China's commodity exchanges

China is seeking to gain a role in global commodity pricing commensurate with its demand for raw materials and boost use of the Yuan as an international currency of exchange.

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- **China's ferrous futures markets influential but volatile**
- **New crude contract has chance of success**

Historically closed to the outside, China is gradually opening up its derivatives trade to foreign investors.

The government's aims are twofold: to improve the interconnectivity between Chinese and international commodity markets, and thus gain more influence over the price China pays for its commodities, and to promote the use of the Yuan in global trade as an alternative to the US dollar.

To this end, the Shanghai Futures Exchange (SHFE) launched in March a crude oil futures contract open to the international community. Iron ore futures, already well established domestically, are expected to be opened to foreign investors later this year.

However, shifting a meaningful volume of international trade onto Chinese trading platforms may prove challenging.

US dollars are the "lingua franca" of international commodity trade, and international players may display significant inertia when it comes to using futures contracts prices in Yuan.

As with all new crude futures contracts, there are doubts over whether China's will attract sufficient liquidity to make it a useful trading tool. There are also fears of speculative trading behavior causing large and unpredictable price swings, as well as the potential for government intervention.

These factors could impede the uptake of Chinese derivatives by the international community.

Irrational exuberance

China's steel and iron ore futures are widely considered to be a key indicator of Chinese steel market sentiment and have exerted growing influence on physical prices over the past two to three years. This is not surprising given China imports more than 1 billion mt of iron ore annually and produces half of the world's steel.

Rebar futures were launched on the SHFE in early 2009 and the rebar

futures contract is now the most actively traded metals futures contract in the world. With "lot" sizes of just 10 mt, it enabled small players to participate easily.

However, in many Chinese futures contracts, including rebar, all the liquidity is concentrated in one month, typically several months out to avoid the risk of physical delivery.

Owing to the lack of a liquid and well-defined forward curve, they are often seen as an indicator of market sentiment more than as a tool to hedge physical price risk for delivery in the month ahead.

In addition, while large financial players, trading houses and steel companies in China are major users of derivatives, hundreds of thousands of wealthy individuals also participate in rebar and iron ore futures.

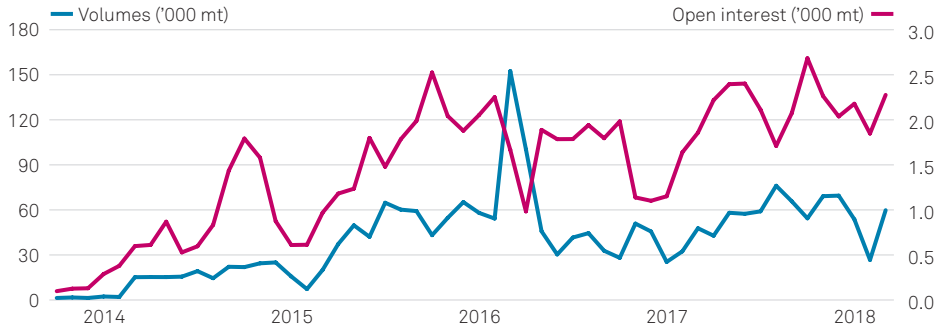
These participants are purely financial players; many entered the market after the abrupt falls in China's stock markets in 2015.

Many observers consider China's rebar and iron ore futures contracts a speculator's haven; a place for day-traders and punters with no physical exposure to gamble hot money, as suggested by the high ratio of volume to open interest.

The market can also be extremely reactive to Chinese government policy announcements, or global events such as fears of a trade war with the US.

