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The lead-zinc spread ongoing recovery continues

The lead-zinc spread has improved considerably, but we think there is still a little bit more room for improvement as the strength in their fundamentals suggest. Zinc is finally transitioning to a surplus market, but for lead we think the global market balance needs to be reconsidered

Source: Shutterstock

The restoration of lead-zinc spread goes on

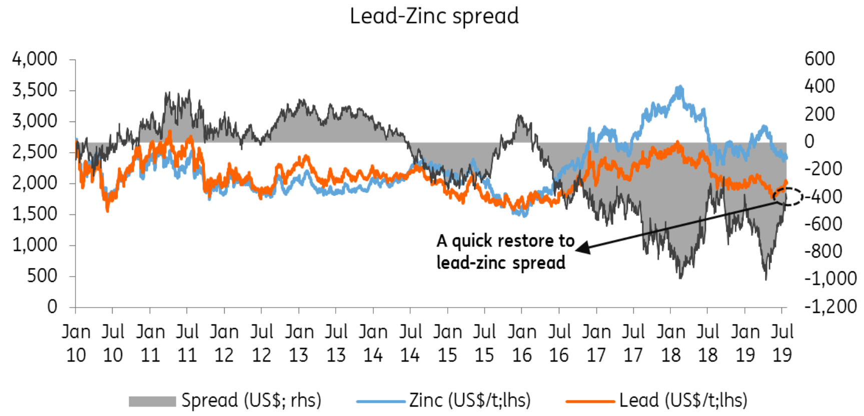
The relative value between lead and zinc has been shifting with zinc's premium over lead narrowing from over $1,000 in mid-April to just around $400 at the end of July. We think their relative strengths stemming from fundamentals have been driving the lead-zinc spread and there is still more room for the remainder of this year.

For zinc, the LME spread ease may suggest the market is finally transitioning to a surplus market

For zinc, the London Metal Exchange (LME) spread ease may suggest the market is finally transitioning to a surplus market. You can also see this phenomenon in rising Chinese productions at the back of large-scale smelters. One risk is that the current low LME zinc stock implies that selling at the nearby contracts looks dangerous. However, a recent contango is rolling towards February 2020 according to the LME zinc forward curve, providing opportunities to sell longer-dated contracts.

In terms of lead, we think there is a need to re-evaluate the global market balance, and we feel a turn in expectations could have already hit the market. As a result, we think lead's price strength looks stronger than zinc, which should help to restore the spread.

Lead-Zinc spread



Source: Bloomberg, ING

Re-evaluating lead's market balance

By re-evaluating the global lead market balance, we think the surplus could end up smaller or even balanced than the market previously expected. This suggests a potential expectation correction among investors. In fact, we feel that given the LME stocks are at its 10-year lows, some speculation may have already come to surprise despite the battery metal is in seasonal demand lull. In LME, lead has been the second-best performer after nickel over the past two weeks.

> *Re-evaluating the global lead market balance, we think the surplus could end up smaller or even balanced than the market previously expected*

Earlier this year, the International Lead and Zinc Study Group (ILZSG) reported the global lead market is flipping from a deficit of 78kt from 2018 into a surplus of around 70kt in 2019. However, the outage at Nyrstar's Port Pirie smelter could result in 30kt supply losses. In the meantime, two large Chinese primary lead smelters went into unplanned maintenance from the end of June and could collectively bring another 20kt supply losses. Going forward, the risks of supply pointing to the downside are still high and possibly from China due to the country's stringent pollution control measures which place a cap on both primary and secondary productions. In early July, Beijing sent inspection teams to eight more provinces and regions to see how well they are complying with the state environmental rules, which suggests the authorities hasn't really relaxed monitoring the industry closely.

In the meantime, to better regulate scrap lead acid batteries (LABs) recycling and transportation, Beijing has launched campaigns in more than 20 pilot regions in March in 2019. One of the immediate results we heard from the market is that the availability of scrap LABs has largely reduced. But sine scrap LABs are a major source of secondary lead productions, a prolonged tightness could result in lower secondary production from the country.

Zinc market finally transitioning to a surplus

The timeline for zinc's return to surplus keeps shifting. This is in large part due to a 'smelter bottleneck' from Chinese smelters capping production growth despite margins improving in 2018. Previously, the market expected smelters to respond sooner to higher treatment charges but refined productions from the country turned out to be a bit disappointing.

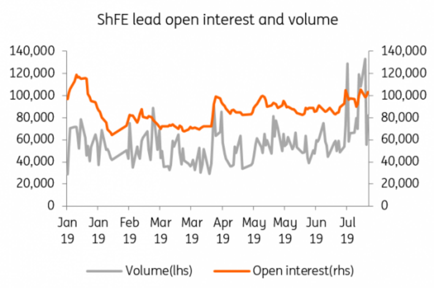
> *The recent collapse of the LME zinc spread could be suggesting the galvanising metal is finally transitioning to a surplus market*

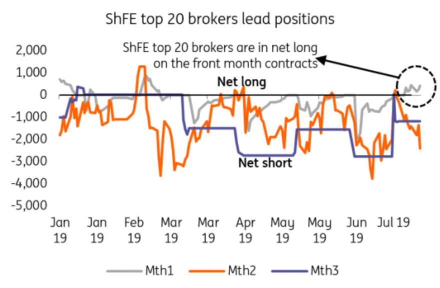
The recent collapse of LME zinc spread could be suggesting the galvanising metal is finally transitioning to a surplus market. Of course, this is not without help from weaker than expected demand year to date. Despite that, the study group has a small deficit on the global level. ING zinc balance for China is showing the world's largest refined zinc producer and consumer market has flipped into a small surplus from July, although we don't expect this would directly help shore up LME inventory level.

On the demand side, we only see marginal improvements towards the end of Q3 and early Q4 primarily from white goods and infrastructure sectors from China. Overall, supply growth is still outpacing demand which means the market is well supplied.

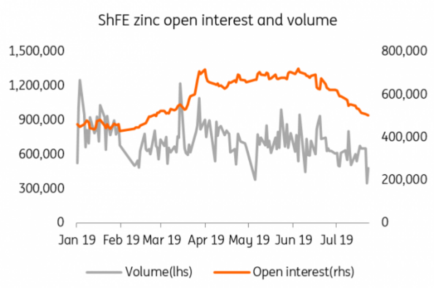
ShFE positioning signals the market is in favour of lead

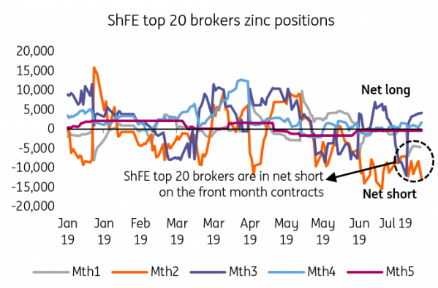
Looking at the Shanghai Futures Exchange (ShFE) lead, recent prices are in defiance of surging stocks (latest at 35kt on July 19), and both open interest and volume have risen. The top 20 brokers have returned to net longs on the near dated contracts. In contrast, they went for net short on zinc's near dates contracts. Meanwhile, both trading volume and open interest have declined a lot in July.





Source: Bloomberg, ING





Source: Bloomberg, ING

Moving to LME, inventory continues to fall to just close to 57kt, with a year-to-date decline of 47%. This has been sending bullish signals for the lead market technically despite the forward curve not suggesting a shortage of metal. There is a possibility that sometime later the near dated spread would flip to backwardation as we saw two weeks ago.

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