The Market Observer

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Iron Ore Markets

The strength in Iron Ore prices surprised most market commentators during 2016 and was the key driver for the significant level of earnings upgrades for the major Australian producers during the year. Simply put, the key driving forces for the price strength was the combination of stronger than expected demand during a period of weaker than expected supply. Chinese Steel demand growth surprised on the back of Chinese stimulus flowing through to infrastructure and property sectors in particular. This combined with weak supply output in both Western Australian and Brazil provided significant price support.

We expect demand to remain robust during 2017 with Chinese supply side reform providing further support for Iron Ore consumption. At the same time (unlike 2016) we expect supply growth to continue, somewhat incentivised by recent high pricing. With this backdrop, we expect spot Iron Ore prices to moderate from current levels, however, consensus broker forecasts for the commodity remain too low and are likely to continue to drive earnings upgrades for the Australian Iron Ore companies.

Robust demand expected to continue through 2017

We expect commodities demand, and in particular Chinese demand, to remain robust over the course of the year. Recent economic data from China remains encouraging and suggests an ongoing recovery from a steel demand perspective. China is experiencing ongoing broad-based strength in demand in all the key steel consumption industries. Strong demand from infrastructure, machinery and whitegoods continued, and the strength in property sector continues to surprise the market to the upside despite various restrictive policies put in place. We continue to expect ongoing demand benefits to be seen through of follow-through effects on construction activity from infrastructure spending and housing market strength.

Stability targeted in the Chinese economy into the leadership changes later in the year

Over the course of the year we also expect the Chinese government to continue its focus on maintaining stability in the economy. Policy in our view is likely to be supportive of growth into the Communist Party of China's 19th Party Congress towards the end of the year where material senior leadership changes are likely. While reform is likely to be an ongoing focus during the course of the year, on stability within the economy is expected to be the government's utmost priority, and as a result growth below 6.5% is unlikely to be tolerated.

Chinese supply side reform to add further to Iron Ore demand

In 2016, the Chinese government singled out the steel and coal industries for capacity reduction and they were the only two sectors with tangible targets, at 45mt and 250mt respectively. The capacity targets appear to be comfortably exceeded, with 65mt steel capacity understood to have been closed last year. For 2017, the government is targeting a further 50mt of steel mill closures. This was in-line with expectations, as part of the 150Mtpa capacity closures due before 2020. These closures are important from the perspective that they increase industry utilisation rates, enhance overall steel mill profitability and simplistically enable higher prices to be paid for raw materials (including Iron Ore).

Additional to these closures, the Chinese government is also targeting the closure of Induction Furnaces. These are unapproved furnaces that melt scrap metal to produce low quality steel as construction products. These closures are required before June 2017 and could represent up to an additional 100Mtpa of capacity reductions. This will shift operating capacity to Blast Furnace steelmaking methods which primarily consume Iron Ore (and coal) rather than scrap metal. The shift in demand as a result could be very material to the Iron Ore market.

Supply growth moderated during 2016

The weak Iron Ore market in the years leading up to 2016, resulted from a combination of weakening demand and strong supply growth. The major producers added roughly 160mt of supply over 2014 and an additional 80-100mt of low-cost supply growth was estimated to have entered the market in 2015. Rolling into 2016, weaker-than-expected supply growth was a contributing factor behind the rally in Iron Ore prices. While 2016 was expected to see material supply growth continue, Samarco and Roy Hill issues coupled with production downgrades from BHP Billiton and Rio Tinto tightened the market materially relative to expectations; with new supply additions were understood to be only ~30mt.

High prices will see supply growth resume

Weak seasonal Iron Ore supply during the first quarter of 2017, again combined with ongoing strong demand, were the key factors driving Iron Ore prices higher in recent months. This was particularly noticeable for prices of high quality ores which traded at a premium. These seasonal supply issues are likely to resolve themselves near-term and recent high prices are likely to continue to incentivise Chinese and non-traditional suppliers to re-enter the market. This will likely be combined with continued ramp-up in the production of Vale's 90Mtpa S11D project and modest growth from the other majors.

High prices likely to moderate, but consensus broker earnings remains understated

In summary, we expect demand to remain robust with Chinese supply side reform providing further support for consumption. At the same time we expect supply growth to continue, somewhat incentivised by recent high pricing. With this backdrop we expect spot Iron Ore prices to moderate from current levels, however despite this, consensus broker forecasts for the commodity remain too low and are likely to continue to drive earnings upgrades for the major Iron Ore companies (including BHP Billiton, Rio Tinto and Fortescue Metals Group).