OpalCrest

A Digital Commodities Firm

Liquidity intervention in agricultural markets

Participants who surf on the commodity markets achieve different outcomes every year, depending on their timing and the size of the wave on which they ride. I define the size of a market wave as the liquidity in that market. Usually, the greater the liquidity, the greater the incentives to participate in a market. Within the commodities asset class, agricultural markets have unique liquidity characteristics, which I will address below.

First, in agricultural markets, liquidity is a function of seasonality. In general, planting and harvest times bring the greatest market participation of producers. Growing cycles bring traders into the market. Pre-planting and post harvest are generally times when passive investors participate. These observations are supported by publicly available data. Any sudden change in weather that affects seasonality can also significantly impact market liquidity.

Second, the amount of market volatility in agricultural markets influences active funds to either participate or stay away. Generally, the greater the volatility, the greater the incentive for funds to participate, as they can achieve higher returns. Volatility is different across agricultural commodities (e.g., palm oil, cocoa, sugar, wheat), leading to an ebb and flow of capital among these products, which then can lead to a change in the liquidity profile of each.

Third, fundamentals play an important role in attracting liquidity into the agricultural markets. In general, high supply makes it unattractive to pour liquidity in, and lower supply makes it more attractive, if demand is held constant. This type of liquidity cycle is also long term, as it lasts longer than a season or a year. One such example can be seen in this year's grain markets.

While the reasons illustrated above cause the shifts in liquidity profiles, a few indicators such as bid/ask spreads, sudden changes in curve structures, and divergence between cash and futures markets are good predictive tools for an impending liquidity event in the future. Once we have identified the causes for liquidity events and indicators that predict such events, we are compelled to answer two questions: Do we intervene to prevent a possible liquidity crisis? And if so, how?

The first answer should be yes, as liquidity in markets is something that benefits all market participants – it can be defined as a common good. Liquidity intervention reduces sudden shocks in the market and substantially lowers risk for participants. In my view, there needs to be a clear definition of a minimum threshold liquidity level that government or regulatory bodies should maintain. *(My proposal can be viewed in one way as a subsidy, but in other ways, it can be justified as a maintenance cost instead of a*

PRUDENTIAL TOWER, 30 CECIL STREET, SINGAPORE 049712
www.opalcrest.com | INFO@OPALCREST.COM
© opalcrest 2016

cost triggered by a one-off event in case of crisis). This solution is analogous to how the central banks maintain a money supply in the economy.

There are several advantages of this proposed solution: First, it is a preventive and predictive solution for liquidity management. Second, it reduces the costs of aftershocks for the government, should there be a market failure. Third, the price of liquidity risk falls, benefiting market participants. Fourth, entry barriers for new participants are lowered. Fifth, and possibly most important is that the aforementioned effects of seasonality, volatility, and fundamentals on liquidity changes can also be mitigated.

© opalcrest 2016