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Base Metals – Cautious Times Ahead

Executive Summary

- China and Europe are the main consumers of base metals, accounting for approximately 40 and 20 percent of world consumption.
- China has experienced slowdown in secondary industry growth and decline in PMI, possibly signaling lackluster demand for base metals. China PMI has a positive relationship with aluminum and copper prices, and recent decline in PMI points to downside risk for metal prices.
- Germany and France, the main engines of growth for Europe, recently observed a slowdown in production and construction growth, again signaling lower demand for base metals.
- Investment demand of copper, as represented by the net long position in the futures market, reached a 1-year low in the week of 19 Aug.
- Global base metal productions have been relatively constant for the past 4 years.

Introduction

Following the post-recession recovery, global economy has been experiencing headwinds, especially amongst the developed nations. Subsequently, rising concern over global growth has prompt us to reassess our base metals outlook. In this article, we aim to provide a broad overview of base metals by looking at the sustainability of their demand and supply.

China and Europe: Main Consumers of Base Metals

China is the main consumer of base metals, accounting for approximately 40 percent of the world base metals consumption, almost double that of the second largest consumer, Europe. (Table 1) Accounting for more than 60 percent of base metal demands, these two economies play a huge part in determining the demand and support for prices of the metals.

Table 1: China and Europe are main consumers of base metals

| Base Metals | % Share of World Consumption | | |
|-------------|------------------------------|--------|-------|
| | China | Europe | Total |
| Lead | 48 | 16 | 64 |
| Zinc | 44 | 18 | 62 |
| Aluminum | 41 | 20 | 61 |
| Copper | 38 | 21 | 59 |
| Nickel | 46 | 23 | 69 |
| Tin | 47 | 18 | 65 |

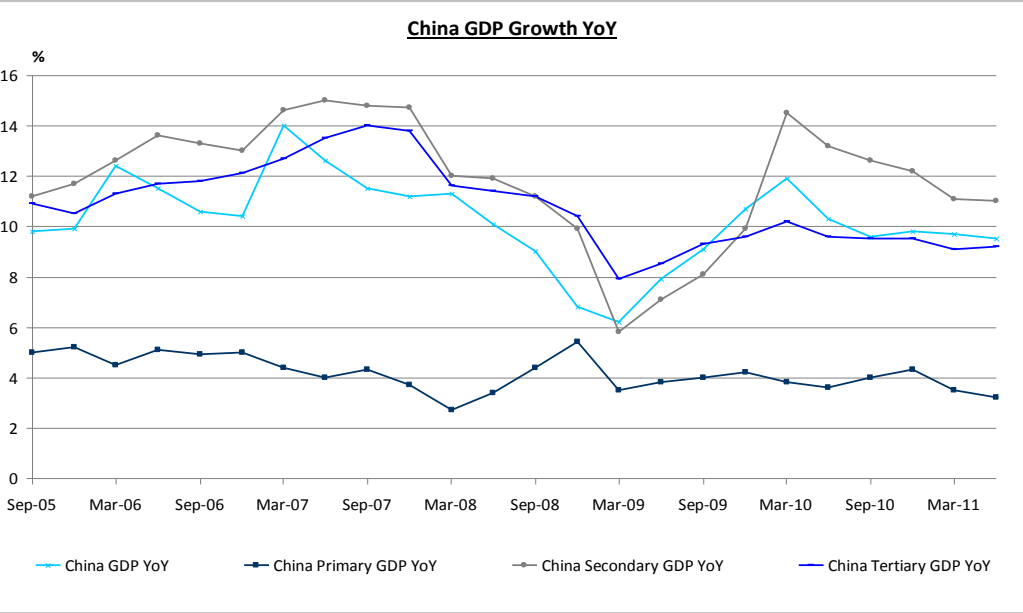
Source: Bloomberg, as of 30 Jun 2011



Demand: Slower Growth in China

China has been tightening since last year to curb inflation, and its GDP growth has since shown signs of slowing down. The growth of secondary industry, which includes manufacturing, processing and construction, was affected the most as it declined from 14.5 in 1Q2010 to 11 percent in 2Q2011. (Chart 1) The effect was also felt in Fortescue Metals Group Ltd. (FMG), Australia’s third-biggest producer of iron ore, as they mentioned on Bloomberg that tighter credit conditions in China have slowed orders from steel mills. As inflation stay elevated in China and easing inflation remain as the top priority of Chinese officials, possible further tightening puts downward pressure on the secondary industry, posing a risk to the base metal demand.

