China Iron Ore: Stronger for Longer?

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The start of the year proved a testing time for commodity investors, global market turmoil and a lack of faith in global central banks prompted large scale capital flight from the majority of risky asset classes but arguably none were as hard hit as the commodity sector.

Iron ore had a particularly rough start to the year; with the benchmark MB 62% Fe CFR Qingdao index hitting a fresh multi-year low towards $37/tonne as we neared the end of 2015. Having come under significant pressure throughout the year it looked as if 2016 had more of the same in store.

Metal Bulletin 62% Fe CFR Qingdao: *Posted a strong start to the year and remains well supported towards $50/tonne.*

Source: Bloomberg

The bears were not disappointed as the benchmark tried in vain to build on $40/tonne throughout January but failed for the most part due to weaker investor sentiment and emerging market concerns. There were some signs of life towards the end of February, with prices rallying above $50/tonne in the run up to Chinese New Year.

Mill restocking in the build up to and immediately after the New Year celebrations was quickly cited as the main driver for the rally in spot prices. Soon the steelmaking raw material extended gains as participants slowly returned to the market after the holidays and it seemed as if it was business as usual for iron ore traders. However, the seasonal spike in spot prices was far more pronounced this time around. In a matter of weeks prices had almost doubled and were trading above $62/tonne, at one point posting a ten dollar increase from the previous day's settlement.

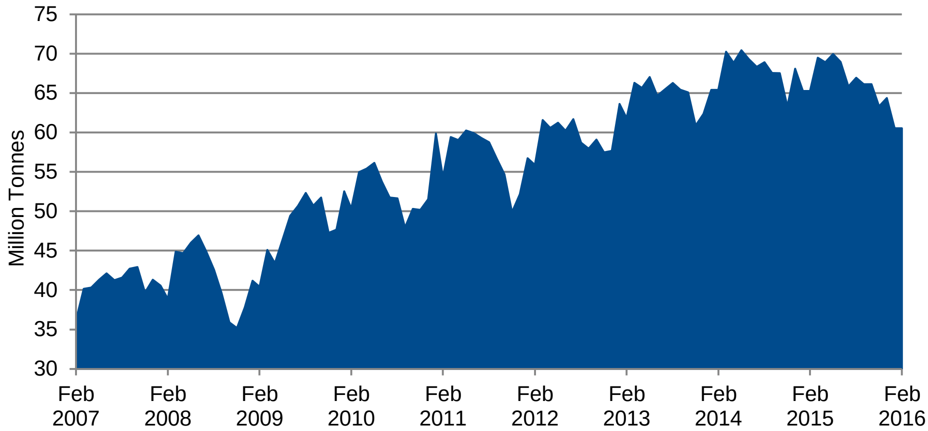
"…prices have only drifted marginally from the recent high and remain well supported on any approach towards $50/tonne."

As with past seasonal cycles, the market would have expected selling to resume once restocking by Chinese mills and traders was completed but prices have only drifted marginally from the recent high and remain well supported on any approach towards $50/tonne.

"China's monthly output of crude steel has declined almost 17% from its peak in May 2014…"

So what's driving this rebound in spot prices and is this sustainable? Taking a deeper look at China's steelmaking output the World Steel Association reports that China's monthly output of crude steel has declined almost 17% from its peak in May, 2014 where it produced 71.12m tonnes of crude steel, to 58.52m tonnes in February 2016.

Crude Steel Production: *Monthly output in China dips at the start of the year.*



Source: Bloomberg

While it is true that policymakers in Beijing have gone to considerable lengths to curb excess capacity, reflected in February's output falling 4.0% y/y, the industry continues to struggle with oversupply, inefficiencies and high debt levels. It would be reasonable to assume that the steady cuts in monthly crude steel production have seen demand for iron ore come under renewed pressure with a downbeat demand outlook as the domestic construction and manufacturing sectors face strong headwinds.

March data from the world's second largest economy was more positive. Projected growth over the next 1-2 years has been upgraded by 0.2% and all exports grew 18.7% y/y in Chinese yuan terms. This news was welcomed by economist as up till now poor data and volatile markets had analysts in a spin. This suggests that if handled with care the future may not be as bleak as market commentators would suggest. The expansionary policy in January is unlikely to be the only one of its kind in the foreseeable future.

"Conventionally it does seem that construction in China has passed its peak..."

Infrastructure and construction activity account for about half of China's steel consumption as it stands. Conventionally it does seem that construction in China has passed its peak, as intensive steel demand owing to its rapidly expanding share of the global economy starts to temper. Per capita steel consumption is expected to decline steadily as China transitions to a more service oriented economy.

