



Market Commentary
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English Version

Insigneo Weekly Dispatch

Heavy Metal

Thoughts on the steel and aluminum markets after our conversations with leading industry players.

Guidance on investments and the major structural factors behind your clients' portfolios.

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Heavy Metal

We had the pleasure of sitting down this week with the management team of Alcoa, one of the largest producers of aluminum in the world. We also met with a roundtable of metals and mining industry participants, including the London based CRU, one of the world's leading providers of analysis and consulting in the metals and mining industry. We thought it would be of value to convey some of the insights we gained from these meetings.

As we can imagine, the metals and mining industry is large and diverse, encompassing base metals such as iron ore, nickel, and tin, industrial metals like steel and aluminum, and precious metals such as silver and gold. Our conversations revolved mostly around industrial metals. Within this sub-industry, the supply and demand dynamics of the different types of products were at the forefront of the discussion.

Coming out of the Covid-19 pandemic, the market appeared to be expecting the global supply of steel to outpace what appeared to be tepid demand. However, demand has improved, maybe even more than expected, and steel producers appear to be exercising discipline. This dynamic has led to rising steel prices. Demand for end products such as steel used for automobiles and construction remains stronger than expected. Another dynamic in this industry that appears to be developing is a change in how steel itself is manufactured. Historically, most companies have operated large steel mills using what is known as blast furnaces to

produce steel. These furnaces and production lines use a lot of energy, increasing costs, as well as pollution. However, we are seeing a move towards the increased use of smaller footprint “mini mills”, using what is known as electric-arc furnaces. This type of furnace, combined with “mini mill” operations, is reducing costs for producers, as well as reducing carbon emissions. This combination has become so prevalent in the industry, that companies such as Steel Dynamics (STLD) use it almost exclusively to run their production operations, reducing costs and increasing profit margins.

Another trend that we thought was interesting was the increased need for electrical steel in order to upgrade the global electricity grid. Electrical steel is a specialized type of steel utilized mostly by utility companies. However, this type of steel is only produced by a small number of companies, some in Asia, but others like ThyssenKrupp (TKA GY) in Europe and Cleveland Cliffs (CLF) in North America. Some industry participants we spoke with estimated that the grid could potentially need to double by 2050 to accommodate the increased

use of renewable energy. Such a large amount of potential demand for electrical steel, coupled with a very limited current supply, could lead to increased prices for this product over time.

As would be expected, the aluminum market was also an important topic of conversation. Especially interesting was how production capacity, which was expected to come back online post-pandemic, has been slow to do so, particularly in Europe. At the same time, demand for the product has remained relatively stable, and actually increased in some industries such as automotive and aerospace. In fact, the current lead-times in the aerospace industry (or how long an airplane manufacturer, for example, would have to wait to receive an order of aluminum placed today) could be as long as one year or more. Additional demand stemming from a reopening in China after the Covid-pandemic could drive the need for this metal even higher. The Western ban on Russian aluminum products was also discussed, yet participants stated that this had little impact on global prices, as Russia was finding other markets for its product in countries like China and India.

LME Aluminum Prices 3 Months Out (in \$/Metric Ton)



Source: Bloomberg, Insigneo (as of 3/7/23)

As we can see on the chart above, aluminum prices moved sharply higher as production ground to a near halt during the Covid-pandemic, but then came back down last year. Prices have since stabilized and as of March 7, 2023, traded at \$2,350/ton. **We believe that prices could move higher from this point if the current supply & demand dynamics remain in place.** We are not alone in this line of thought. Goldman Sachs sees aluminum prices averaging \$3,125/ton this year, and potentially rising to \$3,750/ton by the end of the year.

We would be remiss if we did not point out that a scenario involving higher interest rates around the world and the possibility of a recession could hurt near-term demand for the metals we discussed above, potentially leading to lower prices. That being said, it is also important to point out that the aforementioned scenario may also lead to further decreases in supply, as companies would likely curtail production in response to lower prices. Although it might appear counterintuitive at first, this response could further place structural constraints on supply, driving prices higher over the

long-term. So, although higher rates or a recession could lead to a further pullback in stock markets, including the stocks of many of these producers, this could actually create potentially fruitful opportunities for investors with long-term horizons and a high tolerance for risk.

It is important to keep in mind that the individual equities mentioned here can exhibit high degrees of volatility and are not suitable for every investor. These investments are best considered on a case-by-case basis, based on a particular investor's willingness and ability to tolerate risk. If you need more information or would like to discuss these or other potential ideas in more detail, please do not hesitate to contact the Insigneo Research Team.



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