argusmedia.com

Argus White Paper:

# Paper tiger: 65pc high-grade indexes

**62pc indexes get all the attention in iron ore, yet they are only one part of a huge market. The high end of the Fe spectrum helps increase steelmaking productivity and reduce emissions. 65pc Fe indexes have seen huge volatility because of China's increased focus on both boosting productivity and lowering emissions in recent years.**

**Demand for risk management tools is understandably growing: high-grade fines indexes now have a new derivative tool. Expanded use in physical contracts is also being proposed. But physical buyers are pushing back against a wider 65pc index linkage, and derivative volumes are stalling after a bright start. Why?**

## One size does not fit all

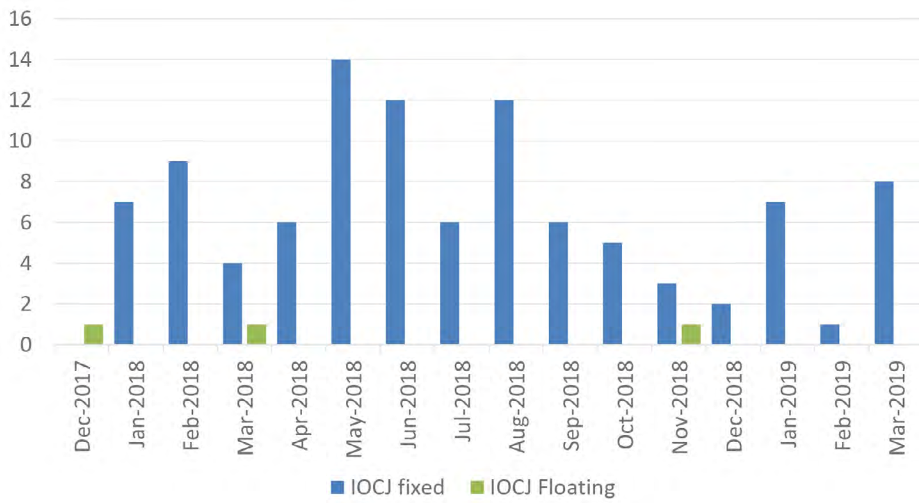
The iron ore pricing history centres on the 62pc Fe benchmark. It is where physical indexation and futures began, and its ongoing strength has been in inspiring structural trust: it is liquid, diverse (multiple brands) and well contested (multiple sellers).

Despite these formidable selling points, its utility outside of the 60-63pc band is poor. Put simply, 62pc indexes are an unacceptably blunt tool to use for 65pc fines, and the need for accuracy has become increasingly acute.

Chinese spot buyers set the global tempo of iron ore prices and proactively optimise furnace blends to suit market conditions. An atypical period of bumper profits and environmental pressure in China over 2017-2018 saw a strong focus on productivity. This blew out valuations among different iron ore grades as buyers chased high Fe and avoided impurities. The premium for 65pc Fe fines (as well as pellet and lump) ballooned and, with it, demand for risk management.

As high-grade ore became unmoored from the 62pc benchmark, 65pc futures were launched. They promised tighter hedging for the high Fe segment, as well as the opportunity to trade a 62/65pc spread – a potential proxy for Chinese mill margins. The contract had a strong start, with volumes exceeding those of the 62pc Fe contract at launch (see chart).

**Missing diversity targets: 65pc index inputs**




With a renewed focus and utility for 65pc indexes, additional migration from the 62pc benchmark is now being proposed. High-grade fines such as 65pc Carajas Fines (IOCJ) have long traded off a 65pc index. But increasingly, concentrate and pellet are being pushed to be based off that reference, too. Buyers report that major pellet producers have been seeking to change the basis of their pellet contracts from a 62pc index to a 65pc one, which more closely reflects the underlying ore from which pellets are made (the feed used to create pellet is closer to a 65pc fines product than a medium-grade Pilbara ore).