Chart 1: Slowdown in China Secondary Industry



Most obvious slowdown is observed in the secondary industry of China, which includes manufacturing, processing and construction.

Source: Bloomberg, as of 22 Aug 2011

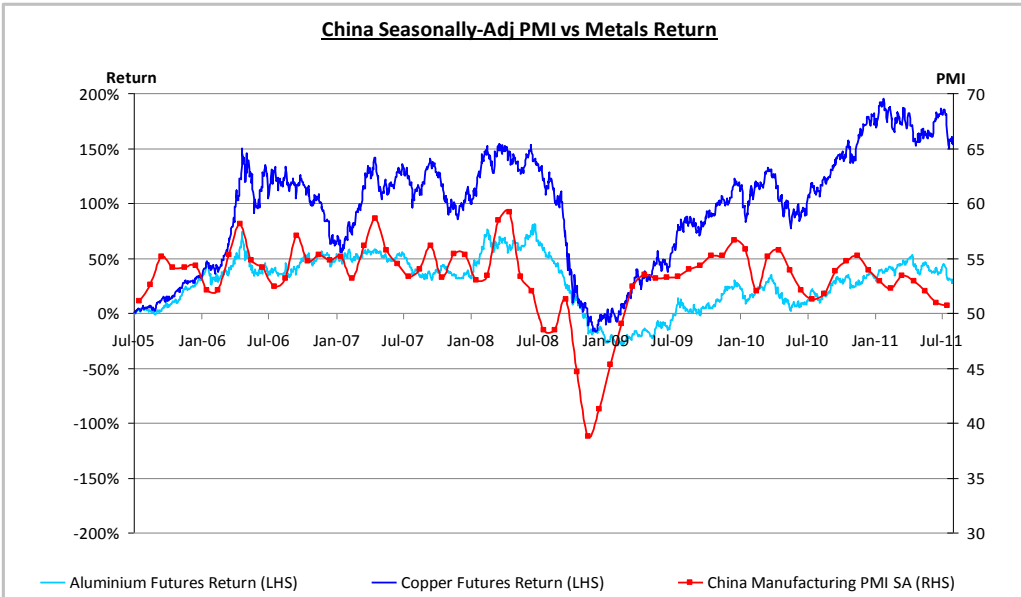
China Purchasing Manager Index (PMI) has been on the decreasing trend for the past five month and nearing the 50 mark. Historically, copper and aluminum futures prices have been moving in tandem with China PMI. (Chart 2) This is probably because China consumes a large amount of these metals and PMI is a significant indicator of demand and prices. Consequently, HSBC’s below 50 preliminary readings of of the China PMI in July and August could be a signal for lackluster demand and prices for metals in the coming months.

Demand: Slowdown in Europe Growth

Aside from China, Europe economies are also showing signs of weakness as they battle the ongoing debt crisis and rising borrowing costs. Quarterly growth in Germany, the largest European economy, slowed to just 0.1 percent in the second quarter from 1.3 percent in the first, and similar trends were observed in France and Italy.



