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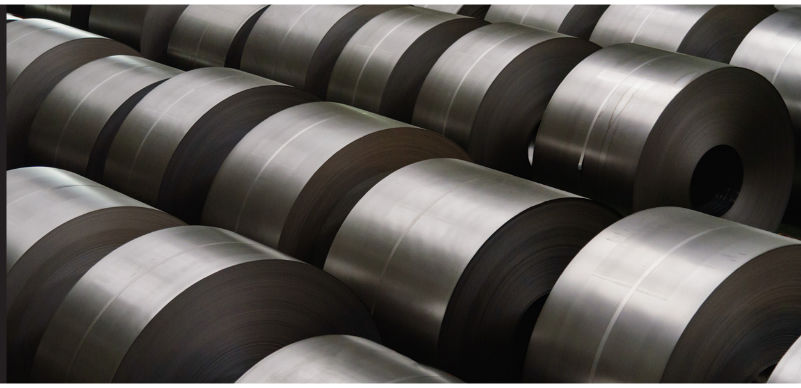


Argus White Paper:

Coronavirus impact highlights changed game in Asia's steel market

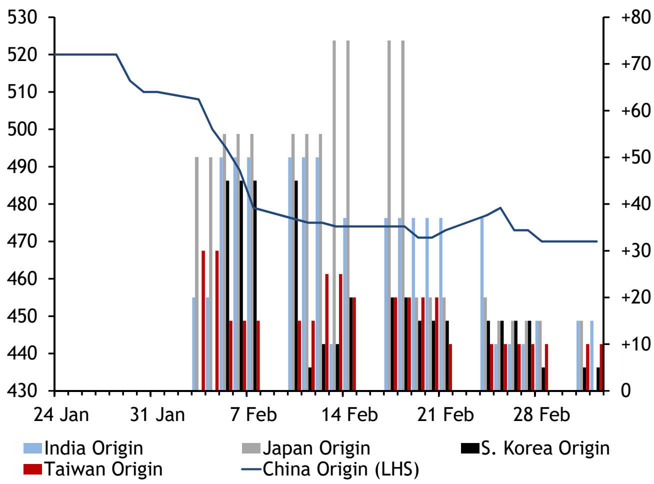
Even before the coronavirus, or Covid-19, started making waves, problems in Asia's flat steel trade were increasingly evident because of rising regional product commoditisation. Steel markets are braced for a wave of exports as China returns to work. Price and counterparty risk stalk the markets. Much is unnecessary.

Apocalypse...Now?

Vietnam's market has long been the key import hub where the region's steel giants do battle. India snatched China's crown in summer 2018 as the country's lowest priced hot-rolled coil (HRC) import source. India's impetus was a need to balance output in the context of a stuttering domestic market. China's exporters were not pressured to compete at the time because of a thriving domestic market.

China since the end of 2019 began vying for orders again. But it was not the only one forced back to the export table to balance domestic supply and demand. Incredibly before the lunar new year break offers into Vietnam from China, India, Japan, South Korea and Taiwan were all at parity. Why?

CFR Vietnam HRC and Origin Premia



China has been closing the gap where quality premiums traditionally existed for different origin material. This, coupled with stuttering demand across Asia forcing steel mills to seek overseas sales, further narrowed origin differences. Flat steel is becoming a commodity.

This was before Covid-19. Chinese export offers sharpened considerably in February, as a virus containment-induced demand shock cancelled the usual seasonal demand rebound. This triggered another downwards spiral and highlighted just how China-driven the market is.

Regional pain has been exacerbated by rigid fixed-price structures that no longer serve buyers or sellers well.

