

Research Global

Power crunch supports metal prices despite fading demand outlook

- **Refined metal prices have continued higher amid continuing production shortages and power outages**
- **At the same time, final demand outlook from the largest metal consumer China has faded, construction sector worries loom and ore supply recovers**
- **Longer-term outlook supports moderating metal prices, but in the near-term low metal supply could continue to contribute to global inflationary pressures**

Power crunch affects Chinese metal production

Metal price developments have been a mixed bag over the past months, driven by a weakening final demand outlook, but supported by various supply side issues. The demand boost from China's pandemic-era stimulus is now over, and the focus on deleveraging and the ongoing construction sector worries add to the weakening outlook. This is already visible in iron ore prices, which have plummeted from early summer highs. China consumes 70% of iron ore globally, and over 60% of the steel produced from the said iron is consumed in the construction sector.

Rising energy prices have an impact on metal prices, however, as the price of coal used in metal production has risen in line with broader gas and electricity prices (Chart 1). Coal is still the primary energy source in China, with 57% share of the total energy production (Chart 2). Higher electricity prices and recent power rationing directly affect Electric Arc Furnace production (EAF), which utilizes scrap material and electricity for steel production and accounts for around 15% of Chinese steel production. Despite this, traditional blast furnace production from coal and iron ore has also seen costs increasing, as prices of metallurgical coal have risen in line with thermal coal.

High coal price levels help to explain the divergence between iron ore and steel prices over the past months, and the effect can be seen across other refined metals as well, such as copper and aluminium. China's trade spat with Australia continues to make the situation even more challenging, as China has not imported any Australian coal since last December despite the price surge. Australia has been able to divert majority of the Chinese exports to other trading partners, namely India, South Korea and Japan, (Chart 3) and as such, no quick supply boost is available for China even if the dispute would suddenly be resolved. Australia accounts for around 50% of the world's metallurgical coal exports.

Another factor supporting prices of Chinese manufactured metals have been the environmental restrictions, which have limited the highly polluting metal production. As a result, we have seen steel production declining since March 2021 despite the recovering demand globally (Chart 4).

China to remain under pressure in the short term

Looking ahead we see clear downside risks for Chinese construction. The developer crisis has severely squeezed financing channels for the big majority of developers and focus will be on deleveraging and securing liquidity and less on starting new projects that require more debt. Home sales have also declined adding to developer's liquidity challenges and

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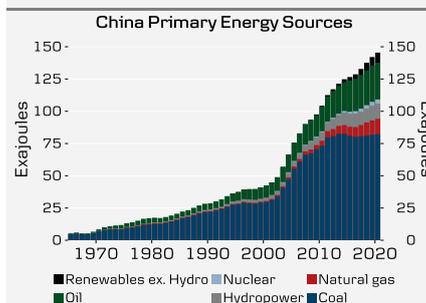
- *Research Euro Area - Looming energy crisis creates a perfect storm*, 4 October
- *China Macro Monitor - Growth revised lower as property crisis to linger into 2022*, 5 October

Chart 1: Elevated energy prices affect metals as well



Sources: Macrobond, Dalian Commodity Exchange, China Iron & Steel Association, Note: Past or current performance is no guarantee of future performance

Chart 2: China still relies heavily on coal in energy production



Sources: BP Statistical Review of World Energy

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reducing the need for new construction. We do not expect a severe financial crisis as the government is likely to step in before that happens. For now, they have been quite passive with no sign of bailing out the ailing developer sector. But, we expect authorities to step in soon to underpin home sales and increase lending from big state banks in order to avoid a financial stress from spinning out of control. Infrastructure spending will likely also see a small lift as this is the main tool, the government can use to avoid a big drop in overall demand. But generally, we look for Chinese growth to be very weak in Q3 and Q4 before gradually turning higher during 2022, see also *China Macro Monitor – Growth revised lower as property crisis to linger into 2022*, 5 October 2021. The bottom line is that Chinese demand for metals should be subdued in the coming quarters before improving slightly during 2022.

