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Commodities: East v west, China to drive resources in face of weaker growth

Research & Insights

July 2022

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Over the past few months, we have seen a significant selloff in global equities, mainly driven by concerns around slowing economic growth in both the US and Europe. As central banks tighten to curtail inflation, the risks of recession have increased, however this view does not yield the entire picture. While western developed economies are certainly slowing, China is reopening, and is likely to accelerate growth coming out of recent hard COVID lockdowns through significant stimulus. In natural resources, China dominates demand for most commodities, offering some insulation for commodities from the impact of slowing world growth, in a situation where the east is actually accelerating.

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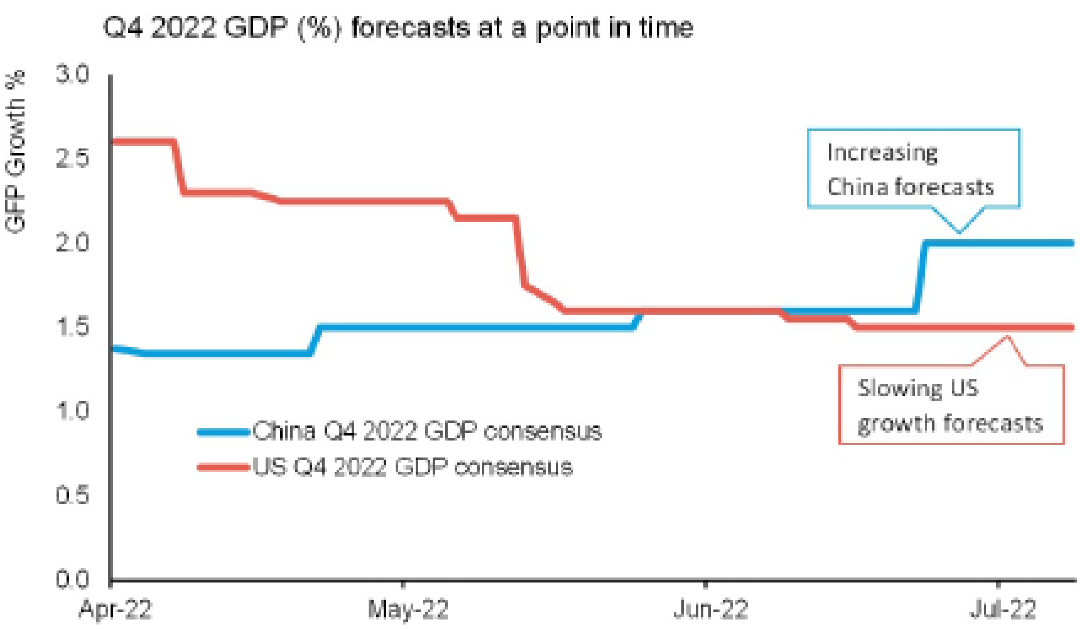
Slowing western forecasts vs accelerating Chinese forecasts

There is a divergent story developing in the world economy, between the east and west in the current environment. The US and broader western developed economies are slowing, driven by increased central bank intervention with the goal to stem surging inflation. Chart 1 illustrates the different outlook between east and west. China is seeing an acceleration in growth forecasts, driven by the announcement and expectation of stimulus measures following extended lockdowns.

