Chi Time

FOR PROFESSIONAL INVESTORS – 8 June 2018

CHINA'S IMPACT ON THE COMMODITY MARKET

If you exhaust natural resources, there will be nothing left for your children. If we continue in the same direction, humankind is headed for some frightful ordeals, if not extinction.

Christian de Duve

There have been concerns about China's growth slowdown adversely affecting the commodity market. How bad could this Chinese impact be? This is a question about China's cyclical growth trajectory. What about its secular impact? To assess that, we need to examine the drivers of China's commodity demand under its evolving economic environment.

No growth crash

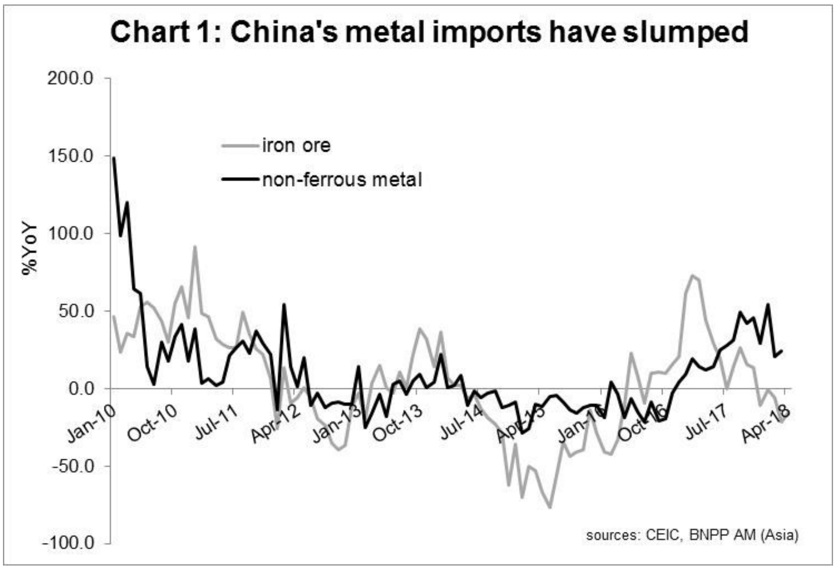
The good news is that China's GDP growth is unlikely to fall below 6% anytime soon[1], in my view. Beijing has been fine-tuning its demand management policy to balance between sustaining growth and implementing structural reform and deleveraging measures. Both fiscal and monetary policies are neutral but on standby modes to ease on any potential signs of GDP growth falling below 6%[2]. In particular, monetary policy has been used to offset the financial stress stemming from the deleveraging and structural reform measures[3]. Beijing's acute sense of policy sensitivity has allowed it to force debt- and excess-capacity reduction without inflicting a heavy cost in the economy so far. GDP growth has moderated and systemic risk has been contained.

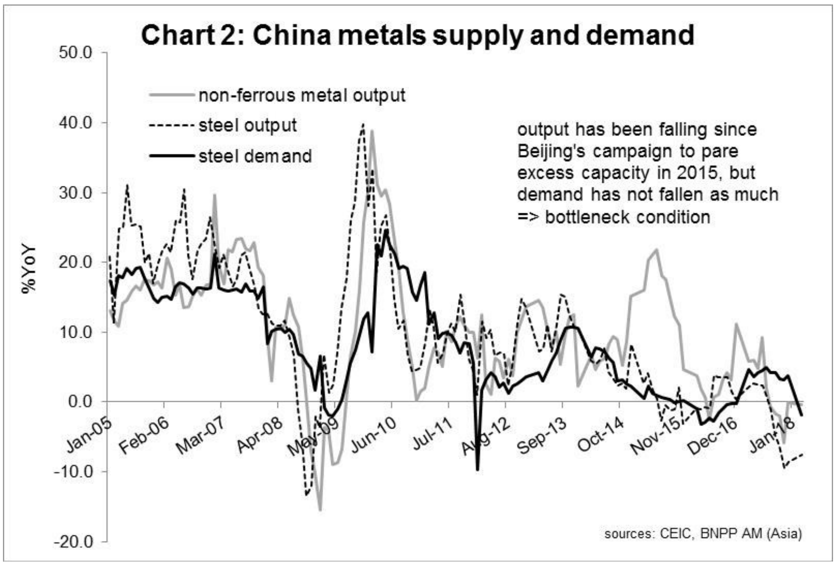
China's property market, which is one of the major drivers for investment and growth, is cooling but not crashing. Housing inventories have dropped to between 10 and 18 months recently from over 30 months at the market trough in 2015. This has kept developers building, even though sales are expected to remain weak. This suggests that growth in construction and heavy industry would slow further, but they would not be so weak as to threaten the official 6.5% GDP growth target.

