58pc Fe Indices:

An Emperor Without Clothes

Don't look now, but someone is walking around naked - 58pc iron ore indices, to be precise. Argus count a mere four spot trades as being done in the past year for sub-60pc Fe fines, and not one of those happened since June 2017. Illiquidity compounded by market torpor has thrown the entire raison d'être of lower Fe indices into question. But this huge market comprising hundreds of millions of tonnes is currently poorly served by existing indices. Could a number based on a liquid secondary market better represent the lower grade market?

Background: A bad fit

Index providers have typically split the iron ore market into a three-tier structure served by three indices: a benchmark 62pc index with a 58pc and 65pc number representing the lower and higher ends of the spectrum respectively. The 62pc indices have always been grounded in a **decent pool of liquidity**. The nature of the index system encourages activity and gives companies an incentive to ensure enough data points back to the indices. At the upper end, 65pc indices have seen supply linkage, underpinned by regular spot activity.

By contrast, 58pc indices have suffered from a perennial identity crisis. In the early days, they reflected the price of 56-59pc fines shipped from India to China, and had high alumina specifications to match. However, the rapid decline of India's role in the spot market and subsequent increase in low alumina, high loss-on-ignition (LOI) products from Western Australia, posed a challenge in terms of how to reflect the market with an index.

One approach for index providers was to publish a single 58pc number normalised for the differences between Indian and Australian material. Another was to reflect Australian product as a premium over an underlying or existing 58pc index based on Indian material. Each had its problems. Normalising between products from completely different ore bodies never worked as they bore little relation to each other. And as Indian 57-58pc volumes evaporated, or were replaced by even lower Fe product out of Goa, reflecting the price of Australian material as a premium started to look like a house built on sand – or more specifically, a premium added to a product which no longer traded.

Low alumina indices and swaps

The rising share of Australian sub-60pc Fe material in the iron ore market in 2014-2015 following the rapid expansion of Fortescue Metals Group (FMG) in the Pilbara increased the uniformity of the ‹60pc Fe (Australia-origin) market. Indices settled around a 58pc low alumina specification or similar, which covered a broad range of slightly more homogenous Australian products. At least one producer utilised 58pc indices in long-term contracts, necessitating regular spot transactions to underpin those indices.

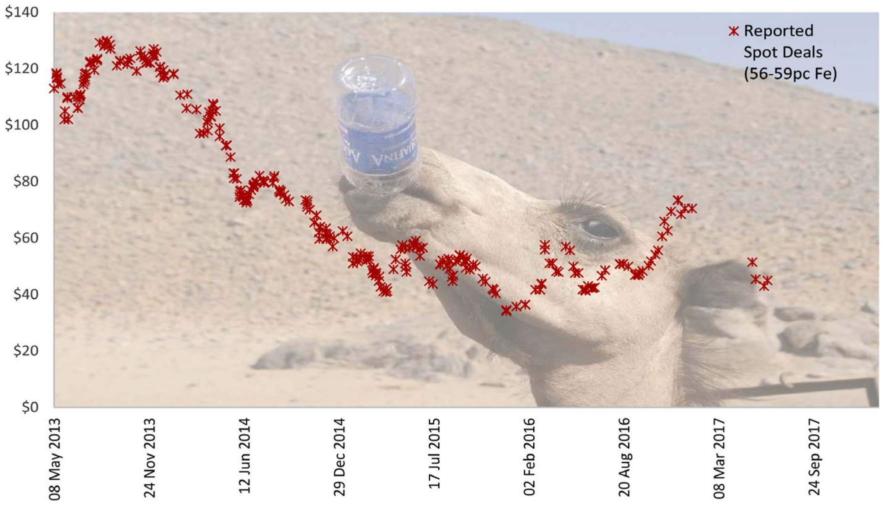
The disruption to the supply and demand balance from FMGs expansion and the basis risk it created also stoked appetite for more price risk management tools. A number of exchanges launched 58pc swaps and futures contracts, hoping to mimic the success of the 62pc contract. For a time, it seemed the iron ore market was ready for more than one contract.

However, physical supply-linkage did not migrate to lower grade indices. With few exceptions, sales of 56-58pc fines continued to be tied to a 62pc index. So 58pc indices and financial contracts alike lacked the support their 62pc brothers had enjoyed in 2008-2010. Despite a huge surge in low-grade volume, there was no notable uptick in spot sales to underpin the lower grade indices which existed, nor was their much incentive for any producer to support price discovery. Futures contracts, after some initial interest, saw open interest quietly dissipate.

See no liquidity, hear no liquidity....

Then, from early 2017 fixed-price spot liquidity for lower-Fe fines disappeared more or less entirely. The last major product to be tied to a 58pc index was pegged to a 62pc number from April

Looking for Liquidity: Recorded Spot 58pc trades



that year. With 58pc indices no longer in use, there was limited incentive for any market participant to provide the fixed-price spot liquidity off which to base an index.

Indeed, Argus has recorded no fixed price trade for ‹60pc Fe ore to speak of for nearly a year. Given the absence of trade, what are indices based on? Firm bids and offers? Not really. All that exists now are indicative values or cargoes linked to 62pc indices. But former is no basis for an index beyond being an absolute temporary backstop, and the latter lacks a link to the 58pc index. Despite all this, the 58pc indices live on.

In light of entrenched structural market change, Argus recently reduced publication frequency from daily to weekly for 58pc index. Data is so thin as to not merit more than a weekly assessment. And given the lack of deals, even the weekly price is largely for maintenance – a bookmark in the unlikely event that seaborne liquidity one day returns.

