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Article

War risk spurs repricing in base metals

War in Ukraine has fanned the flames of the metals market which was already stretched. There is still significant uncertainty and confusion around the various sanctions on Russia. If there is no quick de-escalation, upside risks will dominate especially for those with larger exposure to the current crisis



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Russia-Ukraine war fans the flames of the already-stretched metals market

The Russia-Ukraine conflict has prompted a re-pricing of base metals to reflect the likely supply disruption. What happened after Russia's attack on Ukraine has essentially added fuel to the flames. Almost all base metals are in deficit this year, with depleting stocks leaving little buffer for the market to weather further disruption. Unsurprisingly, the market is more vulnerable to explosive spikes in metals with larger supply exposure to Russia, and the current conflict, either

directly or indirectly.

[As for the direct impact, we noted earlier](#) that Russia is a sizeable producer of metals like palladium, aluminium, and nickel, and it's a significant exporter to certain markets. The sanctions packages currently being announced have yet to target the producers in Russia or their owners. Nevertheless, the sanctions on Russia's access to SWIFT and certain Russian banks have caused great confusion among market participants about trading metals with the country. Wary of reputational damage, some have been self-sanctioning, for example, some shippers have stopped taking Russian bookings, and banks have stopped financing the deals. These measures have worked as effectively as sanctions. While things remain uncertain in regard to the Ukraine war, the markets are already doing the job of any government. In the meantime, the war in Ukraine has clearly put the region's industry at risk. One of Rusal's alumina refineries, with capacity of 1.7mt, has been disrupted, increasing the risks to aluminium smelting.

There are indirect impacts as well, and this is chiefly due to the current gas market, especially in Europe. Higher gas prices effectively translate into higher power prices. Energy-intensive metals, such as aluminium, are very exposed. Since 4Q21, higher power prices in conjunction with rising carbon prices have knocked out aggregate capacity of 850ktpa in Europe (ex-Russia). Russia's attack last week only makes things worse for power prices in Europe. Meanwhile, there are fears that train transport or Black Sea shipping could be disrupted, hitting supplies of other non-Russian metals from central Asia to the European markets. Even disruptions to small volumes could make things worse given the already stretched market.

It's yet unclear how many Russian metals would be affected as things are still playing out. A quick de-escalation seems unlikely in the short term. In the scenario that all Russian metals remain within the country and there are more supply disruptions from Europe, we see aluminium prices crossing over \$4,000/tonnes and copper to retest its record high last year in the next three to six months. And nickel may see a further explosive run towards \$30,000, with market positioning also providing some catalyst.

Far-reaching impacts to supply as a result of elevated power prices

Putting Russian metals aside, the power costs to produce one tonne of aluminium are even higher than the price currently traded in the London Metal Exchange (LME) market based on the baseload spot prices. Power costs account for around half of total aluminium smelting costs. Power hedges have helped producers shield themselves from the spot price and lock in some margin, although the situation varies from one to another.

A key problem facing the industry is that some producers could become increasingly exposed to spot prices in the future if they fail to hedge their power exposure for future use. If not in 2022, then in 2023 and beyond. So, as long as power prices remain elevated, it won't be surprising to see curtailments in metal production. This could be the case for aluminium given that the smelting process is very energy-intensive, or it could be zinc or other base metals depending on the producer.

China is on the soft side, but there are expectations of demand pickup

The deficits in the global metals market are uneven. This not only reflects the different market dynamics but is also due to various trade barriers and supply chain bottlenecks that have made the flows across regions more restrictive during the pandemic. Ex-China markets such as Europe and North America have seen more acute tightness with even less cushion against further supply shocks. Therefore, it's not surprising to see that some physical premiums have surged to record highs.

For China, we entered the year expecting to see slightly firmer demand this year as the country's policy turned to a pro-growth stance. However, the China market has been in a bit of a soft patch since the Chinese New Year at the beginning of February. First, the seasonal inventory building has not stopped (drawdowns would be a sign of demand picking up) and the Covid outbreaks from multiple provinces and cities remain a concern. Second, market participants are expecting an influx of flows from Russia that will add to rising supply in the China market, especially aluminium, nickel and some copper as well. Even in the short term, some onshore traders are desperate to get rid of Russian metal, wary of further escalation.

Nevertheless, based on current information, there is no evidence that China will become a dumping ground for Russian metals. Economically, this is not a favourable time for China to import the metals based on current London and Shanghai prices. It remains to be seen whether there will be any large influx into the China market; this has kept the onshore market on the soft side of expectations and some market participants in 'wait-and-see' mode.

Should we see higher flows from Russia later, this may weigh on Shanghai prices versus London, reducing China's appetite for more imports of primary metals. However, if Russian metals don't find their way into China, this presents more upside risk. The next two weeks are key as the US Federal Reserve decides on rate hikes and China's Two Sessions commences later this week. If Beijing were to come up with a firm growth target and authorities decide on more detailed stimulus measures to foster growth, this could spark optimism and be a catalyst for an earlier start to the pickup in seasonal demand.