Given the outlook it seems demand will face considerable headwinds in the coming years. However, long run growth forecasts see construction growth averaging 4.8% per year between 2020-25 and up to 5.2% per year between 2025-30. The housing sector may be the slowest growing sector at 2.5% per year until 2020 before accelerating to 4% per year between 2020-30 (Global Construction Perspectives and Oxford Economics). Many industrial economies would be envious of such figures but having dropped from doubled digit growth; significant adjustments are needed for China to make the transition smoothly.

"…healthcare spending could increase to $1tn by 2020, with over 24,000 hospitals needing modernisation".

By 2030 China, the US and India will account for 57% of the global growth in construction and engineering projects (Global Construction Perspectives and Oxford Economics). The ageing population in China is also something to consider with the need for increased medical care in years to come. Construction of new hospitals and other healthcare facilities seems paramount with McKinsey & Company predicting healthcare spending could increase to $1tn by 2020, with over 24,000 hospitals needing modernisation.

As well as the push to expand and improve current infrastructure, structural reforms could also underpin long term support for Iron ore. The recently approved 13th five year plan puts additional focus on modernising infrastructure and reforming heavy industries.

China's share of the world construction market will increase at a steady pace as growth steadily slows over the next five years in the world's largest construction market. There are some industry participants that are more optimistic however, with Sinosteel identifying investment in real estate development in China. Demand for steel and iron ore could therefore be expected to rise as efficiency and cost cutting give way to the most attractive and profitable opportunities.

Chinese Industrial Production: *After a tough end to the year, investors hope 2016 is a better one with expectations of 5.9% y/y growth in Jan-Feb.*

Source: Bloomberg

"…the economy needs a little more stimulus to promote the levels of growth needed for a smooth transition."

The Chinese economy has come under a lot of scrutiny in recent months as economist look for answers from the behaviour of the recent volatility of the markets. Growth is slowing with some believing that they will struggle to reach their 6.5% annual growth target. The effect of a slowing China can clearly be seen around the world and across industries and, recent data may indicate the economy needs a little more stimulus to promote the levels of growth needed to maintain smooth transition. Recent data backs this up after the stimulus that was injected into the China at the beginning of the year.

Chinese Manufacturing Producer Price Index (PPI) improved slightly to -4.5% at the end of February, up from -4.9% the previous month. The most recent figures show a steady improvement with PPI coming in at -3.6% in March. Despite PPI showing steady improvement a year-on-year comparison for March puts the 2015 figure at -3.5%, suggesting there is still a long way to go as factory gate prices slow their rate of decline month-on-month but on a year-on-year basis have only just recovered from the rout towards the end of 2015. Chinese industrial production is forecast to stay stable at 5.4% year-on-year in February down from 5.9% year-on-year in December 2015. It was reported that the slump in industrial output was due to seasonal factors and deterioration in sectors such as steel and chemicals.

"…expansionary monetary policy has taken longer to find its way back into the economy…"

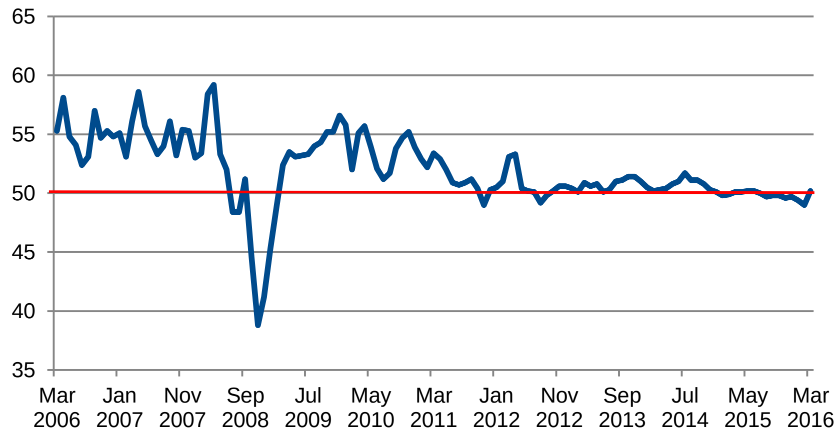
Since the end of February we have received additional positive news from China and we believe that industrial production will either stabilise around current levels or move back towards 6% year-on-year in April's data. We primarily hold this view because expansionary monetary policy has taken longer to find its way back into the economy and while there is considerable lag in its implementation and impact, this was distorted by the significant capital outflows at the start of the year which have since calmed.