An underserved market

Going into 2018 the iron ore pricing system is fragmenting into one of multiple indices and pricing structures. Trends in Chinese buying habits triggered by policy and soaring coking coal prices have resulted in a multi-tier market and diverse pricing arrangements. Yet outside of mainstream fines products, price discovery is limited.

Fragmentation is particularly acute in the 58pc segment, which has always been more heterogeneous. For example, a case can still be made that low impurity, high LOI products belong in the same tier as their higher Fe brothers. Calcined Fe levels are comparable. But how about outside of these products? Linkage to 62pc fines is more tenuous, particularly as Fe levels drop below 57pc.

Given the complete lack of seaborne spot data, price transparency in this area is limited. However, Argus has for several years tracked the discount to the 62pc index reportedly applied by FMG to its Super Special Fines and Fortescue Blend products, which contain 56.7pc and 58.3pc Fe respectively. (It should be stressed these are based on anecdotal reports, but a similar trend is observed in port stock prices.)

The discounts have always fluctuated, but the recent surge in demand for higher Fe ores in China has resulted in an unprecedented expansion of discounts. With these changing frequently, the case for indexation begins to weaken. Pegging to an index should remove the need for constant negotiation, whilst using related futures markets should allow hedging. In the absence of these, neither side of the price risk management equation is performing as it should.

This is important. It is a huge segment of the market. Increasingly, other smaller producers are looking to the most liquid products in each “58/62/65 band” as a reference, often due to a lack of alternatives. Many may to look to 58pc indices as a guide. But despite their continued existence, they are increasingly an inadequate reference - they have become unmoored from spot sale validation. Today, however, Argus may have a more useful indicator.

China portside to the rescue

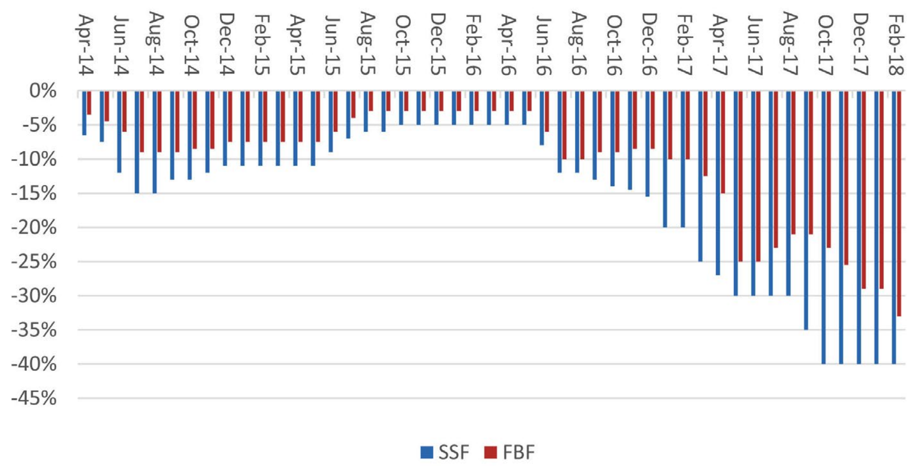
Ports in China are heaving with iron ore. Around 150m tonnes are piled up along the coast. Especially lower grade ore. Capesize vessels are discharged at port, stockpiled,

then broken down into smaller parcels and sold. Consequently, the portside market is deep and liquid. **Portside data** collected by Argus in December shows fixed price liquidity at port being fifteen times greater than the seaborne market.

Increasingly, the absence of seaborne indicators means more and more market participants and observers are looking to China’s ports for information. For anything below 60pc Fe, this is the only logical place to look. The 56.7pc Fe SSF product sees multiple transactions every day at port where in the seaborne market it sees none – at least on a fixed-price basis.

Argus publishes a daily port stock index for 62pc Fe fines (the P CX™62pc

Discounts for SSF and FB



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index) in yuan per wet tonne – the direct counterpart to the US$/dmt seaborne ICX™62pc Fe index – with a history going back to 2014. More recently, four brands differentials were added, each underpinned by daily transactions: BRBF, PBF, NHGF and SSF.

The latter is of particular interest as a reference for the lower Fe market. Indeed, several market participants have reported that they already look to US dollar back calculations of SSF port stock prices as a reference for the lower grade ores. In light of this, and the fact 58pc indices are no longer serving their purpose, Argus has launched a daily US$ seaborne equivalent price for SSF, derived from the liquid trade at port, complete with back history. The Portside SSF seaborne equivalent (PA Code PA0022813) prints daily and has history back to August 2017.

Not just a one-way bet

Recent trends have seen lower grade ores penalized and discounts widen. However, there is no reason to say this is a one-way trend. For example, the pending removal of tens of millions of tonnes of low-grade ore from India's Goa mines is expected to be bullish for lower Fe products, as is falling profitability at Chinese mills. In the outlined scenario, spot prices at port would forerun any negotiated tightening of discounts to the 62pc index, just as they did when they widened.

Yet until now, no index has existed that is grounded in spot transactions that capture the supply/demand dynamics of the marginal tonne.

History shows a good correlation between the SSF port stock seaborne equivalent price and implied realised contract prices based on 62pc with discount (R squared of 90pc+ over Q4 last year). However, physical-linkage to a number such as the Argus SSF port stock seaborne equivalent price – a much more liquid reference than the 58pc indices, which came before – would mean both buyers and sellers alike benefit from utilising a spot price set daily, transparently. A well-functioning index, grounded in a liquid spot market, in other words.

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