The always moving target

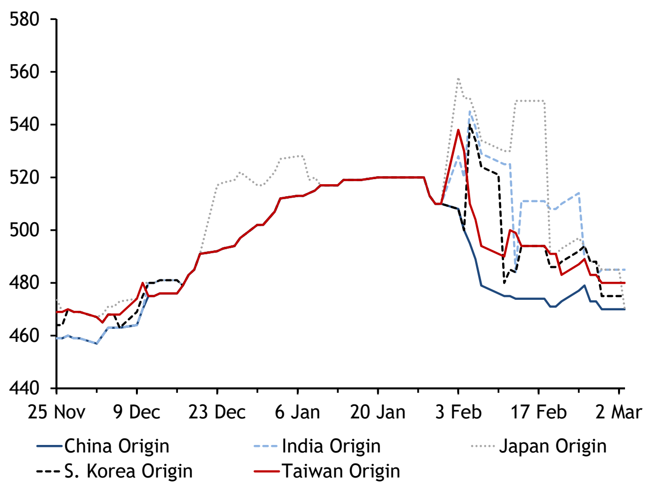
Observing the unfolding chaos waylaying China's usually efficient infrastructure, a number of China's export rivals in the flat steel market sensed an opportunity. Calculating that HRC bookings made before the lunar new year holiday — and before the Covid-19 outbreak — would be cancelled because of a lack of inland transport, rivals marked offers higher in the expectation that buyers would have to pay for prompt shipments from elsewhere.

This was a mistake.

With factories shut and a billion consumers under virtual house arrest, China sought to ease output and increase exports to alleviate the pressure of record high inventories. Their export offers sunk below price parity competition, even as others moved higher, making Chinese exports hyper-competitive.

Metals
illuminating the markets

CFR Vietnam HRC, by origin



The miscalculation was painful for ex-China mills in countries like Japan and South Korea trying to balance output with their own falling domestic demand. Export steel price weakness bled back into domestic sales prices. Worse, even after retracing offers lower by up to $70/t, Chinese offers crept lower still.

The combination of exporter greed and fear of missing out stopped many cargoes from being booked. Supplies that might have been shifted were not, at huge opportunity cost.

Pain was not limited to exporters either. The fast-falling Chinese export price left domestic Vietnamese mills, which had raised offers going into the holidays, looking uncompetitive price-wise. Vietnam's main mill filled out only 30pc of its February order book going into the month's final week.

It's all relative

Price chaos has been an annual event in Asia since 2017. The collapse of China's domestic demand because of Covid-19 is just a more extreme example. People doing the same thing over & over again and expecting different results risk being diagnosed as insane. But at a corporate level it seems common.

China sets the price of Asian HRC imports, since the entire region effectively prices their HRC exports at a relativity to Chinese exports. These themselves are set by the strength of the domestic China market. It has been like this for years, with ex-China steel producers in denial. But recently and, for the first time, the origin premium spread has closed to zero.

If it's broke, fix it

Many of today's conditions are self-inflicted, avoidable and unnecessary. Athletes knows that when competition gets tight, the very worst thing to do is tense up. But that is exactly what exporters are doing. The last few years could and should have been ones of loose and fluid experimentation. Pricing structures instead remain stagnated and inflexible, unable to absorb shocks.

"Holding out" is not a reasonable strategy for sellers in an increasingly structural buyers' market. The steel market needs a mechanism to allow trade during falling, as well as flat and rising markets.

Alternative pricing models clearly exist. No producer, trader or buyer of steel-producing raw materials freezes in fast-moving markets. Supplies need to be moved, ovens must be fed. Instead of trying to catch a falling knife by agreeing a fixed price in a falling price environment, they switch to floating prices against an index to conclude a sale. Supplies sell at the index price, reflecting a market average.

Today there is an additional tool. A futures market on the London Metals Exchange (LME), cash settled against the Argus China export price for HRC allows forward hedging of prices.

Buyers on an index basis either benefit from the downside if it falls, or pay a fair price should it rise. This cancels counterparty performance risk. And if they hedge using futures, then they can lock in their price in advance via an opposing paper position.

