

Aluminium: Calm before the next storm

It's been quiet, too quiet in the range-bound aluminium market. Rusal is moving fast to try appease US sanctions and US 232 negotiations are going down to the wire. The outlook is soon approaching a crossroads



Source: Shutterstock

What's next for Rusal?

It's looking increasingly likely that sanctions on Rusal will at some point be lifted. This will return supply from the world's largest ex-China producer to the whole market and release any unsold stockpiles. Since US sanctions were imposed on 6 April, Rusal and the 66% Deripaska-owned holding entity EN+ have been busy taking steps to have the sanctions repealed. After a shuffle of management, the key remaining action appears to be for Deripaska to relinquish his substantial holding in the company. According to an earlier EN+ release (27 April) Deripaska had indeed agreed in principle to reduce his holding, on the condition that sanctions are lifted. On Thursday, Bloomberg reported that the US Treasury had set a target (mid-40% range) as was hinted by Treasury FAQs in April.

We have tried to stay out of the 'will they or won't they' debate on the US lifting Rusal sanctions, but traders need to be prepared for the increasing likelihood and resulting volatility. When this might happen is unknown but news of Deripaska's shareholding will be the key. Bloomberg cited

sources talking about a targeted OFAC-Rusal deal through June/July. On 23 April, Rusal was thrown a temporary lifeline as far as 23 October when OFAC extended the period for which existing sales contracts could continue. We understand a number of traders are continuing to take metal (especially into Europe) and shipments are restarting. Some buyers such as Japan's UACJ have been reported as not taking the material. Crucially, the OFAC extension (general license 14) allows payments into non-blocked accounts, providing Rusal access to revenue (in addition to domestic sales) until that deadline. Before losing its customer base to the risk of secondary sanctions, it's certainly in Rusal's interests to wrap up the matter before that deadline expires.

Rusal sanctions timeline



Source: Bloomberg, ING Research

If Rusal sanctions are lifted?

LME aluminium prices have settled in around \$2,200-2,300 since the US gave the aluminium industry its 23 October breathing space. Having come down from highs above \$2,700, the market is clearly pricing in a good possibility of the sanctions being lifted but the room for doubt still sees prices up 13% on the \$2000/mt levels seen prior to the sanctions. If the 3.7Mt supplier (2.9 ex-Russia) fully returns to the market, it's possible the market once again approaches those levels. If so, we would stress that these prices are in fact too low. We were bullish aluminium prior to the Rusal sanctions. The ex-China market was already set to face deep deficits (c.1.7Mt). If the Rusal sanctions are lifted, we would stick to our original, pre-April, forecast of \$2,300 for the second half of 2019.

There will, of course, be physical motivations for such a sharp sell-off. As well as ensuring Rusal's steady state sales, there is likely a sizeable backlog of unsold material standing ready to flood the market. Russian news agency Ria Novosti cited railway data pointing to a 70% drop in exports through April but a slightly slower decline through May as some sales have resumed. Just taking the April data and lull in May, we could estimate 300kt of fresh material sitting unsold (on top of previously produced inventory) and that number swells each month the sanctions go on. As that stock becomes available, we expect physical premiums to drop, then as the LME resumes accepting Rusal metal (post 6 April), the LME price will fall in lockstep. Any tonnages that cannot find a consumer will find their way to the exchange.

What if Rusal sanctions stay in place?

If we roll into August without progress on the sanctions, increasingly nervous eyes will look towards the 23 October deadline. Prices will trend higher and, failing a last-minute pre-23 October deal, we might well expect another sharp rally to take hold.

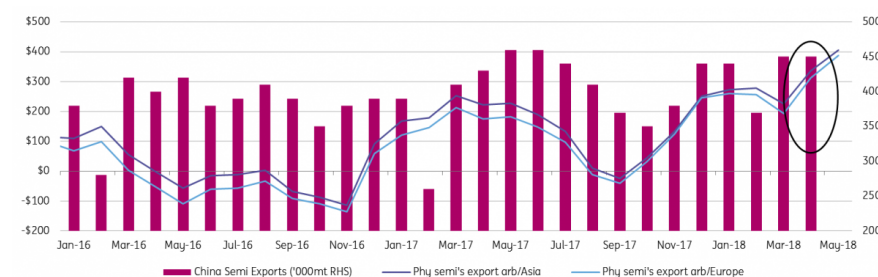
We have played out this scenario in [our earlier note](#) and suggested a middle-ground case where Rusal is able to find a home for a good portion of its metal. Rusal's own analysis to the Kremlin- as reported by Russian media- shows a 30% production loss in a best-case scenario and up to a 50-70% loss in a more extreme scenario. That upper limit effectively suggests all sales outside of Russia are lost. Our earlier work was more closely aligned to the better-case scenario and relied on

the assumption that, at some discount, Rusal metal could be sold to China. This should depress Shanghai vs LME prices and support an arbitrage wide enough to encourage semi and refined exports to fill the void.

