Best and Worst of Trade

Nickel Outperforms in Q1, Copper Loses Steam

- Metalworld Research Team

In 2014, Nickel has proved to be the best performing base metal on the LME, advancing by more than 14.8% since January, helped by the new export rules in Indonesia, the world's biggest supplier of nickel ore. Over the last couple of months, nickel prices on the LME have risen to their highest level in 11 months on signs that Indonesia's export ban on unprocessed mineral ore is starting to bite, and affect Chinese stockpiles and the fears about the potential for sanctions on Russia have compounded jitters. From being the industry that was plagued by oversupply and high inventories, the nickel industry is seeing a reversal. The only reason for the muted reaction of nickel prices in the wake of the ban is that Indonesia has a history of dropping controversial policies and making last minute compromises.

By contrast, copper, one of the leading indicators of global economic health, is by far the worst performer among the metals this year. Various macroeconomic influences have added to its misery - ranging from Chinese credit tightening concerns, Russia-Ukrainian tensions, sluggish Japanese data, mixed US data, muted steel demand in China to the overall slide of industrial commodities, pushing it into a bear market The fate of copper is a real concern now, as copper futures dropped ~9% to $6380, from recent highs of $7220 over the last few sessions, the lowest level since June 2010. Copper is already down ~13% YTD, but the demand for the industrial metal is being questioned further as China sees exports and inflation contracting at a faster rate than expected. Benchmark Shanghai and LME copper prices have been falling steadily this year mostly because of tepid economic growth in China, which accounts for more than 40% of global demand for the metal. But after the sharp price drops in recent days following the bond default, the 'would-be' importers in China are finding it tough to get credit.

Indonesia Fueling Nickel

Indonesia's stringent ore export rules, which were announced in January, are catching up with the producers who had stockpiled ore since before the new year, causing a shortage. The deteriorating stockpiles have coincided with an increased demand for nickel from stainless steel mills, which is helping nickel prices soar currently. Indonesia's forced export ban and the likelihood of its enforcement till a long time has potentially transformed nickel's outlook in the past few months. Along with higher raw materials prices due to Indonesia's nickel ore export ban, also underpinning nickel's price rise are strong fundamentals, including higher physical metal premiums and higher demand from steel mills due to improved melt rates.

INDONESIA & RUSSIA'S CONTRIBUTION (MINE PRODUCTION, '000 TONNES)					
Particulars	2010	2011	2012	2013	2014 (F)
World Total	1397	1484	1539	1659	1862
Indonesia	132	128	129	137	117
% of World Capacity	9.7	8.6	8.4	8.3	6.3
Russia	300	300	300	300	300
% of World Capacity	21.5	20.2	19.5	18.1	16.1

F = Forecast

Although, around the world output at new mines has been rising, the biggest source of supply growth in recent years has been China, where output of nickel pig iron, a cheap nickel substitute, has surged. Estimates show that global nickel output reached 1.92m tons last year, of which 480,000 tons, or 25%, was nickel pig iron. Huge investment in new low-cost rotary kiln electric furnaces (RKEF) in China has fundamentally altered the nickel cost curve, driving prices below the point at which many existing nickel producers break even. The rest of the global nickel industry, now caught up in the long-term investments made in the wake of the 2007 price boom, are struggling to compete with the new reality of low cost NPI output.

However, the Indonesian ban has the potential to kill off the major source of supply growth as the high grade nickel laterites required by Chinese pig iron factories are only found in tropical regions with high rainfall – in particular Indonesia and Philippines. While China had over 23Mt of nickel ore stockpiled at the country's major ports as on March 2014, the lack of incoming supply would undoubtedly drive ore prices up in the domestic Chinese market. This will mainly affect smelters employing RKEF technology, as for the process to work efficiently; it requires high-quality ore with a Fe/Ni ratio of about 6-10:1, and an ore grade of 1.5% or above – the quality of Indonesian ore.

Gradually over the next few months, this will push up RKEF cost of production considerably to above $15,000 a ton, while the break even cost for RKEF smelters located further from the coast will be even higher. Smelters employing BF and EAF technology will still be able to maintain output using alternative sources of feed. For example, China imports around 30 mtpa of nickel ore from the Philippines, representing about 250,000 tonnes per annum of metal.

