren given the massive tailwinds in their favor.

Of course the weak Euro has helped tremendously as well. The USD adjusted returns for Eurostoxx 600 look a lot less exaggerated at +6% for the year vs. S&P 500 up 2%. I do not doubt the merits of this trade but am more cautious on adding to this macro trade today given how one way the bets seem to be currently.

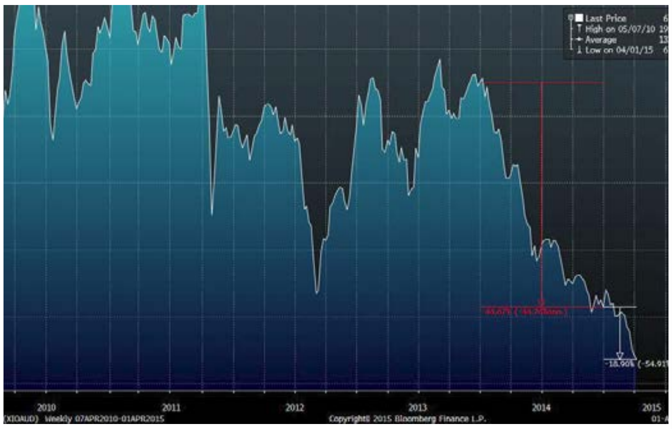
Enough about Macro, what is the trade in Commodity markets right now?

When one looks beyond just the USD trade, the physical Commodity markets tell a more real story. Three Commodities that show some anomalies are Iron-ore, Copper, and Oil.

Iron Ore: Iron-ore collapsed more than 50% last year. But since the beginning of this year alone it has fallen from $70/tonne to $46/tonne today. Going through the various supply side projects and cost break-evens, about 292 million tonnes worth of capacity is set to lose money at these prices. But only the levered players like Vale, Fortescue Metals Group and Cliff Natural Resources have suffered during this setback. What about the diversified players like Anglo American, Rio Tinto or BHP Billiton where a big portion of their EBITDA is generated from this Commodity as well? Granted they have a higher free cash flow yield, are extremely cost efficient and taking market share from the smaller players but the price of Iron-ore is threatening even their $30-35/tonne cost support level and they are seeing earnings downgrades as well.

Environmental policies are of prime focus for the Chinese government currently. Steel demand is set to remain weak together with high port inventories; the demand for Iron-ore looks bleak. As you can see in Chart 1 below, the Iron-ore price in Australian dollars is below 2009 levels but still holding up a lot better than the price in USD quoted on the exchange. This has insulated the major Australian producers to an extent judging by Rio Tinto and BHP Billiton proceeding with their expansion plans vs. the likes of Atlas Iron, Australia's fourth largest producer, shutting down production despite aggressive cost cutting efforts. Prices need to go lower before we see a substantial cut in volumes across the board, balancing the physical market.

Chart 1: Price of Iron Ore in AUD still a lot higher than its USD equivalent



Source: Bloomberg

Copper: Copper has rallied 12% since February lows on back of Chinese stimulus expectations, some temporary tightness in the scrap markets and some supply side outages. The copper market is not as oversupplied as the Iron-ore or Thermal Coal market but the recent announcement by China State Grid to increase power grid construction from 412 bln RMB in 2014 to 500 bln RMB in 2015 seems to be taken out of context. The weakness in late construction cycle copper intensive completions is going to more than offset some of this demand pick up from power grid investment where the direct use of copper in power lines is not certain. As copper's input costs go down, the overall cost curve should move lower and settle around $5200/tonne.

Oil: Brent is trading at a premium of ~ $6/bbl over WTI. The range for this spread has been anywhere from $1-$15/bbl over the last few years. WTI is a land-based crude oil based in Oklahoma whereas Brent is a global benchmarked oil. WTI price is based on the physical market balance in Cushing at any given point. Currently US refiners are going through maintenance that demands less US crude and causes Cushing to build up causing weakness in WTI time spreads.

What is the Cushing balance currently?

