

Aluminum As A Financial Asset. Who Knew?

A graduate student in international economics had a part-time job a wine store in the heart of Washington's lobbying corridor almost forty years ago. One of the regulars, an impeccably dressed man who always bought the finest, was looking over the young man's shoulder into the cooler. What, fine sir, are you looking for? "About what percentage of those cans are aluminum?"

A guesstimate of 35% seemed right as did an impromptu soliloquy on the environmental costs of aluminum: The metal requires two energy-intensive steps to produce and unlike steel cans that rust away, the damn things will outlast the pyramids. Duly informed, the elegant customer thanked the student for his studied opinion and departed. The store manager arrived. "Do you know who that was?" Um, no. "He is the chief lobbyist for Alcoa (AA)." Uh-oh. All's well that ends well: Later that week the young man was thanked, "No one else in this town would ever have given me an honest answer."

The Motown Sound

Back in those days aluminum was a wholesale market between large producers and large industrial customers such as Boeing (BA) or Procter & Gamble (PG). Contracts were arranged bilaterally, the spot market was small and the London Metals Exchange did not even list forwards on the metal until 1978. But if we have learned anything since the late 1970s, there is no aspect of human existence that cannot be digitized or turned into some aspect of financial engineering or both.

This has become evident in the Midwest aluminum market, centered in Detroit to serve the likes of Ford (F), General Motors (GM) and their supply ecosystem. Here you have an incongruity between rapidly rising warehouse stocks of aluminum and rapidly growing premium between the delivered price and the LME price. As former graduate students are alleged to know, rising supply should mean shorter vendor delivery times and softer spot prices, not vice-versa.

The Sequence Of Events

Bizarrely enough, the rising premium is a direct result of ample supply. Here is how that works:

1. Ample supplies and solid financial demand for aluminum futures and forwards push the forward curve into a carry structure;
2. This invites cash-and-carry arbitrage where physical metal is put into warehouses and hedged with those same futures and forwards;
3. Even if the costs of carry are not covered fully, they can be recovered and then some if the change in the premium exceeds the net loss on the combined cash-plus-futures trade; and
4. As automobile manufacturers and, yes, their associated ecosystem (I love this jargon, just love it) find it cheaper to pay an outrageous premium than to close production lines, the net gain on this sort of trade is relatively unbounded and takes on the profit profile of a call option

Nature Abhors A Vacuum

These shenanigans can go on for only so long before someone gets a cosmic cease-and-desist order. In the case of other markets, such as Brent Blend crude oil, the spot premium is traded through a system of contracts-for-differences between crude oil for loading in 10-25 days and the forward contracts. Right now there is an open niche in the aluminum ecosystem for a futures contract based on the all-in price at delivery, premium included. The CME Group (CME) is expected to launch such a contract later this year. This would allow aluminum buyers to capture the rent of ample aluminum supplies now flowing to warehouse operators.

By the way, a glance into the cooler these days would reveal something called aluminum bottles. I wonder what sort of comments those might elicit.