China Pulling Copper's Plug

What is compounding the Chinese situation is the emergence of how much copper is being used as collateral. If there are worries in a general sense about financial conditions in China, Copper is perhaps more exposed to that than other metals, because seen a substantial rise in inventories in China was not seen this year. There is expectation that around 60 to 80% of China's copper imports in recent years may have been used as collateral. Chinese imports of copper products hit a record 536,000 tons in January, up 53% YoY. The inflow slowed somewhat in February to

379,000 tons but was still higher year on year. If this is true then it would change the way one has to look at Chinese numbers and Chinese economy, as it's not being used for industrial production, but rather as a financing tool. Copper stocks in warehouses monitored by the Shanghai Futures Exchange are bulging, up 65% since early January to around 200,000 tons, with no real rise in demand. Another 750,000 tons of the metal is held in bonded warehouses, according to CRU estimates. A lot of the money raised in the financing deals has been invested in China's real estate market, but the falling yuan and China's cooling property prices have already started to eat into profits of some financing deals. People appear to be worried that China is getting real about credit and that in such an environment, industrial demand growth for copper will be less. With slower demand growth and possible liquidation of surplus metal units from financial arrangements, there are concerns over the short-term demand outlook for copper.

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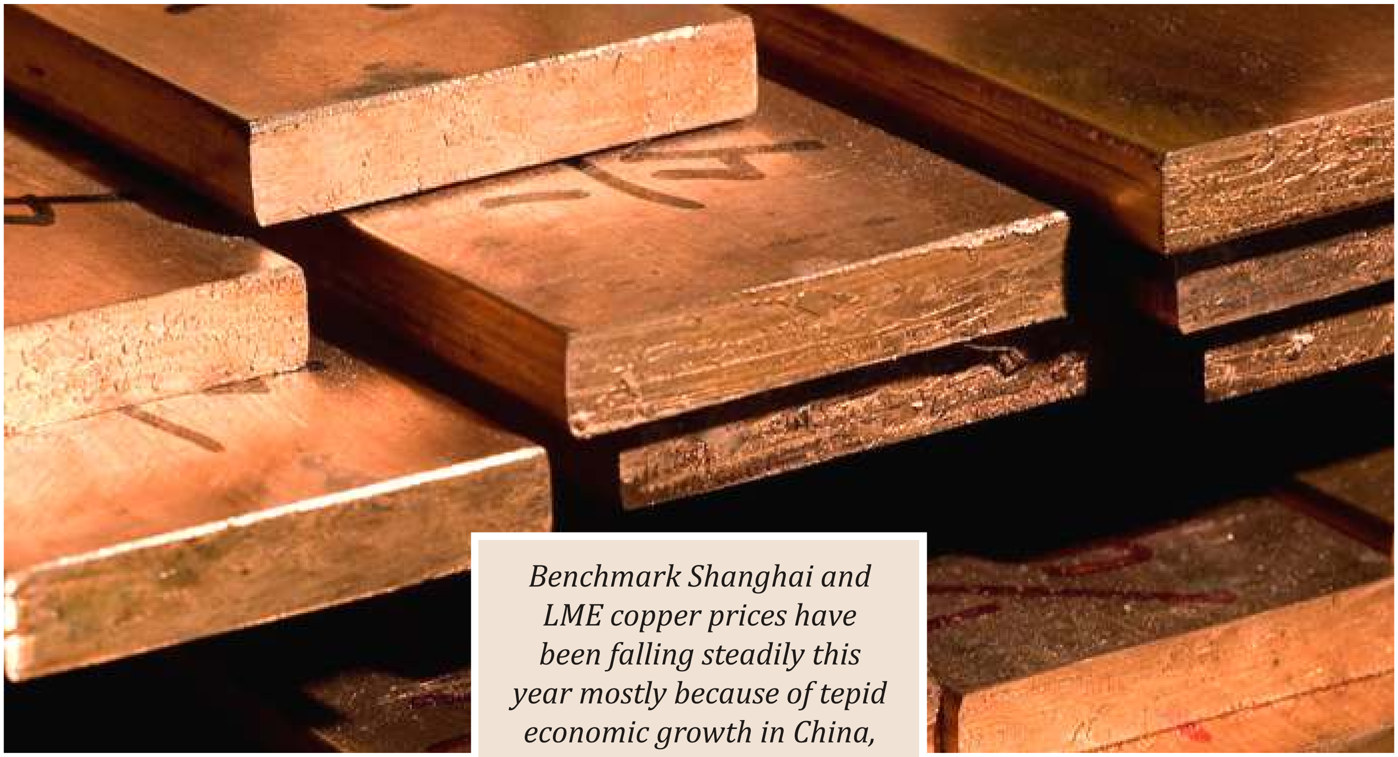
Pick Up in Stainless Steel Demand

