# COMMODITY TRADING'S $100 BILLION YEAR

Record trades, intense volatility, extraordinary endurance

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The commodity trading industry set an all-time record in 2022 for gross margin, surpassing $100 billion. The expansion comes off intense volatility in commodity markets amid dramatic shifts in supply chains. This made 2022 a big year for traders in every sector, but a profile emerged of the players who deftly navigated the chaos. Trading firms that spent years developing their portfolios, agile culture, and expertise were well positioned to handle the disruption and keep commodities flowing.

Russia's invasion of Ukraine in February 2022 shook commodity markets, altering supply chains and sending prices bouncing. The world should not take lightly the role of a smart, well-capitalized trading desk willing to take risks in a time of upheaval. During a year when an important supplier cut itself off from much of the world, traders did their part to move commodities to consumers, helping to keep the pantries stocked, the lights on, the furnaces burning, and the factories supplied across many countries.

The growth in trading took place across all commodities, however some segments were impacted more than others. The river of oil and gas that once flowed from the eastern part of the world to the west changed course, with the effects rippling across the commodities industry and the globe. Leaders turned to renewables to address energy crises, boosting both green energy related commodities and natural gas. And while physical product flows drove markets, growth among the non-asset-backed traders accelerated faster than asset-backed peers, with these non-asset-backed traders now accounting for about 60% of the market (see Exhibit 1).

Trading groups that spent years developing their businesses, breadth, and talent saw that patience come to fruition. They were positioned to handle change in real time. Agile players with big, diversified systems and access to large amounts of cash and capital, combined with a culture of encouraging traders to evolve and take risks, were in the best position to thrive in 2022.

Industry revenue has **nearly tripled** since 2018 and **doubled** the 2009 gross margins when commodity markets boomed after the global financial crisis

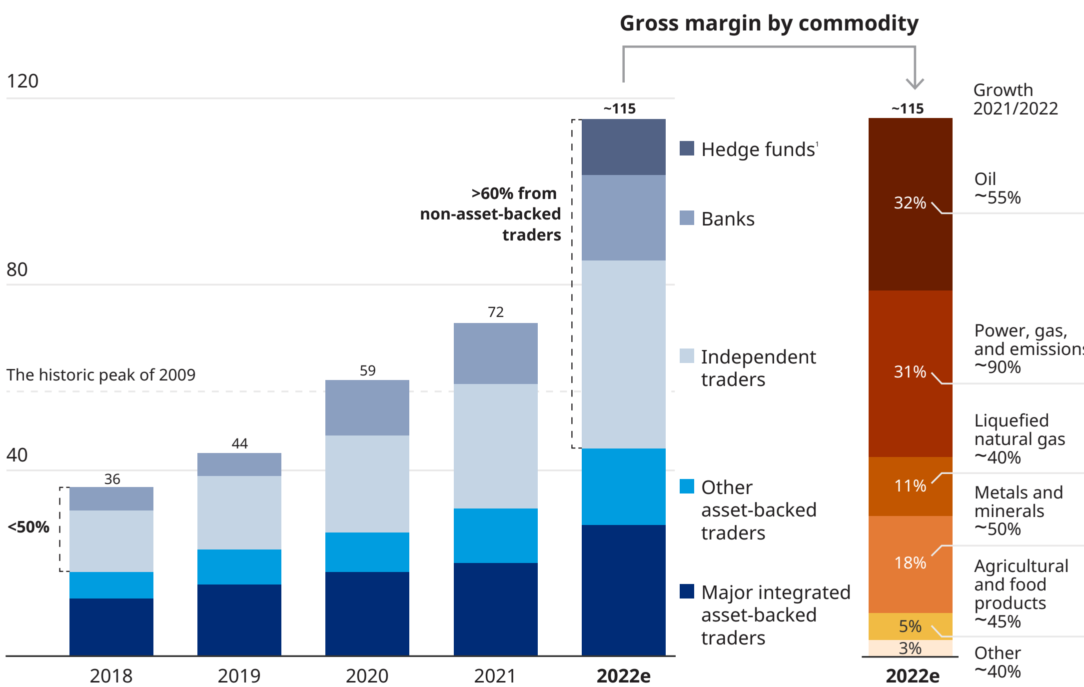
# THE RALLY CONTINUES

After two record years, 2022 marked another all-time high for the commodity trading industry. For the first time, the industry gross margin surpassed $100 billion. Industry revenue has nearly tripled since 2018, when it was $36 billion, and has nearly doubled the $57 billion in gross margins in 2009 when markets boomed after the global financial crisis. It is the most significant yearly increase we have observed (see Exhibit 1).