The expansionary budget in January of 3.4tn renminbi ($560bn) prompted economists to revise upwards their construction forecasts. We may be seeing the impact of this with the most recent round of manufacturing data out at the start of the year; with Chinese factory output growing for the first time in 9 months in March putting a slight spring in its step. This news backs up our thinking that the considerable efforts to transform from a primarily manufacturing based economy to a service led one is only just starting to yield the desired results.

"…China seems to have overestimated their services industry; hence additional stimulus…"

However, China seems to have overestimated their services industry; hence additional expansionary policy may be needed which will further buoy investor sentiment. Stimulus will support spot iron ore prices for a sustained period of time, further detaching it from the fundamentals. There is no doubt that the transformation will be a bumpy ride and more stimuli are likely to be needed throughout the process.

Chinese Manufacturing PMI: *March data surprises on the upside with the official PMI rising above 50 for the first time since June last year*

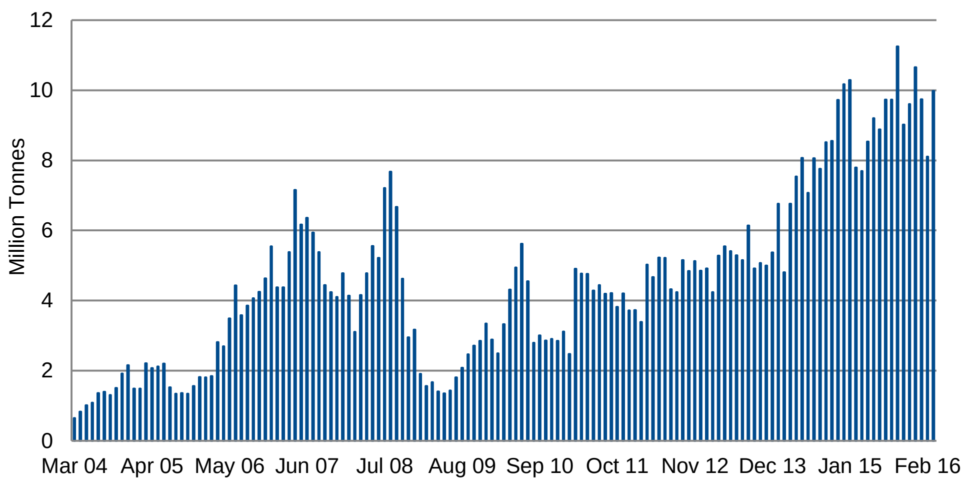


Source: Bloomberg

"Increasing production from Chinese factories coupled with a soft demand outlook will see more material available for exports…"

Perhaps most telling of supportive effort is China's Purchasing Managers Index (PMI) which has risen to 50.2 points in March. The encouraging data signals that activity in China is improving steadily and after a soft start to the year could be on track for further gains. Increasing production from Chinese factories coupled with a soft demand outlook will likely see more material available for exports, exerting significant pressure on western producers. According to China customs data, shipments of Chinese steel surged in March to 9.98 million metric tons, an increase of 30% year-on-year. This data takes exports for the quarter to 27.83m, approximately 8% up on last year. An expansion of this size can somewhat be explained by soft domestic demand and will only serve to put further pressure on ex-China steel producers as they seek to protect their market share.

Chinese Steel Exports: *As domestic demand falters, more and more material has been directed to export markets.*



Source: Bloomberg

While some of the rally can be attributed to recovering industrial production and construction demand, we feel that the recent rally in spot iron ore prices are not fully justified by this reasoning alone.

"Dalian prices quoted in renminbi and Singapore prices quoted in dollars have provided traders with an opportunity to minimise exchange rate risk…"

Arbitrage opportunities between the Singapore Exchange (SGX) and Dalian commodity exchange (DCE) iron ore contracts could be one possible explanation for the buoyancy in spot prices. Dalian prices quoted in renminbi and Singapore prices quoted in dollars have provided traders with an opportunity to minimise exchange rate risk at a time when policymakers and central bankers continue to surprise market participants with further easing. Traders could be taking advantage of hedges against further renminbi devaluation or perhaps taking a play on recent dollar volatility.

