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Commodity giants are threatened by a liquidity crisis - the consequences can be severe: - It will be so dramatic that you won't understand

Heat, hot water, light and food. The very basics are at stake in the commodity markets now, according to hedge fund manager Tor Svelland.

Tor Svelland's commodity fund has a return of 20 per cent so far this year, but Svelland is cautious: - You cannot trade as normal in a market like this. You have to be able to handle what are really unimaginable fluctuations, he says.

- I'm not saying that Kiwi will be empty tomorrow, but if something happens to these companies, a loaf of bread will not cost NOK 30, but NOK 100.

That's what the experienced commodity trader and hedge fund manager Tor Svelland says.

In recent weeks, he has witnessed a commodity market thrown completely out of balance.

Russia's brutal invasion of Ukraine has created price swings that are rare in history. Oil, the very lubricant of the world economy, is trading at levels not seen since the financial crisis in 2008. The prices of steel, gas, aluminium, wheat and fertilizer are at "all-time highs".

Now Svelland, who is most recently known as the head of shipping billionaire John Fredriksen's empire, is worried about the companies that trade and transport "all" of the world's food.

- Nothing can happen to them. It will be so dramatic that you won't understand. They must work, and the politicians must understand that.

Extremely careful

Tor Svelland has run the London-based hedge fund Svelland Capital since 2016. So far this year, the fund, which trades in commodity securities and commodity- and energy-related shares, has risen 20 percent.

- I have to stress test the positions every day, because you never know what can happen in such a market. One headline can change the risk picture completely.

Hedge funds use advanced and complicated financial instruments to neutralize risk, but can also invest crudely across assets such as shares, commodities, currency and others in order to attempt a large payout.

Tor Svelland says that he is extremely careful.

- You cannot trade as normal in a market like this, because suddenly you have to be able to handle what are really unimaginable fluctuations. It's about risk management more than ever.

At the center of the extraordinary commodity situation are the large trading houses Glencore, Vitol, Gunvor and Svelland's former employer, Trafigura. They earn enormous sums from moving raw materials around the world - including Russian oil - and from speculating on price fluctuations.

In the last week, Trafigura has been on the hunt for money after the uncertainty in the markets has increased, and the banks want more security to carry out trades - even for the almost legendary traders. Trafigura recently got 12 banks together to secure NOK 20 billion in financing to deal with what the trading house describes as "unprecedented market conditions".

Trafigura must provide security for both the cargo it transports and the financial trade it carries out, and these so-called margin requirements increase in line with increased prices and fluctuations.

- For the large trading houses, this is really a dream situation. Most people are guaranteed to make a lot of money from this. The problem is the extreme fluctuations that increase margin requirements, which in turn create major liquidity problems, says Svelland and continues:

- The margin requirements are simply too large, and they come before the trading houses receive settlement for the physical commodity. This is historic.

Most traders trade in the physical markets, where they agree to deliver specified goods at agreed times. At the same time, it is common for them to lock in all or part of the payment on futures contracts in the financial markets, in order to reduce the risk. Then they have to provide security.

"Business as usual"

Recently, Trafigura's CFO spoke out in the Financial Times saying he feared a wave of bankruptcies by smaller traders as a result of liquidity problems.

- Whether the little ones survive depends entirely on the financing situation they have. It is not the case that just because you are small, you are at risk, says Svelland.

He mentions Gunvor and Litasco, which turn over several hundred billion kroner annually. Both companies have recently sent out letters to the market and assured that everything is in order and that it is "business as usual".

- The market questions that, because it is not normal.

What happens if one of the major oil and metals trading houses is no longer able to make ends meet? Svelland is not worried, and believes that they will get the help they need in the market. In the worst case, it will be one less competitor for the others.

But some houses are more important than others. Svelland explains that the liquidity situation is very challenging for the so-called ABCD companies: Archer Daniels Midland, Bunge, Cargill and Louis Dreyfus, which trade and transport foodstuffs and ingredients such as wheat, soybeans and fishmeal.

