Where's The Floor For Iron Ore?

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MB 62% Iron Ore to Qingdao: *The index continues to post strong gains*

Source:Bloomberg

It was a year ago when we witnessed the MB 62% Fe CFR Qingdao Index surge to $63/tonne, the move shocked the market and left participants searching for an explanation. Fast forward 12 months and the move looks rather pedestrian compared to the last 100 days of activity which has seen spot prices of the steelmaking raw material rise 63% and held above $90/tonne for the majority of Q1 2017.

Last year we attributed most of the gains to a pledge by the Chinese government to support the economy at seemingly any cost, with stimulus efforts ramped up as policymakers attempted to transition the economy from a manufacturing based economy to a more balanced consumption driven one. As is always the case, the benefit of hindsight, it can safely be said our price target was conservative, however, few in the market forecast such a sharp move higher, back above $90/tonne and no one expected prices to hold around these levels.

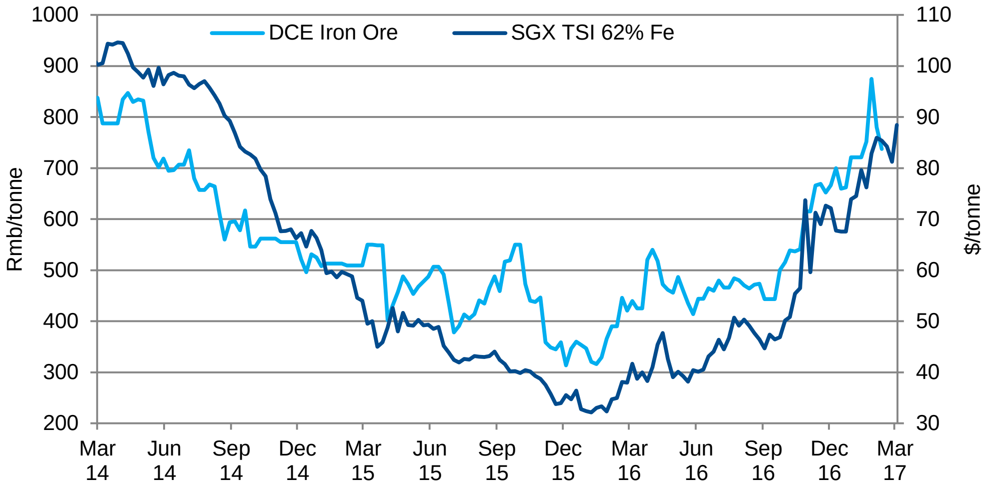
While we caveat our current view in light of recent strength in spot prices, we continue to hold the view that current prices are unsustainable and anticipate a correction in due course, however, what can market participants currently do to best position themselves in these uncertain times with volatile ore prices? With the fundamental outlook well documented, we have outlined a few scenarios, laying out the possible investment opportunities available and trades, if timed right, could deliver competent gains.

Arbitrage opportunities between SGX/DCE

In recent months traders have been taking advantage of arbitrage opportunities between the Singapore Exchange (SGX) and the Dalian Commodity Exchange (DCE). The root argument being that contracts on the SGX are denominated in dollars while the equivalent listed on the DCE are priced in renminbi, creating an opportunity for speculative investors on any prolonged mispricing. The ISI 62% Fe front month contract trades around $90/tonne with the lower grade 58% at $77/tonne, savvy speculators could capitalise on disproportionate price rises in the 62% grade against the less popular 58%.

"…savvy speculators could capitalise on disproportionate price rises in the 62% grade against the less popular 58%."

Dalian Iron Ore vs SGX TSI 62% Fe active contract: *Both contracts continue to remain elevated.*



Source:Bloomberg

“Chinese mills have stated that buying iron ore on a US dollar basis may not be economical…”

With the recent increase in US interest rates, the dollar has held its value against most major currencies as well as emerging currencies. Fed Chair, Janet Yellen is on course to fulfil her promise of two more interest rate hikes this year after raising the target rate to 0.75-1% at the most recent Fed meeting. This could act as a headwind to renminbi as it looks to recuperate some of the weakness recorded these past months. Hawkish comments during March’s meeting suggest that whilst the Fed would not move too quickly to increase rates, economic data would weigh heavily on their decisions. Chinese mills have stated that buying iron ore on a US dollar basis may not be economical due to the stronger greenback and therefore further weakness in the yuan on international markets.