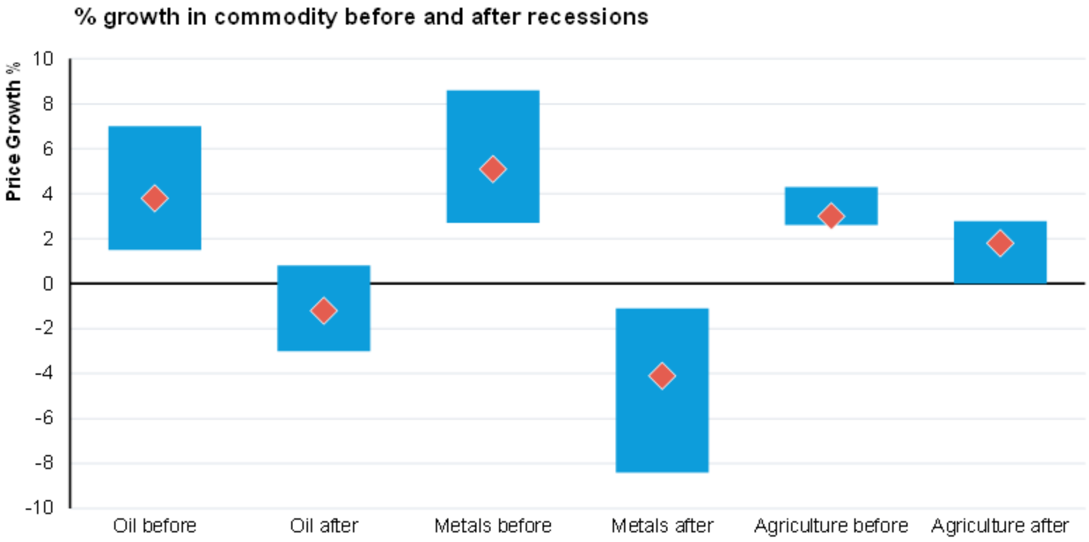
Chart 1: A diverging outlook for eastern and western economies



Source: Ausbil.

If you subscribe to the view of a slowing western outlook versus an accelerating Chinese outlook, the question then becomes – how does this play out in commodities? History can provide some insights into the impact of slowing growth. Firstly, looking at history in a recessionary environment, commodities demand typically declines, as illustrated in Chart 2.

Chart 2: The impact of recession on commodities



Source: World Bureau of Metals Statistics

The World Bureau of Metals Statistics has assessed the impact of oil and metals demand after four recessionary period, 1974-75, 1981-82, 1990-91 and 2008-09. The results show metals demand fell around 1-8% (average 4%) in these periods, while oil demand fell on average around 1% (range +1 to -3%). In a recessionary environment therefore, demand for commodities is a risk which can weigh on commodity pricing.

How has China reacted previously to bouts of economic weakness?

Our base case view is that central banks do not trigger an extended recession in order to curtail inflation, rather they react quickly to slow it, but not to the extent that the global economy is completely undermined. Our view is that Chinese demand will increase, while ex-China growth slows.

China was the first major economy to emerge from the Global Financial Crisis, driven by aggressive domestic stimulus. The Chinese economy grew by 8.7% in 2009 and by 10.4% in 2010. This growth was underpinned by massive stimulus programs introduced from the fourth quarter of 2008 and implemented through 2009 and 2010.

The initial programme that was announced totalled RMB 4 trillion. The package comprised four main components: an investment program, accommodative monetary policies, tax cuts, and measures to ease the burden on state-owned enterprises.

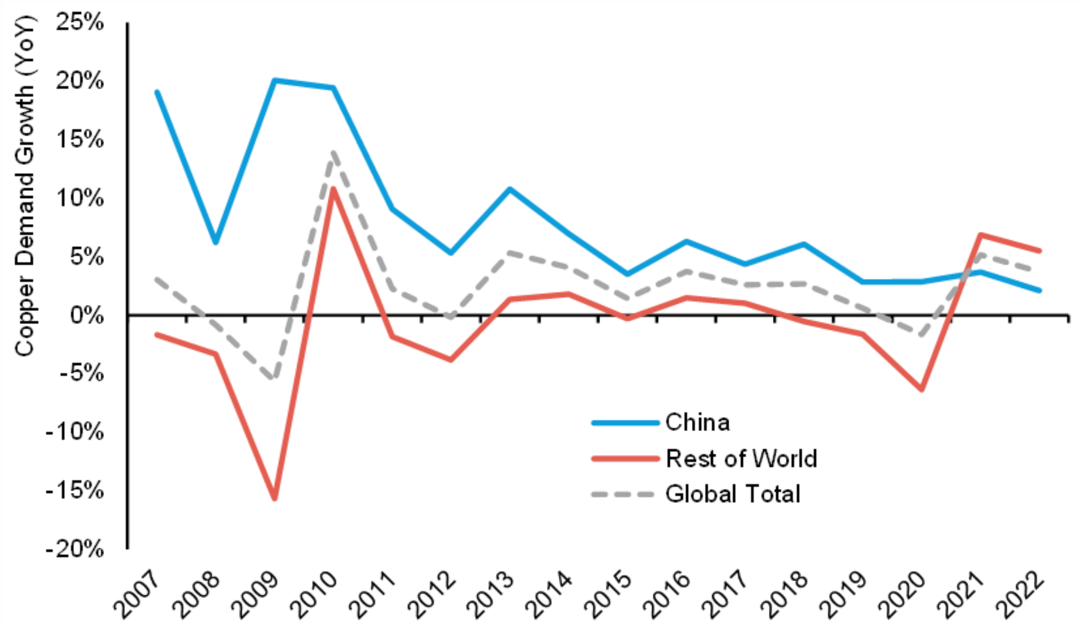
Assessing metal demand around the GFC, what can history teach us?

