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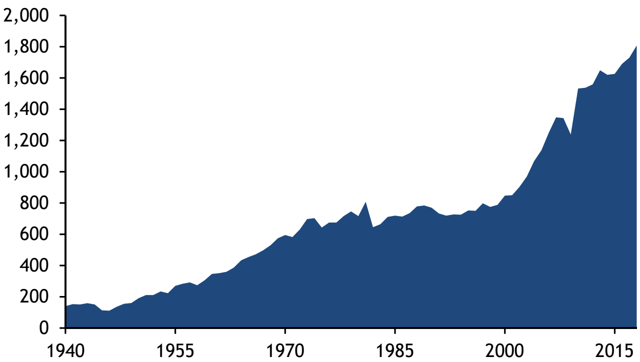
Argus White Paper:

When politics Trump fundamentals: steel trading in an age of uncertainty

Steel analysts lavish models with data feeds, but much price movement is now driven by factors other than fundamentals. When a single tweet from the US president is able to crash markets, how can the steel industry adjust to this new environment?

Steel mills are surprisingly price inelastic for inputs. Because they are so exposed to price movements, raw materials are often hedged, with indexes used for purchases and financial settlement. Yet finished steel exports, (a quarter of global production), remain bilaterally negotiated & unhedged. This will change.

Global crude steel output *mn t*



High noon in the steel industry.

Anyone joining the industry in the last decade, might not know steel was seen as a sunset industry in the late 1990s. Asia's growth effectively re-extended the industry life cycle, turning the clock back to a new dawn or sunrise. That was back in the new millennium but now it is at least noon.

The five industry life cycle stages are start-up, growth, shakeout, maturity and decline. China has been "shaking out" over the last few years, with closures and mergers throughout 2017-18. As output moves beyond demand, the industry is shifting to another stage. Maturity is typified by participants moderating the intensity of industry competition, by reducing rivalry.

But outside China to date there has been no attempt to reduce price-based infighting in the wider Asian market. The traditional global clearing ground for steel imports, Vietnam, sees regular competition from India, China, Japan, South Korea, Taiwan, Russia, Turkey and Brazil to sell spot tonnage. That competition is overwhelmingly cost based, leading to a form of Mexican stand-off.

China can supply the most tonnage, so India prices at a slight discount to China. To remain competitive, this encourages Chinese prices to fall. And so the cycle continues. All other parties are manoeuvring around the steel giants. Rational participants do not compete on price. But this is the first sustained period of oversupply for a generation of steel salespeople in Asia.

So what solutions are there? There are two separate issues. The first is too much spot-based competition, the second is short-term volatility in a world sometimes detaching from market fundamentals.

Indexation coupled with tradeable steel futures offer potential lifelines.

The index link

Starting with the first, the obvious action is to identify the price setter, and stop competing on price with it. The price setter has been, and remains, China by sheer volume.

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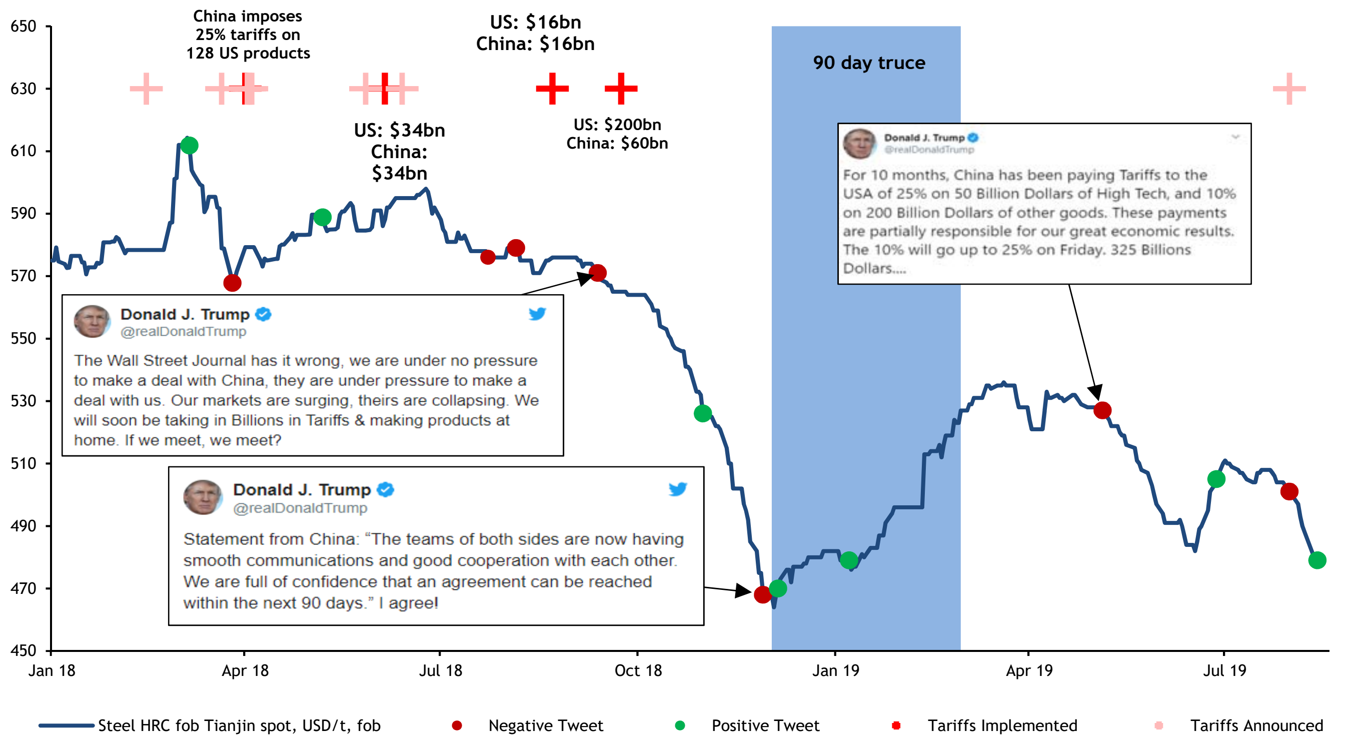


