US steel, scrap hedging still seen as confusing, panelists say

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Hedging in the steel and ferrous scrap industries in the United States is still not mainstream due to nagging perception issues that contribute to misunderstandings about how it really works, according to panelists at the 37th annual Steel Success Strategies conference this week.

"Unlike every other major metals market… futures represent just 6% of the domestic steel trade, so there is huge room for growth," Kerry Deal, Freight Investor Services head of business development, said on Tuesday June 7 in Miami Beach, Florida.

"Some of it is education… what's stopping people more though is a perception issue."

The idea that futures are "gambling" and somehow increase risk is still prevalent, according to Deal.

"If you're holding any physical inventory or if you need to purchase physical products on a consistent basis and relying on a spot market price, you are already gambling," he said.

"The best way to regard utilizing futures together with your physical trade is reducing that risk and effectively taking yourself out of the casino – that's the perception issue that needs to budge for this market to grow," he added.

Much of the steel in use today in the United States was developed within the last 20-25 years, which previously presented challenges for standardizing derivatives contracts to be launched and adopted, according to Sean Kessler, a director at Flack Global Metals.

"We're past that now," Kessler said, but ingrained habits still linger. "There needs to be some recognition that doing things the way they've always been done is not always the best way things should be done."

Deal pointed out that there was a "frequent" expectation from some market participants that they needed an exchange contract to match the exact product they want to hedge. But this is a mistake, he said.

“Other markets have actually built liquidity around very standardized, widely used benchmarks,” he said, citing iron ore as a prime example. “Despite the fact that there are dozens of grades of iron ore and producers around the world, the global community trading iron ore decided to focus on two – 62% Fe and 65% Fe – and normalize the differential between the products they’re holding,” he said.

Seaborne iron ore 62-65% Fe spreads are narrowing thanks to stronger preference for mid-grade fines and stable demand from buyers, which was reflected in exchange data this week, according to market participants.

“There are some very simple calculations that everyone who [buys or sells steel] can use to normalize,” Deal said, in reference to several existing US-based steel and ferrous scrap contracts currently listed by exchanges.

Steel market participants do have some legitimate concerns about hedging, countered Andrew Lichter, vice president of corporate strategy and development at Mobius.

“There are a lot of reasons out there that people aren’t involved – some make sense and some don’t,” Lichter said. “Everyone is looking very logically at the impact of margining and liquidity, which is a significant risk that hedging entails. There are ways you can mitigate that – you can go direct, you can use options, there are different structures you can put in place.”

“Frankly, the people responsible for educating [the market] historically have not addressed this as well,” he added.

Hedging alleviates significant day-to-day concerns about market volatility and frees up time, according to Kessler.

“It frees us up to focus on our business’s core competencies, such as providing good customer service and delivering product on time, and doing other things that increase margins and improve returns on invested capital,” he said.

The CME Group’s busheling scrap futures are settled against Fastmarkets’ steel scrap No1 busheling, index, delivered Midwest mill, which was at $705.08 per gross ton on May 10, down by 9.45% from $778.65 per gross ton on April 11.