Even the lower 30% loss costs 1.1Mt of supply from an already 1.7Mt ex-china deficit. The pull on off-warrant stocks and Chinese supply is going to be severe. Our 4Q \$2,450/Mt year-end forecast looks tame at anything above the low-end of Rusal's scenario. So we are now hiking it to \$2,500 but still trending lower as fundamental headwinds take hold. A lasting, more extreme loss of Rusal production/sales beyond the 50% level would bring us to \$2,700 later on. We resist calls that \$3,000/Mt is a sustainable high because we see good resistance from the following:

- **Off-warrant stocks getting sold off:** We estimate 3-4Mt ex-China with traders tempted by higher premiums and a return to deep backwardations.
- **Spare capacity ramps up at higher prices:** Harbor estimates ex-China/Russia utilisation at 86% capacity. 5% utilisation effectively yields +1.5Mt or half of Rusal's ex-. No doubt there is a discrepancy between real and effective spare capacity but even +500kt fills a good portion of the hole.
- **Alumina prices are coming down:** Spot transactions at \$700/t in April reeked of desperation at certain smelters caught short and we do not think were reflective of wider market conditions. Rusal is net a minimal seller but chaos ensued because it stands between the supply chain as a major buyer and seller. Now the market has until October for these would-be-buyers to meet would-be-sellers. If Rusal's alumina production and sales stop, then we expect they also have to cut their demand through aluminium production in turn. Further, we see a good chance Hydro's Alunorte refinery is allowed to return to full capacity before then.
- **Chinese exports will grow:** The arbitrage for exporting semis remains hugely profitable (\$300/t into Asia). The big question is what levels incentivise primary metals exports (inc. a 15% export tax). On a crude basis, \$2300/Mt satisfies China's smelting costs (with some risk of inflation) and export taxes with transportation incentives etc easily covered by the sellable premiums. Were it not for supply-reform, we would have expected to see China readily play swing supplier at these prices and utilise some of its 20% spare capacity that outweighs Rusal. But Chinese's aluminium is in a far more restrictive place nowadays so we peg our forecasts higher, respecting the need for the ex-China market to actively direct units off-shore to fill the void rather than just incentivise new production. We note our original 1Mt Chinese surplus for this year and 2Mt of social inventories. The units are there but the LME will need to outperform SHFE by 15% to direct the flows. On current SHFE prices, that requires \$2,650 but the more Rusal can sell into China the easier this might be.

Chinese aluminium product exports set to surge on arbitrage



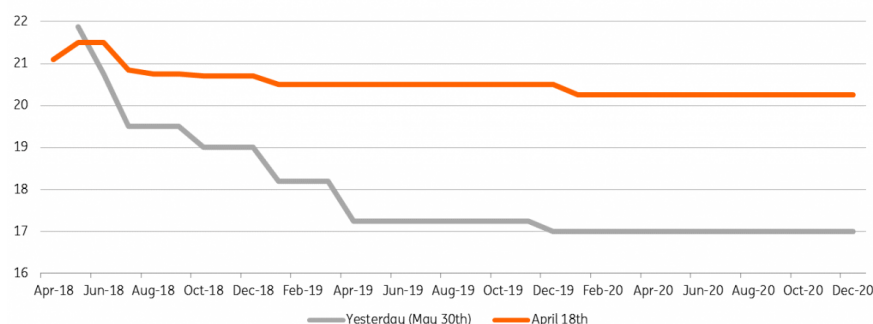
Source: China Customs, Harbor, SMM, ING Research

Sections 232 tariff exemptions expire

Temporary exemptions granted to Canada, Europe and Mexico for US steel and aluminium tariffs, are now set to expire. 232 tariffs matter most for aluminium since the US relies on imports for 85% of supply compared to 30% in steel, which we think it could largely displace (varying by product). It's the US aluminium premium that is, therefore, most exposed to the news. The premium has swelled from 9c/lb in December to 19c/lb; the tariffs were announced in March and a further 3c/lb following the Rusal sanctions. Prior to today's news, the forward curve thought it had all gone too far and saw the market settling at 17c/lb by April 2019. This is still too high if Rusal gets resolved but might also look complacent if today's tariffs announcement is upheld or the US gets tough on import quotas.

Canada is everything when it comes to US aluminium, supplying 50% of imports. We think it's unlikely that Canada will not eventually get a tariff exemption, today's news is likely to be appealed. Whether quotas are put in place is key. It was tariffs or quotas put on currently exempt Argentina and South Korea, for example. But the more exempt suppliers are not permitted to fill the void left by Rusal exports of 690kt and other currently non-exempt exporters (Bahrain + UAE, = 27% of imports etc), the higher the US premium must settle to incentivise a greater portion of 10% duty paying metal. A clear ceiling is evident at 20c/lb (10%* (LME + Duty unpaid premium)+ freight)), but that's clearly set to fluctuate depending on how the Rusal situation drives premiums globally. With US duty cleared stockpiles likely to be sold off and consumers negotiating down in competition from duty-exempt suppliers, we think it should settle some way lower than that ceiling. The current 3c/lb 2019 forward discount seems fair until the Rusal situation resolves or Middle Eastern countries also get an exemption. This said, watch out for another consumer bidding frenzy as Canada's tariff-free status is jeopardised.

The market was expecting premiums to settle down (c/lb)



Source: CME, ING Research