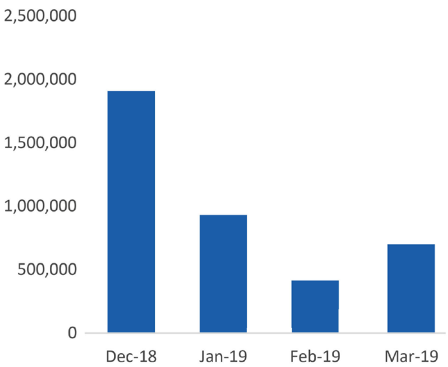
## Waiter – there's a fly in my soup

The logic for the switch is sound – the feed from which pellet is produced resembles a high-grade fines product. And the demand for risk management is there. Yet futures volumes are falling and the increased use in physical contracts is being resisted by buyers. Whilst some smaller mills in Asia appear to be haltingly accepting a rebasing of pellet contracts, it has not been without pushback. Meanwhile, Atlantic market and larger mill discussions were recently said to have stalled over this point. Objections fall broadly into three categories:

- Loss of the ability to hedge using the very liquid 62pc swaps market.
- The limitations of the market underpinning the index.
- How much confidence to put into lone indexes tracking relatively illiquid markets.

The reasons are related and apply to both the physical and futures markets.

Unlike the 62pc index, inputs to a 65pc Fe number are limited: in number, origin and diversity. A look at the inputs to the Argus 65pc index over the past year shows just one product (see chart) – and not one that trades very often either.




As a non-mainstream product, there is less of a secondary spot market. Over the six months to March this year, Argus received on average just one trade a week for its 65pc Fe index (see chart). This is unnerving for buyers, who derive comfort from regular testing of spot prices.

Parts of this situation are avoidable. There are fewer producers of this type of product, and consumers typically look to contract as much long-term tonnage as possible to maintain blend consistency amid limited spot availability. This attitude could be revisited.

A dynamic spot market helps underpin both indexes and successful derivatives contracts. In the early days of the 62pc futures market, support from producers as well as active participation from traders seeking to limit basis risk in the underlying index helped grow volumes. Both are lacking for the 65pc market by comparison, and volumes are retreating from an enthusiastic opening month.

There is a further problem more exclusive to the 65pc Fe market. A great deal of usage lies outside of China. Buyers argue that having a 65pc index set by Chinese spot buying is unreflective. Much of Europe and Asia ex-China depend on pellet and high-grade ores, whereas China's spot buyers only dip into this market when they can afford to. So a whole range of pellet and concentrate products – on which they depend – are being set by marginal and irregular buying in China. There are parallels here to premium low-vol coking coal.

## Low-hanging fruit and the wisdom of crowds

The decline in volumes in the 65pc Fe futures contract is disappointing since it addresses a real need. China's integrated mill buying habits are slowly changing and the 65pc market is a different beast to the 62pc. But for it to succeed, concerns around index liquidity should be addressed. To do so, there are two low-hanging options.

One hangs lower: the first and quickest fix is to seek reassurance via a basket-type arrangement (average of more than one 65pc index) for offtake agreements, as is currently being examined in the 62pc Fe market. James Surowiecki popularised the notion of better decisions being reached by larger groups than single agents in his book, The Wisdom of Crowds. Using baskets in more opaque markets is a useful risk-mitigation strategy.

Despite some added complexity, having a basket can be an effective way of hedging bets across methodologies or day-to-day moves of specific indexes, particularly if the products underpinning them are illiquid. This is truer of the 65pc index, which is based on far fewer data points than the 62pc, making them more subjective – thereby reducing correlations.

The second fix would take longer but probably be more satisfying. An increase in spot market participation would engender long-term confidence in index validity and its application in markets other than 65pc fines. This means more producers and consumers of high-grade fines participating in the spot market – initially on a fixed-price basis. Buyers too must address the market structure through buying a high proportion of spot; it is not enough to highlight deficiencies without being part of the solution. They can participate in a more broad-based price formation, possibly even via a fob index.

## The right tool for the job

The argument for physical linkage to a 65pc index that reflects the higher Fe products is sound, and the need is clearly there. But understandable nervousness around thin liquidity is holding back adoption in wider physical contracts, as well as undermining support for new and useful financial contracts. This is both regrettable and unnecessary.

These physical and paper issues can be tackled on different timeframes. Physical linkage adoption may well be hastened by reassuring buyers via basket use. Derivative market usage will increase along with increased fixed-price sales, more producers being involved and wider spot buyers having exposure. That would deliver the win-win that both the buy and sell sides are seeking. Until then, buyers report being worried that they are looking at win-lose.

For more information, contact us at:
**singapore@argusmedia.com**
**+65 6496 9966**
**Argusmedia.com/metals/argus-ferrous-markets**