Funds as well as traditional players have attempted to take advantage of the current mispricing; however, the trade is not currently profitable. In today’s market the DCE iron ore trade at 721Rmb/tonne, using the current exchange rate of 6.9Rmb, in dollar terms this equates to $104.5/tonne thus this arb trade is not profitable with spot price currently at $85/tonne even with freight and additional customs duties added on.

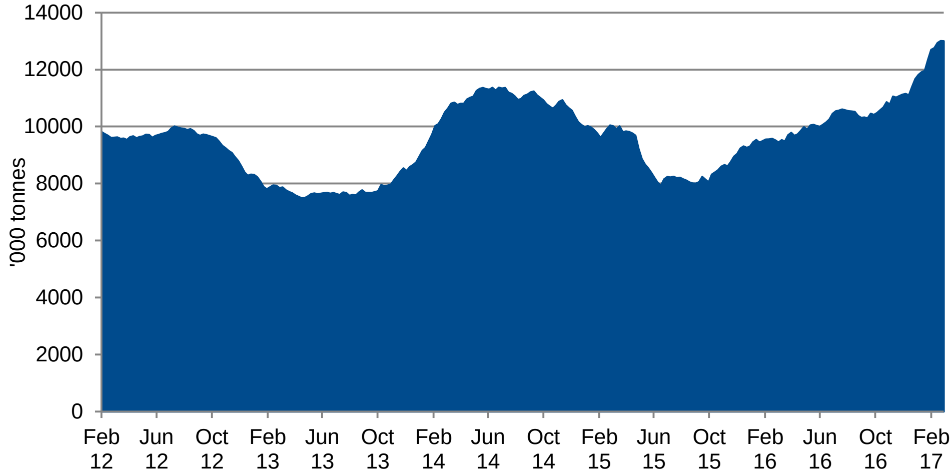
Due to the PBOC the exchange rate is not fully floating, the synthetic arbitrage is not viable. However, the physical trade where participants take delivery of iron ore is not restricted and producers can still profit from this trade.

“…arbitrage needs to widen towards $7/tonne to yield a sufficient return.”

For the trade to return a positive yield, using the current exchange rate of 6.9Rmb we would need to see the DCE active contract move back towards 500Rmb/tonne while the MB 62% Fe CFR Qingdao Index would need to pull back to $75/tonne for the arbitrage to work. Under these conditions investors could yield $2.53/tonne. This does allow for the Yuan to strengthen to 6.7Rmb and still yield a positive return however transactional fees and freight costs for the DCE exchange would eat in to any upside potential. The SSY iron ore shipping route from West Australia to Qingdao with capacity of 160,000 DWT for April 2017 costs $6.55/tonne. This on top of transaction costs indicates the arbitrage needs to widen towards $7/tonne to yield a sufficient return.

Recent data out of China suggests demand remains strong with construction starts for January and February growing10.4% y/y to 172.4m square meters. Investment in real estate development including commercial and residential increased 8.9% y/y in the same period to 985.4bn yuan. Despite this data, China iron ore port stocks are at record highs of 130m tonnes and due to this overhang we could see Chinese demand fall. The quality of ore in stock is not clear which could further complicate things and may be why prices have remained elevated through uncertainty and speculation.

Steelhome China Iron Ore Total Ports Inventory: *Stock levels continue to rise*



Source:Bloomberg

Strategies to employ

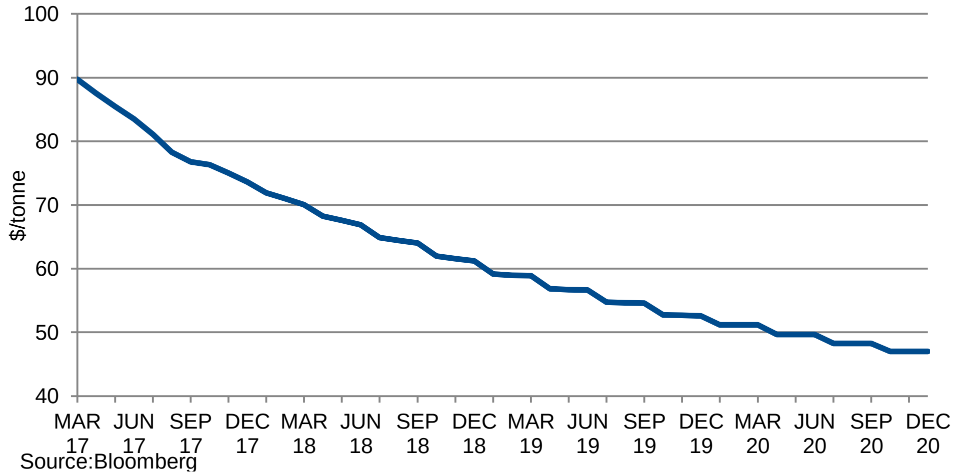
With the market seemingly overinflated and with the Chinese government aware of this we see a move back towards the 1 year average of $66/tonne for the MB Iron Ore 62% Qingdao Index.

