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Explosive rise in iron ore derivatives trading forecast over next 10 years

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Published: March 31 2010 03:00 | Last updated: March 31 2010 03:00

Banks and brokers are gearing up to exploit the new iron ore pricing system by developing a multibillion-dollar derivatives market similar to the ones that exist for commodities such as oil, aluminium and coal.

As the 40-year-old pricing system based on annual contracts is replaced with short-term deals linked to the spot market, analysts forecast that the iron ore swaps market will grow to $200bn by 2020 from $300m today.

"All the ingredients are here for the market to take off," said Andy Strickland, associate director at inter-dealer broker Icap. "The market for iron ore swaps could grow exponentially by a factor of 20 or 50 times its current size. The extreme price volatility will trigger interest from the consumers."

And, as with the development of the derivatives markets in oil in the early 1980s and other commodities during the past 10 years, banks and brokers hope to benefit as a market develops that allows speculators to bet on the direction of iron ore prices. A derivatives market will also allow producers and consumers to hedge their positions more easily in the physical commodities market, minimising price risks.

Eoghan Cunningham, chief executive of the globalCoal physical trading platform, which is expanding from coal to iron ore, said: "The new pricing provides the market with more flexibility and paves the way for people to take positions. Banks will certainly see this as a big opportunity for speculation and making money."

As the importance of the spot physical market for iron ore grew, derivatives emerged in 2008, with Deutsche Bank and Credit Suisse launching iron ore swaps. Since then, other banks have joined in, including Morgan Stanley, the commodities heavyweight, and brokers such as London Dry Bulk, Freight Investor Services and Icap.

Bankers and industry executives expect other banks such as Barclays Capital, Citigroup, Goldman Sachs and JPMorgan to be increasingly involved in the ore swaps market.

Michael Gaylard, strategy director of Freight Investor Services in Singapore, said the market was "finally seeing a situation where the physical spot market and iron ore swaps are becoming an accepted means of doing business".

Bankers said the pricing system was a significant development that could encourage more companies to hedge. In particular, junior iron ore miners were likely to hedge their output as a way to raise finance more easily, while some steelmakers could hedge their input costs.

The moves, if they materialise, would be similar to those in the oil market, where oil companies, refineries and consumers such as airlines and big utilities hedge their exposure to volatile prices.

"With a new market like this, there tends to come a point when more people use the market, creating more liquidity," a senior commodities banker said. "This feeds on itself as other participants are then encouraged to use the market as well."