ABN·AMRO

Industrial Metals Insights

ABN AMRO
Group Economics

3 July 2019

Tensions in metals markets add to pressure on prices

Casper Burgering
Senior economist
Industrial metals Markets

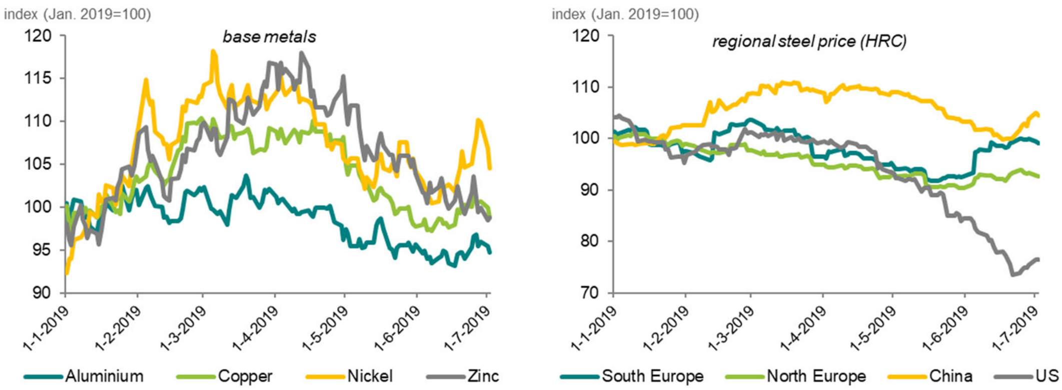
casper.burgering@nl.abnamro.com

	Spot price (USD/t)	% price change (1 Jan.)
	2-7-2019	
Aluminium	$1,756	-5.7%
Copper	$5,869	-1.4%
Nickel	$12,005	13.2%
Zinc	$2,537	0.7%
Global Steel (HRC)	$518	-6.2%
South Europe	$542	-2.2%
North Europe	$553	-7.8%
China	$507	5.0%
US	$532	-26.5%
Iron Ore	$122	69.9%
Coking Coal	$184	-5.4%

Scrap	Spot price (USD/t)	% price change (1 Jan.)
	2-7-2019	
Aluminium (tabloid)	$1,536	-5.4%
Aluminium (taboo)	$1,491	-5.5%
Aluminium (taint)	$892	-1.2%
Aluminium (tense)	$892	0.1%
Copper (candy)	$5,478	-1.2%
Copper (berry)	$5,297	-1.2%
Copper (birch)	$4,981	-1.6%
Zinc scrap	$2,056	-4.9%
Steel scrap (NE USA	$211	-29.7%
Steel scrap (Europe)	$231	-29.9%
Steel scrap (China)	$315	0.0%

- **Relatively low metal prices due to uncertainty about trade negotiations**
- **Trade conflict, monetary policy, the dollar and the economy determine prices**
- **Base metals: prices are under pressure but will soon start to recover**
- **Steel: the global steel sector is cornered**
- **Steel (raw materials): pressure in steel sector affects iron ore and coking coal**

Figure 1: Trend in prices base metals and steel (by region) since 1 January 2019



Source: Refinitiv (formerly: Thomson Reuters Datastream)

Industrial metals markets have struggled so far this year. In the first quarter, sentiment in most base metals markets was still in full swing and optimism about a trade deal between the US and China prevailed. The mood shifted at the start of the second quarter when trade negotiations between the US and China stalled. Economic activity in the US, China and Europe decreased as tensions increased, and prices fell.

The so-called LME index - which reflects the weighted trend in the prices of aluminium, copper, tin, nickel, lead and zinc – has risen on balance by just 1% this year. The price trend in the different base metals is almost identical, but there are differences per metal. While the aluminium price lost almost 6% until 2 July 2019, the price of nickel in particular has risen sharply this year by more than 13%. The zinc price recorded a modest increase of a meagre 1%, while the copper price is now down by almost 2% compared with 1 January.

Since the introduction of Trump's import tariffs, steel prices have been under pressure. The import barriers created by the US President had a disruptive effect on the global steel trade flows. The sector is facing abundant supply, weak demand, higher purchasing costs and persistently low steel prices. These are challenging circumstances.

A combination of factors will become price-determining in industrial metals markets in the coming months. The most relevant are the trade war, the monetary policy of the central banks in the US (Fed), eurozone (ECB) and China (PBoC), the direction of the dollar and economic activity in many countries.