The simple hedging strategy used by miners would be to go short on the July SGX 62% contract, thus protecting them from future price reductions in the underlying. The iron ore active contract's forward curve is in backwardation and declines at a consistently steep gradient for the remainder of 2017 and is at its steepest between today and the 9th month contract (October) which is trading at $76.34/tonne with the expectation of futures prices being down15.07% in the coming 6 months.

The cost of rolling a futures position can be expensive depending on the differential between the contracts. With the market in backwardation rolling the SGX 62% 2nd month contract to the next month with a calendar spread of $2.26/tonne seems attractive but further rolls could prove costly

"…a calendar spread of $2.26/tonne seems attractive but further rolls could prove costly."

SGX TSI 62% Fe forward curve: *The market is in backwardation and is steepest 9months out.*



Source:Bloomberg

"…the modest backwardated nature of the forward curve means this would prove costly…"

Given the fundamental outlook of the iron ore market, it is our view that prices are overextend and due for a retracement. As a result we would therefore look to short the market, however the modest backwardated nature of the forward curve means this would prove costly and may not yield a sufficient positive return. Accordingly, option positions could be the preferred idea.

The 1 year average of $66 for the MB 62% Fe Qingdao index currently seems like an unrealistic downside target. In the near term we see $80/tonne a more obtainable level however due to the high level of stocks in China buying may slow and prices could fall further towards $75 in the coming weeks and months. Our view is therefore tended heavily to the downside. A 2nd month SGX 62% Fe contract currently trades at $85 and buying a put with a sub $80 strike price is a position that we feel can significantly reap significant rewards.

"We believe the preferred position would be a put option for Q3 2017 $70…"

With many mills already long physical cargoes, selling the 2nd month future would help offset any potential losses. However this position would not give the investor much flexibility if prices strengthen, which we anticipate is unlikely. We believe the preferred position would be a put option for Q3 2017 $70 which has a premium of $6.68/tonne and a delta of -0.42USD. This would leave a breakeven price of $63.32, thus the underlying would need to fall below this level to be in the money (as of 15/03/2017).

While we anticipate prices will pull back, $63/tonne may be too much to ask and it could be worth considering a higher strike price. The Q3 2017 put with a strike price of $75 is more expensive with a premium of $9.48/tonne thus a breakeven of $65.52. Higher premiums have factored in elevated volatility (40%) however this can be offset by writing puts at lower strike price. Selling put options at a strike of $55 for Q3 2017 would yield $1.67/tonne per put and offset some of the premium cost of the $75 put.

"…we anticipate a retracement to trade within a range of $70-80/tonne."

To summarise, the outlook suggests that demand from china the biggest consumer may be dwindling. The US may act as a tailwind to prices due to their increased expenditure however their overall proportion of the market may not be enough to keep prices supported in the long run. This leads us to our view that the market is overbought and we anticipate a retracement to trade within a range of $70-80/tonne. In our opinion market participants with natural longs are best positioning themselves in a falling market by purchasing put options and offsetting the cost of these options by selling puts with a lower strike price.

SGX TSI Iron Ore 62% Fe Technical Outlook

Second month SGX iron ore futures started the year on the front foot, carrying through the positive momentum from the second half of 2016 into Q1 2017. After prices spiked higher in April 2016 the market traded within a range of $45 to $60 per tonne until the final quarter of last year.