Chart 2: China PMI vs Metal Returns

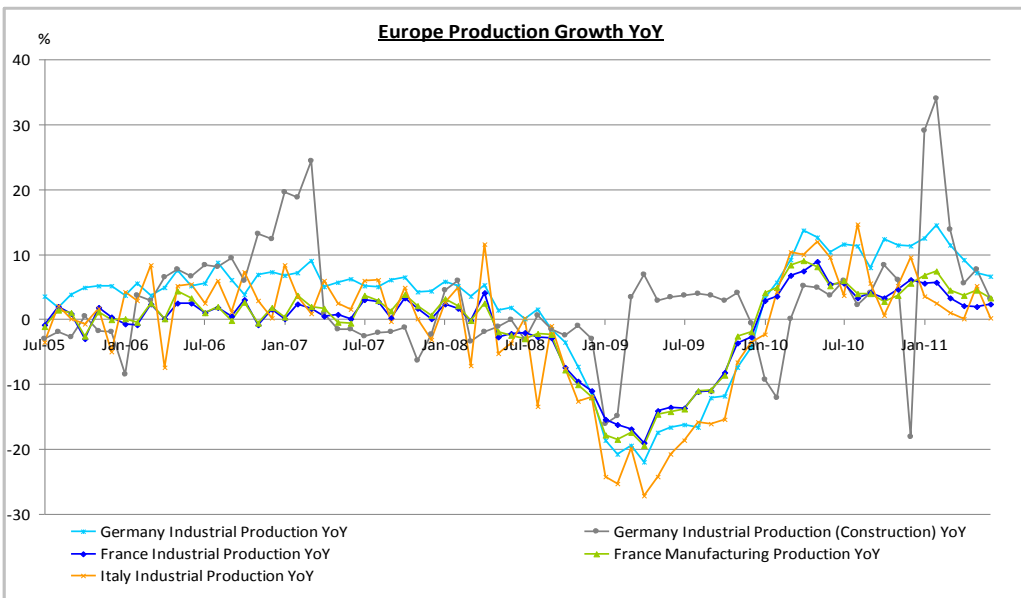


China PMI and metal returns tend to move positively with each other. Recent decline in China PMI points to downward pressure for metals returns.

Source: Bloomberg, as of 22 Aug 2011

On top of slowing overall growth, production growth are also affected in the European countries. In Germany, seasonally-adjusted industrial production growth has been slowing for the past four months and construction has fallen significantly in the past five months. (Chart 3) Similarly, growth in France and Italy are stalling and do not appear like it can support the decline in Germany growth. With ongoing austerity measures and rising borrowing costs in other parts of Europe, possible slower production and construction can result in lower base metal demands in the coming quarters.

Chart 3: Europe Production and Construction Growth Slows



Europe production and construction growth slows, with effect being felt more significantly in Germany construction.

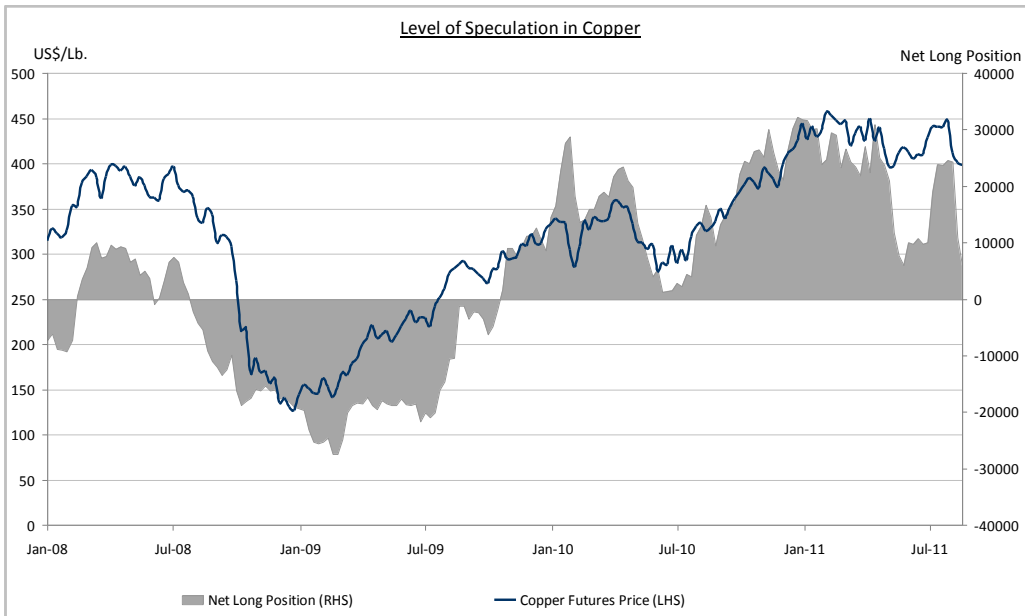
Source: Bloomberg, as of 22 Aug 2011



Investment Demand Falter Along with Physical Demand

Given growing concerns over global growth outlook, it is not surprising that investment demand for base metals has been declining as well. As shown in Chart 4, the net long position of speculators for copper has declined sharply and reached a 1-year low in the week of 19 Aug 2011. Copper rose slightly prior to the Jackson Hole meeting in Wyoming on speculation that the Federal Reserve will act to boost the economy, which was not confirmed by Ben Bernanke on 26 Aug. Therefore, unless signs of economic recovery show in China, US and Europe, investment demand for the base metals could remain low for the time being.

