Sympathy for devil's copper: Nickel

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The London Metals Exchange (LME) is experiencing its longest period of disruption since the Tin crisis of 1985. After the International Tin Council (an inter-government-backed body) defaulted on its position in Tin in 1985, it wasn't until 1989 that the LME resumed trading in the metal[1]. Trading in LME Nickel was closed for over a week in March 2022. While trading is open now, it is still disrupted.

Nickels dark days

Frustrated fifteenth-century miners in the German state of Saxony called an ore kupfernickel, broadly translated to "the devil's copper" when they failed to extract copper. It was only centuries later that the technique to extract nickel from this ore emerged. Frustration seems to be returning to the metal with recent events.

Nickel markets experienced unprecedented events over the course of the month, with the London Metals Exchange (LME) closing trading in the metal for over a week and disruptions still ongoing. Nickel was among the many commodities impacted by the Russia-Ukraine conflict, given Russia is the third-largest supplier of nickel worldwide. Russia also stands out for producing high-grade nickel that can be used in batteries. Since the start of the conflict (24th February 2022), the price appreciation had generally been in tune with other commodities impacted, like aluminium and wheat, until 7th March 2022. On 7th March, however, nickel prices saw a vertical surge in prices driven, most likely by a short squeeze.

Tsingshan's hubris

Among the holders of a short position in the nickel contract on the London Metal Exchange (LME) was the Chinese nickel producer Tsinghan. The company has, in recent years, had very ambitious plans to produce high-grade nickel in Indonesia using lower grade inputs through the so-called high-pressure acid leaching process (HPAL)[2]. Last year the company tried to shock the market with claims that it would flood the market with supply of battery-grade nickel using a process of converting Nickel Pig Iron to matte[3]. However, as our partners at Wood Mackenzie argue, the process is more costly to the environment and does require a relatively high nickel price for the economics to work.[4] While they have largely underachieved relative to their goals, their short position amounts to a bet on their success in bringing more nickel to the market and thus pushing prices down. While on the surface it may look like they were placing routine producer-hedging (short) positions on, the fact that they don't currently make enough Class 1 Nickel[5] units to deliver to the LME meant they were only hedging by proxy. Tsingshan is still overwhelmingly a Nickel Pig Iron producer, not a Class 1 Nickel producer.

A short squeeze

Tsingshan's broker, China Construction Bank, missed a margin call payment to the LME on 7th March 2022. The LME questionably gave the bank a reprieve to avoid it (and Tsingshan) going into default. But other participants on the exchange in knowledge of this began abandoning their shorts, setting alight a short-covering rally, which at one point drove the price of nickel above $100,000/tonne intraday on Tuesday 8th March 2022 (as a point of reference Friday 4th March closing price was $29,494/tonne). Belatedly realising that prices were far from fundamentals, the LME closed trading on 8th March 2022 at around 8.15 am and then cancelled all morning trades (up to midnight). The exchange then closed the market for over a week (until 16th March 2022), with the closing price on Monday 7th of $48,211/tonne as the only market reference for products linked to the contract.

Unlike other exchanges like the Chicago Mercantile Exchange's COMEX or the Shanghai Futures Exchange, the LME didn't have in-built circuit breakers like price limits in place. Instead, risk management was left to human discretion. The evidence seems to point to the humans being slow to react at the LME.

Opening in fits and starts

On 15th March 2022, the LME imposed price limits across its base metals range of +/-15%, with the exception of Nickel which began trading on 16th March with a +/-5% range. This was arguably a very tight range, given that Nickel contracts trading in Shanghai were pointing to an LME-equivalent price of closer to $30,000/tonne (i.e. a drop of 37%) to get the markets aligned and avoid a sizeable arbitrage. Predictably nickel prices traded limit-down on 16th March. While limits were widened each day from 5% to 8% to 12% and finally 15% by Monday 21st March, the metal traded limit-down each day until 22nd March, which represented the first day of undisrupted trade. Indices and products referencing LME contracts finally found a price they could reference determined by the market after two long weeks. However, on the 23rd and 24th March, LME Nickel traded limit-up[6], rising more than 15% each day. These disruptive events once again impeded the price-discovery process and presented a challenge for indices and products referencing LME Nickel.

Exchange traded products with exposure to nickel futures contracts, listed on regulated markets like the London Stock exchange and Borsa Italiana still trade (even though trading margins may be wide) and provide a venue for price discovery even though the underlying is disrupted.

Where are we heading

While we can't say for certain, maybe more short-covering has driven the recent price gains. Certainly, with the European Union wanting to wean itself off Russian oil and gas reliance[7], the expectation is that the Energy Transition will accelerate over the coming years, boosting nickel demand.

Fundamentals are constructive for the metal, but current trading conditions are challenging.

On 25th March 2022, Shanghai Nicekl traded to an intraday record high before the first Ring of LME opened. LME Nickel rallied as much as 9.1% and then fell as much as 7.4% in the first 45 minutes of trading, highlighting the volatility has not really subsided, however, at the time of writing (12 noon 25th

March 2022), there has not been a disruption event. The LME has also reported today that they will double the clearinghouse default fund in order to build buffers that mitigate against the rising stress-tested losses.

In the aftermath of the 2008 Global Financial Crisis, regulators encouraged greater trading on exchange rather than over-the-counter. They viewed central counterparties to be superior in managing risk. We believe the regulators will try to prove they are right and force the LME to get a better control of the situation. This is also an opportunity for soul-searching. The LME will have to find a way to press forward with some its earlier recommendations to improve transparency and accountability that its members rejected.

We will continue to provide commentary on this evolving situation.

1 https://www.latimes.com/archives/la-xpm-1989-04-13-fi-1866-story.html

2 See Nickel: it's a question of class for a description the high and low grade inputs, processes for steel production and battery chemistry

3 See Nickel: it's a question of class for description of Nickel Pig Iron and Tsingshan's goals

4 See Tsingshan's predicament – High CO2 nickel sulphate for the Electric Vehicle sector

5 The high quality nickel required for delivery to LME

6 In fact second Ring session trades were deemed null and void: https://www.lme.com/api/sitecore/MemberNoticesSearchApi/Download?id=33717ba2-b7b1-4897-9f70-88dfbaa51c8b

7 https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1511

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