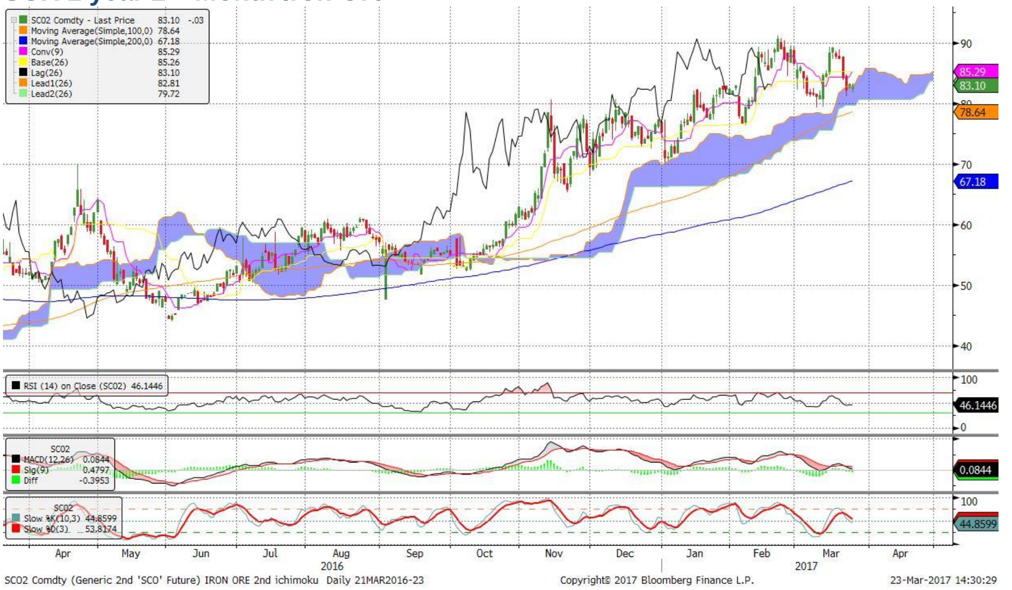
Upside momentum continued to strengthen throughout the final quarter of last year as prices rose 37% towards $80, where resistance stood firm. However, renewed appetite at the start of this year has seen futures move swiftly past $80 prompting a test of appetite for $90/tonne; however **momentum is showing signs of faltering with the market trading sideways for the year so far, albeit up 18% Q1 2017**.

SGX 1 year 2nd Month Iron Ore

On the daily candlestick chart, the Bollinger bands have consistently provided strong resistance with recent tests rebuffed, triggering a retreat back below the BB average of $85. The upper band has started to show signs of weakness and while the lower band holds firm, we anticipate further downward pressure as resistance closes in and support falters.

Turning out attention to the Ichimoku indicator, **cloud support has remained strong in recent months, confirming the bullish trend** after being tested in early January, and more recently in mid-March. However, **bullish appetite continues to face resistance at $90 with recent activity squeezed between this level and cloud support towards $83/tonne**. As a result, we anticipate that any subsequent test around this level could breach near term support while any acceleration of selling could see a shift in momentum, prompting a test of $75.

SGX 1 year 2nd Month Iron Ore



Contracts were met with resistance just under \$90 in late-February, prompting a retracement towards support at the 76.4% fib level towards \$78/tonne where buying appetite was reaffirmed and prices bounced back towards trend resistance approaching \$90.

However, recent price action is strengthening the case for waning upside momentum. Early signals have been received by the RSI and slow stochastics after they failed to post higher peaks in tandem with the fresh highs in prices seen in late February. **Signs of faltering buying appetite are further backed by the most recent failed attempt to test \$90/tonne**, signalling a potential reversal in the coming weeks**.**

SGX 2nd Month Iron Ore 1 month 1 hour

Market **participants continue to display a certain apprehension as prices struggle to gain a footing around near term support levels**. On any return and subsequent breach of $80 we could see selling pressure gather pace.

If trend support at $78/tonne, which coincides with the 100 day moving average is taken out this could trigger an acceleration of selling activity, potentially testing the 61.8% fib towards $70/tonne.

Additional selling pressure in breach of this level could potentially unwind the entirety of gains posted this year so far with key long term support towards $60/tonne not out of the question

For any continuation of the bullish outlook the market would need to take out near term resistance which could then strengthen the outlook for a targeting of resistance towards $97 with the next key level after this the 123.6% fib level at $104.19/tonne.

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