ABN·AMRO

Industrial Metals Monitor

Cautious tone in metal markets persists

Group Economics

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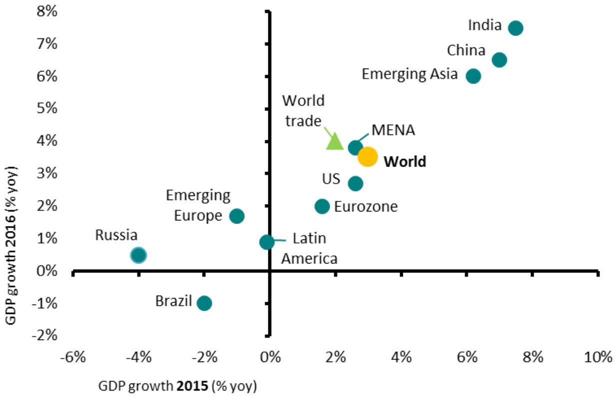
November 2015

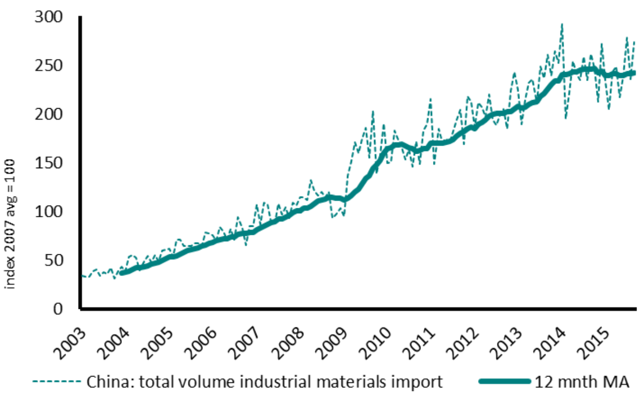
- **Well-supplied ferrous metals and aluminium markets are keeping prices low**
- **Metals demand from construction, automotive and manufacturing sectors still moderate**
- **China demand worries, overcapacity, US dollar and Fed rate hike will determine price direction**

Figure 1: GDP growth per region (% yoy)



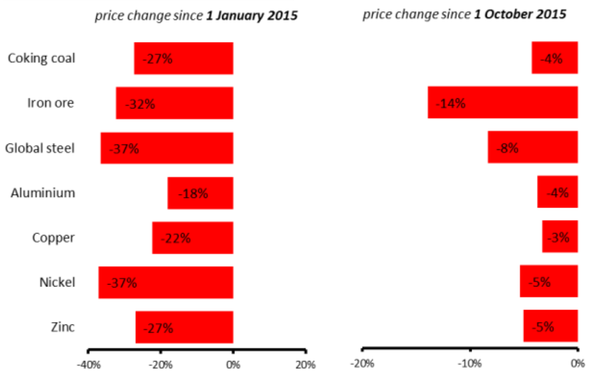
Source: ABN AMRO Group Economics

Figure 2: China total industrial materials import



Source: Thomson Reuters Datastream, ABN AMRO

Figure 3: Industrial metals price performance



Source: Thomson Reuters Datastream

Decoupling BRIC

Weakness in manufacturing output, moderate construction activity and ongoing relatively low auto sales volumes have shifted economic growth in many regions into a lower gear. The bright spot, however, is consumer spending, which is holding up well in many economies. Growth in emerging Asia is still resilient, despite the increased macro-economic and financial risks. India's economic growth is expected to outperform China's economy in 2015 and 2016, thanks to the fast-growing services sector. In China, the slowdown remains gradual. Weakness in China is concentrated in manufacturing and construction, while services are doing much better. At the other end of the growth spectrum, we have Russia and Brazil with a negative growth outlook. Both countries are in recession and their prospects remain challenging. In Russia, there are signs that the economy is bottoming out, based on a consumer and investment growth revival. In Brazil, on the other hand, the recession is expected to intensify further next year.