Here he believes states will intervene, if necessary. Among those who know the markets best, the energy disaster and food crisis are being talked about with increasing seriousness.

The question is no longer if it will happen, but how bad it will be.

- This is about basic things such as having heat in the house, hot water, light and food in the cupboard. That is what we are talking about, says Svelland.

Receives a record number of inquiries

It is not just the financial circles in London that are shaken. Now it is also knocking on the doors of Norway's largest bank.

- We receive more requests than we have ever received to secure commodity exposure. Many who have not insured before will now, says Kristoffer Dale.

He is head of the commodities department in DNB's brokerage house, follows the markets closely from day to day, and assists customers in being prepared for stormy weather.

The raw materials manager cites a recent example where they were asked to secure costs for a major industrial installation. In came a detailed list of various metals down to the kilo class for which the customer wanted to secure prices.

Never before has DNB received more requests to hedge commodity exposure, according to the bank's commodity manager Kristoffer Dale (left). Here together with Børge Rogstad, the bank's head of risk advice for corporate customers. (Photo: Fartein Rudjord)

His colleague Børge Rogstad heads DNB's risk advisory department, and says customers are more concerned about risk now than in the past.

- The risk you have seen now is great compared to what could be predicted.

Last summer, Rogstad went out to customers with possible scenarios for gas prices. Now, three quarters of a year later, even the most optimistic outcome rooms have been put to shame.

The DNB duo sees that more and more producers, instead of selling their goods on a stock exchange, for example the electricity exchange, now rather establish credit lines so that they do not have to provide large amounts of cash as collateral.

This is how the market works

The financial market for power is a futures market, which means that you can enter into a contract today to sell power that will be delivered in the future.

Some producers do this to secure fixed prices for future production, while others buy and sell such contracts to bet on future prices.

When a producer enters into an agreement to sell a certain quantity at a certain price, it must provide security so that the stock exchange can protect itself against the buyer or seller not being able to settle for themselves.

If overnight prices double, the seller must cough up the negative value change on the futures contracts in cash security. This is what is referred to in English as a "margin call".

The future production that is secured will also have risen accordingly in value, but those values are not realized until the product is produced and delivered. In the meantime, a need for liquidity arises.

When there is so much uncertainty and big price changes in the market, even solid companies can have problems covering losses on futures contracts.

More

When the prices of the raw materials rise, the requirement for safety will rise accordingly.

- The liquidity you have to bring in can be significant, says Rogstad.

- A danger in this market

Investor and former manager Peter Warren believes it will "hit everywhere" if access to liquidity is reduced.

- When there is a stressed market situation, there is also stress on liquidity. This is what happens when you have suppressed the fluctuations in the markets with the help of central banks for over ten years.

- No one is used to volatile markets. Those who managed risk when the markets were free, and then you have to go back before 2008, are no longer there. Those who are there now have not dealt with a large fluctuation and have not been out on a winter night before. There is a danger in this market, he says.

- The downturn comes when no one thinks it's coming, says investor Peter Warren. (Photo: Elin Høyland)

Warren believes Trafigura was sweating during the period it was working to raise new funding.

- Trafigura is one of the best-known and largest commodity traders out there, which trades physically and on the stock exchange, and has established lines with all the major investment banks. Even Trafigura spent a week getting things in place, he says.

In London's financial district, Chinese Xiang Guangda's crazy bet, which ended with the nickel market tumbling, remains as the manifestation of the extreme financial movements in the commodity market.

Although other metals have also become record expensive, no other has suffered quite the same fate. There is also no sense of panic on the stock exchanges.

- The downturn comes when no one thinks it will. The more people who answer no, the more dangerous it is. That's exactly what they said in 2007 and 2008 as well, and it was exactly the same thing they said during dot.com, says Peter Warren, and continues:

- The traders I speak to who sit in banks and funds are worried. Some of them envisage the price of oil at 200 dollars and above.(Terms)