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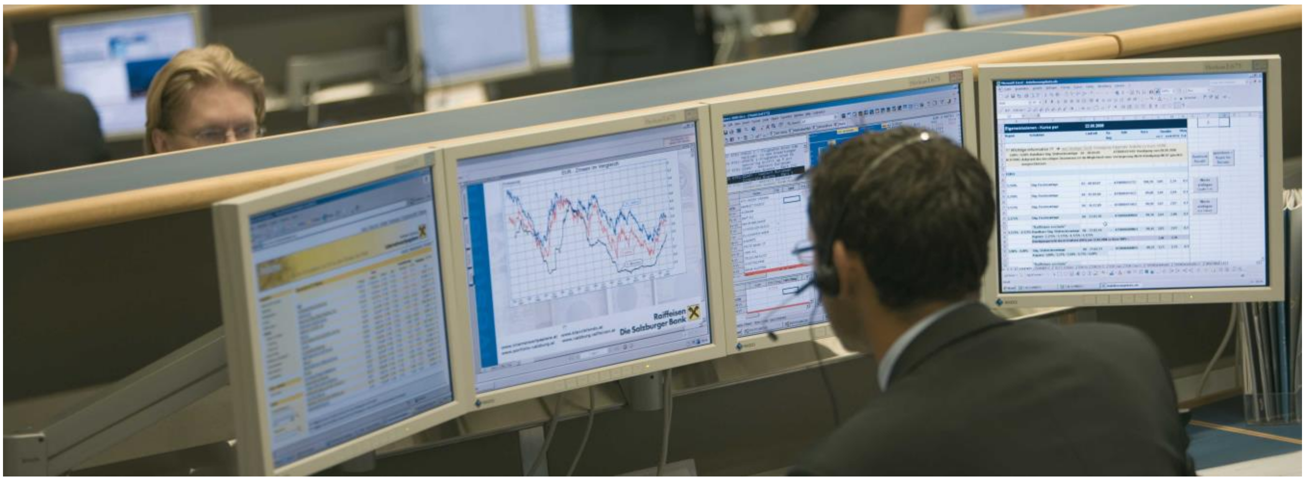
The Evolution of Commodity Trading

Many people consider commodity trading mainly as a ruthless profession where the interests of traders are merely driven by profits. However, the truth lies far beyond that. Gone are the days when commodity traders used to rely purely on trading along with asset-light structures to make massive profits. Today, commodity traders play an integral role in the supply chain of materials through the acquisition of physical assets and becoming a part of the value chain.



Many independent trading houses own fields, storage facilities, port terminals, refineries, and other relevant infrastructure that ensures a smooth supply of goods around the world. All of this makes it all the more important to understand how commodity trading works along with the impact of commodity giants on the world economy.

Basics of Commodity Trading

The term "Commodity" refers to the common raw materials that you generally see in your daily life. Some examples of commodities are wheat, rice, gold, oil, natural gas, etc. As the name suggests, commodity trading refers to the trading of these commodities. In general, commodities are classified into 4 categories:

- Energy Commodities (crude oil, natural gas, and gasoline)
- Metal Commodities (gold, silver, nickel, and platinum)
- Livestock and Meat Commodities (pork bellies, live cattle, and feeder cattle)
- Agricultural Commodities (wheat, rice, cocoa, coffee, cotton, and sugar)

When talking about commodity trading, we differentiate between physical trading and financial trading. Physical trading involves the transfer of goods from the seller's location to the buyer's required destination. It is generally used by companies that are involved in the production of goods and require the commodity as raw materials or for other purposes. The pricing of physical commodities involves extra costs such as freight, transportation, taxes, etc. Financial trading mainly involves the buying and selling of commodities on the exchanges to make gains or hedge against a price rise or fall. It does not involve any movement of goods. Financial trading is mainly carried out by commodity traders and multinational companies.

History of Commodity Trading

Commodity Trading has made its impressive journey lasting as long as the human civilization. The commodity markets have seen it all from world wars to global financial crises, and now the pandemic and the Russia/Ukraine clash.

The roots of commodity trading can be traced back as early as between 4500 BC and 4000 BC in Sumer (modern-day Iraq). The Sumerians used clay writing tablets that contained information such as the number of goods to be delivered, date of delivery, etc. Such a contract has a resemblance to the futures derivatives contract used today. In the early days, civilizations were involved in the trading of goods such as cattle, gold, silver, grains, etc.

The establishment of the Chicago Board of Trade (CBOT) in the 19th century was an important milestone in the history of commodity trading. CBOT initially offered commodity trading for corn and wheat with further expansion to plywood and silver in 1969. The volumes in commodity markets have grown at an exponential rate with further potential to rise with the advent of modern technology and online trading. Some of the biggest commodity exchange markets in the world are the Chicago Board of Trade (CBOT), London Metals Exchange (LME), New York Mercantile Exchange (NYMEX), Shanghai Futures Exchange (SHFE), and European Energy Exchange (EEE).

Working Mechanisms of Commodity Trading

In the earlier days, commodity trading used to take place through Pit Trading. Here, the buyers and sellers placed an order with the broker on the trading floor of the exchange. The broker used to relay the order details to the desk clerk on the commodity exchange floor who further conveyed the details to the floor broker. Next, the floor broker executes the trade on behalf of the customer by contacting another floor broker or a market maker (individual or member firm of exchange that buys and sells securities). Finally, upon execution of the order, the floor broker informs the desk clerk who informs the commodity broker. In the end, the commodities broker informs the customer of the trade. Pit Trading is a highly time-consuming process that requires a lot of effort on behalf of the commodity trader.

