TRILAND METALS

EXPERT GUIDE

FERROUS DERIVATIVES ON THE LME

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Ferrous Derivatives on the LME

Contract Design

Steel scrap and rebar futures have been listed on the London Metal Exchange (LME) since 2015, while the bourse added HRC futures to its ferrous portfolio in early 2019.

One feature of these contracts is cash-settlement upon a contract's expiry – i.e. there is no option of physical delivery. The complexities and challenges with both physical delivery and storage of steel and steel raw materials makes cash-settlement a necessity.

Price Discovery

Price indices as a basis of settlement at the end of each month are established and published by 'price-reporting agencies' (such as Fastmarkets MB, Argus Media, S&P Global Platts) and ensure price convergence between paper (i.e. derivatives) and physical markets. Put another way, these contracts do not trade in the traditional LME ring, but on LMEselect – the LME's electronic trading platform and inter-office telephone market.

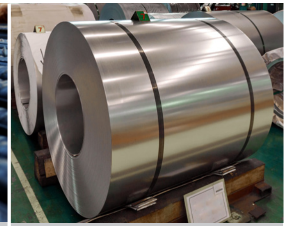
Another key feature of ferrous futures on LME is their simplified date structure. Prompts are monthly out to 15 months forward with two-way pricing across the forward curve.

Benchmark Pricing

Given the fragmented nature of steel and steel raw materials trading, the LME contracts typically reflect forward pricing for bellwether regions which act as key supply and/or consumption hubs.

For scrap, this means the LME contract's primary focus is on deep-sea cargoes into the world's largest importer – Turkey. Given much of this supply is sourced from nearby regions – Western Europe, Baltic and US East Coast, cargo demand (or lack of) from steel producers in the Turkish Republic tends to impact pricing in those domestic markets, thus, giving the contract a broader appeal.

The LME scrap grade – Heavy Melt Scrap (HMS) acts as a reference point with premiums and discounts for other obsolete grades such as shredded, bonus and plate & structural scrap priced off the benchmark.

			
Product	Obsolete Scrap	Steel Rebar	Steel HRC
Region	CFR Turkey	FOB Turkey	US Midwest (ex-works Indiana) and China Export (FOB Tianjin port)
Sectors	Recyclers, demolition, steel producers and merchants	Construction, steel producers and traders	Automotive, white goods, construction, OEMs, service centres, stockists, traders and steel producers

Steel - US and Asia

While hot-rolled-coil (HRC) contracts are regional by nature, they follow a similar pattern to scrap. The US flat-rolled market often uses the Midwest (ex-works Indiana) as a pricing basis for shipments.

In Asia, HRC remains the single largest steel product exported by China, despite numerous duties and quotas imposed on Chinese-origin material in recent times. With China accounting for over 50% of global crude steel production, steel exports from the Middle Kingdom exhibit a high degree of correlation with pricing in the wider North Asian market and South-East Asia, where much of the marginal tonne is consumed.

HRC grades are a foundation for pricing downstream strip products such as cold-rolled coil (CRC) and hot-dipped galvanised coil (HDG).

Summary

Around 40% of the world's steel production uses scrap as a feedstock. Scrap's 'green' credentials will see its use continue to grow as states enforce even greater environmental restrictions on heavy industry. The LME scrap contract is well placed to support this shift and provide forward price certainty.

For steel markets, the diversity of end-use sectors for HRC and the associated flat-rolled product segment points to great potential for the LME's steel contracts, as the move to indexation and commoditisation of the steel value chain takes hold.

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