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Swings and roundabouts in the iron market

Are markets efficient?

As with all such apparently simple questions, the answer is very much a nuanced combination of "yes and no", with the further proviso that it depends which market you're talking about.

In the case of iron ore, it's certainly true that the market is more efficient than it used to be. Around ten years ago, a long-standing, though unofficial cartel that operated between the major producers BHP Billiton (LON:BLT), Rio Tinto (LON:RIO) and Vale (NYSE:VALE) broke up.

The reason was simple: iron ore prices were soaring away. There was no longer any need on the producer's part for concerted action, and the free market was given carte blanche.

Ten years later and the picture is a little different. The main players in the iron ore production game remain the same - Rio, BHP and Vale - but the iron ore price has been weak for some years on slower demand from China.

This situation has lead the head of Fortescue Metals Group (ASX:FMG), one of the leading companies in the second rank of producers, to call for iron ore producers to curtail output. And not just on their own.

Andrew Forrest, otherwise known as Twiggy, is actually calling for an official Australian government investigation into the strategy of Fortescue's larger rivals, arguing that the relentless downward pressure on price has "crushed" the Australian economy.

Given that the iron ore price has actually just undergone a remarkable uplift, or as UBS termed it in a note of 8th March, an "up-crash", it's a funny time to be making such claims.

But Fortescue's message is not new.

In fact he's been calling for some form of action for over a year now, and although his cries have fallen on deaf ears at Rio and BHP he has found some support from elsewhere in the industry, most notably from Lourenco Goncalves, the head of Cliffs Natural Resources (NYSE:CLF) and, at a more subtle level, from his Brazilian counterpart at Vale.

Mr Goncalves in fact has turned out to be a key ally in Mr Forrest's as-yet unsuccessful campaign.

"I hope the Australians will continue to question themselves why one or two companies are giving their finite resource away to the Chinese while the Chinese builds into a military powerhouse in the South China Sea," Mr Goncalves told analysts back in October.

And this week, at an iron ore conference in Perth, he highlighted that where the combined market capitalisation of Vale, BHP and Rio was US$469bn in 2014, a year later it had dropped to US$190bn.

"In other words US$290bn of market capitalisation was destroyed with the intention of growing market share", he said.

It's an interesting point, and takes us back to our starting point: in terms of efficient markets, it all depends which markets you're talking about.

Politicians may be taking up the calls of Forrest and Goncalves with gusto, but those same calls have nevertheless been greeted with a certain scepticism by analysts in the market.

It's not hard to see why. Average cash costs across Rio and BHP's operations are currently running at about US$10 per tonne, according to analysis from SP Angel, whereas Fortescue's costs are significantly higher at US$17 per tonne. The most recent numbers from Cliffs are even higher.

So on a lower iron ore price, guess whose margins are being squeezed the most and who's demanding action the loudest? Yep, Fortescue and Cliffs, the only major players in iron ore left with enough clout to make some real noise.

Still, it's worth noting that among the big three, all is not necessarily sweetness and light. Vale's costs are comparable to Rio's and BHP's and have been helped in recent months by the depreciation of the Brazilian real. But its ability to deliver into China from its own Brazilian backyard is economically suspect given the huge distances involved.

So the formalisation of the relationship between Vale and Fortescue that crystallised around an iron ore blending joint venture in the Pilbara this week should be viewed as a largely defensive move.

And against all this, the real question is: where will the price go from here. Iron ore prices were trading sUBStantially lower than US$40 per tonne back in December, but have now recovered to a current price of around US$56. At one stage this week they even hit US$63 per tonne.

Is it sustainable? Not according to consensus analysis, which tends to highlight recent lower export and import numbers from China, as well as lower manufacturing PMIs.

"The latest iron ore rally appears based on macro hopes and short-covering, with little evidence of fundamentally better demand," wrote UBS.

Investec meanwhile, notes the imminence of a major horticultural and environmental conference in Tangshan, for which it says major steel mills will be shut down to reduce smog.

The likely long-term impact on the iron ore price: nil. But as to whether shutting production for a flower show amounts to an efficient market, that's a rather more nuanced question.