In the most recent period of price chaos, had Indian, Japanese, South Korean or Taiwanese exporters priced against a fob China index, even with a premium, supplies would have traded.

Formalise good relationships

But why stop at one-off floating price trades? When a customer likes a steel source and service, as well as receiving a competitive price, that is the perfect environment for a long-term customer-supplier relationship. The easiest way to formalise that is via a term contract.

These provide a reduced-friction environment where the price is a function of the market, rather than a zero-sum game played out monthly. Tussling over prices every month only encourages the likelihood of buyer "switching" or, worse, defaulting.

Getting to a common language

Although raw materials markets moved to index pricing a decade ago, the finished material has not. This was fine for a while, but increasingly, high utilisation rates are crucial for profitability. A major obstacle to uptake has been the lack of an agreed price point. Lack of a common reference has stalled the adoption of index pricing when it would have been most useful.

Resurgent Chinese exports and increasingly narrow quality premiums point to a clear Asian price setter. The fob China price has 90pc+ correlations with many exporter and domestic markets. It is not just a China price. It is a regional one vying to be global. Its affects are felt across both northeast and south Asia, and reach as far afield as the Middle East, north Africa and Turkey.

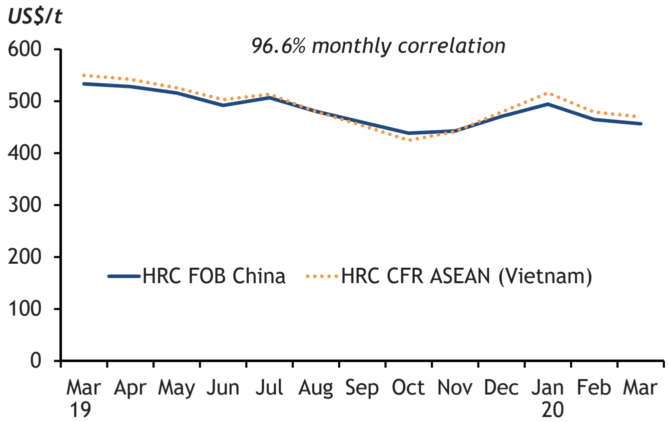
The success of the HRC futures contract on the LME should further concentrate eyes and minds on the fob China HRC price against which it settles. Finished steel markets can match the commonplace strategy of raw material markets, by linking physical deals to the index and hedging on exchanges.

The contract for the past three months has been averaging 125,000 t/month of HRC volumes, providing appropriate levels of liquidity to those that would like to hedge.

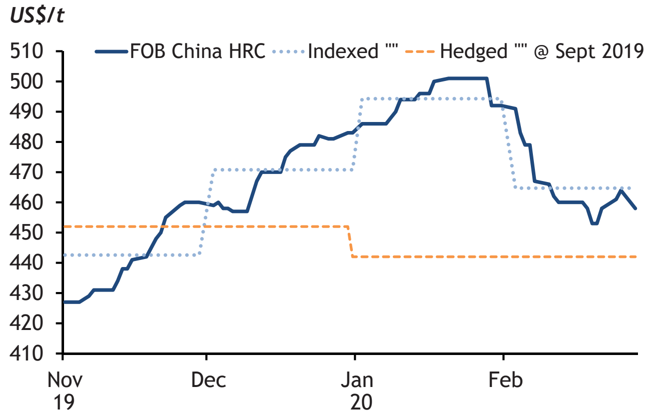
Between Argus and the LME, a screen for the market to check the price and daily commentary is available to interested parties (email to request). The LME has daily forward prices as an independent reference for the market.

For importers and exporters looking to work together to solve the issues that trouble an increasingly stressed Asian steel industry, these sources of accessible information are a great place to start. By practically using this benchmark, companies can trade more volume, more cleanly and with less price or counterparty risk.

Asian HRC benchmark very usable in Vietnam



Using the benchmark, 3 examples: spot, index, hedged



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