

OPINION - CME AUP gains legitimacy with analyst recommendation

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Winter Park, Florida 06/11/2015 - An analyst note yesterday from JP Morgan caught my eye not so much for its overall thesis but more for what it recommended.

The gist of the report was that recently announced aluminium smelter closures by Alcoa and Century Aluminum in the US should boost the Midwest premium but will not lead to a meaningful rally in the underlying London Metal Exchange price. This is a perfectly reasonable assertion - in fact, I made a similar argument a day prior.

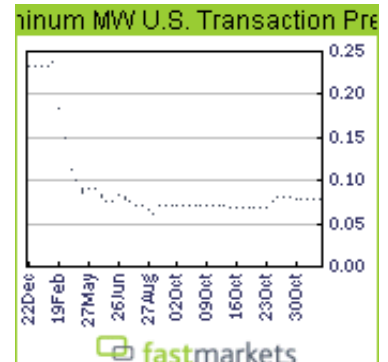
But here's what I found interesting. JP Morgan suggested that best way to profit is to go long the March 2016 CME Aluminum MW US Transaction Premium Swap futures contract at Thursday's price of 8.75 cents per pound, with a stop loss at 6.75 cents and 10.00 cents.

The AUP contract currently trades at 7.950 cents for October, while December is at 8.4 cents and each month in 2016 is at 8.950 cents. Before the Alcoa announcement, January 2016 was at 8.25 cents and the rest of 2016 was priced between 8.5 cents and 8.65 cents.

This is the first time that I can remember a major analyst recommending a position in this financially settled contract that launched in August 2013 but really only started gaining significant traction this summer. It now has open interest of 18,610 contracts (465,250 tonnes) and since October 23 the average daily volume has exceeded 200 contracts.

AUP is not yet a juggernaut but JP Morgan noted that it is an exchange-listed and transparent contract that tracks a market traditionally traded and settled OTC. But the broker warned that investors should remain vigilant for any additional liquidity issues that might arise when the LME introduces an all-in aluminium contract later this month.

Still, there are some important takeaways. First, JP Morgan now feels comfortable advocating AUP as a suitable investment vehicle for both hedgers and financial players. That not something that would have happened even six months ago.



Second, from a more fundamental perspective, the smelter cuts in the US will only further exacerbate the divergence between prices there and in the rest of the world.

Next year, the US will consume more than 5.5 million tonnes of primary aluminium but will produce only about 500,000 tonnes. That equates to a deficit of about 5 million tonnes.

This means that the US will be short aluminium while other regions will be incredibly long due to massive overcapacity in China. The end result is that the US Midwest premium has to climb higher to attract metal from Russia, the Middle East and China.

The US Midwest delivered duty-unpaid premium rose to a three-month high of 7.9-8.4 cents per pound this week, up nine percent from 7.25-7.75 cents in the prior week, according to FastMarkets data.

These higher US premiums will generate some interesting arbitrage opportunities for nimble traders but will also create major headaches for risk managers because hedging premiums has always been slightly tricky.

So it is plausible that more physical market consumers will use AUP over the next several months. And as any first-year economics student would tell you - liquidity begets liquidity.

(Editing by Mark Shaw)

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