

White Paper: Fob China or cfr Vietnam: a false choice for Asia's coil markets

Asia's steel market continues to explore the use of indexes to mitigate risk. Our last [white paper](#) on regional indexation drew interest from companies looking to set up one-off floating deals or long-term index-linked supply contracts. Execution remains challenging however, particularly for Chinese and Vietnamese parties. At heart is a question about which reference to use.

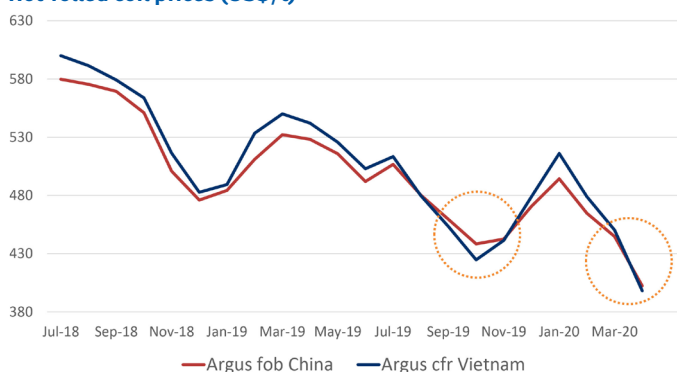
Chinese steel mills tend not to have structural export tonnage. They export depending on whether onshore or offshore prices are higher. Overseas buyers face a similar optimisation calculation — do they buy from China, or is another origin offering a lower deal?

This maintains two hubs in Asian steel. One, the world's largest steel exporter (fob China), the other, Asia's largest hot-rolled coil (HRC) importer (cfr Vietnam). Despite correlations of over 98pc between their respective headline indexes, buyers and sellers are struggling to agree on which to use.

Uncharacteristic inversion

A look at the chart comparing the two makes the reasons clearer. Recently, just as at the peak of the US-China trade war, cfr Vietnam coil prices have again dropped below those of fob China — this time because of a collapse in domestic demand, resulting from Covid-19.

Hot-rolled coil prices (US\$/t)



This inversion has happened in only four of the past 22 months. Yet it has nonetheless derailed indexation. Prior to the trade war and the Covid-19 pandemic, many had been edging towards using fob China as the reference. Now, with Vietnam becoming a global dumping ground for unwanted coil, buyers see value in the “cheaper” cfr price. For their part, sellers contend that cfr indexes reflect the price of the lowest common denominator product.

A very big but

Unprecedented conditions aside, there is a broader issue. Choosing an index is not about the absolute value, but about representativeness. Does it follow the moves of the market as a whole? And is it robust and well supported by data?

Indexes do not reflect specific products but capture a trend. Cfr buyers may technically have done better linking directly to a cfr index in four out of 22 months. But — and it is a big but — typically indexes are used with a premium or discount, rather than an outright value.

There is an even bigger but — parties looking to ‘win’ by linking to the lowest cost number are missing the point. Any buyer succeeding in getting a supplier to link to a lower price will simply find a seller demanding a premium to be inserted to it. That will hurt a buyer even more, once cfr markets flip back to being priced higher than fob. Indexes in commodities markets are used when parties agree they want to do spot business but cannot agree on a price. They also form the basis for long-term supply contracts: regular, fixed tonnage over a given period.

They do not provide a market-beating price, but steady supply, from a trusted partner, at market-representative prices. The deal beats half the market but underperforms the other half. Over time, however, consistency delivers superior results, while eliminating counterparty friction.

For these reasons, indexation has been the norm for years in steel-producing raw materials.

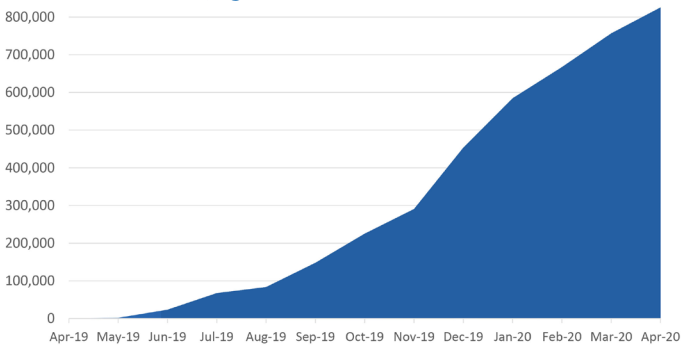
Fob China: a big hairy success story

So which index to use?