The key commodities driving the rise in trade were oil and natural gas. US and EU sanctions on Russian energy forced the country's product to flow east rather than west and drew new sources of energy to fill the demand in Europe. To attract US oil and liquefied natural gas (LNG) away from Asia, prices in Europe rose, resulting in extreme prices for electricity and greater interest in renewables. This contributed to oil trading expanding 55% and power, gas, and emissions trading rising an astonishing 90%. LNG was another key performer, up around 40% as liquefied product filled in gaps where pipeline gas was not available (see "Market by Market" section for details on trends observed in each commodity).

**Exhibit 1: Total global commodity trading gross margin**

US $ billion




Note: 1. Omitted prior to 2022 given relative scale and limited role in commodity markets, using them for macro view taking rather than full participation

Source: Oliver Wyman proprietary data and analysis

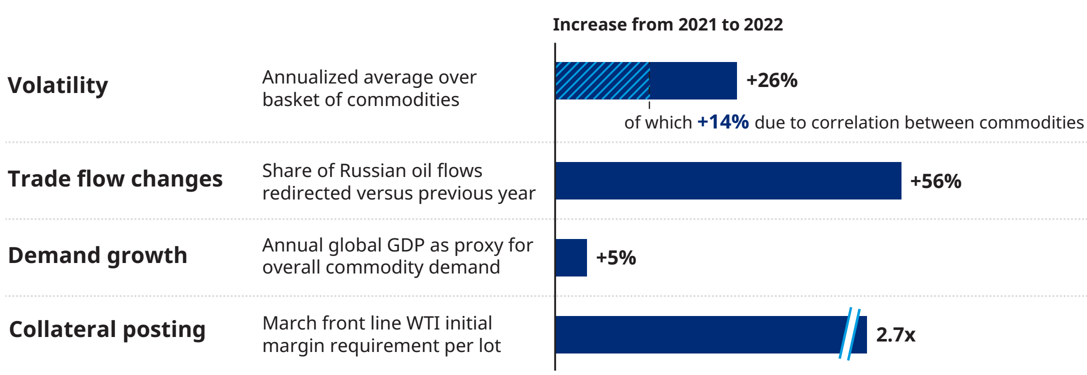
While the rising tide of the cross-commodity trading industry in 2022 lifted all boats, the sectors that saw particularly dramatic growth were the traditionally non-asset-backed traders.

That is, independents, banks, and hedge funds. Independent traders now comprise about one-third of the market, concentrated in just five firms. Banks are back after some firms invested in their capabilities, and now, after years of retraction, the sector represents nearly 20% of the market. Growth continued among hedge funds, too, which represent nearly 10% of the market, now that they have returned to commodities, drawn by the uncertainty in the markets. Together, this means the non-asset-backed players now generate over 60% of trading revenue, up from less than half in 2018.

These increases in trading margin were supported by four key market factors that drove opportunities for traders including: extreme uncertainty, impact of rapidly switching trade flows, expanding demand in short markets, and the increasing cash requirements on operations (see Exhibit 2).

## The sectors that saw particularly **dramatic growth** were the traditionally non-asset-backed traders

**Exhibit 2: Key market factors supporting trading profit growth**




Sources: Thomson Reuters Datastream, bp Statistical Review of World Energy 2021, IMF via Statista[1], Chicago Mercantile Exchange[2], S&P Global's Commodities at Sea service, Oliver Wyman analysis

# Traders' ability to deal with evolving market factors is what **differentiated** the strongest players

### Dramatic volatility

When people talk about high volatility, they are referring to prices taking off in one direction quickly, with ample changes. For example, if an event causes natural gas prices to soar. This situation is often beneficial for traders as they can buy low and sell high on physical and derivatives markets. Commodities markets in 2022 went beyond the normal use of the word "volatility." It was more than one or two price hikes. For some commodities, prices went up and down and up again and down again, each cycle generating opportunities for traders to make money on the upward and downward movements. In addition, the correlation between the different commodities increased, offering more trading opportunities while limiting diversification effects.