Cushing stocks have built for 18 consecutive weeks and now stand 8.3 mln barrels above previous tested highs (January 2013). Cushing current capacity is estimated to be 65 million barrels, which leaves 6 million barrels of spare capacity. There is a lot of talk around Cushing filling up which will lead to a collapse of WTI relative to Brent. Granted there is increased infrastructure and floating storage that can soak up the excess inventories as well but it is the trend that is important even if Cushing does not overfill. All this means is that oil is not going anywhere soon until all this inventory is cleaned up. All the rallies we see are temporary and macro related, as the physical picture is unchanged.

Iran and Iraq...near term risks to the oil price?

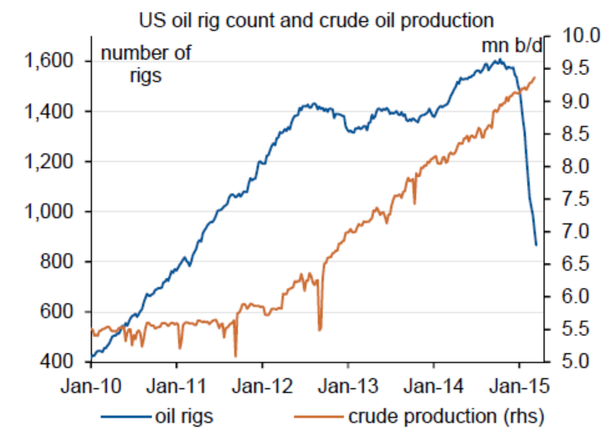
After a framework deal was announced between Iran and P5+1, Brent oil fell 5% on expectations of an increase in supply of 500k bpd into an already oversupplied market. The deadline for a final deal remains 30th June but even if a deal is reached, a lot of conditions will need to be met before actual oil actually hits the market; a concern for 2016.

Iraq and Libya are greater near term risks. Iraq appears to be making up for weather-related loading backlogs. Iraq's Oil Ministry also reported that Iraq exports were up 15% in March to 2.98 mbpd, the highest in 35 years, with production estimated around 3.8-3.9 mbpd. Recent estimates also put Libya near 600 kb/d, double the level just two months ago, with talk of lifting force majeure at two major eastern ports (Es Sider and Ras Lanuf).

Is US production really slowing down?

US oil production is actually up despite the drop in rigs announced. The shale producers have been dropping the least efficient rigs while focusing on well productivity and efficiency. Crude production has continued to shoot up by 1.2 mln bpd year to date despite rigs dropping by 49% since Dec'14. (see Chart 2 below)

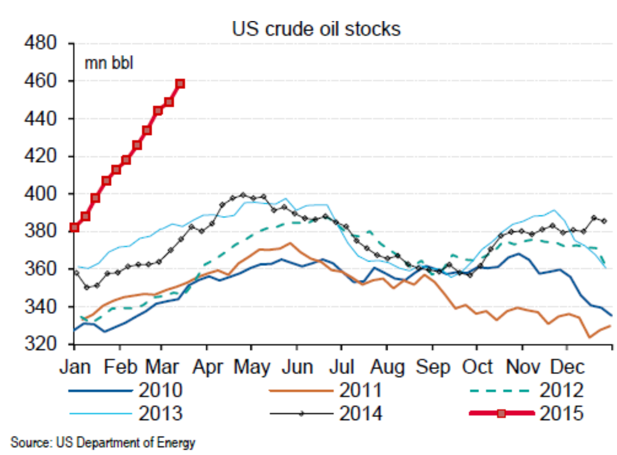
Chart 2: US Oil Rig Count And Crude Oil Production



Source: Bloomberg

US crude oil stocks have built by a massive 100 million barrels year to date and stand 98 million barrels (~ 26%) higher than this time last year! (see Chart 3 below)

Chart 3: US Crude Oil Stocks



The US shale producers have built up a big well war chest, hoping to restart production as soon as prices rebound later this year. Given hedges in place and 12 month forward prices holding above $65/bbl, the real pain has not been felt and the longer the oil prices stay lower, it will force actual US production to be cut which will eventually help in rebalancing the physical market. Only then, will oil be able to rally, if at all.