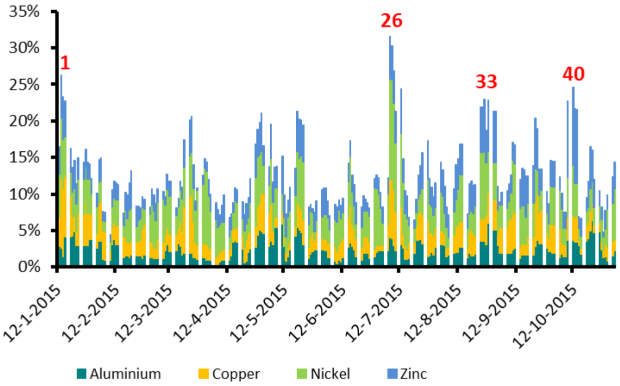
Little sign of cooling in import trend in industrial materials

Over the coming years, China's structural economic slowdown is expected to continue at a gradual pace, as the economic transition goes hand-in-hand with relatively lower growth rates. At this gradual slowdown, manufacturing activity will bear the brunt and industrial materials demand will soften alongside. From the perspective of total industrial imports until September, however, the cooling macro-economic trend has not fully kicked in yet. In fact, the trend in industrial metals imports actually suggests that it has been business as usual over the past couple of years. However, starting from Q4 2014, imported volumes of industrial materials have flattened and decreased by 1% yoy until September 2015. This year, imports of copper ore, bauxite and nickel products have so far held up well, showing strong growth rates. Imports of iron ore into China, the biggest imported bulk commodity in terms of volume, have stabilised until September, even under mounting pressures from the steel sector, with weak demand and a grim outlook going forward.

Ferrous related metal prices strongly down

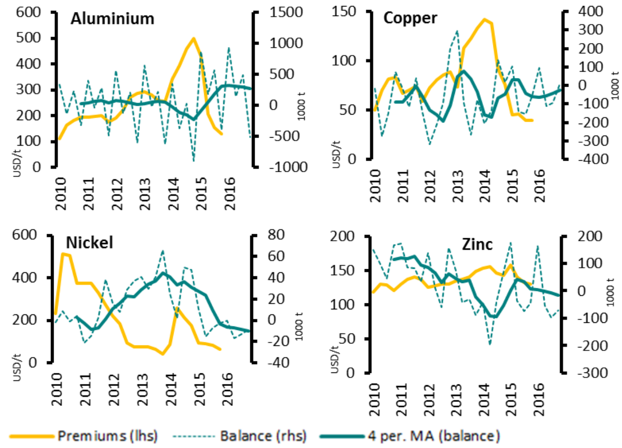
All prices for industrial metals have taken a beating since the start of 2015. But conditions in the ferrous markets are most challenging. Global steel, iron ore and coking coal have fallen strongly. The nickel price also saw a major drop. Nickel is mostly used in the stainless steel sector, were demand have also been rather weak year-to-date. The distress in industrial metal prices can be traced back to five key issues in 2015: 1) overcapacity (ferrous markets, aluminium), 2) China growth and demand worries, 3) the strong US dollar, 4) weak end user demand, and 5) the Fed rate hike. China, which is a heavy industrial metals user, is the main cause of industrial metals prices distress this year. Since the start of Q4 2015, the price of ferrous metals managed to decrease further and prices for base metals have stayed weak also. Well-supplied ferrous metal and aluminium markets are keeping prices low. These markets are in need of significant production cutbacks, which should bring back more market balance and lift prices. But for now, all eyes are on macro-economics.

Figure 4: Base metal volatility in 2015 (%)



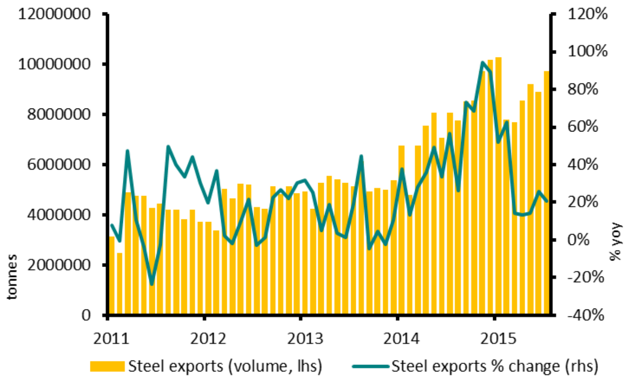
Source: Thomson Reuters Datastream, ABN AMRO

Figure 5: Base metals premiums EU



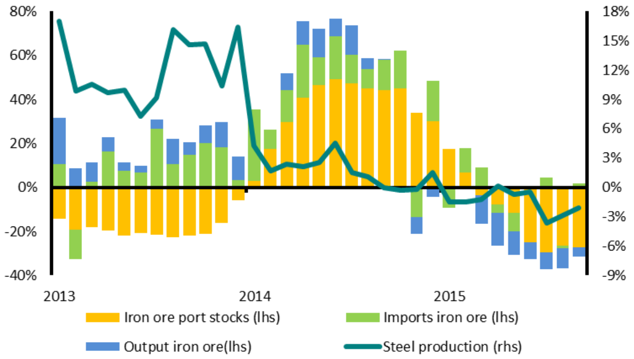
Source: Metal Bulletin

Figure 6: Steel exports China (volume, % yoy)



