BNY MELLON
iFlow
MACRO MORNING BRIEFING

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China's Role In Commodity Price Surge Limited

China's reflation focus unlikely to raise marginal raw input demand

- Fixed-asset investment levels well below during previous commodity super-cycle
- Energy product imports clearly soft and not contributing to current price gains
- Surge in steel exports also points to capacity issues

Manufacturing and light household stimulus is not inflationary

The rebound of nominal and dollar real yields in recent weeks has not materially damaged global risk sentiment. While in equities there may be a structural case for re-rating, price action in many other asset classes is being viewed as a symptom of financial conditions remaining too loose. This is very much apparent in commodity markets and other alternatives such as cryptocurrencies, where the impact of dollar real rates is particularly acute. Last week we highlighted the key features behind The Commodities Super Squeeze Of 2024 but advise caution when it comes to assigning attribution for the moves.

Evidently, changes in expectations for the Federal Reserve's policy path will remain a dominant driver for energy, industrial commodities and other raw inputs. However, by definition, some commodities incur an extremely high cost of carry such that even current levels of financial conditions cannot justify recent price action. For energy prices, geopolitical risk is a clear driver. Yet, in other commodities with an industrial or general demand lean, such as copper, silver and platinum, price gains have been similarly notable.

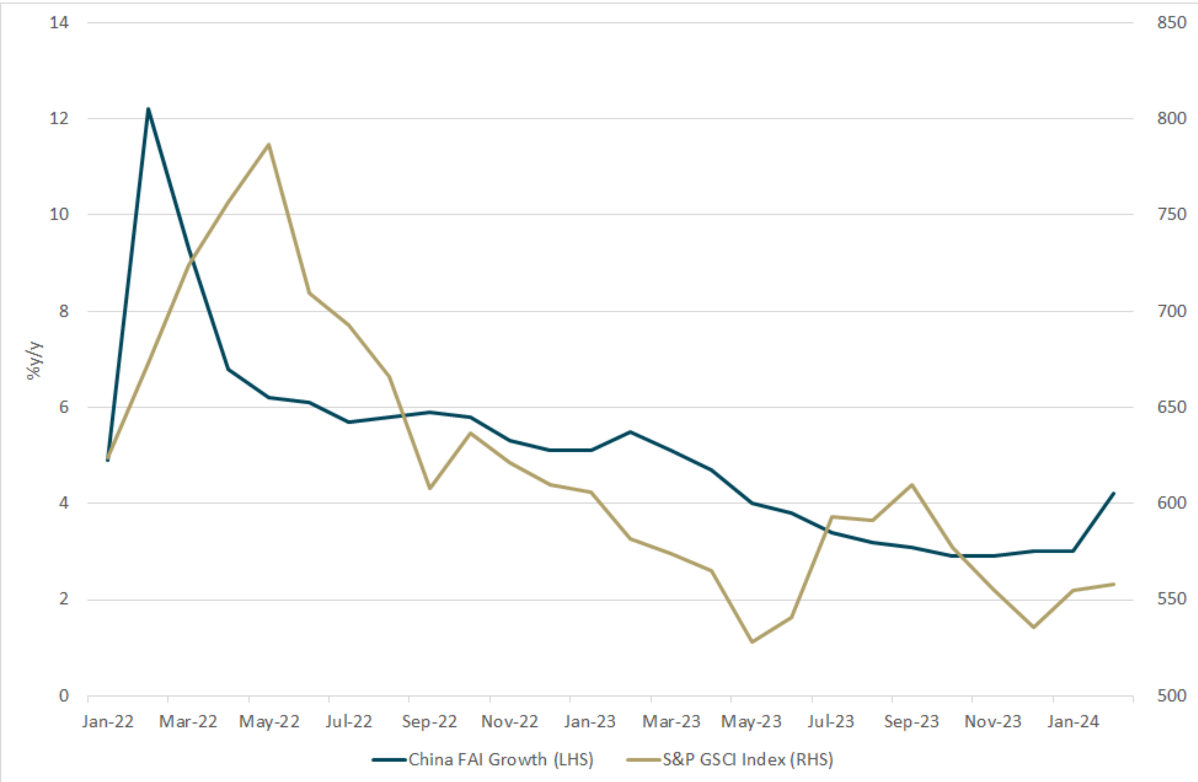
Consequently, the market could be tentatively pricing in reflation. The US is providing a growth narrative, but as the world's biggest source of marginal demand for commodities, China's impact cannot be ignored. Undoubtedly, Beijing is targeting reflation through monetary and fiscal stimulus, but we remain wary of how much growth impulse will be channelled through commodity demand to sustain current price trends.