China sets the marginal hot-rolled coil (HRC) export price based on domestic market profitability. Healthy domestic markets thin exports allowing others to raise export tags. If bad, China competes to win tonnage. Linking to a fob China price, with a discount or premium, formalises that reality, meaning both buyers and sellers can be assured of competitive prices without continually cutting away at each other's necks.

China's HRC exports compete regionally globally. Correlations between the Argus fob China HRC export price with Japanese, Indian and Taiwanese material are above 90pc, as are those with Turkey. It is a global steel price. Linking to it reduces the sheer number of parties competing for fixed price sales.

The second problem is dealing with non-forecastable events. How can sellers or buyers of steel deal with prices being moved by policy, rather than fundamentals?

Twitter happy fingers

Commodities markets in recent years can be felled with a single tweet, or elated by an NDRC communique. The threat, and application of trade tariffs between US and China, coincided with a huge slide in steel prices in China, and globally, as a ratcheting trade war induced economic slowdown.

A truce from December 2018 until March 2019 reversed this trend, before a surprise expansion of tariffs in May – delivered by tweet – sent prices tumbling again.

While there is no way to forecast discontinuous events, this is precisely where hedging has utility.

In March the LME launched a fob China HRC futures contract settled against the Argus index, a hedging tool with global access and utility. Early volume growth indicates appetite.

Used together with indexation, futures secure forward price visibility. For steel producers able to hedge their exposure to China-driven raw material prices via iron ore futures, a further benefit is to lock in the spread between their input costs and output prices in advance – a hedgeable margin.

Levelling the field

The Chinese market is already doing both via domestic indexes and domestic futures contracts for coking coal, iron ore and steel. But that has not crept into HRC export markets, which remain bilaterally negotiated. Here sellers and buyers are locked in frustrating, never-ending negotiations over a fixed price.

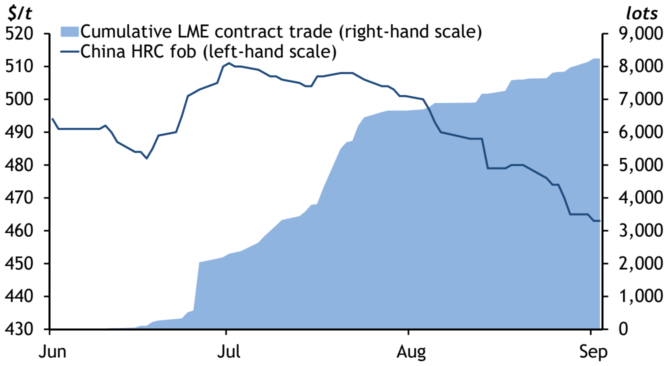
Those competing with China often struggle to keep pace with rapidly changing offers. Japanese and South Korean mills rarely update their export offers more than once a week, by which time their prices may be wildly expensive or unnecessarily cheap.

Indexation and futures offer solutions to the issues of the day – a surplus of spot price competition, fast-moving prices and event-driven price uncertainty. Steel producers, consumers and trading firms in northeast and south Asia can lock in HRC export prices in advance.

Perhaps most crucially, the combination allows the steel market to offer solutions that consumers have cried out for years – longer term and fixed price contracts. Steel producers and steel vendors with differentiated offerings will perform better than those competing for one-off trades at cut-throat prices.

For now, only a limited number of deals done in the Asian seaborne steel market are tied to an index, let alone hedged. But increasingly consumers and steel producers in Europe are transitioning towards shorter term contracts (see white paper), as the US and China already have. Where regional markets lead, export markets must surely follow.

FOB China HRC open interest now past 12 months.



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