Introduction to Trading Metals

Besides stocks and bonds, which are more familiarly traded by the common investor, commodities such as metals can also provide diversification to one’s portfolio. Let’s take a closer look at the basic characteristics of metal trading and analyse the general factors that affect their prices.

Types Of Metals traded

There are basically 2 broad categories of metals that are traded on the commodities market:

Precious metals (which will be covered separately in another article) – gold, silver, platinum and palladium. These are traded on many exchanges around the world, but the primary centres of trade are the London Bullion Market, the New York Mercantile Exchange (NYMEX) and the Tokyo Commodity Exchange (TOCOM). The unit of trade is the troy ounce.

Industrial metals - includes copper, lead, tin, steel, nickel, zinc and many others, these are further classified into Base Metals, Steel and Ferro-Alloys, Minor Metals. The primary centre for most of them is the London Metal Exchange (LME). The New York Mercantile Exchange is also significant, as is the Hedge Street Exchange in California and the Central Japan Commodity Exchange (C-COM). Industrial metals however, are traded in metric tons.

Instruments to trade metals

Besides trading of physical quantities, metals are commonly traded in the futures market, where future contracts are bought and sold for delivery on a future specific date. This allows large importers of the metals to gauge their prices in the near future and hedge their costs when using these metals for production and manufacturing. On the other hand, exporters use these to estimate the production and mining of the metals to control the supply of them to the rest of the world.

Metals can also be traded in other sophisticated derivatives such as options that require a premium as an upfront cost (which is the maximum that the purchaser of the option can lose) and exchange traded funds (ETFs), where a basket of different metals are traded in an investment fund, which is in turn traded like a stock in the stock exchange. We will not dwell into the technicalities of these products in this article.

What you must know before trading each type of metal

Before embarking on one’s exciting journey in commodities trading, it is crucial that he understands the factors that affect its prices throughout the year and even in the long term. This would include demand & supply forces, inflation and the performance of other financial markets.
What affects supply?

For soft commodities such as wheat, corn and soybean, seasons and natural disasters play an important role in determining their supply. However, metals on the other hand are subjected to a completely different set of variables; they are a non-renewable resource and hence considered to be relatively fixed in supply.

In the short-run, their supply is determined by the release of reserves by countries with these ore deposits and how quickly they can be mined. Main exporters of metals include, China, which holds a great proportion of the world’s rare metals such as Scandium and Cerium, Canada, Australia and Russia. Before trading metals, one must be clear of the volume of export of the chosen metal and observe their change in supply from time to time.

Reasons for sudden changes of supply might include the discovery of a new depository leading to new mines, inventory issues or policies by exporters to control trade, and especially protectionist measures under taken by governments.

What affects demand?

The demand of industrial metals is derived from the manufacturing and construction sectors across various regions of the world. We see spikes in demand occur during instances of economic booms, where countries increase their imports for metals for construction of infrastructure or when emerging economies have accelerated manufacturing growth.

New innovative usage of certain metals also cause necessary surges in the demand of metals, take Lithium for an example which has seen much growth in recent years due to its increasing use in ion batteries of portable electronic devices.

Government policies may also have a direct impact on the prices of metals. In November 2011, China shut down almost 90% of lead-acid battery makers in a government crackdown to curb lead poisoning cases, cutting sales and weighing on metal prices. Lead for delivery in three months on the LME dropped to $2,041 a metric ton from a three-year high of $2,904 a ton in April 11.

Will inflation affect metal prices?

Demand and supply aspects aside, inflation can also cause significant price changes of metal, often emerging in the form of cost-push factors. With inflation, come higher energy prices, which eventually drive up the cost of mining and refining. Energy constitutes a significant portion of the cost of steel production, from 20% to 40% in some countries (American Iron and Steel Institute, 2005.) and this alone is enough to propel metal prices upwards even without the consideration of wage increases.
The effects of inflation is indeed crucial in the industry of metal mining and refining; one has to reflect on inflation estimations and forecasts before deciding to invest in certain metal types, lest these costs occur as a surprise. The higher the estimates are for major exporting countries, the more likely prices are expected to increase during the given period and the reverse might also be true in cases where there is widespread economic slowdown as seen from the 2008 global crisis.

**Relation to other financial markets**

As shown from above, the metal markets are highly correlated to the energy market, and it is especially so for oil. This also proves to be true for the real estate market, where metals constitute core construction materials. The higher the price of metals, the higher the cost of construction and hence property prices for the given period of time—though this might not always hold true if there are offsetting factors such as a decrease in labour cost or land prices.

For the stock market, ETFs and indices on the other hand, there is no definitive relationship across the spectrum, it all depends on the nature of the stock or the industry that the index is tracking and therefore one should never blindly take these markets as substitutes. The S&P Metals & Mining Select Industry Index (SPSIMM) for an example tracks down the performances of metals and mining sub-industries and is obvious to have a direct relationship with metal prices. In contrast, the stock of an investment firm that has more stakes in service-orientated sectors may suffer less of a shock from the price changes of metals.

**Risks and limitations of trading metal**

Precious and industrial metals have experienced some extreme price movements in recent years, which have increased investor interest in them. One of the inherent risks of commodities is that the world’s natural resources are located in various continents and the jurisdiction over these commodities lies with sovereign governments, international companies, and many other entities, one has to continually keep track of certain macro-economic and political issues pertaining to the industry to prepare for unexpected turn of events. International disagreements over the control of natural resources are common and can easily put you on the wrong side of the trend overnight.

Another important limitation of metal trading is the speculative risks involved. The commodities market is similar to the bonds and stock market in this aspect, where there is an abundance of retail speculators who add to the volatility of the market. Though it is true that this gives greater liquidity, one must consider the actions of these speculators and not simply the intentions of metal exporters and importers. Excessive speculation may lead the markets in different ways and it can catch one off guard if he is too engrossed with just the commercial users.
Conclusion

Metal trading is not for everyone, but it is certainly a great way portfolio diversification and hedging. Like always, one must ensure that he has done their due diligence before committing to a trade, especially if it is a complex trading instruments such as futures and options contracts, where premium costs and expiration dates are added variables. He should also ensure that he has gathered sufficient information about the choice of metal selected before jumping into a trade upon hearing rumours of an expected spike or plunge in prices.

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