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Argus White Paper:

Iron ore spot liquidity: it only counts...if it's counted

Iron ore spot liquidity is admittedly something of a niche interest. But for China, who import two thirds of seaborne iron ore, it increasingly matters for price formation. Miners have taken note, increasing supply to the spot market underpinning indexes. Mills are also buying more on a spot basis. But this rise in spot activity will prove in vain if indexes disregard those data points. Once again index methodology is being scrutinised.

A call to arms

For over a decade up to 90pc of global iron ore trade has been priced on contracts against an index derived from "spot" trades. The concept of the so-called "marginal tonne" setting the spot price via an index is widely accepted in commodity markets and, generally, more liquid spot trade engenders greater confidence.

Iron ore has seen variable spot liquidity over the past decade. But a fall in recent years has led to buyer criticism about the wider iron ore index system. Wu Jingjing, deputy director of the China Iron and Steel Association (CISA), told attendees at the virtual SGX Iron Ore Week in May this year that both market transparency and liquidity are key to confidence. He urged seaborne iron ore market participants to increase spot trade on trading platforms – where activity is more visible than in bilateral trade – and prioritise trading on a fixed-price basis.

The industry responds

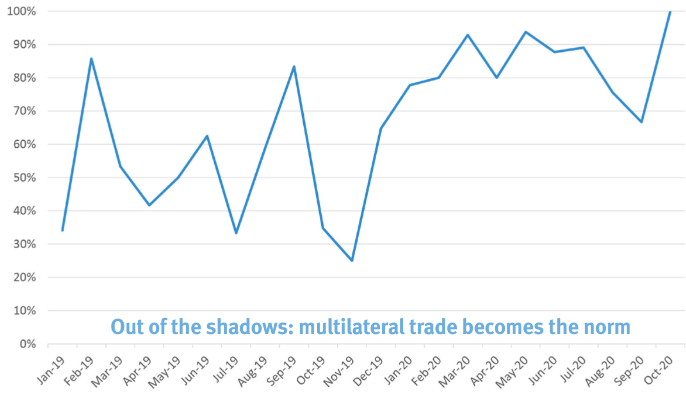
Miners have allocated greater tonnages to the seaborne spot market since June, with more trade taking place on industry-owned trading platforms. But it takes two to trade and steel mills have done their part, buying increased volumes on a spot and fixed-price basis. Hebei Iron and Steel (HBIS), China's largest steelmaking conglomerate, also added to sector liquidity this year, launching a new iron ore "supermarket" on the COREX trading screen, which often sees multiple transactions daily.

A review of Argus-collected spot transaction data shows a healthy 40pc year-on-year increase in concluded deals going into the ICX 62pc Fe benchmark index over the first 10 months of the year. It also shows an increased share of deals taking place "on-screen" on either the COREX or globalORE platform (see chart), which raises deal transparency across the market.

Mission accomplished?

At face value, this should resolve any outstanding concerns about liquidity. It does not. Because while the industry has increased deal volumes and transparency, it does not all necessarily flow into indexes.

2020's trades moved overwhelmingly "On Screen"



Out of the shadows: multilateral trade becomes the norm

Different index methodologies take different approaches in three key areas: the use of floating prices, trade collection windows and the period of the trading day being assessed.

Use all the data, prioritise some

The use of floating – or index-linked – trades can present a conundrum for iron ore index providers. Using a floating price trade necessitates a financial market reference. Not using them can mean losing around 60-70pc of all spot deals.

If the share of floating trades is too great, the index mechanism could be charged with being circular or too heavily reliant on financial markets – a point also made by CISA in May, when they argued spot indexes should be less linked to paper trade, hence the focus on fixed-price trade.

Because of these complications, not all indexes use floating deals. And not all participants support their use. Argus use floating trades, but it is not a black-and-white question: there is room for nuance.

