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New generation energy hedging: When should you mitigate your cobalt exposure?

Cobalt futures volume and open interest are accelerating on the CME

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When most of us think of trading, the first thing that comes to mind is buying at the lows and selling at the highs. One of the biggest fears facing hedging managers is locking in gains and leaving money on the table. Unfortunately, a crystal ball has yet to be invented, so buying at the lows and selling at the highs can be challenging.

While forecasting price movements can be challenging, some tools can make it easier. Evaluating the seasonality of historical volatility, current volatility and liquidity is less arduous.

These tools can help you determine when it's practical to deploy your risk management plan.

What is the definition of historical volatility?

The term historical or actual volatility describes the variance (how different) of a price change from the average price changes. The term standard deviation equals the variance of price changes from the average price change squared, eliminating all negative variances from the mean.

The standard deviation is then multiplied by the square root of time to create a number in percent terms called historical volatility.

Why should you look at the seasonality of historical volatility?

To evaluate the seasonality of historical volatility, you can average the 30-day rolling volatility numbers and create an average for each month. The chart estimates seasonal volatility of cobalt standard grade, in-whs Rotterdam, $/lb.

You can see from the seasonal chart that November is the least volatile month of the year. Q4 is generally the least volatile quarter of the year during the past decade, leading into the most volatile period of the year, usually Q1.

November is a crucial month for the cobalt market, as annual supply contracts are usually agreed upon between traders, producers, and consumers within this timeframe.

The chart might help you answer the question of when you should commodity hedge using cobalt futures. One such answer might be before a period when cobalt prices are most volatile.

Using Bollinger Band Width to analyze current volatility

Another tool that can be used to evaluate historical volatility and periods when volatility is high and low is a technical indicator called the Bollinger Band Width. The Bollinger Band Width indicator uses the high and the low Bollinger Bands created by John Bollinger.

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Bollinger Bands are a technical analysis indicator used to determine how far the proverbial rubberband can stretch. It measures as the default, a two-standard deviation range above and below the 20-period moving average.

The Bollinger Band Width subtracts the Bollinger Band High from the Bollinger Band Low, providing a measure of historical volatility.

Source: Tradingview

You can see from the chart of Cobalt Metal (Fastmarkets) Futures on the CME the Bollinger Bands on the continuous contract are equal to the lowest levels since the inception of the CME futures contract. This information highlights historical volatility is near the lowest levels since inception.

In early August of 2022, the Bollinger Bands were near the year's highest levels, meaning the recent 20-day historical volatility was also near its most elevated.

During this period, rumors circulated that China's State Reserve Bureau was planning to add to its cobalt metal stockpile. China's cobalt metal nearby dated futures contract increased by 12-percentage-points in intra-day trading on August 8.

Look for times when volume and open interest are rising

Another important time to begin to evaluate hedging your exposure is when volume and open interest are rising. If you plan to hedge your cobalt futures risk, you want increasing liquidity, as it'll help keep trade costs low and shorten trade execution timings. Volume and open interest help provide insight into liquidity.

The volume describes how many contracts trade each day. The open interest notifies how many open futures contracts have yet to be closed out.

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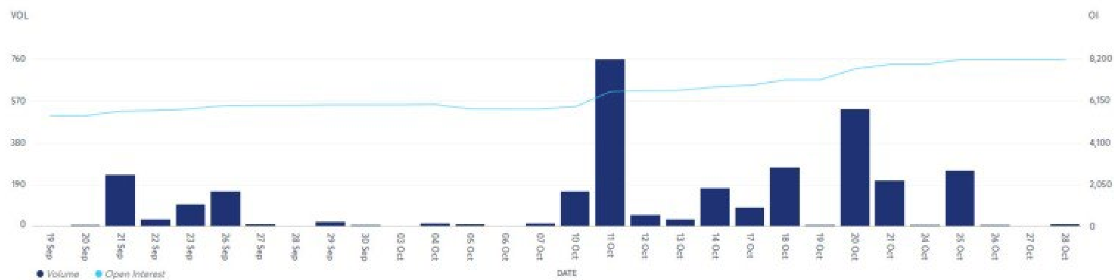

Source: Chicago Mercantile Exchange

A recent chart of Cobalt Metals (Fastmarkets) Futures contracts on the CME have rising open interest and steady and rising volume.

During this period, market participants have utilized the CME to combat ongoing volatility in the cobalt metal market amidst a tumultuous macroeconomic environment.

“Increased volume and open interest is a direct result of increased adoption of hedging strategies from those across the cobalt space. The ability to efficiently hedge long-term contracts all the way through to December 2025 has brought new volume to the market,” said Jack Nathan, Head of Battery Metals at Freight Investor Services.

Hedging can be an effective tool during periods of uncertainty because it can ‘protect’ its user by enabling money to be made if the market moves in an opposite direction to their personal view of market sentiment.

“We want to use the CME to complement our business activities. We use the CME will help to reduce that risk,” commented one consumer.

Cobalt metal can be categorized into two categories; trading physical tonnage and trading futures contracts. The latter is known as ‘paper trading’ because the CME contracts are financially settled rather than with physical volume.

“Cobalt is a difficult commodity to short unless you go on the CME.” You can hedge on the CME if cobalt prices are decreasing. As a trader, you can use the CME to get out of a long position,” said one trader.

Longer-dated futures contracts have recently been added to the CME catalog for cobalt metal, with settlement dates reaching December 2025. Since their addition, the contracts have been subject to heightened liquidity, with electric vehicle manufacturers, cobalt producers, and traders reportedly hedging their exposure further out.

“The liquidity seen on the deferred contracts makes it an attractive option for any business wanting exposure to the cobalt market; this liquidity defines the success of the contract offered, and that is crucial for cobalt,” commented one producer.

The bottom line

The upshot is that there are tools that can be used to help you determine some of the best times to hedge your cobalt exposure. You might consider hedging when volatility is seasonally low or when a technical analysis tool shows that volatility is muted.

Additionally, it’s helpful to hedge using cobalt futures during a period when volume and open interest is rising. Increasing volume and open interest on a futures contract reflect growing liquidity and point to periods that are helpful to hedging your cobalt risk. Contact our risk solutions group to learn more about hedging your cobalt risk.