Our base case is not that we are entering an environment similar to the GFC, but we do believe there are some similarities that help us assess the potential impact on commodities demand. During the GFC, global commodities demand fell, while China accelerated out of the GFC using aggressive stimulus measures, a situation we see playing out at the moment.

Copper. During 2008/09, Copper demand dropped an average of 10% ex-China, and rebounded 11% in 2010 following the GFC. In China however, Copper demand grew 13% pa during the GFC period and 20% in both 2009 and 2010 respectively, following stimulus post-GFC, as illustrate in Chart 3.

Source: Credit Suisse.

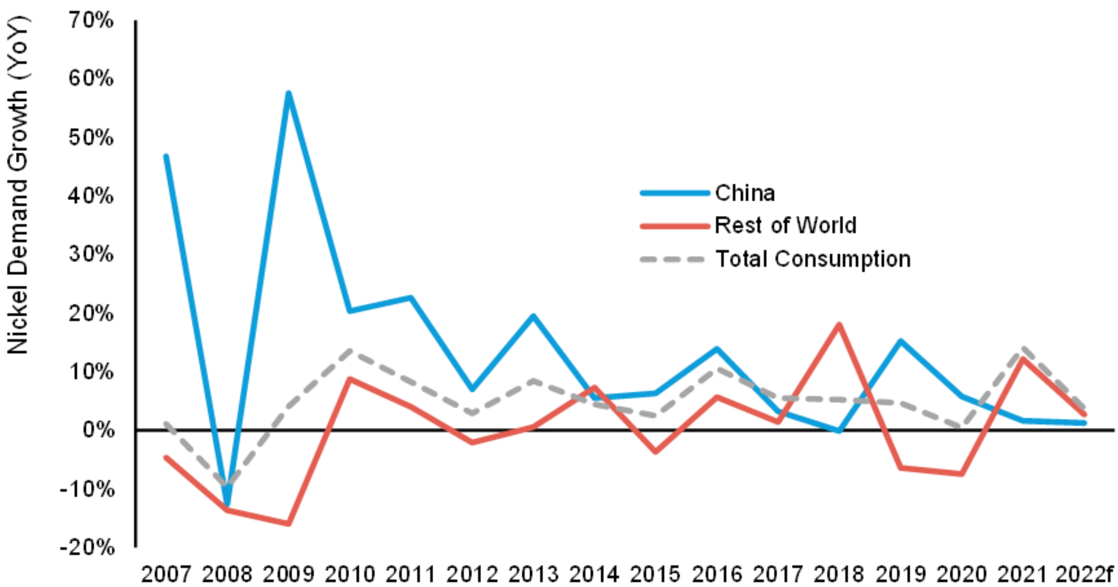
Chart 3: Copper demand during and after the GFC



Source: Credit Suisse.

Nickel. During 2008/09 Nickel demand dropped an average of 15% ex-China, and rebounded 9% in 2010 following the GFC. In China however, Nickel fell only in 2008 (-13%) with demand growing significantly from 2009 onwards, as illustrated in Chart 4.