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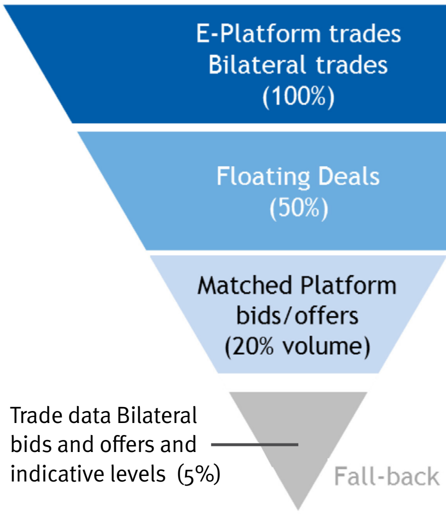
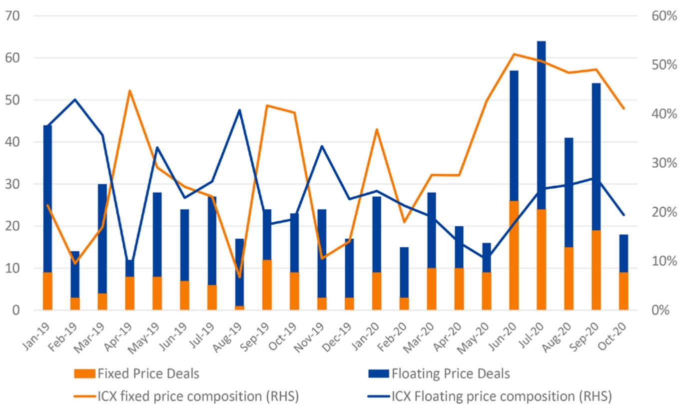
The Argus ICX 62pc Fe iron ore benchmark incorporates floating price trades, but at half the weighting of a fixed-price transaction in the volume-weighted average (see image).



The lower weight of floating price trades in ICX means fixed-price deals are always structurally prioritised, even if overall there are fewer of them (see chart below). The surge in deals between June and September meant that fixed-price deals accounted for around 50pc of the index weight on average, with bids and offers and floating deals falling to around 25pc each.

How fixed-price trade still dominates ICX



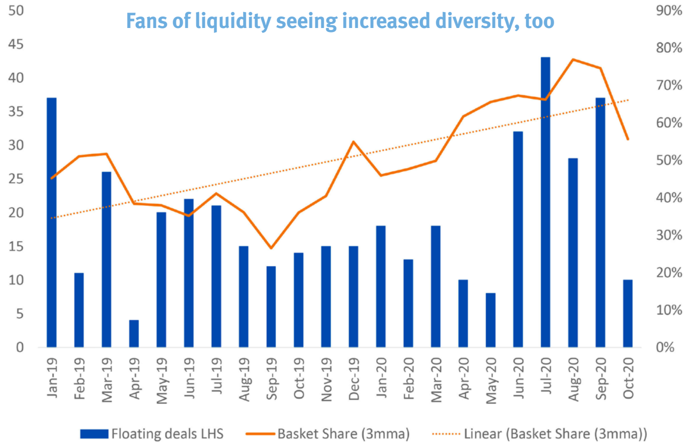
Embrace market diversity

The welcome rise in so-called index "basket" trades (against more than one index) has added a further complication in the use of floating deals. An increasing volume of physical index-linked trade is not against the financial market underlier.

Here, Argus has opted to maintain maximum use of transactions, incorporating floating deals against any mainstream 62pc Fe index. The lower weight given to floating deals and smoothing out of data (through averaging) account for any imperfections inherent in any individual data point. But this approach has not been applied universally.

In an increasingly "basketised" world, where floating trades are linked to a range of indexes, doing otherwise means discounting an ever-growing portion of market liquidity (see chart on next column).

2020's rainmakers sold ≈60% of floating ore in a basket



Too much, too late

It's not just basket-linked trades falling by the wayside. While more spot deals are being concluded, many are coming in too late to be used.

Indices have to set a deadline for submissions late enough to capture maximum trade, but early enough to publish at a useful time.

Argus accepts deals concluded up to 6pm Beijing/Singapore time, aiming to capture the maximum amount of data before publishing around an hour later.

A cut-off any earlier risks losing a significant share of activity. Around 30pc of spot transactions for Pilbara Blend (PB) fines, the mainstream grade closest to benchmark specifications, over the past three months were concluded later than 5.30pm Beijing/Singapore time: a not uncommonly used cut-off time.

Beyond that, there are also striking differences between the time periods being assessed by the iron ore indexes: the two options on offer are, broadly speaking, value at a point in time and an all-day average. In an end-of-day assessment, growing liquidity may also find itself left out if deals take place too early.

The Great Reset

So, while efforts have been made to boost liquidity, there are still multiple potential obstacles to their use in index formation. Deals could be deemed too early, too late, or to be settled against the "wrong index". It is for this reason Argus has opted for total inclusion, using an all-day volume weighted average, capturing a range of data types, including floating trades made against other indices, and setting a 6pm cut-off.

The seaborne iron ore industry is now considering its choice of indexes for next year's long-term contracts amid a greater focus on both fixed price liquidity and industry transparency.

As participants make their choices, a critical consideration must be not just how many of their trades are being captured, but also used, by each of the indexes. Taken individually, missing bits of data perhaps does not matter too much. But taken together, the amount of discarded spot trade data can really add up.

Nothing is static and the evolution of the seaborne iron ore trade is ongoing. Having gone to the trouble of a cross-industry push to raise spot liquidity, the market now has a chance to consider which indexes make the most of their efforts.

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