Source: Thomson Reuters Datastream

Figure 7: China iron ore and steel output (% yoy)



Source: IISI, Thomson Reuters Datastream

Volatility peaks in base metals mainly due to China

In base metals, the average price volatility until November has increased relative to the average level for 2014. This year, we have so far seen several peaks in base metals price volatility, as shown by the week numbers in figure 4. In week 1, prices suffered from a stronger dollar and poor macro sentiment, especially as worries over Chinese demand mounted. The next volatility peak came in week 26, when the China stock market plummeted and concerns over Greece increased. And in week 33, positive data from the US and monetary easing by the PBoC lifted both sentiment and prices. But the gains dissipated again in week 40, when manufacturing PMI in China dropped to a six-year low and import data were disappointing. Over the last few weeks, volatility has seen new increases in the wake of liquidity injections. In China, demand worries and import data from China, but also on supply cuts and dollar movements play their part. These themes will continue to dictate sentiment and volatility in base metals markets.

Market balance main driver for premiums

In general, premiums tend to increase when markets are tight; they decrease when markets are oversupplied. In 2014, aluminium premiums reached a peak and producers were able to continue to operate, even in the low-price environment. Owing to complaining US end users and changing LME warehousing rules, premiums fell to 2010 levels again. Premiums for direct delivery in Europe dropped strongly in 2015. Since the start of 2015, EU premiums for aluminium have shown the steeper fall of all base metals. Aluminium premiums went from USD 490/t on 1 January to USD 145/t late October, a 70% decline. But the EU premiums for copper, nickel and zinc also fell sharply in the same period, by 38%, 36% and 12% respectively. The main drivers for premiums will remain supply and demand balance going forward, but costs of freight, rental, withdrawal and trading are contributing factors as well. We think that, given the oversupplied aluminium market, premiums will maintain their relatively low levels well into 2016.

Chinese steel export up strongly

All major steel producing regions saw prices decline due to weak global steel demand and oversupplied markets. Chinese excess steel was pushed into internal markets and put further pressure on market conditions. So far this year, steel exports from China have been up by 27% yoy. Prices in Latin America have seen the sharpest drop since the start of 2015 (by 45%), closely followed by China (by 42%). In China, US and Japan (jointly representing 62% of total steel production), output decreased for the ninth consecutive month in 2015. In a way this should be good news for a sector burdened by overcapacity, but unfortunately the pace in global steel output decline is not significant enough for a balanced market at this point. Therefore, the steel sector outlook remains grim. Demand from construction, automotive and the manufacturing sectors remains subdued, with moderate activity growth rates. For many steel mills, the current market conditions are very challenging and an increasing number of mills are in the red.

Have stocks run their course?

Owing to the steep drop in steel production growth early 2014, volumes of iron ore stocks in China were able to build up. Domestic iron ore availability was plentiful, but inventories started to drain early 2015. Until October this year, total imported volumes of iron ore remained fairly stable compared to 2014. And while Chinese iron ore output until September dropped strongly (by 9.5% yoy), iron ore stocks at Chinese ports have fallen by 17% since January. At the same time, Chinese steel output until September decreased also, but at a far lower pace (by only 1.5% yoy). Chances are that this, combined with the traditionally strong Q4 and Q1 2016, could result in some fresh buying activity. But given the grim steel sector outlook, we do not expect many mills to be eager to purchase too much steel raw material. Therefore, the pace of growth in buying will remain relatively low at first.

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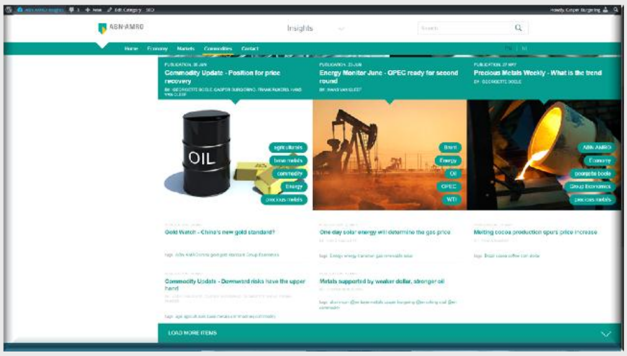

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Last editing of this publication on 11 November 2015.