Chaos in Nickel: Geopolitics Meets Market Microstructure

March 9, 2022

What just happened in nickel?

- Nickel futures prices skyrocketed in recent days amid a violent short-squeeze that forced the London Metals Exchange (LME) to halt trading in the contracts on Tuesday, March 8th.
- Conditions that triggered the squeeze played out in phases (top chart):
  1. Over the past two years, growth in demand for high-grade "Class 1" nickel, which is used in electric vehicle (EV) production, has outstripped production, depleting stocks (bottom chart). Futures prices ground steadily higher, as a result.
  2. Intensification of the Ukraine crisis added supply concerns, with Russia's production of Class 1 nickel, which exceeds 15% of the global total, at risk due to sanctions.
  3. As prices rose further following the invasion, holders of short futures positions, including a Chinese metals producer that was hedging large physical holdings of nickel, faced pressure to cover, thereby inducing a historic squeeze.

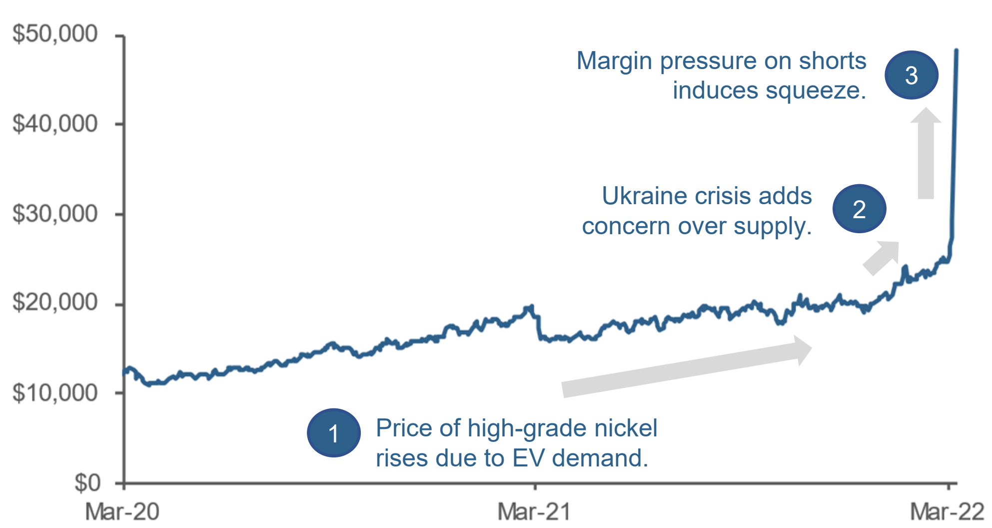
Important nuances of the nickel market

- LME futures are based on high-grade nickel. While new sources of nickel supply have emerged in recent years, much of it has been low-grade ferronickel, which is pure enough for stainless steel production but cannot be used in EV batteries without costly and highly toxic processing.
- Owners of lower grade nickel stocks may have been hedging with the tradable Class 1-based nickel futures due to their historical correlation. However, ferronickel cannot be delivered to satisfy LME futures obligations due to its impurity, so such hedgers instead would have had to buy back the contracts.

Cautionary reminders for investors

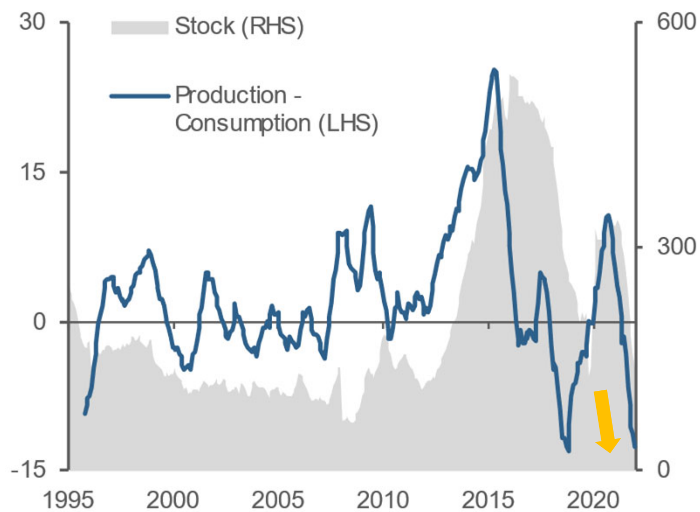
- In commodities investing, nuance matters. Much like when WTI crude futures dipped below zero in 2020, this episode is a reminder that while commodities offer valuable diversification and return generating opportunities, they demand deep institutional and microstructure knowledge.
- In macro investing, it is critical to stay diversified and not rely solely on backward-looking risk management frameworks. Geopolitical shocks can (and will) produce sudden and historically exceptional market moves, which can produce severe losses from concentrated exposures that might appeal under normal market conditions. As such, portfolio construction should be informed by scenario analyses that cover a wide range of market circumstances, whether or not they have yet been observed.

Class 1 Nickel Price (LME futures)

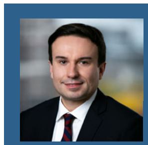


Source: Acadian based on data from Bloomberg. For illustrative purposes only.

Class 1 Nickel: Evolution of the Physical Market



Data in thousands of metric tons. Production – Consumption is a 12-month moving average. Source: Acadian based on data from World Bureau of Metal Statistics. For illustrative purposes only.



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