Scrap Price Volatility Triggers New Interest in Futures

Prices for steel scrap imports into Turkey have dropped around US$80/tonne (25%) since the turn of this year alone. This has provided another reminder, if it were needed, of the challenges facing scrap suppliers, traders and steel mills.

The root cause of this fall can arguably be traced back to slowing growth in Chinese steel demand and production, coupled with increasing iron ore supply, depressing iron ore prices. With significantly lower raw material input costs, Chinese steel exports (produced predominantly via the blast furnace/basic oxygen furnace route which converts iron ore into steel) have slowly but surely been influencing the traditional export markets of Turkish steel producers. In turn, this has put pressure on their raw material costs – which are predominantly scrap, given around 70% of steel production in Turkey is via Electric Arc Furnaces – as they battle to maintain market share and remain competitive.

On the assumption the price of the two steel-making ingredients is intrinsically linked, Figure 1 below shows that the scrap-iron ore ratio has hinted at either scrap being overpriced or iron ore being under-priced during the past 12 months relative to historic norms. With iron ore mining capacity continuing to increase and little sign of a return to strong growth in the Chinese steel market, the implication would seem to be that scrap prices could drop further.

Figure 1

The traditional link between scrap and iron ore prices is beginning to be questioned, however, with a number of market participants suggesting the two may have disconnected. If true, this brings even more uncertainty into scrap pricing, with iron ore price movements no longer providing a directional guide.
The last few months have provided a timely reminder of the need for scrap price risk management tools. Swings of around US$100/tonne in the ferrous scrap price in the space of a few weeks have inevitably created huge challenges for participants throughout the scrap-steel supply chain, with margins adversely affected. As those who have been around the industry for more than a year or so will quickly tell you, this recent level of volatility is certainly not unusual in the Turkish scrap market – prices have moved by at least US$100/tonne between their annual peak and trough in four of the past five years.

Price risk management tools allow companies to effectively lock in a sales price or raw material cost over the life span of a project or budget period, giving them the confidence to make important investment or other business decisions going forward without the fear of margin erosion. They also offer producers, consumers and investors the opportunity to diversify their portfolios.

With this in mind, a couple of major exchanges have announced plans to launch new scrap futures contracts in the coming months. On April 2, 2015, Borsa Istanbul will be launching a steel scrap futures contract, cash-settled using the average of The Steel Index’s daily benchmark price for Turkish scrap imports of HMS #1&2 80:20 CFR Iskenderun port in the expiring month. The contract will be quoted and settled in US Dollars with a lot size of 10 metric tonnes. Takasbank will serve as the central counterparty for the contract.

The London Metal Exchange has also announced plans to launch a cash-settled ferrous scrap contract in October this year. This will go hand-in-hand with a rebar contract, allowing market participants to lock-in both raw material and finished steel prices.

**Figure 2**

**Price Spread between Turkish Scrap Imports and Turkish Steel Rebar (US$/tonne)**

The potential benefit of having access to both of these contracts is shown in Figure 2 above. Despite the evident correlation between scrap and rebar prices, the spread between the two maintains an element of volatility – one which shows no sign of abating.
For further information

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The Steel Index (TSI) is a leading specialist source of impartial steel, scrap, iron ore and coking coal price information based on spot market transactions.

Iron ore price indices are published daily at 19:00 Singapore/Shanghai time (11:00 GMT) and coking coal price indices daily at 18:30 Singapore/Shanghai time (10:30 GMT). Steel prices for Northern Europe, Southern Europe and US HRC are published daily at 14:00 UK time and for ASEAN HRC imports daily at 18:30 Singapore time. Scrap prices for Turkish imports are published daily at 13:30 UK time. Weekly steel and scrap price indices are published every Monday and Friday respectively, with each price representing the average transaction price for the previous calendar week.

Transaction price data is submitted confidentially to TSI on-line by companies buying and selling a range of relevant steel, iron ore, scrap, coking coal products. TSI’s index reference prices are then calculated using transparent and verifiable procedures.

TSI’s indices are widely used by steel mills, miners, traders, distributors and manufacturing companies worldwide as the basis for their physical pricing arrangements. TSI’s indices are also used as the industry standard in the settlement of ferrous financial contracts.

Singapore Exchange (SGX), LCH.Clearnet (London), CME Group (Chicago), NASDAQ OMX Clearing (Oslo) and Intercontinental Exchange (ICE) all use TSI’s iron ore index for settling their monthly cleared iron ore financial contracts. SGX also uses TSI’s coking coal indices and hot rolled coil index for ASEAN imports to settle its coking coal and Asian HRC futures and swap contracts respectively. In addition, TSI’s prices are used for the settlement of European hot rolled coil steel contracts and Turkish scrap imports contracts on LCH.Clearnet and CME Clearing Europe. In all cases, settlement prices are the average of TSI’s reference prices published in the expiring month.

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