What's Hot: As zinc is fuelled by supply tightness, a thematic future awaits

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Investors looking at zinc's price chart in October might wonder, is it natural gas they're looking at? Industrial metals don't normally exhibit such volatility. But then again, natural gas does have something to do with it.

On October 13, Belgium-based Nyrstar, one of the largest zinc producers in the world, reported a production cut of up to 50% at its three European smelters due to a surge in energy prices. The combined capacity of these three smelters, located in the Netherlands, Belgium, and France is 700k tons. This amounts to lost supply of up to 350k tons which is equal to 5% of ex-China production and 2% global[1].

According to Citi, supply cuts may last through the fourth quarter. Resumption in normal supply in the first quarter of next year will ultimately be determined by how tight energy markets are at that point. This means that unless there is immediate support from Dutch, Belgian, and French governments, supply pressures may persist for months.

But given the strong market reaction to the development in Europe, might there be further upside to prices from this point? Potentially. Supply challenges could be exacerbated by the situation in China. China holds a 50% share of global smelter supply. Around 60% of this production is concentrated in sectors that are likely to ration power in November and December. Additional supply losses from China could be in the range of 100k-200k tons[2].

Market pricing, however, suggests that zinc could be undersupplied for a lot longer. The zinc futures curve is now in backwardation[3], a significant shift from a relatively flat futures curve at the start of the year (see figure below).

Source: Bloomberg, data as of 20 October 2021.

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Before the announcement about Nyrstar was made, the International Lead and Zinc Study Group (ILZSG) was anticipating a supply surplus of 217k tons in 2021 and 44k tons in 2022. With the latest cuts from Europe, and potentially more cuts from China, zinc may be meaningfully undersupplied in the coming months.

All of this is happening at a time when demand is already on the rise. ILZSG expect global demand to rise by 6.2% year-on-year in 2021 and a further 2.3% in 2022. And although recent Chinese activity has

slowed compared to the first half of the year, zinc usage is expected to be supported by demand from several countries including the United States, Japan, India, Brazil, as well as key economies in Europe.

So, what is zinc used for? Zinc is currently the fourth most widely consumed metal in the world after iron, aluminium, and copper[4]. Around half of it is used in galvanizing, a process of adding zinc to iron or steel to prevent rusting.

But zinc is fast emerging as an important metal in the energy transition on account of the value it adds to energy storage systems. As the world transitions to renewables like solar and wind, a well distributed energy storage network will be needed to ensure that power supply to consumers is uninterrupted. Currently, energy storage systems largely rely on lithium-ion batteries which are very effective for short duration storage. Flow batteries, which utilize zinc, are emerging as a key technology for low cost longer duration storage. An effective grid, which distributes energy where and when its needed, will ultimately require a mix of short and long duration storage.

So, the long-term prospects appear promising. Nonetheless, there are still near-term risks. China could release additional state reserves to ease some of the current tightness, something the country has been doing since July. A colder than average winter may, however, make energy markets tighter putting further pressure on smelters. The balance of those two key risks will ultimately determine the price trajectory in the coming weeks. But ultimately, zinc will join the ranks of copper, nickel, aluminium, and others as a thematic investment linked to the energy transition.

[1] Citi Research, data as of 14 October 2021.

[2] Citi Research, data as of 14 October 2021.

[3] Backwardation is a state when the futures curve is downward sloping, i.e., longer dated futures are less expensive than shorter dated futures.

[4] Geology.com

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