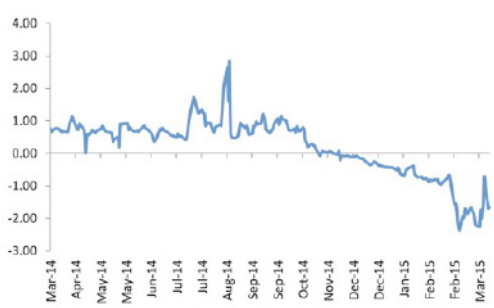
What to do now?

Buy a select basket of US refiners; Valero Energy (VLO US Equity), Tesoro Corp (TSO US Equity), and Phillips 66 (PSX US Equity):

Refining has always been a cyclical business and US refiners have been victim to its whims over the years. Over the years the refiners have worked on getting more efficient and upgrading their refining units to capture higher premiums than their benchmark margins. Another very important feature of the past few years has been the collapse of WTI oil vs. Brent oil. The difference in this spread has been a massive tailwind for US refiners as their input cost is WTI that trades at a massive discount to other blends of crude. The companies have been generating significant cash flow despite the cyclicality of margins and management are committed to returning this excess free cash flow back to investors.

So what's the story today and why be long?

As you can see in Chart 4 below, the WTI curve has been in contango since end of last year and is moving into an even steeper one as Cushing builds. If the current contango $2/bbl persists throughout 2015, then the US refiners can see about 15-20% earnings tailwind vs. 2014! The street '15 earnings estimate assumes Brent/WTI in the $5-8/bbl. range, which is a bit conservative, based on Cushing's trend.



Source: Bloomberg

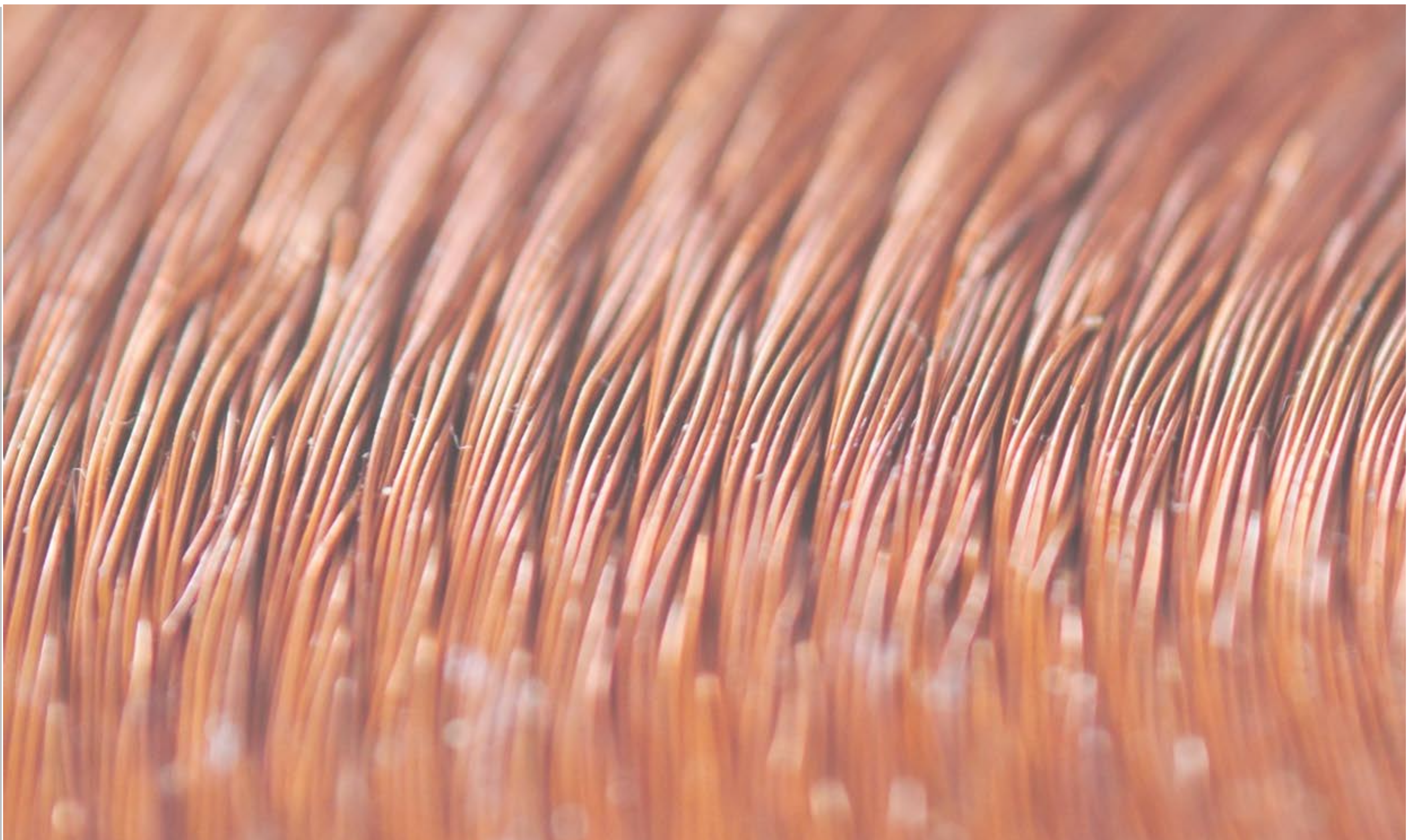
Chart 4: WTI Timespreads (Front Month – Second Month Futures Contract)