Historically, China's commodity demand has been closely tied to credit impulse. Based on total social financing numbers reported last Friday, credit demand fell 15% y/y in Q1 – not a surprise in a deleveraging economy. We believe the market is now of the view that additional downside risk in China's growth is very limited. Asset allocation reflects this: we have highlighted in iFlow that positioning across all asset classes is extremely light in the wake of February's equity-led outflows. As such, the risk seems to the upside, depending on the design of policy stimulus. At a high level, the risk is that markets continue to expect China to push through investment-based growth despite all the evidence to the contrary.

While infrastructure and urban upgrades will always comprise part of China's annual growth strategy, the manufacturing and export focus is clearly seen as the new priority. Furthermore, in recent days Beijing has been rolling out details on its consumer trade-in programme, calling for increases in recycle rates of consumer goods and pledging subsidies for battery-electric vehicles (BEVs), also called new-energy vehicles (NEVs) in China. It is quite telling that lithium is not one of the industrial commodities gaining in price of late.

We highlight that at current levels of credit growth (or lack of), it is unlikely that fixed-asset investment (FAI) will rebound. The long-term link between China's FAI growth and global commodities (exhibit #1) remains intact, so on this factor alone we would be very cautious in anticipating any reflation-based gains for commodities based on China's stimulus. Simply put, the numbers realised and put forward by Beijing are, for now, simply not large enough.

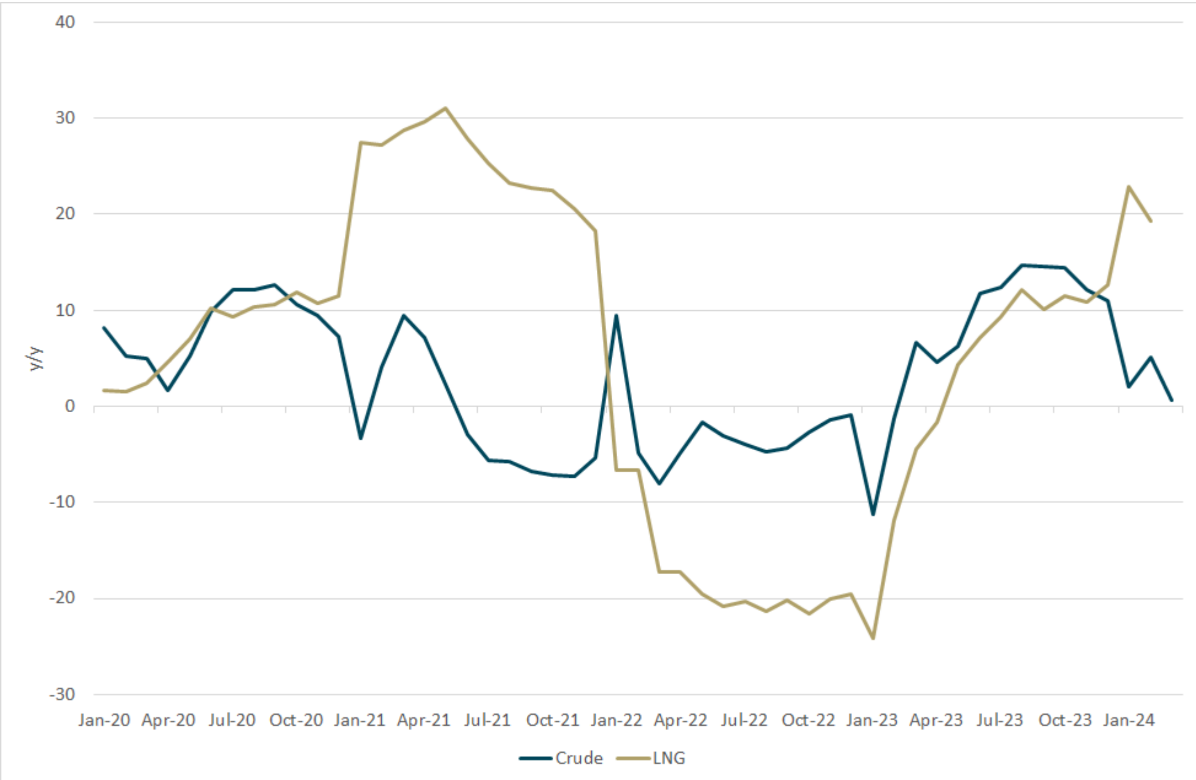
Exhibit #1: China FAI Growth vs. S&P GSCI



Source: Bloomberg, BNY Mellon

While China's growth structures are changing, energy demand is a good barometer for reflation. Similar to in industrial commodities, China is no longer the swing buyer of energy products in global markets compared to periods of stronger growth. Natural gas, petroleum and other liquids only accounted for 27% of China's primary energy consumption in 2021 (US Energy Information Administration 2023 update). Based on the latest China customs data (March 2024), crude volume imports are barely growing. This is in part due to the base effect from a strong reopening-based restocking round last year, but still speaks volumes about overall demand. Liquified natural gas imports, on the other hand, continue to grow strongly due to imports from Russia, but circumstances dictate that such purchases are highly unlikely to be inflationary for China's input prices, and would also have very little bearing on global prices (based on generic 1st futures prices) – which have recovered from recent lows but remain down around 50% from 2023 highs, even more vs. 2022 extremes.