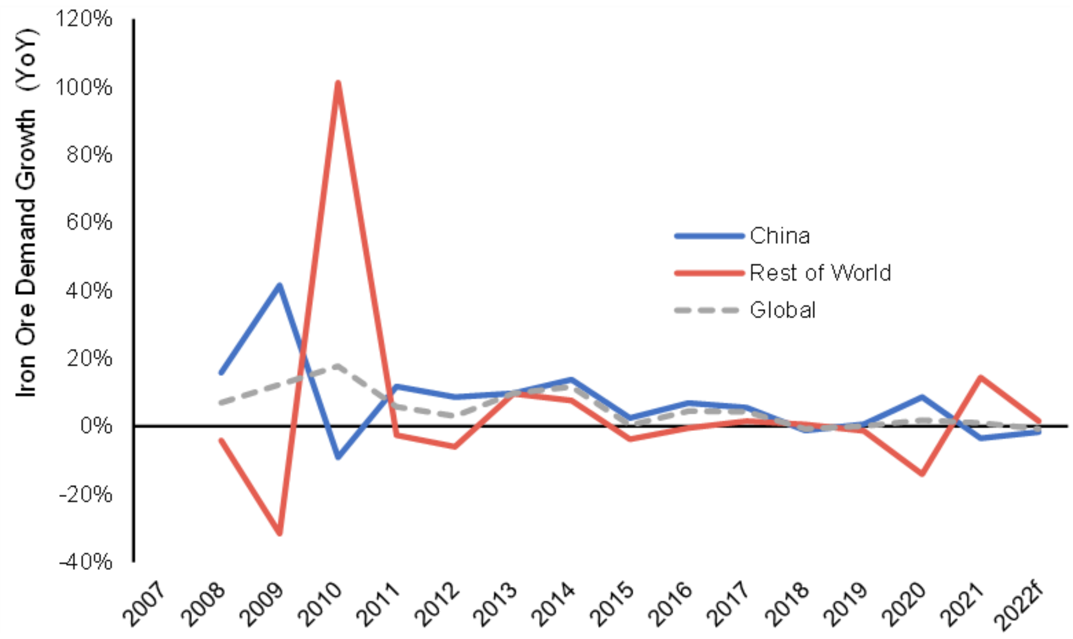
Chart 4: The path of nickel through and after the GFC



Source: Credit Suisse.

Iron Ore. Iron Ore demand growth in China during 2008/2009 was supported by stimulus activity, growing 16% and 41% respectively, before normalising slightly in 2010. Demand through the rest of the world was volatile during this period, as illustrated in Chart 5.

Chart 5: How iron ore fared in the GFC and beyond



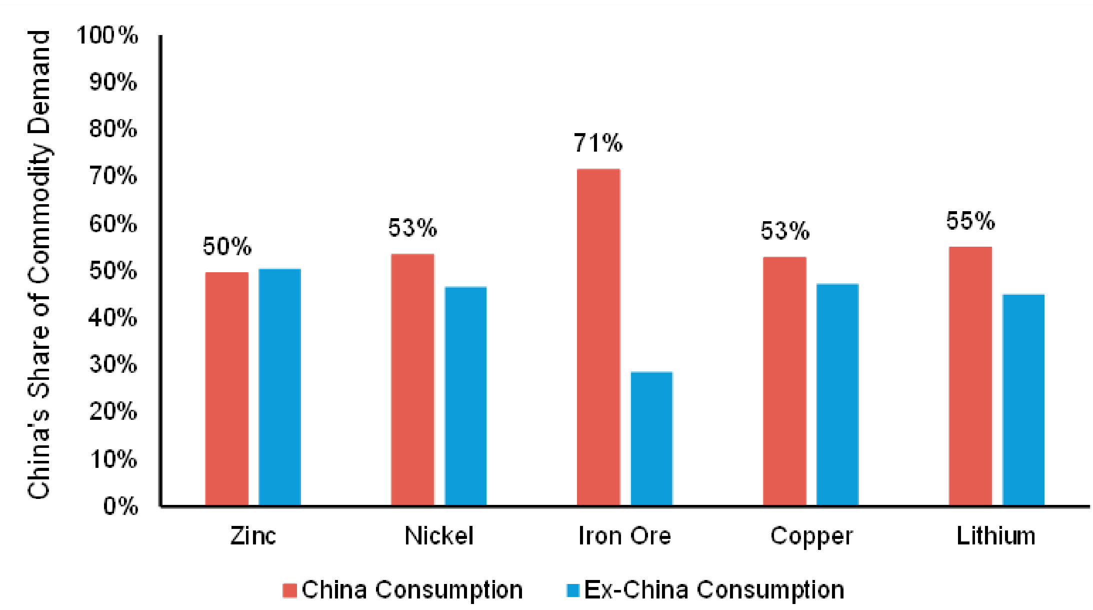
Source: Credit Suisse.

