COMMODITY DERIVATIVES

There has been a lot of hype surrounding derivative instruments (specifically financial derivatives or single stock futures) over the last few months. While all media coverage has focused on the financial markets, the commodity derivatives market in SA continues to build on the past 14 years of operation, providing both future and option contracts in order to facilitate price risk management.

Early evidence of the use of derivatives instruments can be traced back to Ancient Greece when the price risk of the local olive crop was managed through an option-type contract. Further examples can be found in the 12th century and later in the 17th century, specifically in the trading of rice by the Japanese.

Derivative instruments used to manage price risk therefore hail from commodity markets and not financial markets. The commodity derivatives market in SA may not be of any significant age but provides the same tried-and-tested instruments that were designed all those years ago.

Following the demise of the agricultural control boards in the mid-1990s, Safex (which was then trading financial derivatives) agreed, through a separate membership, to create the Agricultural Markets Division of Safex. The division commenced with a cash-settled potato contract and a chilled beef carcass contract. However, it was the white and yellow maize contracts that ensured the success of the division.

Still today, the JSE white maize futures contract remains the only white maize futures contract in the world as the rest of the markets prefer to trade 'yellow maize' or 'corn' as it is referred to in many countries.

The division then introduced bread milling wheat, sunflower seed and soybean contracts, providing both future and option instruments on these products. Essentially, Safex became the pricing benchmark for grain products and the ultimate tool for price risk management.

Through committed members, supporting clearing members and many hours of face-to-face marketing and training, SA has a large number of producers and end users participating directly in the market.

Since the exchange has only ever traded electronically, the system is transparent and provides direct market access for farmers from as far afield as Mafikeng. Traders predominantly access the exchange from the

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core production areas within SA and have represented clients from five different continents.

In 2001, the JSE bought Safex and the division became known as the Agricultural Products Division of the JSE.

As with any exchange, the agricultural derivatives market recognises the importance of adding value to those who either participate directly or who refer to the market as a benchmark for pricing. The division operates under defined rules and contract specifications which continue to evolve as the market matures. A good example of this is the introduction of speculative position limits on the very liquid white maize contract to manage the dominance of such players.

The transactions recognised by the exchange are guaranteed by the clearing members thereby removing any counterparty risk. There are five clearing members, most of which are large SA banking institutions, that stand good for all their members' transactions.

The grain prices that are disseminated each day via the local and international media are a direct result of trading activity undertaken on the agricultural derivatives market. The JSE's agricultural products market, due to its liquidity and acknowledged integrity, is referenced throughout southern Africa and is used by the cash market in SA to determine the fair value of grain.

Commodity markets are known for their volatility, since production is so reliant on nature. In SA, which has a limited water supply, a shortfall or surplus of maize is determined in the short space of two months – rain is critical in January and February for efficient pollination and plant growth and so it is usually during this time that the market tends to be most volatile.

This volatility also attracts speculators to the commodities markets who hope to benefit from favourable price movements. Often speculators are frowned upon, particularly in commodity markets trading a staple food; however, they are key to ensuring liquid markets as they often take on price risk where a traditional hedger would not be interested in participating.

A good example is when maize was trading at R480/ton. There were very few producers who sold their product at this time. While end users were interested in hedging their future consumption, speculators saw further opportunities for prices to decline and so ensured there was a willing seller to facilitate the trade.

The importance of managing price risk in commodity markets and the ability of the SA grain participant to adapt to the freeing up of the agricultural markets largely contributed to the success of the agricultural derivatives market. 2008 was a record trading year with just over 2.6 million contracts dealt. White maize represented 50% of the total contracts traded while wheat was the second most liquid product with 25% of total contracts traded.

2009 saw the launch of the Chicago corn contract on the Agricultural Products Division. For the first time ever South Africans have the ability to hedge their maize price risk on the international benchmark, namely the Chicago Board of Trade.

A licensing agreement with the CME Group, the largest and most diverse derivatives exchange in the world, allowed the JSE to introduce the Chicago corn contract which is cash settled off the physical contract traded in the US.

The contract, traded and settled in rands, allows local producers and end users an alternative hedge possibility. So should a producer view the international market as a more efficient hedge, the contract could be traded without any additional paper work or Reserve Bank approval. Speculators also have easy access to the international market.

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It is also easier to take advantage of trading the difference between the local versus international crop as they are now accessible on a single trading platform with the benefit of reduced initial margin requirements.

By introducing the corn contract as the first foreign-referenced, cash-settled commodity, it has paved the way for the Agricultural Products Division to expand into other commodities. The division is actively pursuing the introduction of derivatives on crude oil, gold and platinum which will be cash settled off an international benchmark. These additional commodity products will provide both the retail and institutional investor direct exposure to foreign markets through derivative instruments.

The division will later rebrand to become the Commodity Derivatives Division, more accurately reflecting the product range soon to be available.

The division may have been called a number of things in the past, but we continue as commodity specialists, to provide price risk management tools to South Africa and southern Africa.

For more information visit www.safex.co.za/ap or email commodities@jse.co.za.