Exhibit #2: China Energy Import Volumes



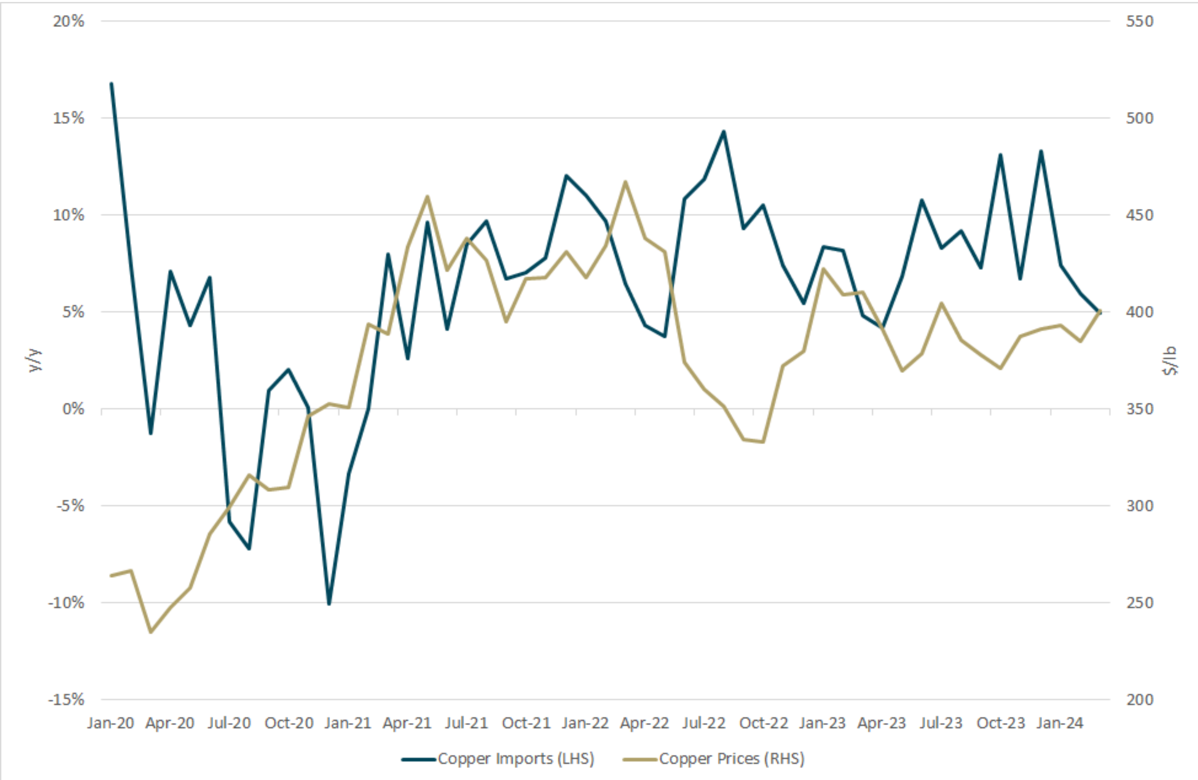
Source: Bloomberg, BNY Mellon

We have previously expressed scepticism over the state of the carry trade due to dollar strength and easing cycles prevailing across Latin America. The Chilean peso is notable with rates having fallen by nearly 500bp since the first cut in July last year. Based on the country's sequential inflation prints year-to-date (running at just above 7% y/y), real rates are already negative. However, CLP is the best-bought LatAm currency in iFlow over the past month. As noted above, this certainly seems not due to BEV demand from China, as lithium prices have collapsed in recent quarters and global demand is also softening.

However, we note that copper prices have started to surge, which we attribute to renewed demand arising in industries such as Green technology and microchips – areas where China is undoubtedly seeking to strengthen its market position. Last week it was reported that Beijing asked telecom companies to replace foreign microchips in their systems within three years. Coupled with stable (rather than contracting) FAI growth, there is a case for normalisation in copper import volumes, which is very much in place (exhibit #3). Even so, China demand alone appears insufficient to sustain copper, or even its proxies such as CLP, as marginal demand is now far weaker compared to the country's prior growth cycles.