In all commodities, as China exited the GFC, commodity demand increased significantly.

China's commodity dominance

So why do we focus so much on China versus the rest of world? China is without question a dominant force in commodities, consuming at least 50% of core commodities. Iron Ore is absolutely dominated by China, with in excess of 70% of global demand, but Chinese demand for all key commodities exceeds 50%, as shown in Chart 6.

Chart 6: China's dominant demand for commodities



Source: Credit Suisse.

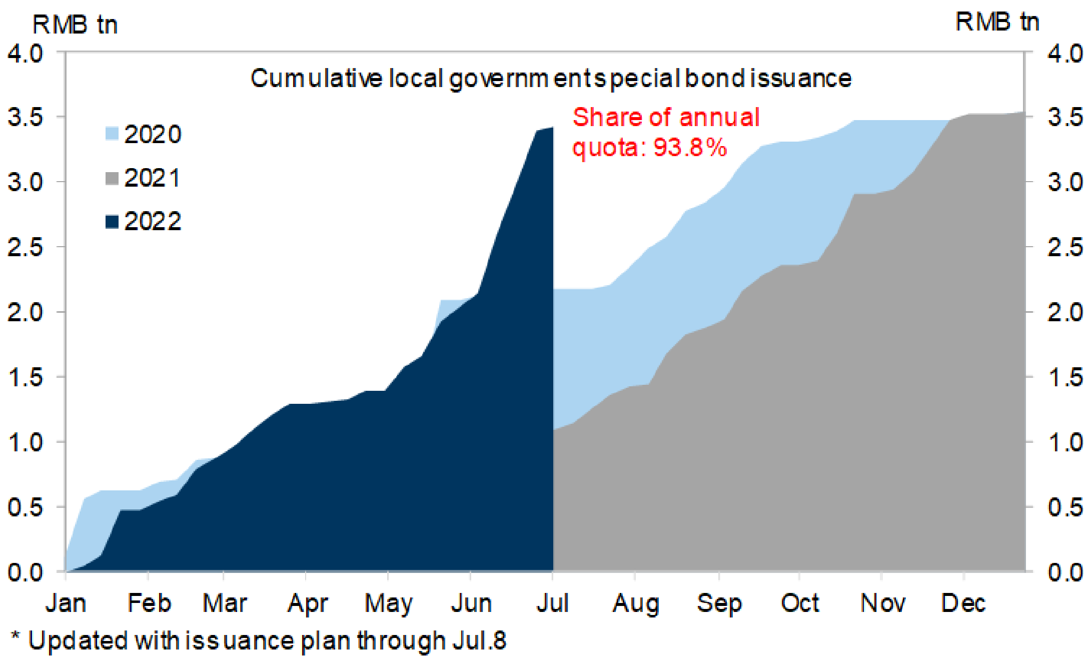
China's post-COVID stimulus programs have commenced

China, as a result of COVID, has already seen an aggressive fall in growth as a result of domestic lockdowns, curtailed industrial activity and travel restrictions. So right now, China is effectively already in a similar position to late 2008 when stimulus measures were announced. The economy has already slowed, and stimulus measures are being announced at a scale larger than in 2008, albeit off a larger economic base.