[1] See "*Chi on China: Mega Trends of China (6) – Evolution of China's Growth Model*", 6 April 2018.
[2] See "*Chi Flash: PBOC Signals Easing Amid Economic Rebalancing*", 23 April 2018.
[3] See "*Chi on China: China's Deleveraging Strategy and Evidence (II) – Rising Credit Spread*", 30 May 2018.

Cyclical impact

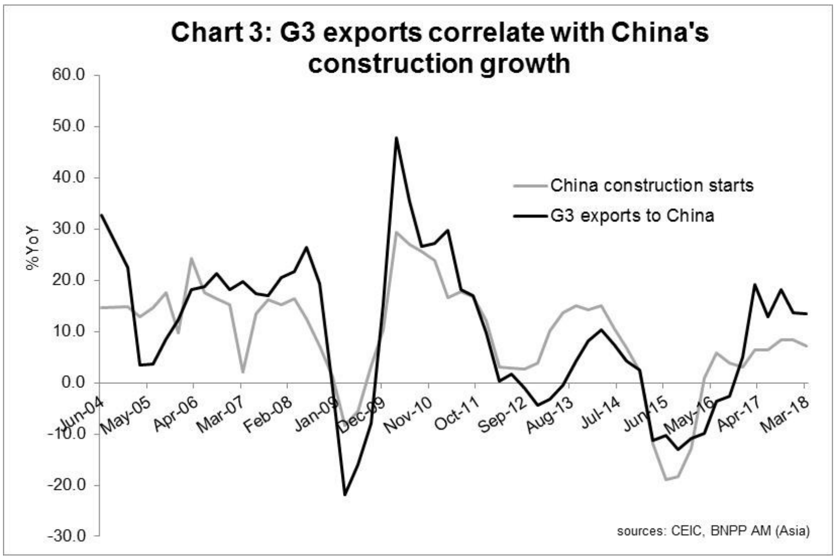
Commodities, especially iron ore and coal, are strongly influenced by China's construction cycle which is, in turn, affected by its property market conditions. China's metal imports have been dropping since 2017 (Chart 1), underscoring a weak property market. A weakening construction cycle in China is thus not good news for metal prices. But Chinese domestic supply has been constrained since 2015, when Beijing started to cut excess capacity, while metal demand has not dropped as much as supply (Chart 2). This has created a bottle-neck condition in the metal sector and helped to prevent any price crash.





Impact on developed markets

China's construction cycle is not only key to demand for commodity-exporting emerging markets. It also drives many developed market exports. The US, Europe and Japan (G3) are important capital goods exporters to China and their shipments closely track swings in China's construction activity (Chart 3).



However, a moderate slowdown in China's construction activity may not cause any major damages on developed market growth, just as the deep decline in 2015 did not derail Europe's economic recovery. US growth did suffer in 2015 but it was mostly a result of the oil price collapse hurting its domestic energy investment.

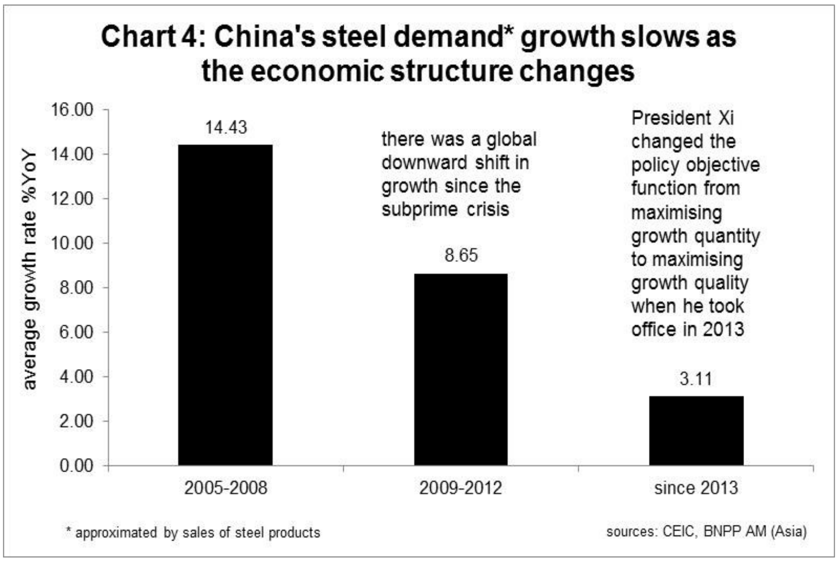
So the cyclical impact of China's economic slowdown on commodity prices is likely to be moderate. The risk for the commodity market lies more in the combination of China slowdown, oil price fluctuation and other geopolitical risk factors such as Europe's political turmoil and US trade conflicts with its trading partners.