### Stable demand growth and short markets

Economic recovery ensured demand for commodities and energy remained high throughout the year. Global GDP continues to grow, up 4.6% in 2022 according to International Monetary Fund estimates, indicating an ongoing increase in demand for energy and raw materials. This rise in demand overall, while supply remained tight and potentially unavailable, pushed prices and volatility higher and created opportunities for traders.

### Trade flow changes

Shipping patterns changed, especially in the energy industry. Natural gas and refined oil products that used to flow to Europe and the US were forced to find homes in the Asia Pacific region. Once the flows reversed, other sources of commodities rushed in to meet demand, so the market could find equilibrium. Traders' ability to deal with these changes, re-direct cargos, find new sources and new outlets, is what differentiated the strongest players. The process of finding equilibrium opened opportunities for traders to optimize the system, while single origin or destination players were stuck.

### Significant increase in collateral posted and cash requirements

The demand for cash collateral at certain times nearly tripled in 2022 compared with 2021 based on stricter margin rules by the exchanges and fears of credit events. Some traders had to abandon in-the-money positions due to lack of liquidity, meaning some were forced to forego even more upside while others took this balance sheet pressure to assess the situation and drive increasingly capital efficient returns.

# OUTSIZED PERFORMANCE

The entire industry expanded in 2022, but some players outperformed others. The trading groups that had been investing in size and breadth, developing long-term trading strategies, and building their systems and talent base, were prepared right away to direct and re-direct commodity trades in real time as events unfolded. Their years of patient industrialization and professionalization paid off, and they were ready to capture these opportunities.

Two factors always explain a significant portion of the returns realized by the top commodity trading players: Size (that is, asset size, flow footprint, and amount of flexibility and optionality) and available, flexible, self-determined access to capital and cash (see Exhibit 3).

### Asset footprint and flexibility

There is no question that players with large diversified systems proved strongest in 2022. Usually, diversified systems smooth the ups and downs on the income statements, but last year this access to global flows was key to driving profit. Short and long positions across the globe helped re-balance the physical system. Large, flexible portfolios and the inherent intelligence from the physical flows also helped deduce the next market trend to place the right bets on derivative markets.