The growth outlook for the rest of the world may be slowing, but China is setting up 'extraordinary' measures to support the economy. Since the GFC, China has tended away from broad-based stimulus measures, instead using targeted stimulus. Even during 2020, post-COVID stimulus was deliberately targeted. Throughout 2022, however, we have seen the government setting up for more aggressive stimulus, which we expect to play out during 2H 2022. While rolling lockdowns remain in place, the implementation of stimulus measures is likely to be somewhat constrained, but the building blocks are in place to accelerate economic activity.

Announcements in relation to special purpose bonds are probably the most obvious sign of impending stimulus. Through 2020 and 2021, a total of RMB 3.5 trillion in local government special purpose bonds were issued. This quota has already been issued, only halfway through 2022, with an incremental RMB 1.5 trillion understood likely to be issued shortly, accelerating 2023 issuance. Importantly, bonds have been issued, but activity is yet to accelerate, meaning pent-up demand for commodities is yet to flow through.

Chart 7: Quantum of bond issuance support in China



Source: Goldman Sachs.

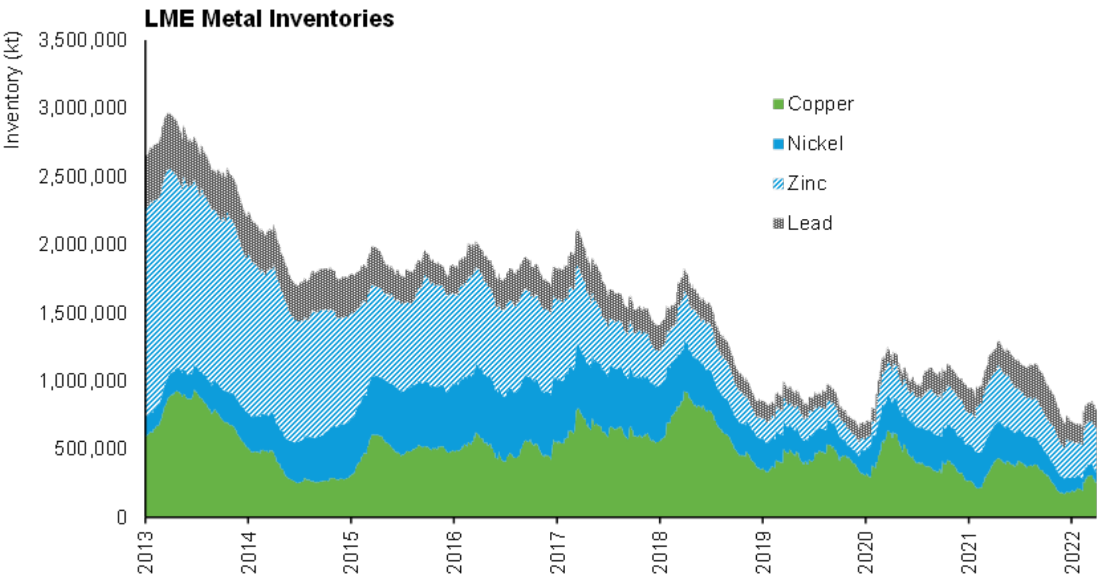
In conclusion

It is acknowledged that the outlook for the west has slowed, however China has already commenced the process of stimulating growth, and we expect this to accelerate through 2H 2022 and into 2023. Given that China represents at least 50% of commodity demand, we believe commodities are likely to benefit from Chinese stimulus which is yet to hit the ground. From our perspective, physical activity has been constrained by lockdowns to date, but this is alleviating (albeit outside small flare-ups in COVID cases). We therefore expect that Chinese demand is likely to accelerate in the coming months.

From an investment perspective, this does not mean we are aggressively invested in the current environment, given significant uncertainty, but this view does support us maintaining a positive net exposure in the current market.

Metal markets are currently tightly balanced in terms of supply and demand, with limited excess capacity available in any commodities following an extended period of underinvestment. Metals inventory remains low, as shown in Chart 8. Although demand may soften from the west, markets are tight, and any acceleration from Chinese demand should underpin prices that are already stretched due to low inventories and underinvestment in supply.

Chart 8: Key metal inventory levels are down 75% since 2013



Ausbil, Bloomberg, April 2022.

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