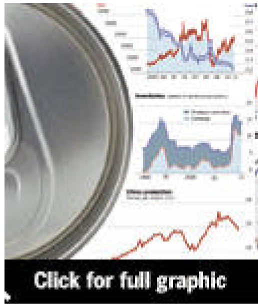

FT.com
FINANCIAL TIMES

Aluminium hots up as supplies start to buckle

By Jack Farchy
Published: February 9 2011 17:44 | Last updated: February 9 2011 17:44

For much of the past two years, aluminium was the metal everyone loved to hate. While copper, the darling of hedge funds, has raced to one record after another, hitting $10,000 a tonne last week for the first time, aluminium, the most widely used metal after steel, lagged far behind.

Energy factor

Producing aluminium requires so much energy some traders joke the metal is "congealed electricity". On average it takes about 15.7 kilowatt hours of power to make one kilogram of aluminium from alumina, an intermediate compound, meaning electricity accounts for about 40 per cent of production costs.

For that reason, some bulls argue, aluminium prices are set to rise sharply in the long term as energy costs rise. The current supply curbs in China, they say, are a glimpse of what the market has in store.

As Klaus Kleinfeld, chief executive of **Alcoa**, the US aluminium producer, said recently: "Whenever I go around, people are saying, my God, wouldn't it be great if aluminium would be like copper?"

Such disparaging words may be a thing of the past. The lightweight metal, used in consumer and industrial products from cars and aircraft to drinks cans, has recently been winning favour in the metals community. Strategists at **RBS** have made it their top pick for 2011, while **Macquarie**, Barclays Capital and **Deutsche Bank** have also turned bullish.

Investors are beginning to take note. Hedge funds have begun to unwind one of last year's most popular trades – that copper would outperform aluminium – by buying aluminium and selling copper. That helped push the benchmark aluminium contract above $2,500 a tonne for the first time since September 2008: on Wednesday it hit a two-year high of $2,575.25.

Unlike copper, however, aluminium remains a long way from its peak of the last cycle, $3,380 in July 2008. Indeed, copper is now nearly four times as expensive as aluminium – the highest such ratio on record.

That alone is one reason some believe aluminium could rally. "Aluminium is set to play catch up and redress the imbalance," says Nick Moore, head of commodity strategy at RBS.

More important, though, is a change in perceptions about the balance of aluminium supply and demand.

The most significant change is in China, where aluminium production – a notoriously energy-intensive process – has been curbed by the government's push to reduce power consumption, culminating in power being cut off to smelters late last year.

The sharp fall in Chinese aluminium production, from about 17.5m to 14.5m tonnes on an annualised basis, has changed the balance of supply and demand in the country. Traders say that aluminium stocks in China are very rapidly being drawn down towards critical levels of about one week's consumption, despite sales of 213,000 tonnes in December from the State Reserve Bureau, the government stockpiling agency.

That means inventories on the Shanghai Futures Exchange – the visible part of China's aluminium stock – could fall sharply. The country could even be forced to turn to the international market for supplies, driving prices higher. Alcoa has predicted that Chinese demand will outstrip production by 700,000 tonnes this year even as the rest of the world has a surplus aluminium output.

Adding to that, traders and analysts have been surprised by the strength of aluminium demand: global consumption of the metal will rise 12 per cent this year, according to Alcoa forecasts, after a 13 per cent rise last year, with the growth coming as much from the US and Europe as China or the Middle East.

A final upside risk to the aluminium price is the potential for the launch of new exchange-traded funds that buy up physical metal. The first two such investment products are slated to launch this quarter: ETF Securities, which in December launched ETFs in three LME-traded metals, has said it hopes to bring an aluminium ETF to market, while Credit Suisse has filed an application at the London Stock Exchange to launch its own aluminium ETF after earlier trying to launch the product in Switzerland.

All this makes a quick spurt to about $2,700 or more a tonne likely, some analysts and traders believe. But their bullishness is tempered by the massive overhang of aluminium inventories, which were built up when manufacturers slashed production during the financial crisis. There are 4.6m tonnes of aluminium in LME-registered warehouses and by some estimates total global stocks could be in excess of 10m tonnes.

The existence of huge stockpiles has not led to a price crash because they are mostly locked up in long-term financing deals held by banks such as **Deutsche Bank** and **Goldman Sachs** or traders such as Glencore, keeping them off the market. However, the deals rely on a combination of low interest rates, financial incentives provided by warehouses and the fact that aluminium for delivery soon has traded at a large discount to longer-dated futures. Already that discount – called the "contango" – has narrowed significantly, while premiums paid in some locations above the LME price have reached record levels – both indications of tightening physical markets.

If things turn out as the aluminium bulls predict, the rise in prices could have the effect of squeezing the international market until metal starts to come out of financing deals. Already, traders and bankers say, profitability has been significantly reduced on financing deals, making them shorter-term in nature and only available to those able to secure bargain warehousing rates.

Thus the bullish call comes with a hefty caveat. “Be wary of holding on for too long,” says Max Layton of Macquarie. “There is a cap to prices.”