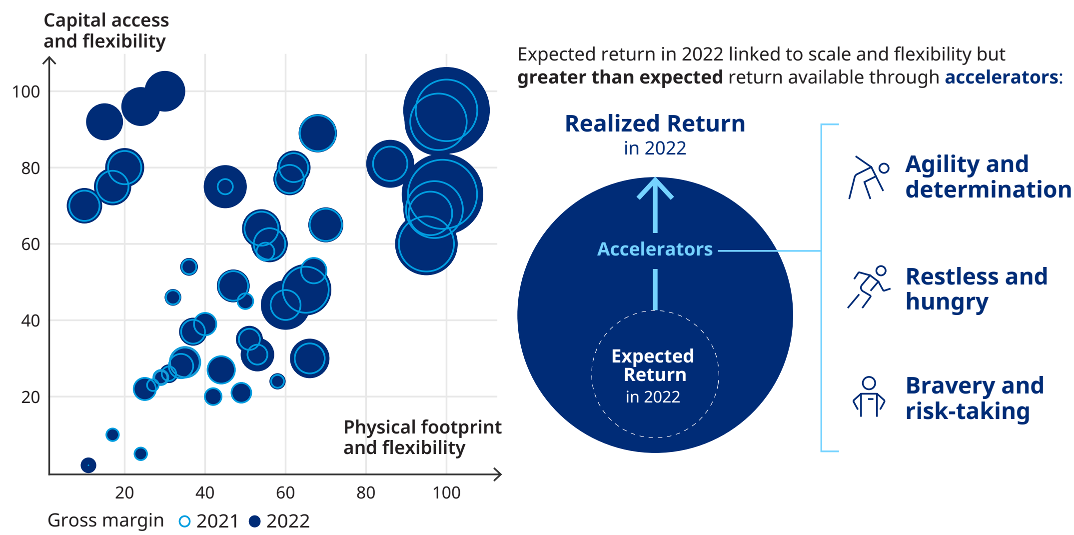
### Capital access and flexibility

Cash was king in 2022, that is, access to cash and ability to deploy it quickly. And this likely will prevail. Access to funding and cash was essential to succeed. Without ample funding, commodities in transit could not be financed, but even more important, derivatives positions for hedges and speculation could not be maintained on the books. Traders appealed to the public for help, and then moved swiftly to secure as much financing as possible.

There were though three other character traits of great traders that became performance accelerators, boosting performance beyond expectations based on assets and capital. Players that have developed a culture of agility, constant evolution, and bravery saw that investment in talent come to fruition.

Great traders had three character traits that boosted performance beyond expectations. Players that have developed a **culture of agility**, **constant evolution**, and **bravery** saw that investment come to fruition

**Exhibit 3: Characteristics of successful players that expanded beyond the expected**




Source: Oliver Wyman proprietary data and analysis

## Agility and determination

When trading markets suddenly changed directions in March and April, physical trade flows made a significant change. The agility to change trading strategies and to take decisions quickly and directly on the floor was critical, as was the pairing of permission and determination to embark on new markets, counterparts, and qualities. To a large part, systems-based clarity on the health of market, credit, and liquidity exposure and its integration into day-to-day decision making helped found both the agility and determination that separated winners from losers.

## Restless and hungry

There is a hunger and restlessness that sets apart successful traders. They never stand still, they are quick to learn, they are never complacent. They constantly evolve. The easy path during the past couple of years would have been to take a break and enjoy the dividends of a strong industry. Instead, the best traders invested in themselves and their work, creating new offers (or re-engineered existing ones) for their customers when parts of the disrupted market infrastructure and incumbent players could not provide their traditional services. They were ready to react to the situation in 2022, driven by the long- and short-term trader incentivization systems that keep the front office seeking ways to maximize the value of the most successful traders.

## Bravery and risk-taking

Trading markets in 2022 were not for the faint of heart. Willingness to take market risks got rewarded, with the traders who were brave enough to run large speculative books gaining a competitive edge. The hedge funds serve as perfect examples. At a hedge fund, two to three individuals trading European gas might have been allocated as much market risk appetite as the whole trading unit of an asset-backed trading house. This trust in the traders and the willingness of the traders to trust in their well-funded and structured analytics teams, technical toolkits, and physical information, and trade on the intelligence, generated billions of dollars in profits. In the fewer cases where traders got it wrong, significant losses were incurred, leading to much more differentiated performance compared to 2020 and 2021.

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# ENDURANCE PAYS OFF

Last year's global upheaval and market volatility shined a light on commodity traders, separating the good from the great. The experience revealed the wisdom of playing the long game, of building capabilities over decades, of creating a culture of talent capable of taking calculated risks. To succeed, players needed to manage some of the most complex systems in the world from both a physical infrastructure and a financial risk perspective. Those with patience and endurance saw strategies developed a generation ago come to fruition. The biggest wins were not based on one year of proprietary trades but on the culmination of a number of strategic bets in terms of portfolio and operating models, and especially in terms of intelligence and analytics.

The year was also a testament to the vital role the trader plays in the international economy, lubricating the markets, providing liquidity and financing, and ensuring prices can be found uniformly on a global basis. When the world faces intense change, and consumers begin to doubt energy and food security, traders play an important role in meeting that demand. And as the energy crisis accelerates a shift to green energy, traders will contribute mightily by developing the markets and supply chains for new, critical materials.