One of the other strong drivers in refining has been midstream growth and value uplift via MLP dropdowns. Dropdowns on average drive 50% + IRR on midstream spending vs. the usual 12% IRR projects. 55-60% of the industry value is midstream and implied multiples on refining is ~ 2.8x, ex midstream value, a significant discount to ~ 5.5x historical valuation. The re-rating in the space seen since last summer should continue.

Which names to own here?

Valero Energy is one of the best-placed US refiners as 60% of its global refining system is located in US Gulf Coast and so it benefits massively from widening of Brent-LLS differential. The company will generate close to $2.7 billion during 2015-2019 (after capex) or $3.7 billion a year assuming $1 billion of asset drop downs to VLP. Its current marketcap is $30.8 billion, which translates into a average yearly free cash flow yield of 8.8% or 12% including drop downs! Recently management hiked their dividend by 45% and stepped up their buyback program as well boosting investor confidence. Phillips 66 is ideally positioned within the US with significant exposure to both the inland and the US Gulf coast markets. Every $1/bbl change in Brent-LLS or Brent-WTI spread can raise its annual EPS by $0.30-0.35/share ~ 5%. Management believes that the refining business will generate $1-2 billion in free cash flow. They also reiterated 40% of its full cycle cash flow to be returned to shareholders. Tesoro Corp is exposed to the West Coast US market and its margins. North American heavy and light oil will soon find its way into West Coast which will then become discounted benefitting refiners in this region. TSO will be the biggest beneficiary of unplanned FCC outrage at XOM's Torrance refinery into the summer.

One caveat to the above recommendations is the potential weakness during q1 '15 earnings reports on back turnaround activity, chemical earnings down 25% q/q (impacting PSX ~ 25%). Lower Gulf Coast activity will hurt Valero (-8% throughput q/q) and PSX (-20% throughput q/q). Street is already aware of these issues at PSX and taken numbers down accordingly. Weakness in q1 '15 earnings report should be used as an opportunity to be long these select US refining names.



YTD PERFORMANCE:

Portfolio	% YTD
Gross Returns (Open Positions)	0.77
Gross Returns (Closed Positions)	4.54
MBCC Net Return YTD	**8.84**
SPX YTD	2.87
Eurostoxx YTD	22.22
SXPP (Basic Resources Index)	10.19
SXEP (Energy Index)	17.70
S&P GSCI Commodity TR Index	-5.24

Maleeha Bengali - Founder, MB Commodity Corner

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

ADMISI Algorithm Analyst

ALGO TECHNOLOGY LIMITED

Anthony Edwards

Methodolgy:

The basis of our approach to analysing asset prices is that the price of an asset reflects the markets view of all the public information about that asset. By analysing how prices have changed over time we can gain insight into how market participants typically react to changing information and hence determine how prices are likely to change in the future.

What are Algos?