Upward effect on price:

- Trade Deal between the US and China
- Decrease risk aversion of investors
- Fed rate cut, economic stimulus ECB and PBoC
- Higher oil price and improved sentiment equity markets
- Stronger demand growth emerging markets (esp. China)
- Weer (heavy rain fail Latin America, lower supply of ore and transport problems)
- Supply disruptions due to strikes, maintanence, force majeur

Downward effect on price:

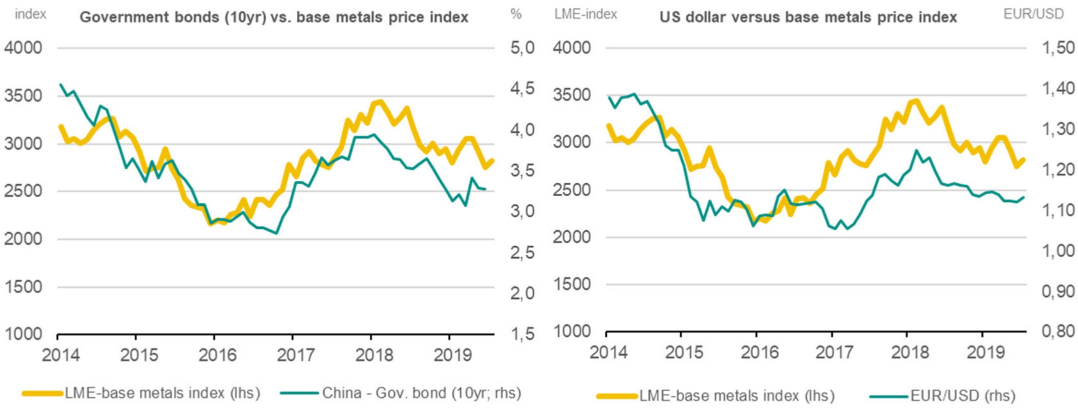
- Trade tensions between US and China persist
- Unrest in Europe, mainly related to Italy and Brexit
- Short term: Fed rate hike, stronger dollar
- Disappointing macro-numbers and stronger cooling Chinese economy
- US-EU trade tensions with focus on auto import US

Base Metals: prices are under pressure but will soon start to recover

The trade conflict is the central theme in base metals markets. Chinese President Xi sets high standards to which Trump only wants to agree under certain conditions. But Xi does not want to accept those conditions. Early July it became clear that the US and China plan to talk again. However, a quick solution to the trade conflict remains unlikely. The resulting uncertainty is reason enough for many investors to ignore base metals markets for the time being. This is because they believe that the longer the trade dispute persists, the greater the chance of a global recession. In that case, cyclical commodities are not a preferable investment. It also means that as long as there is no satisfactory solution to the trade conflict, prices of base metals will remain relatively low. However, as soon as a deal has been concluded, prices will start to recover strongly.

Investor uncertainty can also be seen in the trend of the 10-year government bond yield. The rule of thumb is that when there is a lot of uncertainty, investors are satisfied with little return on such bonds to keep their money safe. The relationship between the average base metals price (the LME index) and the return on Chinese government bonds is high. The trends in both series are almost parallel to each other. This close relationship is due to China's emphatic role in base metals markets. The strongly cyclical nature of base metals markets also takes this into account.

Figure 2: Price index base metals versus 10-yr government bond China and US dollar



Source: Refinitiv (formerly: Thomson Reuters Datastream)

If the trade dispute is protracted, it will be bad for the world economy, which is why Draghi (ECB), Powell (Fed) and Yi Gang (PBoC) are hinting at more monetary easing if economic activity disappoints. The ECB will restart its bond buying program and the Fed is prepared to lower interest rates. The PBoC is likely to stimulate the economy through targeted expansion measures (e.g., infrastructure investments).

The Fed's interest rate cut is most relevant to the base metals markets. A reduction in interest rates results in a weaker dollar. In counter currency it then becomes more attractive to buy more materials. That has an upward effect on many base metals prices. This year, the dollar continues to move within a tight bandwidth of 1.10 to 1.15 against the euro. From this perspective, the upward trend will be limited in base metals prices. At the end of 2020, ABN AMRO expects that the EUR/USD will stand at 1.20. Another factor that will contribute to higher prices is that the market balance for many base metals markets will show a deficit until 2020.

Upward effect on price:

- Significant capacity reductions in China and Europe
- Recovery of demand for steel from construction, automotive
- Belt & Road initiative China with investments in infrastructure
- Restocking traders at relative low prices
- Fed rate cut, economic stimulus ECB and PBoC

Downward effect on price:

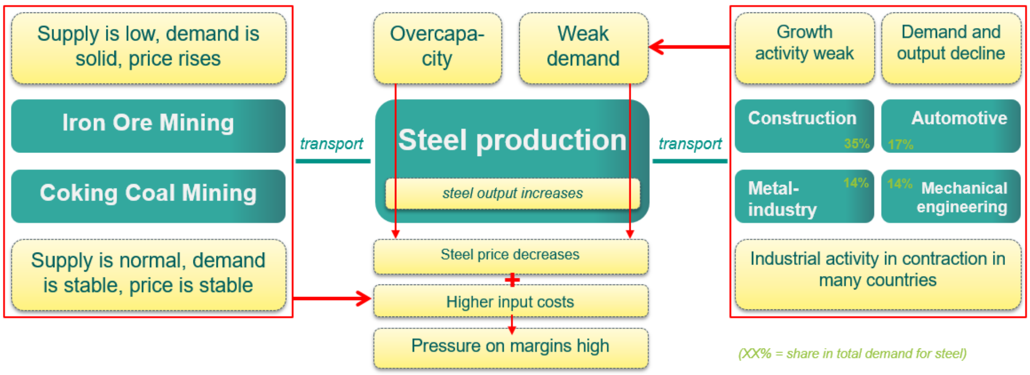
- Overproduction China continues with export of cheap steel
- Sufficient supplies and global high stock levels
- Decrease in pace of demand growth in developed countries

Steel: the global steel sector is cornered

Steel production is growing fast without any significant end-user demand growth. Inventories at steel mills remain high and a lot of cheap steel is flooding export markets. The sector receives financial support through tax regimes or all sorts of stimulating economic policies. This results in the creation of a huge pool of inefficient and non-productive steel companies. These zombie companies have enabled the global production capacity to grow into an untameable monster. The steel sector has been struggling with this situation for a long time and for now, it will continue to affect the industry.