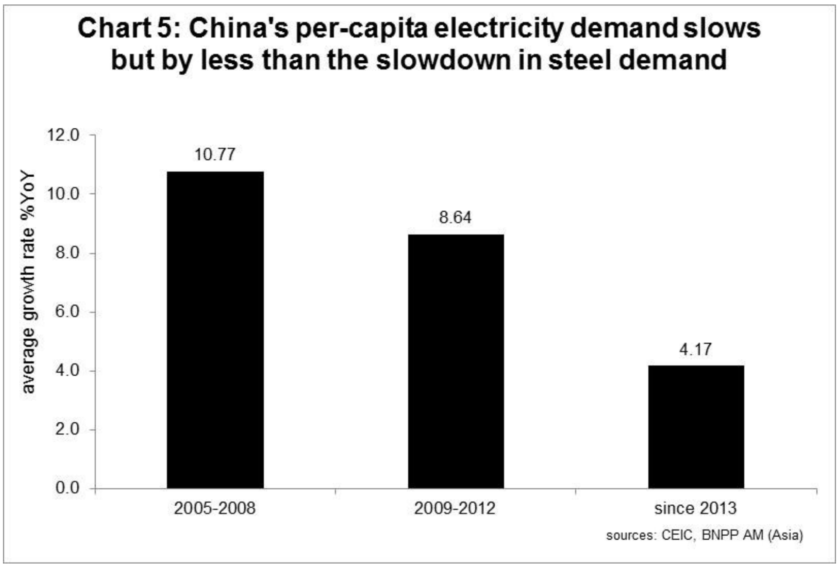
Secular impact

China's commodity demand is undergoing a structural shift from metals to energy and foods, reflecting the creative destruction process that is moving the economy from investment-led to consumption-led growth. China's industralisation in the past three decades created huge demand for metals and energy. But since President Xi Jinping came to power in 2013, he changed the objective function of the economy from maximising growth quantity to improving growth quality through structural reforms. The resultant growth moderation means that in the coming decades, China's commodity demand will shift from metals to energy and high quality foods as income level rises.

Growth in China's steel demand has already fallen from double-digit growth rates in the mid-2000s to low single-digit rates recently, reflecting the structural shift in the economy (Chart 4). This would seem to imply a large disruption to the steel sector and to the markets related to steel production, such as iron ore and coke. Nevertheless, although the growth rate has and will continue to come down, the base for China's steel (and other commodities) demand is still very large so that the annual demand increment in volume terms will remain large.

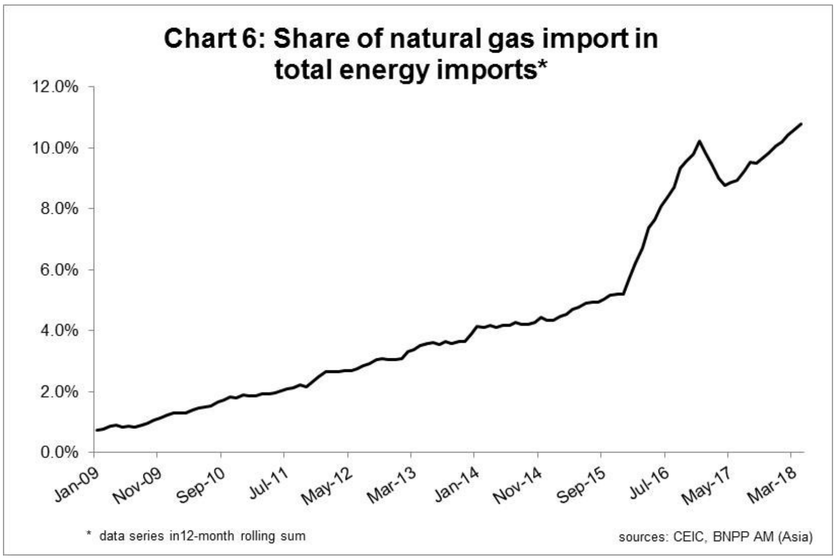
China's per-capita energy consumption has also fallen but not as much as the decline in steel demand (Chart 5). The reason is that even as China's need for steel-intensive construction and heavy industries has dropped, energy demand from the new industries (such as those featured in the "Made in China 2025 industrial policy) and the new economy characterised by household consumption, transportation, services, information technology, computer, commerce and finance has grown. This new energy demand will continue to rise, offsetting the decline in demand by the old economy.





