LME urged to act over nickel

BY GÜNTER KREISSEL AND TOBIAS KÄMMER

In the past few months there has been a significant drop in commodity prices — including in some of those traded on the London Metal Exchange. Significant pressure has been exerted on nickel, pushing the cash price to $4,320 per tonne in June 1998 from the March 1997 peak of $8,250 — a loss of 48%.

An analysis of this dramatic price erosion requires examination of the fundamental and technical aspects in order to formulate an opinion.

In principle, we must differentiate between two factors that influence price developments: fundamental market moves, such as changes within the physical supply-demand curve, and technical aspects, such as changes concerning demand for commodities within investment portfolios.

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Stainless steel producers are the main consumers of nickel, accounting for approximately 65% of global nickel production. On an annual basis, stainless steel production within the reference timeframe — March 1997-June 1998 — increased worldwide from approximately 15.5m tonnes to approximately 16.3m tonnes. Demand for nickel and ferrochrome — the main additions to stainless steel — grew proportionately.

Fundamental market developments can easily be detected by changes in nickel stocks held in LME warehouses. Since the beginning of this year they have been in a range of 64,000-67,000 tonnes — showing largely a supply-demand equilibrium. In recent years a stock drawdown of approximately 1,700 tpw has occurred, reducing current stocks to 59,000 tonnes.

In relation to this, it should be noted that the price of ferro-chrome (a commodity not traded on the LME) has remained stable during the reference period at 47-50 cents per lb. Weak nickel prices, therefore, can hardly be seen as a consequence of fundamental market factors.

Commodities are becoming increasingly subjected to influences other than the supply-demand fundamentals: institutional investors, such as hedge funds, are adding LME nickel contracts to their portfolios.

Besides generating speculative income (participating in price moves), a main ingredient within their strategy of diversification is generating income from the prevailing contango. Hedge funds are using their "muscle" (large volumes in a basically illiquid LME market) to reach the desired price target.

When in March 1997 nickel traded at $8,250 and technical trading systems generated a "sell" signal, hedge funds started to run massive short positions. In a fundamentally balanced market, short positions create artificial over-supply, forcing prices lower. This scenario of "over-supply" enables institutional investors to generate nearly risk-free income in illiquid markets from two components.

First, from contango income, which reflects basically the cost of financing metal and to a small degree also the cost of warehousing and financing. Depending on the actual nickel price, the contango varies between $350 and $450 annually.

Second, short positions generate income from falling prices.

Channelling liquidity generated from these operations into booming stock markets, while simultaneously "short-ing" commodity shares (with no possibility of price advances due to falling commodity prices) creates an additional potential income stream.

This technical interaction with fantastic sources of income for institutional investors is the basic ingredient of their extremely good performance in recent months.

Attractive opportunities for institutional investors has brought about fierce competition for other market participants. Primarily nickel producers have long started to fight for their existence. At full cost, present nickel prices are well below production costs. Inco of Canada, the largest western nickel producer with a global market share of 28%, has been subjected to a dramatic erosion of its share price in the overall booming stock market. This has seen the value of its outstanding shares halved to around $2.3bn.

The management of this prominent nickel producer is being asked whether shareholder value and entrepreneurial orientation are part of the company strategy. The ambitious nickel project in Voisey's Bay, with a total investment of $4.5bn, will be an additional burden for the company. It should be noted that the feasibility study was based on a nickel price of $8,500 per tonne. Assuming a depreciation requirement of the magnitude of $1.5-2bn, shareholders will seriously worry about the remaining worth of the company.

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Other nickel producers will be faced with a similar development.

Apart from producers, other market participants within stainless steel production, as well as in the trade of primary and secondary metals, are seriously threatened by these extreme market conditions.

The present situation, in our opinion, is detrimental to the actual function of the LME; it is in the process of degenerating from a hedge instrument for producers and consumers into a market accommodating the strategies of institutional investors.

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In order to stem this tide and make the LME return to its historical function, several alternatives appear available. One simple scenario would be for nickel producers to reduce output.

Strong physical demand for nickel would result in a price rise, forcing hedge funds to cover their shorts. As a first reaction, nickel prices would rise significantly and then eventually stabilise in a range of $6,500-7,500 per tonne.

Special responsibility is required by the governing body of the LME. The directors of the LME should look at the "artificial factors" affecting the market so that the LME can regain its original status as a hedging instrument for producers and consumers. Additional liquidity could be provided through the introduction of a new nickel contract for uncut cathodes.

An additional instrument would be the obligation to publicise the open positions of the hedge funds, forcing them to reveal their hand on the LME.

It raises the question of to what extent the LME board, in its present form, represents the interests of the market.

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The above views are the authors' own and do not necessarily reflect those of MB.

METAL BULLETIN

Metal Bulletin and Metal Bulletin Monthly published by Metal Bulletin Journals Ltd (a subsidiary of Metal Bulletin plc).

UK Editorial Office: 16 Lower Marsh, London SE1 7RJ. *Tel:* 0171-827 9977. *Telex:* 917706. *Fax:* 0171-928 6892 and 0171-827 6495.
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Web Site: http://www.metalbulletin.co.uk
MetalNet: http://www.metalnet.co.uk

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ABC AUDIT BUREAU OF CIRCULATIONS BUSINESS PRESS

Registered as a Newspaper at the Post Office ISSN 0026-0533