Whilst two index options exist, the fob China number has several advantages as a reference over the cfr one.

- i. It is an acknowledged global benchmark. Just as China sets the price for global iron ore imports, its steel exports dictate the level of finished export prices.
- ii. A growing derivatives market prices against it on the London Metals Exchange (LME). This offers optionality to both buyers and sellers, allowing them to hedge, or convert fixed prices to floating and vice versa. LME volumes average around 100,000 t/month, which are expected to rise over this year's second quarter.
- iii. Applicable to many origin points and markets. Non-Chinese HRC exporters must price against the regional giant. Despite the fob China name, it works equally well for regional mills or trading firms, whether the material is Chinese, Japanese, Indian, Russian or South Korean.
- iv. Vietnamese import market material is not fully fungible, while a growing domestic industry may push the only free port in Asia outside of Singapore to follow its protectionist neighbours. This would affect exports from India, Russia, Taiwan and Japan, but not China.

LME fob China HRC (Argus), tonnes traded



Avoiding the zero-sum trap

A commercial drive to link to an index that is unacceptable to the counterparty ends up unproductive. Meanwhile, short-term interests at the point of signing a contract are frustrating efforts to enter long-term supply relationships.

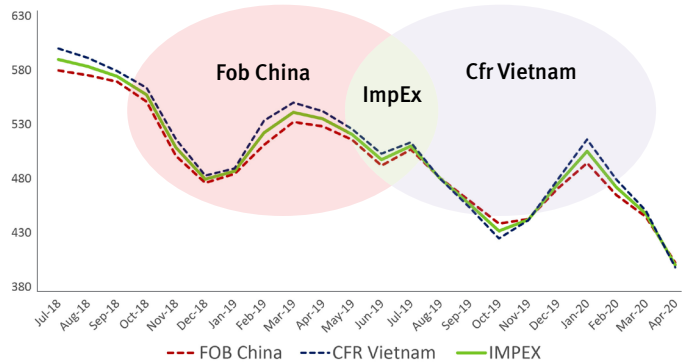
Zero sum thinking must be put aside for companies to enjoy the medium-term win-win delivered by indexation. When linking to a spot average, a fair deal has two equally unsatisfied parties, at least as far as price is concerned! But uncomfortable beginnings allow trade to flow and long-term discussions around volume, quality and service to flourish.

So the question over whether to use a fob or cfr index may simply be a distraction. Choosing one over the other gives the impression of creating a winner and a loser. Perhaps a choice is actually unnecessary. Could companies hedge bets across both?

The Middle Way

ImpEx (HRC Asia-Pacific Import-Export index) is a new regional HRC index from Argus that averages the prices of the key HRC import and export hubs within Asia. It is calculated as the mean of two existing Argus HRC indexes — Cfr Vietnam (PA0021940) and fob China (PA0021938).

Minimising opportunity costs (US\$/t)



Combining Asia's two most liquid indexes removes buyer and seller regret by pricing at the mid-point of the cfr and fob numbers.

By structurally incorporating the fob China number, users of ImpEx can access the LME contract. For cfr buyers, the hedge even improves. An already close correlation between fob and cfr rises to an almost perfect 99.6pc between ImpEx and fob. LME contract accessibility allows both buyer and seller further price optionality and price risk management.

Even before Covid-19 struck, Asian steel clearly faced challenges. Indexation and futures are powerful in facilitating trade through pricing cycles and mitigating price, timing and counterparty risk.

To fulfil those needs the index must measure a durable, long-term reference point and have robust data underpinning it. Reasonable questions are asked about whether Vietnam will remain a free port or adopt changes to most-favoured nation status. Equally, China is not always in the market.

If pricing against an average of the fob and cfr helps buyers and sellers to bridge the divide, the market may be able to move closer to this end goal. This could provide a middle way for northeast and south Asian steel markets to move forward, together, to a new, more flexible pricing paradigm.

The daily Argus ImpEx HRC print is publicly viewable [here](#) on Argus Metals platform.

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