Chart 4: Copper Investment Demand Decline



Net long position of copper declined to a 1-year low amid global growth concern.

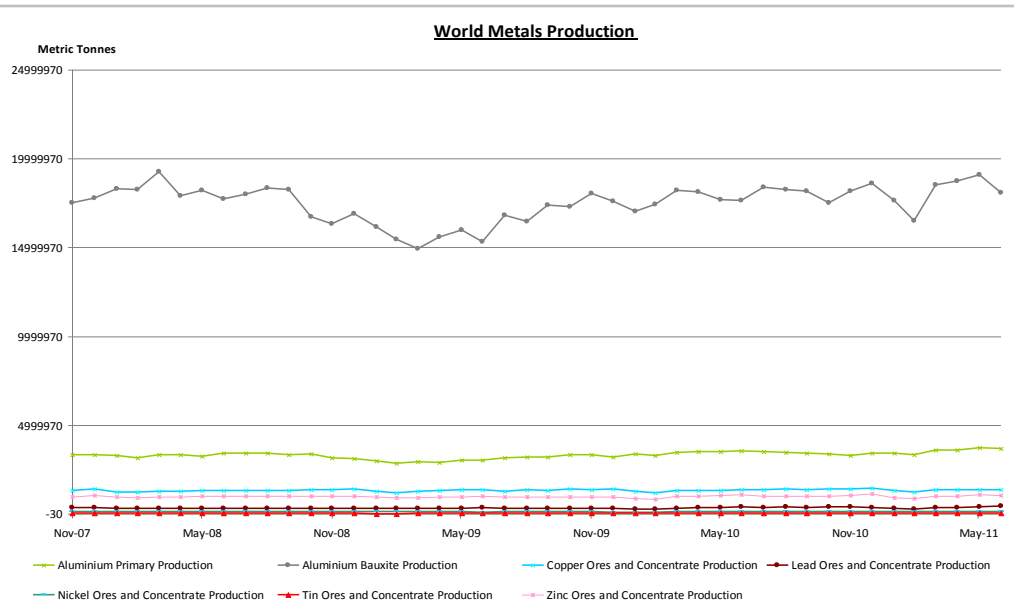
Source: Bloomberg, as of 22 Aug 2011

Supply Relatively Constant

On the supply side, base metal production has been relatively constant in the past four years as shown in Chart 5. Most metals, with the exception of copper, observed increased production as compared to a year ago. Copper production was disrupted as Codelco and other mining companies in Chile, which supply a third of the world's copper, faced strikes and bad weather in the Atacama Desert. Chilean production of the metal may have been cut by about 8 percent because of the disruptions, Codelco Chief Executive Officer Diego Hernandez said 12 Aug, as reported by Bloomberg. Given relatively constant supply, possible slowdown in global growth and demand for base metals do not point to a positive scenario for base metals. However should the production disruption continues, copper prices may be supported despite decline in growth.



Chart 5: Metals Production Relatively Stable



Metals production have been relatively stable for the past 4 years, pointing to a more stable supply.

Source: Bloomberg, as of 22 Aug 2011

Upside Potential

That being said, upside risks remain for base metals on the condition of improved global economic growth. In the US, Ben Bernanke’s “decision to extend next month’s policy meeting to two days stoked speculation the extra time may allow him to forge a stronger consensus on monetary easing”, according to Bloomberg. Should there be further quantitative easing in the US, possible inflationary pressure and growth could lead to upside for commodities in general.

In addition, while China’s economic and manufacturing growth has slowed, growth remains above 8 percent on a year-on-year basis and is likely to support base metals to a certain extent. Moreover, the decline in growth is mainly led by tightening policy, which is within the control of the China officials should growth decline too drastically.

Conclusion

While positive growth in China should support base metals demand to a certain extent, slowing growth in China due to tightening policies and slowing secondary industry are causes for concern. Coupled with weaker European production and construction, base metal demand may decline if global growth continues to slow. In addition, with a lack of catalyst for base metals, lower investment demand may further aggravate metal prices, prompting us to downgrade our base metal outlook to underweight. That being said, contingent risks to our outlook will be a third round of quantitative easing by US and halt of China tightening, which remain inconclusive at the moment.



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