

What are implied markets?

The London Metal Exchange (LME) has a unique prompt date structure which can be used by both the physical and financial communities in order to manage their metals’ price risks. An interesting feature of the LME ecosystem is that the foundation of liquidity and price discovery is found in the 3-month rolling prompt date, while the majority of open interest sits on 3rd Wednesday “monthly” contracts. Some users have requested a market structure which provides more direct liquidity in the 3rd Wednesday contracts and the LME has responded to market feedback by enabling implied markets on our electronic trading platform, LMEselect.

3rd Wednesday contracts

3rd Wednesday contracts are the monthly dates in the LME’s prompt-date structure which expire on the third Wednesday of the month. They are the contracts most frequently used by participants in order to carry open positions between trading days, much like a standard “monthly” contract. Since the most liquid contract in the LME prompt date structure is the 3-month rolling prompt date, users tend to trade into the 3-month date and adjust their end-of-day position to the monthly contracts.

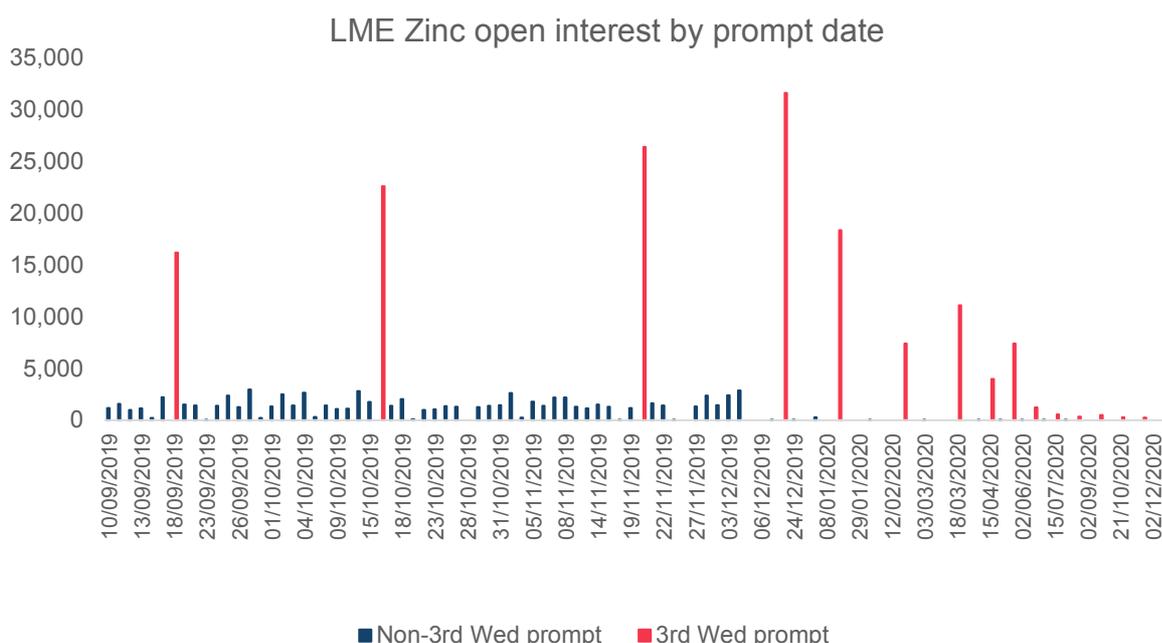


Figure 1: LME Zinc open interest by prompt date

The LME received feedback from its 2017 Discussion Paper on Market Structure that some participants would prefer to trade directly in to the monthly contracts, removing the need for an adjustment trade. The LME has responded by introducing implied functionality, which uses the foundation of liquidity in the 3-month contract to create additional liquidity in 3rd Wednesday contracts.

Implied functionality

The implied functionality relies on liquidity in “carry contracts”. These are the calendar spreads that connect the 3-month contract with 3rd Wednesday liquidity. The LME’s unique prompt-date structure creates too many possible combinations of prompt dates for a full matrix of implied routes to be active. The functionality is enabled for the prompt dates which are most active, a complete list of which can be found on LME.com.

Carry liquidity develops throughout the day. When the electronic market opens, there is limited natural order flow in the 3-month to 3rd Wednesday carries. As the trading day progresses, carry contracts become more liquid, which in turn creates more liquidity in 3rd Wednesday contracts through the implied functionality. As a result of this dynamic, 3rd Wednesday contracts tend to be most liquid during London trading hours.

When an implied trade occurs, the electronic trading platform (LMEselect) will generate a match in the 3rd Wednesday contract, the 3-month contract, and the carry contract which connects the two prompt dates. All matches occur simultaneously, so there is no “slippage” or “legging risk” associated with trading through the implied functionality. Users are able to access the deep liquidity of the 3-month order book, the traditional foundation of LME liquidity, but trade directly and hold their positions in the 3rd Wednesday contract.

Because implied functionality is automated within LMEselect, users don’t need to change anything to view implied markets. Take a look at the contracts where the functionality is turned on.