Aside from China, the rapid rise in US goods demand was also a driving factor behind the commodity price surge last spring. While the reopening of the services sector has limited the growth in goods demand, it remains clearly elevated, with private goods consumption some 8.3% above the counterfactual trend in August. A new major spike in goods demand is unlikely as the fiscal support to US households ends and the spending normalizes amid fading pandemic restrictions and fears. Despite this, the elevated goods demand continues to contribute to the global supply challenges, and higher freight rates consequently support higher metal prices.

Metal ore supply to ease towards next year

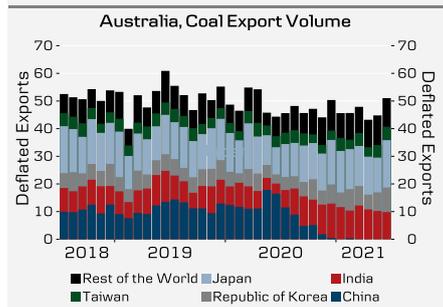
Metal ore production is expected to grow towards next year, also supporting lower prices. While the current metal price levels are mostly related to high demand combined with lower

production of refined metals, ore supply has also been limited over the pandemic period. Covid-19 related mine closures are now mostly over, and Brazilian iron ore supply continues to recover as Vale continues to increase production lost in the 2019 Brumadinho dam collapse (Chart 5). Power outage risks affect ore production as well, but the seasonality in energy demand supports easing situation in key southern hemisphere production sites, as summer and warming weather approaches in South America, Australia and South Africa.

Based on current companies' forward guidance, copper ore supply is expected to increase by 8.3% in 2022 and 6.5% 2023, following practically no growth in 2019 and 2020, and 4,6% growth in 2021. This is largely driven by higher production in South America, which accounts for around 60% of the global supply, as well as Africa (Chart 6). For iron ore, total world supply is expected to grow by 1.8% this year, 2.6% 2022 and 2.3% 2023 driven by recovering supply from South America and growth in Oceania.

All together, we do expect metal prices to moderate over the longer term on the back of both fading Chinese demand outlook as well as recovering supply. In the near-term, the looming energy crisis is unlikely to fade quickly ahead of the winter's heating season in developed economies and China. Thus, both the limited supply and elevated prices of metals are likely to continue to contribute to global supply chain challenges and inflationary pressure over the coming months even if the longer-term outlook is for lower prices.

Chart 3: Trade dispute with Australia limits Chinese coal supply



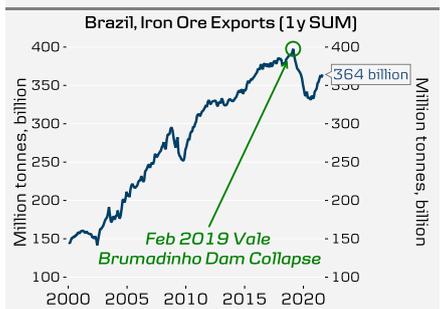
Sources: Macrobond, Australian Dept. of Foreign Affairs & Trade, Australian Bureau of Statistics

Chart 4: Environmental restrictions have weighed on metal production



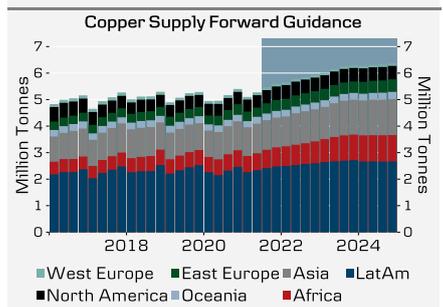
Sources: Macrobond, World Steel Association

Chart 5: Brazilian iron ore supply will continue to recover



Sources: Refinitiv

Chart 6: LatAm and Africa expected to support global copper supply



Sources: Refinitiv, individual mine forward guidance

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None

Date of first publication

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