2008-6-2] **Why does LME wants to get involved with minor metals ?**

Anthony Lipmann offers a personal view on the London Metal Exchange's possible plans to launch contracts in minor metals and ferro-alloys.

There is a very real danger that some in the minor metals and ferro-alloys industry might think the London Metal Exchange's prospective involvement with minor metals is a fait accompli.
The LME has launched the discussion with two medium-sized markets in mind: cobalt (60,000 tpy, worth around $6.6 billion at today's prices)
and molybdenum (400 million lb in Mo, worth about $14.5 billion).

So the first questions must be, in what way is the current means of price discovery of minor metals deficient and in what ways might the LME's expertise in terminal markets improve how we operate?

Minor metals prices are quoted by journalists who speak regularly with market participants, usually by telephone. An informed but disinterested journalist will ring producers, consumers and traders, and then make an assessment.
Quotations given will be matched to what others have said and any back-up evidence that might have been provided, and then a price spread is published.

It seems an imperfect system on which to price a swath of world trade. Detractors claim there is too cosy a relationship between traders and journalists and a lack of effort in making sure that all sectors of the market are contacted. They point too to the dangers of giving credence to unconfirmed contracts and reports.

The odd thing is that it actually appears to work. It does not take long for a journalist to uncover when a participant is merely talking his book, and thus discount him. And the wide range of price outlets has its own self-correcting mechanism because it diffuses any undue influence.
Most business actually takes place on long-term contracts based on the average of published prices, so errors and inaccuracies tend to be smoothed out over time.

Few minor metals trades are entered into on the basis of one quote on one day. Not for nothing is the published price that emerges described as a "reference price", which assists others far from the centre of
activity.

Price settlements are reached globally using various tools in discussions but ultimately are settled by a verbal agreement by two consenting adults, followed up by a contract. It is a rather old fashioned business.

As an alternative the LME would like to offer the industry a platform, its knowledge in running markets, its transparency and the capacity to hedge. But is this just the LME searching to develop its business in a
competitive market, or would it truly bring some added value to the way the minor metals world works?

Certainly, hedging, if it were possible, is the LME's best selling point - though it is not that you cannot hedge a minor metal at present.

There are companies in the cobalt market that are more than happy to entertain offers of both call and put options on a principal-to-principal basis, which is a hedge of sorts.

But hedging on a terminal market is not possible today. You cannot sell a minor metal to a neutral third party through a regulated market, and unwind this sale at the chosen time of your physical sale. Nor can a consumer do the reverse, that is, make a forward purchase and then unwind, either completely, because the material is no longer needed or because a contract with the physical supplier has been concluded.

Being able to hedge in such a way may be desirable - if it is possible. But I have doubts about both the practicability of putting minor metals or ferro-alloys on an exchange, and the possible unintended consequences that may result.

In the molybdenum market, perhaps the most likely target for the LME's attention, out of global demand of 400 million lb, 75-80% is used in the steel industry, while 20-25% is used in other applications such as chemical (catalysts), super-alloys and others. In the steel sector, 50% is traded as MoO_3 powder, 30% as ferro-molybdenum, and 20% as MoO_3 briquettes.

Which of these diverse products would be suitable for a terminal market, and capable of gathering liquidity and momentum? If cobalt were based off 99.3% - lower grade Russian - material, who would deliver higher grade Inco, Falco and others?
If it were based on high-grade, the Russian material would become less deliverable and hedgeable without a complicated structure of premiums and discounts.
And, if there is illiquidity in the nearby, just think how thin trade would be a couple of years out.
Who would make a market in cobalt in May 2010?

Supporters of the idea of contract will answer: "This is what the funds are for - the liquidity they bring would enable the industry to offset risk". The other side of a hedge need not be anyone involved in the metal trade, just a financial institution or hedge fund with a view. It should all self-correct shouldn't it? The danger lies not in the theory - but the practice.
If we take cobalt, you have a market that even at its current size could be swallowed for breakfast by a hedge fund.

Is the LME's incursion into minor metals driven by the belief it truly has a useful service to offer? Or is it responding to the City of London's insatiable urge for another instrument with which to play?
It is not the LME that I fear, but the non-trade participation in the market that it will encourage.

The threat lies with the hedge funds, derivatives traders, banks and others who would use minor metals as a vehicle which, once clothed in the legitimacy of the LME, may act as an outlet for the vast sums of vagabond money stalking the globe.

Further, the very practices of some hedge funds, such as the concept of off-setting one commodity with another would be corrosive. The concept of pension funds or banks being exposed to the commodities markets too is, to my mind, already immoral and, from an actuarial, point of view, inexplicable. It seems plain wrong to expose the so-called 'widows and orphans' of pension-fund folklore to markets as arcane as minor metals.

Conservative voices, like those who should have warned about the securitisation of mortgage debt, need to be heard on this issue. The LME needs to prove that it is in it for our good, and not just as a means to show their shareholders that they are going for growth through the colonisation of minor metals.

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