China's economy mostly runs on coal, which is domestically supplied, so not all of the new energy demand will be felt by global markets in the medium-term. But this situation will change in the longer-term as China is moving away from demand for "dirty" coal to clean energy. Meanwhile, oil will be an increasingly important energy source. China is already importing half of its oil needs and an increasing share of natural gas supply (Chart 6). The pressure that China puts on global energy supplies will increase in the coming years, unless stringent energy conservation policies are strictly implemented to offset that pressure. In other words, China will be a positive force for the global oil and gas market in the long-term.

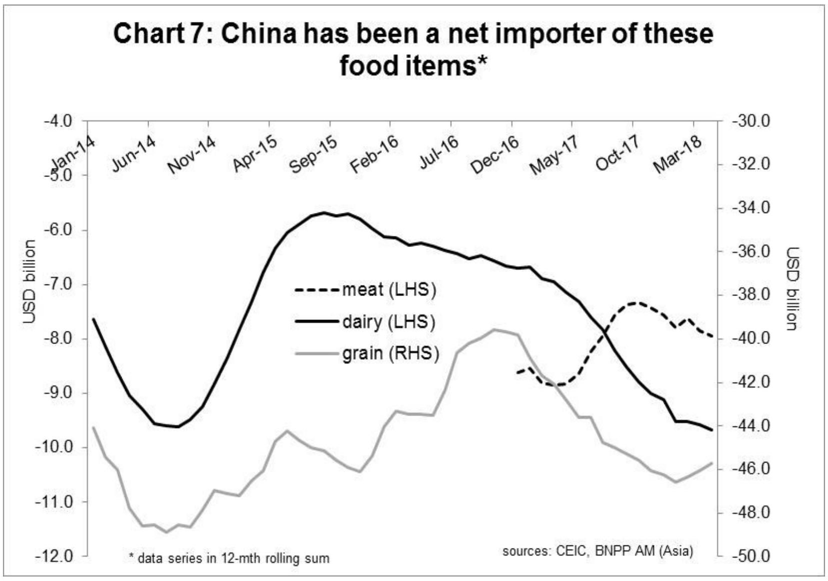
China is also going through a structural shift in the demand for refined oil products. It used to have huge demand for heavy distillates, such as diesel and fuel oil, used in heavy industry and lorry transport. But as its economic structure shifts away from industry-based investment-led growth, diesel demand has slowed sharply since 2013 when the tertiary sector (a proxy to the service-based new economy) started growing bigger than the secondary sector (a proxy to the old industrial economy). Meanwhile, gasoline demand has soared, driven by the new economy's inexorably rising passenger car fleet.



Overall, China's energy and oil intensities (i.e. the amount of oil needed to generate a unit of GDP) are set to fall due to the significant decline in heavy industry and construction activity. This trend is a natural result of the structural shift from capital-intensive investment-led growth to service-based consumption-led growth.

Japan offers a pertinent precedent. Its housing starts peaked in the early 1970s and so did per-capita steel demand. Its oil intensity fell by more than 30% in subsequent years. China is going through a similar structural slowdown in construction activity led by housing. This means that the biggest drop in demand due to this structural shift will be diesel. But the shift towards a consumption-driven economy will create strong demand for light distillates, notably gasoline due to increasing usage of automobiles.

Last but not least, China's demand for better quality foods, including grains, meat and dairy products (of which China is already a net importer, Chart 7), is expected to grow sharply as the general income level rises. The market estimates that, in the coming years, China's per-capita grain consumption growth can easily double from around 1% a year now.



Like energy demand, China will put increasing demand pressure on the high-quality food segment of the global agricultural market as domestic production is now increasingly constrained by the production possibility frontier due to the lack of arable land. Nevertheless, the key variable to watch in terms of the impact of China's food demand on the global agricultural market is the pace of future increase in domestic supply via yield-enhancing technology.

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