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Viewpoint > From-the-capital

China restructuring dictates iron ore outlook

A positive outlook for iron ore prices depends on Chinese policymakers jettisoning longer-term economic objectives in favour of shoring up investment spend.

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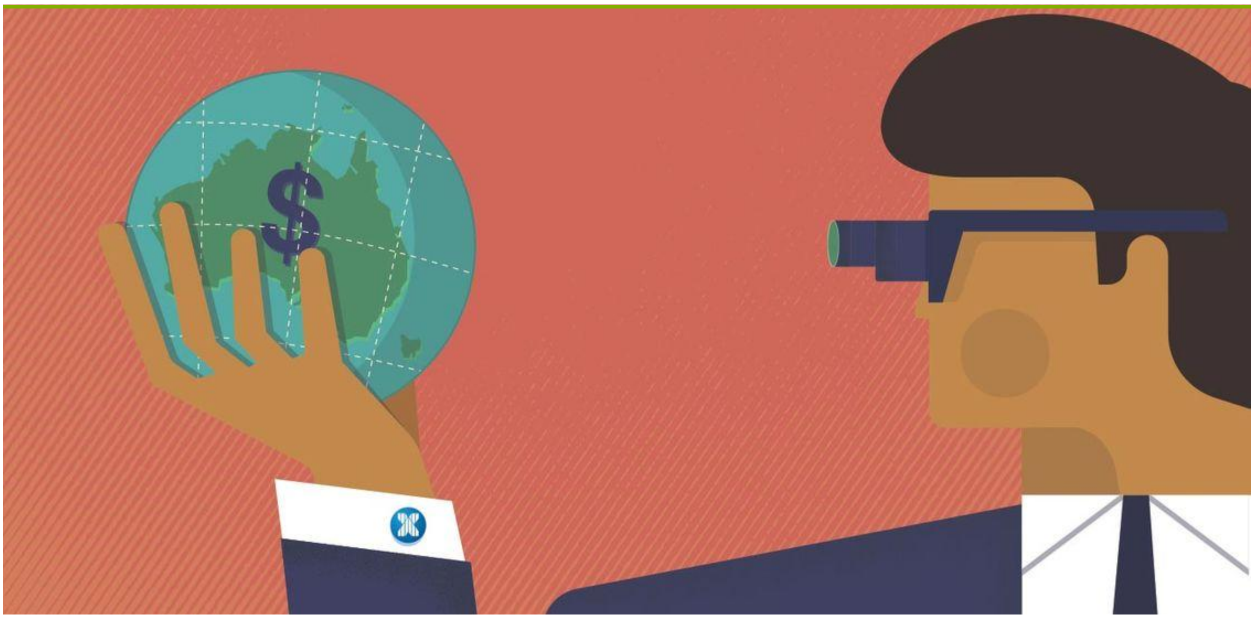

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Iron ore prices rose nearly 80% through the first half of 2019, helping the S&P/ASX 200 resources share-price index to one of its three largest six-monthly gains since 2009, before markets took back two-thirds of the original metal price appreciation.

Fluctuations in iron ore prices have investment effects well beyond their direct earnings impact. A US$50 per tonne movement in the realised price of iron ore, if sustained, would add approximately $12 billion to the annual operating profit of BHP and put an extra $11 billion in the coffers of Rio Tinto each year.

Iron ore prices also have a disproportionately large impact on sector sentiment through the heavy weighting of the world's largest iron ore producers in headline investment indices.

BHP and Rio Tinto have a 25% weighting in the EMIX Global Mining Index; those two plus Vale account for 31%. The S&P/ASX 200 resources benchmark gives the two ASX-listed companies a 38% weighting. Fortescue Metals Group, the third Australian iron ore producer, accounts for another 7%.

A sustained $50/t rise in the iron ore price could easily add 40-45% to the market capitalisation of the S&P/ASX 200 resources index.

China's steel industry plays an outsized role not simply in the cash flow movements of the mining majors but also in the measured performance of the sector overall, institutional flows of capital into the sector, and potentially how much funding is available to companies without any iron ore exposure.

The turnaround in iron ore prices during 2019 surprised forecasters. In mid 2018, the average price forecasts for iron ore over the following three years were $60-65/t, according to S&P Global Market Intelligence (S&P).

A dam wall failure in Brazil six months later cut exports and growth of 9-10% in reported Chinese steel production in the early months of 2019, leaving forecasters scurrying to reappraise the outlook.

> **“ Economists had been warning for years that high rates of investment spending were unsustainable**

Most forecasters see the changed market balance as unsustainable. Average price forecasts drift back to 2018 levels over the coming few years. Iron ore is the only one of the principal mining commodities with a forecast price expected to be lower in 2023 than in mid 2019, according to S&P.

The average encompasses a wide dispersion in forecasts, as Mining Journal reported on September 4. Much of the disparity in views comes down to a reading of the state of the Chinese economy.

China's high savings rate and propensity to invest has underpinned the iron ore market. I wrote in these pages as long ago as November 28, 2012, that the state of the iron ore market for the remainder of the decade will hang on Chinese government investment decisions.

I said then that 2016 steel production could end up as little as 5% higher than in 2012 and potentially drop lower in the following years as the capital intensity of the Chinese economy fell, consistent with government policy, and GDP growth rates moved toward 5-6% nearer 2020.

Back in 2012, my modelling also suggested that steel production could be as much as 50% higher in 2020 than in 2012 if policymakers did not follow through in their plans to restructure the economy.

As it happened, China upped its investment spending in 2013 by 11%. Steel production grew by 12% but did not significantly surpass the resulting output levels until 2018 as the investment intensity of Chinese output edged lower, consistent with my modelling.

Since then, Chinese policy has backtracked from the commitment to become less investment dependent and more domestically focussed and consumer oriented. Investment intensity has risen.

Unsurprisingly, against this background, steel production in the first seven months of 2019 was 36% higher than in the corresponding period of 2012.

Looking ahead, Beijing's macro choices will again dominate the outcomes. Managing the pace of restructuring so that capital intensity returns to pre-2008 levels by 2022 suggests ongoing steel production growth of 3-4% a year.

A fuller embrace of economic restructuring raises the prospect of lowered steel production. Investment intensity levels around those which had prevailed in the early 2000s would imply steel output little different or slightly lower than current rates of production.

From an iron ore perspective, the choice falls between a more-or-less balanced market and one in significant and growing oversupply.

In 2012, the risks to forecasts of steel production and iron ore demand were on the upside as Chinese policymakers, enjoying more flexibility than they have today, proved reluctant to cast off old habits in pursuit of their growth objectives.

The risks today are on the downside. Economists had been warning for years that high rates of investment spending were unsustainable with potentially catastrophic outcomes for the financial system, if pushed too far. The freedom to sustain historically high rates of capital spending has been reduced.

Some will point to the one belt one road investment initiatives of President Xi as potential offsets to a decline in the domestic investment intensity of the Chinese economy. However big, the belt and road numbers are not big enough to compensate.

Belt and road projects with a value of as much as $1.5 trillion dollars are supposedly on the drawing board. The project list might grow but, at best, completion will be spread over a decade or more. Meanwhile, China's spend on fixed capital formation will have reached $50 trillion over 10 years at the pace of spending estimated by the International Monetary Fund for 2018, without making any allowance for recent annual growth of around $300 billion.

China's evolution toward having a sustainable economic structure remains an important economic goal with globally important benefits. Ironically, the most favourable outlook for iron ore producers comes from China maintaining second best policy settings at risk of destabilising its longer-term growth potential.

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