

Shift to iron ore spot sales boosts hedging

AN ESTIMATED one third of traders in the nascent iron ore swaps market are also trading in dry freight derivatives as part of their risk management strategies, *Michelle Wiese Bockmann*.

Buying or selling the two derivatives contracts to hedge against rising or falling iron ore and freight costs is gathering pace, according to Michael Gaylard, strategic director of London-based shipbroker Freight Investor Services.

About 35%-40% of the iron ore shipped from Australia or Brazil is now sold on the spot market, he said.

Less than three years ago, most iron ore was sold based on an annual benchmark price, negotiated between Asian steel mills and the three major miners that hold two thirds of the seaborne iron ore trade.

But the 40-year-old benchmark pricing system is on the verge of collapse, as the

world's largest producer Vale seeks to double prices and move to a quarterly contract.

About half of all iron ore sold to China is now at spot market prices, according to sources there. About a third of the iron ore imported directly by steel mills is sold on speculatively.

The shift in trading dynamics has resulted in plenty of volatility, leading to a sharp rise in cleared, over-the-counter iron ore swaps.

"In terms of trade size, rather than being just a handful of bigger financials and producers, what we have seen is a big uptake from the Asian counterparties," said Mr Gaylard, who moved to Shanghai this month to expand FIS trading there.

"A large base of Asian traders and steel mills are now partaking in the iron ore swap market, although trade sizes are still relatively small.

"The average trade is 5,000 tonnes per month. This means people are just dipping their toe in the market to make sure it works, having a look at liquidity, and are just really trying to understand and get a feel for the market."

FIS began trading iron ore swaps in May 2009, followed by several other London-based brokers looking to diversify as liquidity in forward freight agreements markets dropped following the global shipping crisis.

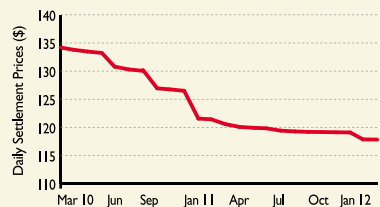
There are now 50 counterparties for iron ore swaps, Mr Gaylard said, with 1.6m



Iron ore being transferred at Shanghai: about half of all iron ore sold to China is now at spot market prices.

Bloomberg

Iron Ore CFR China 62% Fe Fines Swap Contract



Source: SGX

tonnes in iron ore swaps traded in December and 200,000 tonnes in January.

That is still an extremely small percentage of the underlying physical market. Global seaborne trade in iron ore is expected to top 1bn tonnes in 2010, with China forecast to buy around 670m tonnes.

The iron ore swaps are mostly settled against The Steel Index daily physical price for landed iron ore in China at 62% fe. The clearing houses are LCH.Clearnet, Singapore's SGX and ICE.

"The benchmark negotiations are potentially breaking down, with much more spot interest coming from India,

Venezuela and Australia, so there is a lot more spot cargo," Mr Gaylard said.

"There is a desire to manage some of that risk."

While liquidity was still growing, Mr Gaylard said it was easy to buy and sell contracts for the next few months, but more difficult for deferred contracts.