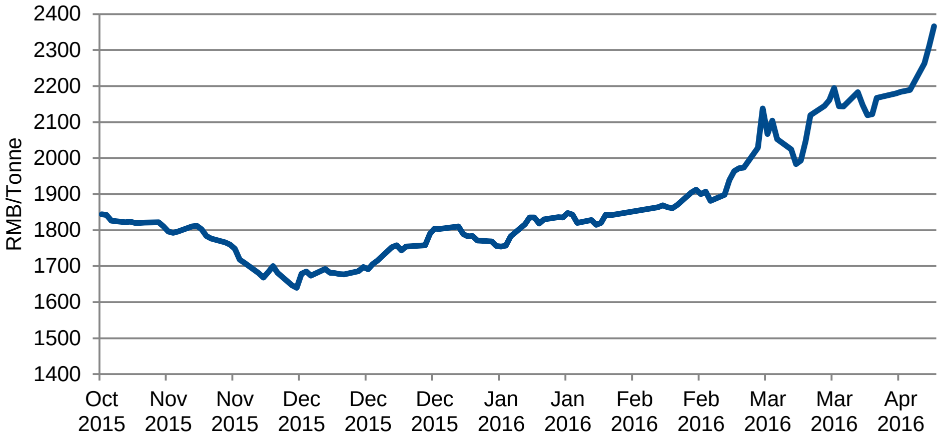
So what's the future for China's burgeoning steel industry? The only answer offering any hope increasingly seems to be to divert as much material as possible to the export market. We've recently seen one significant casualty of this tactic with Tata Steel desperately looking to sell its UK business. Having posted seven straight quarters of losses and with the book value written down by almost £2bn to near zero the UK steel industry is just one such casualty of cheap Chinese material flooding the global market.

Proposals to cut 150 million tonnes per year of Chinese steel capacity by the end of the decade will help address the glut of capacity. With domestic demand faltering exports of Chinese steel will remain a headline feature of the industry while producers showing no signs of cutting back production levels. We remain cautious that this production for export outlook can sustain demand and therefore supportspot iron ore prices above $50/tonne over the long term.

"…cases in the US which could see punitive tariffs of 250% imposed on certain Chinese products could prompt Europe to adopt a harder line…"

The building traction of anti-dumping cases in the US which could see punitive tariffs of 250% imposed on certain Chinese products could prompt Europe to adopt a harder line against wave after wave of cheaper Chinese steel. Given the increasing calls for protectionism across the western world such measures could see Chinese steel struggle to find buyers, especially given the comparative lower quality against its European and US counterparts.

SHFE Rebar Futures: *Front month futures have posted significant gains so far this year as policymakers remain committed to largescale infrastructure projects.*



Source: Bloomberg

For now, producers and traders are welcoming the higher prices buoyed by Beijing's capital market support and while no one expects stimulus measures to persist in the long run, for now they're having the desired impact. However, China must move to the next level at some point and tighten monetary policy. Given the current condition of the global economy, few see global benchmark rates rising soon which will further fuel a low growth environment. Combining this with a tougher global steel market as countries adopt stricter protectionist measures against Chinese steel we could see an already oversupplied domestic market come under further pressure.

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Unless of course the policymakers in Beijing embark on additional stimulus measures which have in the past acted as a robust support to spot iron ore prices. As mentioned above, details from the 13th five year plan suggest significant investment in heavy industries and with the stage set for the development and connectivity of the One Belt, One Road, initiative the demand for steel domestically may be better than analysts currently predict. One thing is clear, the Chinese cannot rely on past actions and export their way out trouble. The burden may again fall on domestic demand as the transition to a service led economy could take a lot longer than investors currently expect.

"…the transition to a service led economy could take a lot longer than investors currently expect."

Producers today may be looking back at the triple digit prices of yesteryear with fondness cursing their current predicament, but given the uncertainty that lies ahead they should perhaps show a little more appreciation for prices today,

$50/tonne doesn't look so bad when you look at the losses racked up in crude oil or the base metals.

Considering the above factors, we expect iron ore prices in the short term to be well supported at $50/tonne and anticipate a bullish near term outlook. Although sentiment is important in today's market, activity during the first quarter of 2016 was largely influenced by the switching risk on/risk off environment. Moves on the upside, while limited by stockpiles at Chinese ports and local marginal producers, have a fair chance of building momentum.

Therefore, it is possible that spot prices could well recover towards $58/tonne in the short term. As policymakers in China remain committed in their supportive efforts we could see traction built around these levels with spikes higher as sentiment once again overrides the fundamentals. However, aside from some potential for tentative spikes towards $70, which in our opinion will be short-lived, we anticipate spot iron ore prices will be capped on the upside by ample supply and lower per capita consumption which could eventually drag prices lower towards the tail end of 2016.

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