As is evident in exhibit #3, we can see that in mid-2022 there was a sharp fall in prices even as imports increased – and this was during the height of a global input/supply shock. China's COVID policies were entering a more restrictive phase at that point, so the market was clearly worried about an inventory buildup depressing future prices. We would closely watch China's incoming inventory figures for key raw inputs to gauge whether reflation is being realised on the ground. Already, there is a risk to copper: it has been reported that "holdings of copper inventories in warehouses monitored by the Shanghai Futures Exchange expanded by 2.7% last week – the highest since April 2020."

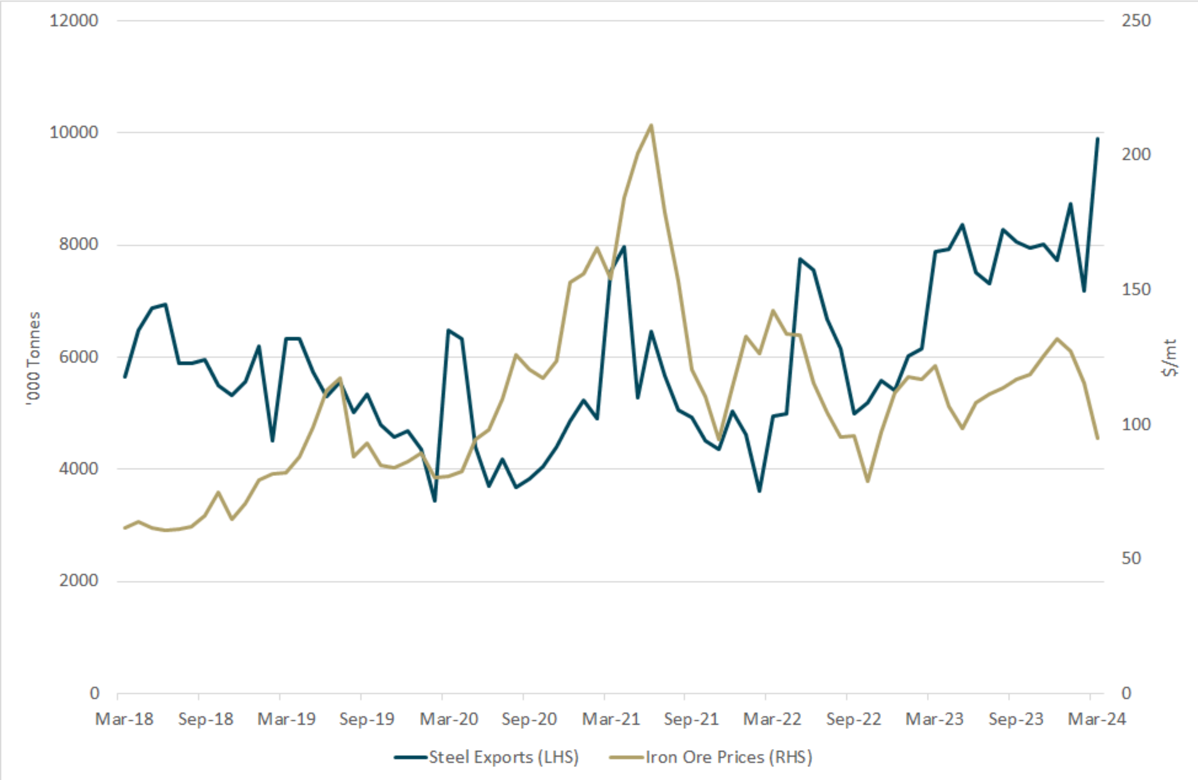
Exhibit #3: China Copper Import Volume Change vs. Prices



Source: Bloomberg, BNY Mellon

Even if Chinese demand (expected or realised) is generating more favourable terms of trade for certain commodity producers via raw export prices, we would be cautious of a disinflationary sting in the tail – though admittedly this is not exactly unwelcome globally, depending on the finished good. "Chinese overcapacity" is a major macro theme at present, largely focused on manufactured finished goods. However, the latest data show that exports of Chinese steel products have also reached a record high, with very limited price impact on iron ore prices (exhibit #4). Final demand for steel products is rarely household- or consumer-based, and the global value-add at present is most likely in labour. Even so, the potential price impact of China's capacity prowess should not be dismissed.

Exhibit #4: China Steel Product Exports vs. Iron Ore Prices



Source: Bloomberg, BNY Mellon

Even if China moves towards reflation, unless its implementation is totally household-focused, the experience of the past 15 months doesn't support the notion that there will be a material inflation impact globally. As highlighted last week, the current run-up in commodity prices is certainly a headache for global central bankers, but the factors behind the moves are complex and do not indicate a new round of demand expansion, at least not yet.

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