Things have become a lot simpler today. Commodity traders use electronic trading where they simply enter orders on an electronic trading platform and the exchange matches the buyers directly with sellers. Electronic trade has led to trades being executed in a matter of seconds along with lower costs.

Evolution of Commodity Trading Firms

In the 1900s, commodity traders were primarily involved in speculative trades and arbitrage opportunities that enabled them to earn good profits. But things have come a long way since then as commodity trading firms are now an integral part of the supply chain. This backward integration in the acquisition of physical assets combined with their trading knowledge gives a huge advantage to commodity trading firms. Owning the supply of a commodity allows the commodity houses to dictate the prices and then take positions in trade markets allowing them to make huge profits.

Importance of Commodity Traders

According to a 2019 report by UNCTAD, more than half of the world's countries (102 out of 189) and two-thirds of developing countries are dependent on commodities. As a result, many global commodity houses such as Glencore, Trafigura, Vitol, Mercuria, Koch Group, ADM, Cargill, and Louis Dreyfus are important figures in ensuring commodity supply with having the power to dictate the flow of assets and determine commodity prices that would have an impact on the entire world.

For instance, Vitol, one of the biggest commodity houses in the world, reported a trading volume of 7.6 million barrels of crude oil & products a day in 2021. Such a huge volume is more than enough to satisfy the needs of various nations. Commodity markets are an integral part of the global company being the primary drivers of inflation and growth. As such, economies around the world have their oversight committees such as Federal Energy Regulatory Commission ("FERC") and the Commodity Futures Trading Commission ("CFTC") that ensure trading takes place while keeping in mind the rules and regulations.

Even though commodity traders are sometimes portrayed as evil corporate men, the amount of risk they bear by owning and trading in such assets is highly remarkable. Commodity traders ensure that the goods reach from the seller to the buyer, fulfilling the gap in global demand and supply. Their existence is vital for the global supply of goods. These companies generate huge business for the economies in the form of taxes, employment, investments, research, and innovation.

Funding Commodity Trading

Commodity traders primarily obtain finances from banks through either a letter of credit or revolving lines of credit. Procuring finances is a particularly difficult area for commodity houses to the inherent risk involved. Many financiers have come under criticism for lending to such companies due to their negative impact on the global climate. The Russia-Ukraine conflict has led to huge volatility in commodity prices, making banks wary of their financing to such commodity houses.

Managing Risk

The pandemic and the Russia-Ukraine conflict has heightened the level of risk for commodity traders due to a sharp rise in price and volumes. As a result of the 2020 pandemic, many commodity traders and firms saw frequent margin calls being triggered that led to their bankruptcy. Also, owning physical assets brings extra costs such as storage costs, hedging costs, transportation costs, manpower costs, etc. Dealing with governments for production and procurement of natural resources involves a lot of bureaucratic issues, particularly in countries with economic instability. Many times, commodity trading firms are forced to shut down mines, plans, and refineries due to protests from local people or other reasons resulting in the loss of huge capex investments. All of these issues make commodity trading a highly risky business.

Commodity Traders role in today's ESG era

The majority of the commodity houses such as Glencore, Trafigura, Vitol, and others have come under tremendous pressure from the public and government authorities for their impact on the environment. As a result, such companies have become highly sensitive to environmental needs along with investing in renewable projects that help in environmental sustenance. Another reason behind the increased focus of such companies on ESG (Environmental, Social and corporate Governance) factors is the pressure from investors.

Many of these companies are required to publish sustainability reports as per regulations to help investors and government authorities understand the impact they are making on the environment.

The websites and social media pages of commodity traders such as Glencore, Trafigura, and Vitol would allow you to see the various ESG actions taken by the company along with their targets for the future.

Bottom Line

Commodity trading has seen a drastic change over the past decade with bigger commodity houses becoming an integral part of the supply chain. With a bigger role to play in climate change and ensuring an uninterrupted supply of goods, commodity traders have a greater role to play in the world economy. Some issues regarding business practises still persist. However, efforts have been taken by both governments and commodity traders to ensure better business practices that are targeted toward sustainability, human rights issues, and compliance with laws. Commodity traders will continue to face a huge amount of backlash and risk in the coming times. The way they adapt to the changing world order of ESG will only be determined in the future.

About ComFin Software

Since 1997, ComFin Software has been trusted as a global leader for affordable, comprehensive, and agile financial risk management software solutions – categorised as CTRM (Commodity Trading and Risk Management). We have helped companies such as trading houses, refineries, and shippers across the globe to minimise their exposure to volatile markets by arming them with the knowledge, resources, and administrative processes they need to perform commodity trading successfully.

With the CTRM solution Comcore™ you will have the perfect tools to maximise your profits by minimising your financial risks.

Instead of having to deal with paperwork, or maintaining, updating, and reviewing multiple spreadsheets, the Comcore™ system helps you streamline everything from trading futures and options to their underlying commodities (i.e., paper and physical markets).

The complete Comcore™ software is available in 108 languages.

Furthermore, ComFin Software is recognised for its ability to provide consulting services in all aspects of commodities trading.

For detailed information go to www.comfinsoftware.com

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