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1. IMF. (October 12, 2022). Global gross domestic product (GDP) at current prices from 1985 to 2027 (in billion US dollars) [Graph]. In Statista. Retrieved February 27, 2023, from https://www.statista.com/statistics/268750/global-gross-domestic-product-gdp/

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# MARKET BY MARKET

## Oil and products

Crude supply tightened as OPEC cut production, demand continues to rise globally, and trade routes have shifted. As reserves become depleted, some key industry leaders have forecast shortfalls into 2023. It all adds up to volatility.

Russian oil volumes found homes in regions without sanctions, largely China and especially India. Those countries are now absorbing around 70% of the Russian seaborne crudes, up from around 20% in early 2022. Russian crude supplants some of the crude and heavier products, as well as natural gas, that previously flowed into these regions from the Middle East and Africa, and supply from the Middle East and Africa is now ending up in Europe and the US — a longer, more complicated, and expensive route.

Tight supply and higher margins, with decreasing volumes in storage, increases market susceptibility to volatility. In this landscape, even minor disruptions can cause outsized market movements. It's an environment of overall escalating prices and reliance on traders.

## Power, gas, and emissions

In Europe, the power story is gas. Sanctions on Russian gas triggered a dramatic rise in electricity prices and a rush to renewables, with the EU rolling out a plan to increase the portion of green power generation to 45% by the end of the decade. In 2022, that meant merchant green power positions were incredibly profitable, and super peaker gas capacity is back in the game.

Small utilities struggled to keep up, as their hedging programs are not adjusted for such a market. That, and the high working capital requirements and risk limits for utilities, gave large traders and the Well-capitalized hedge funds an edge. The limited power supply caused prices in Europe to spike dramatically, but don't expect a repeat as alternate gas supplies and renewable generation come online.

Excluding Russian pipeline gas set off a domino effect of repercussions. The flexibility has been taken out of the European system, with partial gas storage nationalization. As Europe reached for alternative supplies, the global LNG party drove up US gas prices, which then exposed the US market to European weather spikes. This left Asia Pacific short of LNG, as Europe secured cargoes at top dollar, prompting LNG shipping rates to increase too.

Traders who understand gas have benefitted the most from the scenario. As short-term gas markets in the US continued to develop, they offered ample trading opportunities to national — and especially the US arms of European — trading houses.

## Liquefied Natural Gas (LNG)

Russian imports of gas into the EU went from meeting more than 40% of demand to zero in the matter of months. While European producers made up a portion of the shortfall, the situation triggered significant demand for alternative sources, in particular, LNG. Traditional shipping patterns of the US and Middle East moving LNG to Asia Pacific were disrupted, as cargoes were regularly re-directed to the EU.

To attract the supply, EU prices had to rise, offering traders who were long liquefaction capacity and shipping ample trading opportunities. Expansion of Northwest Europe LNG terminal capacity will stabilize flows into Europe, which now constitute a significant influence on international LNG pricing.

## Metals and minerals

Metals trading was active in 2022, but overall flows weren't as disrupted by the energy crisis as other commodities. Significant demand for copper and nickel drove trading activity and secured good margins for the trading houses that are active in this space.

A new group of metals entering the trading arena related to batteries, including lithium and cobalt, as well as the green versions of the traditional metals, offers more opportunities in this sector.

A significant portion of the growth in the sector came from the trading of coal — with gas prices spiking and uncertainty about the supply situation, power producers bought more coal than originally planned to ensure the lights would not go out, As a result, this created ample opportunities for the traders still active in this space.

## Agricultural and food products

Strong global demand, adverse weather, and conflict caused tight supplies and rising prices for the agricultural products used in food, biofuels, and feed. In some places, consumer panic triggered nationalistic policies to stockpile domestic supply, triggering even greater price instability. For traders, margin results were stellar.

The four major grain traders, the so-called "ABCD" quartet, benefited from the strong global demand. The largest players were able to strategically position themselves to benefit from multi-origin supply arbitrage and vertical value chain integration, mitigating logistical constraints of seaborne exports from the Black Sea region. As for small players, they got squeezed by working capital constraints with larger margin calls on hedging and speculative activity.

Global oilseed crush margins were also large contributors to high gross margin results. Yet another domino in the chain of events after the Russian invasion of Ukraine: growth in renewable diesel production capacity boosted demand for vegetable oil feedstock.

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