We use algorithms, or 'algos', that we use to identify potential entry and exit points for trading assets. Algos typically look for patterns that are occuring in an assets price now which have occurred historically. By then looking at those historical occurences the algo can determine what typically happens to the asset prices. Using this approach, we aim to bring a scientific and statistical approach to determining investment opportunities. Our Algos: The list below shows a brief description of the algos available on this site. For our bespoke services we can create customised algos, so please contact us if this service is of interest.

SIGNAL ALGO - The 'Signal Analyser' identifies technical signals that are firing on assets that have a proven track record of success. By 'signals' we mean discrete binary events such as the 2 week price performance being above 10%, or the 20 day Relative Strength Index being below 30. As you raise the performance levels, this algo will identify less assets albeit with higher conviction. We suggest using a sharp ratio setting of 2.0 or more to identify high conviction ideas.

HIGH VOLUME ALGO - The 'High Volume' algo identifies instances where there has been a significant price movement with significant volume. These tend to occur when news has been released that significantly affects investors perceptions of asset prices. This algo therefore identifies assets where recent events have alterred investor sentiment.

OVERBOUGHT / OVERSOLD ALGO - The 'Overbought/Oversold' algo uses a self-scaling relative strength indicator to identify assets which are in either oversold or overbought conditions and at the point when typically the price action begins to mean-revert. This enables the reversal levels to be tuned to the strength of the trend of an asset.

CORRELATION ALGO - The 'Correlation Algo' identifies which technical factors are the most highly correlated to future asset price returns. By 'factors' we mean continuously valued variables such as the 2 week price performance and the 20 day Relative Strength Index. The algo then identifies what typical future returns occur when those factors are similar to where they are today.

TREND ALGO - The 'Trend' algo identifies the direction and strength of a price trend using a proprietary methodology based on a range of moving averages and the position of the price relative to these moving averages.

Anthony Edwards gained a 1st class honours degree in Elecrical and Electronic Engineering at the University of Bath and went on to earn a PhD based on research into power system stability using artificial intelligence techniques. He started working in the City of London in 1998 for Bankers Trust and subsequently became Head of Research IT Development for Deutshe Bank in London. In 2007 Anthony joined Liberum Capital to build out their global quantitative research platform. In 2011 he left Liberum Capital to start AlgoTechnology Limited which specialises in developing bespoke quantitative and technical algorithms and also in developing portfolio strategies.

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+ Positive Signals

Score	Best Signal	Horizon(d)	Avg Return	Sharp	
Endesa SA	+10	Price Volume Trend(55d) signal	60	13.6%	4.1
Givaudan SA	+10	Williams %R(34d) signal	20	4.8%	1.5
ITV	+9	Donchian(144d) signal	60	4.2%	1.0
Kabel Deutschland Holding AG	+8	Exponential Moving Average / EMA(34d) turning upwards	60	10.8%	1.6
Hannover Rueck SE	+7	RVI(233/10d) greater than 60	60	24.0%	4.7
ACE Ltd	+7	Commodity Channel Index / CCI(144d) signal	60	10.2%	2.9
Betfair Group	+7	Price Volume Trend(55d) signal	60	22.4%	1.8
Securitas AB	+7	Force Index(144d) signal	40	6.2%	1.4
Topdanmark A/S	+7	Exponential Moving Average / EMA(89d) turning upwards	60	4.0%	1.3
Sampo	+7	RVI(144/10d) greater than 60	60	5.5%	1.3

- Negative Signals

Score	Best Signal	Horizon(d)	Avg Return	Sharp	
BG Group	-5	Relative Activity Index(55d) greater than 70	60	-6.7%	2.5
Hunting	-4	Relative Activity Index(34d) greater than 70	20	-7.7%	1.7
Tullow Oil	-3	RSI(21d) greater than 70	40	-3.5%	1.1
Anglo American	-3	Price crossing down through SMA(34d)	60	-6.0%	1.2
Afren	-3	RVI(233/10d) less than 70	60	-556.1%	4.4
Vedanta Resources	-2	Simple Moving Average / SMA(89d) turning downwards	60	-5.2%	1.0
Elementis	-2	RSI and RAI(21d) greater than 70	40	-5.3%	1.1
Lonmin	-2	Williams %R(34d) signal	60	-6.1%	1.2
ThromboGenics NV	-2	Simple Moving Average / SMA(21d) turning downwards	40	-6.0%	1.2
DKSH Holding AG	-2	Exponential Moving Average / EMA(55d) turning downwards	60	-4.1%	1.2