In the first five months of 2019, Chinese steel companies have already produced 10% more than in the same period of 2018. Steel companies in the US saw output increase by 6%, while steel production in Europe decreased by 3%. Up to May 2019, global steel production has thus grown by 5% on an annual basis. And that while worldwide demand for steel is weak. Industrial activity is slow, car production and sales are shrinking and the pace of growth in the construction sector is considerably lower. The combination of weak demand, overcapacity and unbridled production growth is putting pressure on steel prices. However, the problems do not stop there.

Figure 3: Steel mills under pressure



Source: ABN AMRO Group Economics

On the input side, the steel sector is also facing challenges. The price of iron ore has risen sharply, and the price of coking coal remains relatively high (see also the analysis on the next page). Together, these raw materials account for almost 60% of the total costs. With persistently low steel prices, this puts increased pressure on margins. Capacity reduction is the only suitable answer to restore balance. This will make the steel sector fundamentally healthy again.

The good news is that global overcapacity has been on a downward trend since 2015. According to the latest figures from the OECD, in 2015 almost 32% of total capacity could be classified as overcapacity. In 2017 this fell to 24%. However, compared to the period before the 2008 financial crisis, these figures are still relatively high. More capacity reductions must take place worldwide, with China – which has a 50% share in global steel output - playing a key role. Another way to curb overcapacity is consolidation, which provides potential cost reductions and efficiency. However, neither solution can be implemented quickly, given the economic importance and the social resistance. This means the steel sector will have to manoeuvre for an even longer period of time in this atmosphere of crisis.

Upward effect on price:

- Higher oil price
- Persistent supply difficulties iron ore from Brazil
- New supply disruptions due to weather, strikes, transport problems, forca majeur at mines
- Stronger demand growth emerging markets
- Trade Deal between the US and China
- Economic stimulus China in order to counter headwinds

Downward effect on price:

- Capacity reductions in China steel sector
- Sufficient supplies and global high stock levels
- Import restrictions coking coal by China from environmental
- Negative sentiment traders

Steel (raw materials): pressure on steel sector felt in raw materials markets

While still relatively high, the price of coking coal has fallen by around 4% this year. This decrease was due to a combination of high stocks at steel mills, sufficient supply from Australia and a slightly weaker demand for coking coal. The price of iron ore has risen by almost 70% this year. A burst dam in Brazil caused a supply disruption, while the demand for iron ore remained at the same level. The iron ore price has increased sharply and is almost back to the level of 2014. For the time being, the pressure on the margins of steel companies remains high. This means that steel companies will seek cost reductions. Part of this involves the purchase of the cheaper types of iron ore.

Figure 4: Trends in steel raw materials prices

Source: Refinitiv (formerly: Thomson Reuters Datastream), ABN AMRO Group Economics

The most common method of steel production involves the so-called Blast Oxygen Furnace (BOF). Approximately 71% of the total steel output is produced using this method. Making steel via the BOF process requires a certain mix of iron ore, coking coal and scrap. To produce a ton of steel requires about 1.5 tons of iron ore, three quarters of a ton of coking coal and one seventh of a ton of scrap. Recently, the pressure of the cost of iron ore has exceeded the pressure of coking coal. This is a result of the combination of a sharp rise in iron ore prices and the higher amount of iron ore required. We assume this situation is temporary. This is because the price of iron ore will fall in the coming months mainly due to a recovery in supply from Brazil and a continuing weak steel sector. However, relatively low stock levels ensure that the price drop remains limited. The price of coking coal will remain stable in the coming months but will weaken slightly in the longer term. This is mainly owing to the fact that the supply from Australia will increase.

However, the costs of raw materials for making steel are not the only reason behind an increase in production costs. Looking ahead, government policy will gain greater influence. The EU has set itself the goal of drastically reducing CO_2 emissions in the coming years. In concrete terms, that means the number of available CO_2 emission allowances is decreasing for many steel companies, and they will have to buy the remaining number of required allowances on the market. Some steel companies are currently holding emission allowances, which is a source of income, but that will change. The total number of available emission allowances will also fall further, and chances are that the CO_2 price could rise in the coming years. This will increase the cost per ton of steel. It is therefore important that the steel mills continue to invest in more efficient and sustainable production processes to reduce future emissions.

Sources:

For this publication, several sources were used, of which Argus Metals, CRU, Mining Journal, OECD, ISGS and Refinitiv (formerly Thomson Reuters Datastream) are the most important.

Text is closed on 3 July 2019

ABN·AMRO