Copper Stocks – Out for the Count

For over 100 years the warehouse numbers of the LME were regarded as a relatively accurate gauge to the amount of any particular metal that was potentially for sale and thus what the overhang on the market might be. The numbers could never be 100% accurate because there might be merchants with stocks in their yards for sale or miners/refiners with stocks awaiting delivery to the warehouses or end users, but generally it was a case of "what you see is what you (might potentially) get.

The reliability of warehouse numbers has been in steep decline since the turn of the century. Much of this decline can be attributed to China. Initially what had once been a monolithic LME statistics was eroded in value by the appearance of Chinese exchanges, most notably that of Shanghai with their own warehouses. This became the tail that wagged the dog both in demand and pricing. After a certain point the Western players lost control of copper pricing to the Chinese and we would attribute this to the traumas of 2008. At some point around then this new dominance was accompanied by the realization that having warehouse numbers that people outside China actually looked at when making pricing decisions meant that the numbers mattered. Moreover if they mattered then the possibility existed that sentiments could be massaged (let's say tactfully) by warehouse numbers in Chinese ports appearing to be of a "certain size". Oddly, warehouse stocks there never seem to drop to critical levels that might cause the type of price spikes that used to occur in say copper (but also nickel, lead and zinc) in the period pre-2008. Our wake-up call was when we were informed that the Chinese warehouses consisted of the "counted" warehouse and the much larger "uncounted" warehouse. Chinese traders and big miners could

with the flourish of a forklift truck (or a fleet of them) move stocks in the adjoining “counted” warehouses up and down to suit where the price of copper was wanted to be seen.

After that point we never bothered to wonder anymore as to the mystery of why copper has traded between $3 and $3.50 per pound over that period. It is essentially because this is the price that the Chinese are prepared to pay. They know the Western miners will make miners (though not enormous amounts) and that there will be no surges or plunges in production or project pipelines from the West. Prices above $4 per lb only ever resulted in arrogant Western miners developing a swagger, started talking about $6 per lb and inevitably leading to a price plunge. The Chinese have taken to loaded pistol away from the monkeys and in the process the veracity of warehouse numbers, like truth in wartime, has become the first casualty.

The Shell Game

The classic trickster’s game for ripping off the unwary involves three rapidly moving walnut shells and pea. The warehouse “game” in China reminds us of this. The issue has come into greater focus with an event that seemingly surprised some international banks and yet seemed par for the course to us.

At the centre of this scandal is one wannabe commodity bigwig, Chen Jihong. He is currently in pre-involuntary organ donor status detained at the pleasure of their Celestial Majesties in Beijing for his troubles. Mr. Chen is owner and chairman of Decheng Mining and its parent, Dezheng Resources Holding Co., and is a director of Hong Kong-based Zhong Jun Resources Co., which has offices in Singapore.

Chinese authorities and bankers are investigating whether traders fraudulently used the same stockpiles of metals to secure multiple loans from Chinese and foreign banks. It is suspected that entities linked to Decheng Mining, which is

based in the port city of Qingdao, illegally pledged the metals as collateral to get the loans. As a result foreign banks and commodities firms have exposure to potential losses of close to US$1 billion, while the estimated exposure for Chinese banks stretches into the billions of dollars.

Not surprisingly the matter has degenerated into a welter of lawsuits, many under the jurisdiction of Hong Kong courts. Everyone knew what that meant back in the old colonial days when British law reigned. It will be interesting to see though what happens when major Chinese banks are claimants and defendants. Even more intriguing is what will happen when the carefully constructed Chinese trading/warehouse scenario starts to come under the magnifying glass.

Other lawsuits have been filed in Singapore and London courts. Citigroup and Swiss-based trader Mercuria Energy Group Ltd. are engaged in legal proceedings against each other in a London court over payments relating to metals-backed financing arrangements in Qingdao and Penglai ports valued at more than $270 million.

Impala, the warehousing and logistics subsidiary of Trafigura, has filed at least six claims in London against a number of parties, including Mercuria Energy and Standard Chartered, to ensure any disputes over its contracts relating to metal held in Qingdao are fought in UK courts.

Standard Bank (of South Africa) and ABN Amro Bank have also launched cases. In Singapore, ABN Amro won a Singaporean court order for Mr. Chen to pay it $22 million owed under a loan agreement with Zhong Jun Resources and another of his companies.

HSBC has also launched legal proceedings against Zhong Jun Resources. Other foreign banks that have exposure to the deals are BNP Paribas SA and Natixis (of France). Standard Chartered has made provisions for about $175 million in potential losses

from a total exposure to Qingdao port of $250 million.

It is claimed (surprise, surprise) that fake documents were provided to prove that metal promised as collateral was in place. To further complicate matters access to storage facilities in Qingdao and Penglai ports remains restricted.

It is said that banks involved in Chinese commodity trades are revisiting lending processes and increasing oversight of clients. Banks have tightened up on issuing letters of credit, which has made it harder for importers to get hold of metal.

The Smart Money Acts

The London-based hedge fund Red Kite Group is scarcely a household name outside trading circles and the more sophisticated mining managements. The current team is the results of the break-up of the old Red Kite with the equity staketakers creating Orion and the "physical" people continuing to operate under the old moniker with the many offtake, VPP and other contracts that they accumulated over time through funding projects.

The name has come into the news again lately as Red Kite currently holds more than half of London Metal Exchange copper inventories according to press reports.

Date from the LME shows that there is a dominant holder of the LME's copper stocks, accounting for between 50-80% of total metal holdings (which currently stand at 159,550 tonnes). That would be worth around $534-$854mn based on prices of $6,675 per tonne.

While it's not confirmed officially that it's Red Kite buying, a survey by the Wall Street Journal found brokers and traders overwhelmingly confirming the evidence. This begs the question of why so large a position and why now? For us the events in

China were a perfect storm. They show that Chinese stockpiles cannot be trusted. If even Chinese banks get taken down in such a scam and they could (in theory) verify what is held in warehouses within the country then the brief rise of China as a trading destination may have been stopped in its tracks. Warehouse numbers must be unimpeachable. We wonder if Red Kite is betting here that unofficial warehouses will fall into disrepute and that the latest "double counting" scandal might not just be the tip of the iceberg with more players in China having to buy copper to back up the theoretical holdings that they have so liberally offered as collateral.

Conclusion

People say to us that copper is "weak". Frankly we don't see it. Where were these people when copper was 72 cts a pound back in the late 1990s. They should brush up on their history books.

One has to face the fact that a trader when cornered by a journalist will start to blather. To claim that its "bad news" that some non-existent or scarcely existent copper stocks have been used as collateral over and over again is hogwash. Any product that has been sold (and a defaulted loan is "sold") many times over and the physical does not exist in quantity to satisfy that loan is not an excuse for the guilty party to "sell" copper as the pundits insist, but is a requirement to cover. Now whether the guilty party ends up on a slab and thus is not able to close his margin calls is another matter.

It would seem Red Kite is of the same persuasion as us that this is a bullish sign for copper, not a bearish one.