Some of the contribution to the latest price rally has come from the escalating tensions in Russia, which is also the second largest producer of Nickel, after China. Concerns between Ukraine and Crimea have taken the limelight in the political arena over the last couple of months, calling from intervention from all the developed nations. There were some wide spread expectations relating to the political sanctions on Russia, exacerbating supply concerns after Indonesia banned unprocessed ore exports. Taking into account that Russia's mine production is close to 300kt, i.e. close to 16% of global mine production, any sanction to supply ore would have had a major impact on the commodity. However, the premiums built into nickel prices over this issue are expected to shed out soon and the political upheaval to settle down soon.

Stainless steel accounts for two-thirds of demand for nickel. The positive correlation between stainless steel production and nickel



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consumption is well known. With economic growth set to accelerate gradually, stainless steel production is likely to improve. Data shows that China's automobile sales were robust in 2013 as sales growth recovered in late 2012, with the inflation rebounding and the government injecting stimulus. Despite all the talks on economic slowdown, Chinese people continued to purchase more cars, and steel consumption has gone up. China's auto sales had risen by 6% YoY in January 2014, to a record all-time high. While China is slowly moving away from investment and infrastructure led growth to consumption-led growth, this change is good for car sales and ultimately steel demand.

Outlook

Continued global nickel surplus, soaring LME inventories which are now at all time highs of 71,000 tonnes, contradicts any notions of tightness in nickel supply. Also, post the closure of Falcondo by Glencore and Xstrata in the last quarter of 2013, any operations shut down outside of China is yet to be seen. Over the next few months, the nickel market surplus is expected to shrink to about 80,000, against previous expectations of 120,000, assuming that NPI output will be curbed towards the end of the year, impacting Chinese nickel output, while demand growth will be flat at ~4.5% for 2014. To sum it up, the nickel price off-late has been much more fickle than other metals, hence picking a price cap over the short term is difficult. Nickel prices is expected to move towards \$15000-\$15750, in best case towards \$16700-17500 a tonne.

Copper, demand benefited from the property boom and select infrastructure stimulus last year. This year, grid spending is all the more critical, as other sectors are expected to come off from 2013 highs. However, the government has shifted its monetary policy from tightening to neutral, which is likely to defend growth. With expectation of financial-product defaults possible in coming months, the government may again lean on targeted investment to protect growth, as it did in June 2013. Talk of defaults rekindled memories of 2008 when prices sank 60% in just four months between September and December at the height of the global economic crisis. Prices ended that year at around \$1.30 per lb. or \$2800 per ton on the LME. Copper's fall is thus far modest by comparison.

The market is not factoring in basic supply and demand elements, and copper may have been oversold. In fundamental terms the global copper market is fairly tight, meaning there is no long-term justification for low prices. Rising mining costs, too, pose a threat to future supplies, and could underpin prices. It has been observed that in 2014 the real expense of producing copper may be as much as 87% higher than back in 2007 due to higher labor and energy costs. But if copper prices keep falling, those holding it in warehouses will be forced to sell, which could push prices lower. Banks as well could be less willing to accept the metal as collateral.

While a falling price outlook and tight credit conditions argue against significant stock-building, physical buying could pick up quickly if industrial activity normalizes. However short term concerns will continue as China slows and rebalances away from investment into consumption.

In the short term, a quick rebound cannot be expected. On a fundamental point of view, it would be interesting to wait and see in the second quarter how China stimulates its economy. This sudden fall in prices has made it very attractive for hedgers to for a long dated hedge. A drastic turnaround in Chinese demand that is sufficient to push prices back to \$7,000 per tonnes levels is not within sight at the moment.