

The evolution of an asset class

Commodities trading in South Africa began with the disbanding of the state-controlled agricultural boards in 1995 and the establishment of the Agricultural markets Division (AMD) of the South African Futures Exchange (SAFEX). For the first time, the AMD of SAFEX provided South African farmers with a tool for price risk management and price discovery for agricultural products. Then in 2001, SAFEX was acquired by the JSE Limited and became the Agricultural Products Division.

This was line with what has happened in agricultural markets across the world in a globalising world economy, where costly agricultural subsidies have failed, as also have state-controlled marketing boards. This trading of agricultural derivatives facilitates marketing and price determination whilst ensuring price transparency in the local agricultural market. However the main objective of a derivatives market is the provision of an efficient price risk management facility. Producers and users of agricultural commodities are able to limit their exposure to adverse price movements resulting from changing weather patterns, currency fluctuations and regional and international product shortages, by hedging their price risk and locking in favourable prices on a guaranteed basis.

This results in increased productivity in the sector as farmers and users are able to concentrate their efforts on managing production risks such as those caused by seasonal conditions, the weather and farm/production management. Farmers who have hedged a portion of their price risk can access funds from financial institutions at cheaper rates than would otherwise have been offered as these institutions are assured of reduced price risk profiles when dealing with such clients.

In fact, the agricultural derivatives market has developed to such an extent that the cash market now largely relies on its price transparency and discovery process to function properly. Prices generated on the derivatives market are now considered to be the industry standard and reference point throughout Southern Africa. In fact this has given rise to an interesting and somewhat anomalous phenomenon. Whereas futures contracts are labelled “derivatives” because their prices are “derived” from their spot or physical markets, in South Africa the spot prices are largely derived from their futures prices.

In October 2009, the division underwent another step in its evolution and was renamed the Commodities Division to signify a broadening of exchange traded commodities offered at the JSE. This does not mean that division will disinherit its roots. “Agricultural products will always remain a core focus for us because agricultural commodities, especially grain, are central to the South African economy. We will continue to serve the agricultural market, but have also broadened our commodities range to offer the South African investor increased investment opportunities,” says Rod Gravelet-Blondin, Senior General Manager of Commodities at the JSE.

For the first time from October 2009, local investors were able to trade in gold, platinum and sweet crude oil commodities listed on the JSE’s commodity derivatives market. The introduction of these commodities is due to an extension of the existing licensing agreement that the JSE holds with the CME Group, the world’s largest derivatives market.

With the extension, investors are now able to trade in futures contracts referencing benchmark gold prices from the CME Group's COMEX exchange and platinum and crude oil prices from its NYMEX exchange. "Expanding the existing relationship with CME Group to incorporate these additional products is an achievement for the South African derivatives market," says Rod Gravelet-Blondin, head of the Commodity Derivatives Market at the JSE. "South Africa is the world's largest platinum producer and third largest gold producer and so it made sense that we needed to offer South African investors related futures products which they could use either to gain exposure or hedge their exposure to a listed equity stock involved in the two commodities. The gold and platinum settlement prices from NYMEX and COMEX, two highly liquid exchanges, will ensure that the locally listed contracts reference an international benchmark for final settlement. This will bring much comfort to investors who will be able to access the international market via these rand-denominated contracts."

While the metals contracts are more likely to appeal to sophisticated investors and gold and platinum producers using them to hedge their production, any South African can trade these through a JSE registered commodities broker. The smaller contract sizes, for instance a crude oil contract could be obtained for only 100 barrels while in New York the contract minimum is 1000 barrels, which makes these attractive to the local investor. "We are particularly excited about the opportunities that a crude oil contract offers. Oil has a knock-on effect on all sectors of the economy. Notably, as diesel is a major cost in farming, this will give our agricultural market a tool to hedge a major input cost. We also expect interest from many other industries, from transport to manufacturing," adds Gravelet-Blondin.

Benefits

- Contracts are rand-denominated and settled in Rands
- Smaller contract sizes adapted for the South African market
- No foreign exchange permission required for corporates and individuals
- Trading on the exchange offers guaranteed settlement, transparency and daily revaluation of positions

Uses of trading these commodities derivatives contracts:

These new contracts offer local investors hedging and speculative avenues including the following:

Hedging

- ⊙ The two metal commodities are bound to be of interest to local investors as South Africa is the world's largest platinum producer and the third largest gold producer. These two commodities reference the international market for prices which could be used to hedge the share prices of gold and platinum mining stocks listed on the JSE, South African investors are now able to hedge their mining investment risk in these companies.
- ⊙ Platinum and gold mining companies will now have another alternative hedging tool for their local production.
- ⊙ Oil has a knock-on effect on all sectors of the economy. Diesel is a major input cost in farming, manufacturing and transport. These industry sectors will be able to hedge their oil component against fuel price fluctuation through the sweet crude oil contract.

Speculation

- ⊙ A weak dollar and recent inflation fears in the US have fuelled demand for mining stocks, particularly gold. South Africans keen to speculate will be able to take a position on the movement of the international gold and platinum price in Rand terms.
- ⊙ These contracts give local investors an opportunity to access off-shore exposure.

The risk factor

No investment trading product can offer returns without the investor having to assume some risk. The JSE cautions that as with any other investment product, investors need to be aware of the risks associated with trading these commodities futures contracts.

About the CME Group

Building on the heritage of CME, CBOT and NYMEX, CME Group serves the risk management needs of customers around the globe as the world's largest and most diverse derivatives marketplace. The exchanges within the Group offer products across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, agricultural commodities, metals, weather and real estate.



Full contract specs on the three contracts are available on www.safex.co.za/ap or email commodities@jse.co.za. To find out more about investing in these international commodity derivatives please contact your broker.

To find out more about the trading opportunities this market offers to both private and professional traders contact the JSE Commodity Derivatives Team on 011 520 7000 or email commodities@jse.co.za