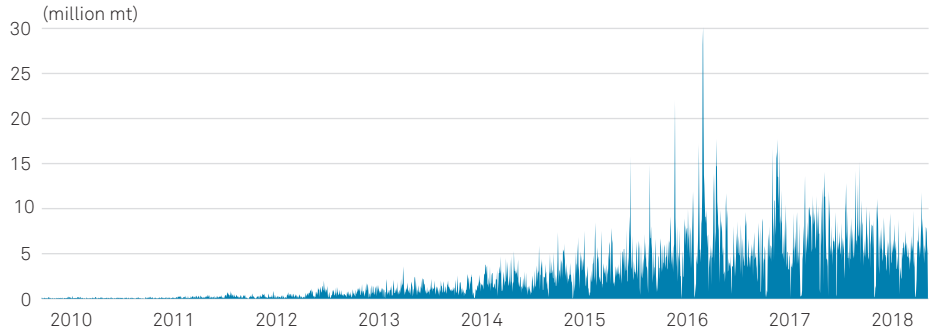
It means that sentiment can play a greater role in influencing prices than supply and demand fundamentals might suggest.

DCE IRON ORE FUTURES: TRADED VOLUMES AND OPEN INTEREST



Source: DCE

SGX HISTORICAL IRON ORE SWAPS VOLUMES



Source: SGX

This was seen in early March 2016, when global ferrous markets were stunned by Shanghai rebar futures rising 10% over a couple of days, while the S&P Global Platts 62% Fe iron ore benchmark experienced one of its biggest day-on-day jumps of around $11/mt.

The excitement was attributed to comments made in Beijing at the National People's Congress – the annual meeting of China's Parliament – about steel production cuts, along with positive noises about the state of the economy.

A week later, few could remember what had provoked the price surges.

Iron ore futures

Launched by the Dalian Commodity Exchange (DCE) in October 2013, iron ore futures were the next contract to capture the imagination.

Chinese iron ore futures have become the second-largest global metals contract after rebar. Platts estimates that domestic players now trade as much as 2.7 billion mt of iron ore derivatives a month.

Similar to rebar, the most active contract on the DCE trades months forward for fear of physical delivery, while international iron ore traders spend their days monitoring the DCE on

their smartphones for cues to settle physical prices.

The DCE is opening up iron ore contracts to international investors, and while futures trading will be priced and settled in Chinese currency, it has added the lure of allowing participants to make deposits in US dollars.

The impact of financialization on the iron ore market has been profound, but critics lament the sharp intraday movements on DCE futures.

Unable to easily access DCE iron ore, international investors manage price risk by hedging, using derivatives hosted on international venues like the Singapore Exchange, where 95% of these volumes are cleared.

Crude contracts

In many respects, ferrous derivatives are the new game in town, built on the vast steel and iron ore capacity expansions made over the past decade to support China's urbanization.

In contrast, crude oil is a mature market with two long-established financial benchmarks, ICE Brent and Nymex WTI.

In addition to these futures contracts there are also widely-used physical benchmarks like Platts Dated Brent and Platts Dubai, used to price physical cargoes and term contracts around the world.

Onto this stage steps China's new crude futures contract. The contract is hosted on the Shanghai International Energy Exchange, a trading venue owned by SHFE.

Unlike ICE Brent and Nymex WTI, which are light sweet contracts, China's new contract reflects mainly Middle Eastern medium sour grades, which account for 40%-50% of China's total crude imports.

The contract has been long in the making, and, like Shanghai rebar and DCE iron ore futures, it can be physically delivered.

There is currently no Asian crude futures contract with the liquidity of Nymex WTI or ICE Brent. With China now the largest importer of crude, the country hopes its contract will be more reflective of China's supply-demand balance than either.

The ambition is to provide an Asian counterpart of equal standing to ICE Brent and Nymex WTI futures.

However, at least in its early days, the expectation is that it could become an alternative contract rather than a dominant one.

Unlike DCE iron ore futures, the crude contract was designed from the outset to be open to international investors.

Beijing has announced a series of special policies on taxation, foreign currency exchange and bonded delivery to enable and encourage overseas participation.

Others have tried and failed to create a futures contract with enough liquidity to rival Brent and WTI, but with China's increasing influence in global markets, and as the world's largest importer of crude and second-largest economy, this contract perhaps stands a better chance than most of joining Brent and WTI as a financial benchmark.