The **AlgoAnalyst** uses a range of bespoke algorithms to identify the probable future direction of asset prices from time horizons from 1 week to 6 months. These algorithms look at a wide range of technical factors and signals and use backtesting to determine patterns and correlations in the data that have yielded consistent returns in the past. The algorithms can be individually tailored to each user's criteria such as investment horizon and risk/reward profile. The system itself covers a wide range of equities and equity indices and clients can create their own portfolios in the system to provide alerts for idea generation and risk management. In addition, the system provides the '**Portfolio Doctor**' which can be used to suggest potential replacement ideas for existing portfolio positions.

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+POSITIVE

Signal Algo - Top 10

Endesa SA	+10
Tryg A/S	+10
Havas SA	+10
ITV	+9
EMS-Chemie Holding AG	+8
Partners Group Holding AG	+8
Hannover Rueck SE	+7
Betfair Group	+7
Securitas AB	+7
Greggs	+6

Correlation Algo - Top 5

Fiat Chrysler Automobiles NV	+1
STV Group	+1
Vertu Motors	+1
Greggs	+1
Endesa SA	+1

Oversold Algo - Top 5

Associated British Foods	+1
Cobham	+1
Swedbank AB	+1

Trend Algo - Top 5

Greggs	+2
Sydbank A/S	+2
Elisa OYJ	+2
Osram Licht AG	+2
Groupe Eurotunnel SA	+2

Overall Most Positive

Endesa SA	+12
Givaudan SA	+11
ITV	+11
Greggs	+9
Betfair Group	+9
Teleperformance	+9
Kabel Deutschland Holding AG	+9
Securitas AB	+8
Seagate Technology	+7
Hannover Rueck SE	+7
Topdanmark A/S	+7
Telenet Group Holding NV	+7
Groupe Eurotunnel SA	+6
ACE Ltd	+6
Sampo	+6
Elisa OYJ	+5

High Volume Algo - Top 5

Teleperformance	+2
Carpetright	+2
Sky	+2
Telenet Group Holding NV	+2
Pandora A/S	+1

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—NEGATIVE

Trend Algo - Top 5

Assicurazioni Generali SpA	-2
BAE Systems	-2
Carillion	-2
Celesio AG	-2
Connect Group	-2

Overall Most Negative

Afren	-6
Anglo American	-4
DKSH Holding AG	-4
BG Group	-4
Tullow Oil	-3
Aegon NV	-2
Allreal Holding AG	-2
BAE Systems	-2
Carillion	-2
Connect Group	-2
Parmalat SpA	-2
ThromboGenics NV	-2
Kazakhmys	-2
ASM International NV	-1
Assicurazioni Generali S.p.A.	-1
Fenner	-1
Salzgitter AG	-1

High Volume Algo - Top 5

Aegon NV	-1
Getinge AB	-1
Parmalat SpA	-1
TUI Travel	-1
Fenner	-1

Signal Algo - Bottom 10

BG Group	-5
Tullow Oil	-3
Anglo American	-3
Kazakhmys	-3
Afren	-3
Vedanta Resources	-2
Elementis	-2
Lonmin	-2
ThromboGenics NV	-2
DKSH Holding AG	-2

Correlation Algo - Bottom 5

ASM International NV	-1
Accor SA	-1
Aggreko	-1
Air Liquide SA	-1
Akzo Nobel NV	-1

Overbought Algo - Bottom 5

Ferrexpo	-1
Ratos AB	-1
Technip SA	-1
Salzgitter AG	-1
Tenaris SA	-1


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SERVING ALL YOUR GLOBAL MARKETS NEEDS
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ADM's operations encompass agricultural producing and consuming regions on six continents for over **113 years**; with a global network of agricultural sourcing, processing, transportation and financial services. Headquartered in Chicago, ADM has over **30,000** employees, more than **265** processing plants and net sales for the fiscal periodended 31st December 2014 of **$81.2 billion**.
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