

Metal Bulletin

*****SPOTLIGHT: Iron ore swaps will give participants the edge in uncertain market, says FIS**

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The over-the-counter (OTC) market in iron ore swaps offers physical market participants a huge advantage, iron ore and freight derivatives broker Freight Investor Services told MB.

Trading in swaps can help market participants to manage their exposure to price volatility at a time of great uncertainty, a spokesman for the company said.

"The benchmark seems to be crumbling by itself," he said. "More and more iron ore is going to be traded on the spot market."

"Producers want it and some consumers want it too, as they need more flexibility," he continued. "The benchmark can't react to the market changes in the same way."

And the evolution of clearing facilities for iron ore swaps gives market participants added security, he said.

"You can manage the physical price risk with the paper instrument [the swap] and, because it is cleared, you don't have the same kind of risk that you have with a pure OTC trade," he told MB.

"If your physical [business] is linked to an index and you trade swaps that settle against the same index you can hedge your position comfortably," FIS strategic director Michael Gaylard said.

"I don't think the market is going to be constrained by producers nor users," Gaylard continued. "The market, at this stage, is probably going to be held back by the dynamic of the contracts."

OTC iron ore business has for predominantly been limited to contracts settled by an index for 62% Fe content delivered into China. According to Gaylard, the challenge is now to develop a variety of financial products for different regions and different iron ore products.

"In order to develop, the market would need different contracts for different geographical areas," he said. "We would need a spot index for Australia, a spot index for Brazil and a spot index for [India]."

"Then we should strip out the freight in order to offer a fob price," he continued. "There is a long way to go, but initially you have to focus your liquidity around one contract to get the ball rolling and then offer new products."

Developing the market for iron ore swaps will also mean bringing financial investors to the market, causing concern that speculative trading will cause increased price volatility.

But Gaylard pointed out that linking contracts to indices would enable physical market participants to manage their exposure to price volatility.

"[One Australian miner], for example, has announced that they are going to use physical index-linked contracts," he said.

FIS believes that 40-50% of iron ore will be traded on the spot market this year.

“Even the Brazilians are starting to trade spot and they had never done that in the past,” he said. “If you are in the spot market then you know exactly what your playing field is and where you are going to be.”

For the moment, however, Gaylard does not believe it is time to trade iron ore on-exchange.

“The value of the contracts is large,” he explained. “A trader doesn’t want to hang himself out on a screen for a contract that could be worth \$15 million — he’d rather get on the phone, speak to a broker, find out what is going on in the market and find out what the sentiment is.”

“My view is that, initially, until you get a certain level of liquidity that allows you to move in and out on a very small margin, there will be no drive to move into exchange trade,” he said.

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