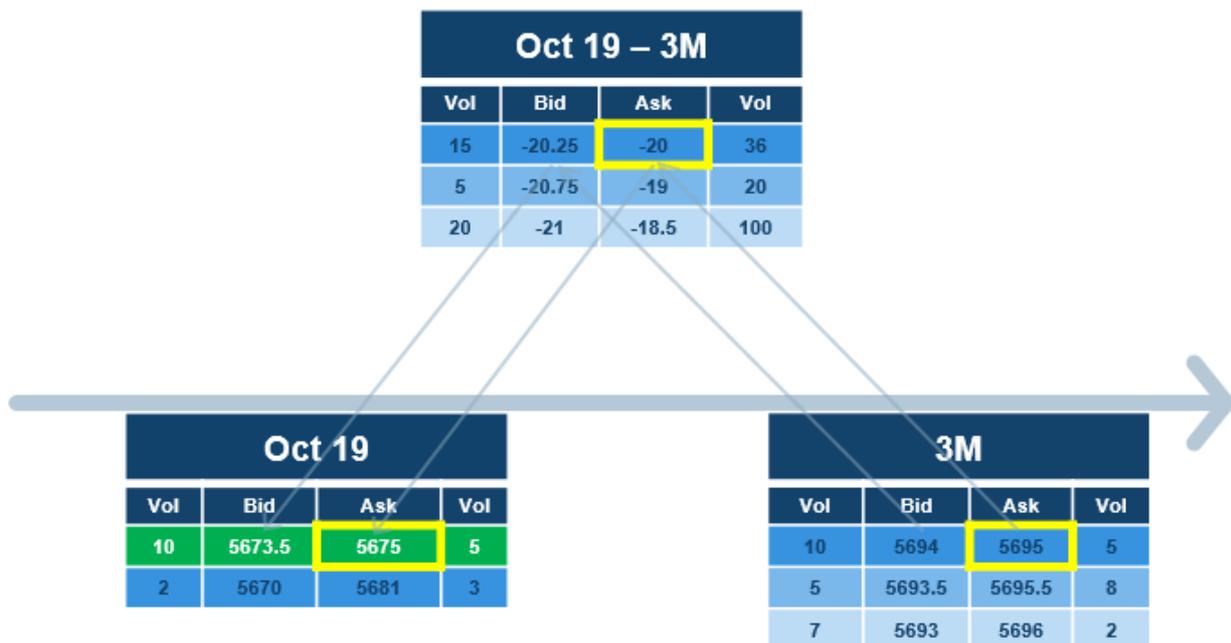


Figure 2: Example of how implied pricing works

The LME’s Strategic Pathway advocates the principle of “user choice”, where participants have the freedom to access liquidity at any point on the curve that meets their needs. Implied markets have experienced consistent trading since the functionality went live in November 2018 with record months in implied trading volumes in July, August and September 2019.

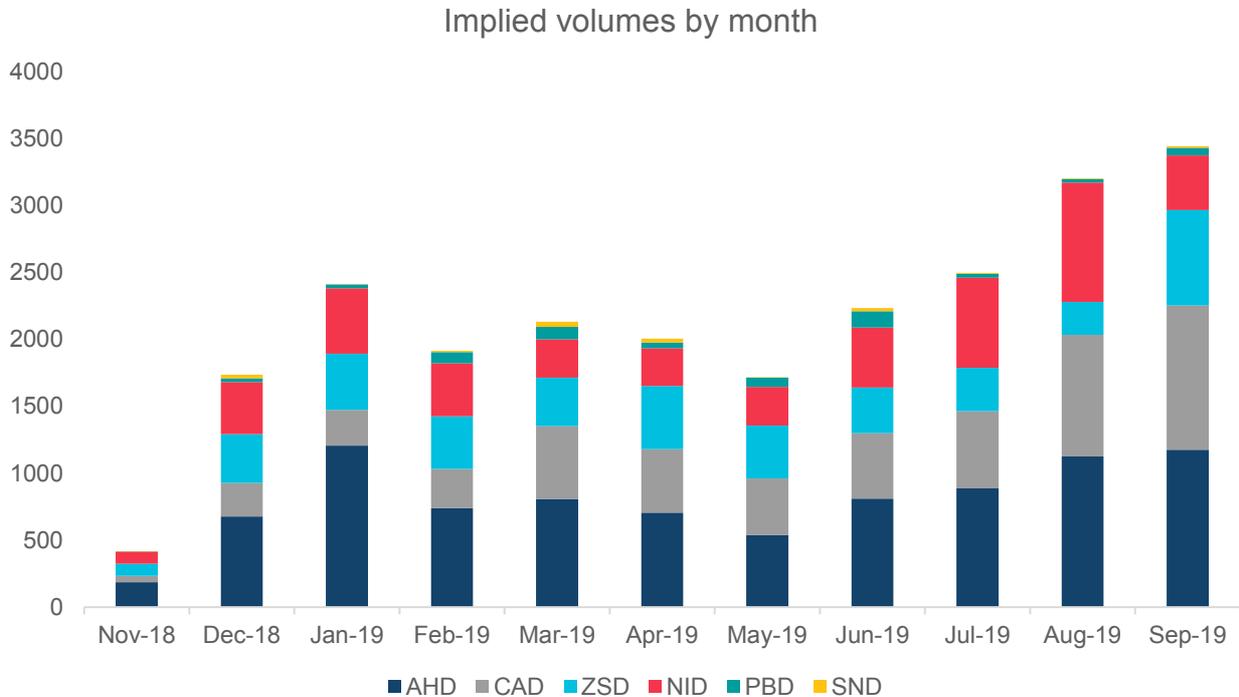


Figure 3: Implied volumes by month

The functionality has been well received by the base metals market and the expansion in liquidity prompted the ferrous community to request that implied pricing be added to the LME Steel Scrap and LME Steel Rebar contracts, and this went live in July 2019.

Get in touch

Want to find out more? Please contact implieds@lme.com or visit our website at lme.com/impliedpricing

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