FINANCIAL MARKETS

FLASH

4 JULY 2022

METALS MARKETS

What trend will prevail amidst the uncoupling between China and the West?

Follow us!

Marion BALESTIER
Commodities manager
OFI ASSET MANAGEMENT

Benjamin LOUVET
Commodities manager
OFI ASSET MANAGEMENT

Two economic hubs, two cycles. In Europe, the United States and many emerging markets, inflation has accelerated spectacularly over the past few months. Central banks have suddenly shifted gears and, accordingly, an economic slowdown is looming ahead. Whether it is slight or severe is not yet clear. Meanwhile, China is reopening after a serious of drastic lockdowns that ran counter to the trend in Western economies.

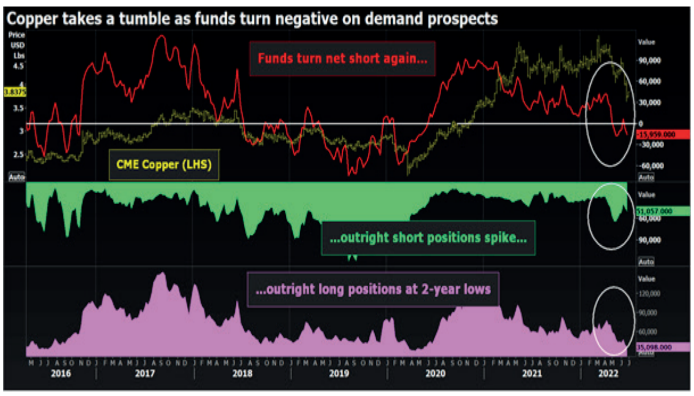
Equity markets have taken note of this recent divergence. Since the end of April, the Shanghai Composite and Hong Kong Stock Exchange are up by almost 15%, while the S&P 500 is down by 10% over the same period. Metals appear to have chosen sides – they have fallen sharply over the past two months, tracking the forecasts of slowdown or recession that are being priced in on Western markets.

In most of the world, the trend is towards a weakening in economic activity **amidst heavy and persistent inflation** and the unleashing of a **tough monetary tightening cycle.** These two factors are expected to weigh on economic activity. Some sectors have already been hit, such as US real estate, where sales have been hit by a spike in mortgage lending rates. It remains to be seen whether we are at the start of a true recession or a mere slowdown. If it is a recession, is it a "technical" recession or a more stubborn one? These are all issues that currently have the markets on edge

They have also triggered **a severe recent correction on commodities markets.** Most metals are down sharply, including copper, zinc, palladium, aluminium and nickel by more than 20% since mid-April, thus erasing a large part of their gains from the past two years.

Market positioning also reflects this highly negative sentiment on the metals markets. Long positions have been rolled back drastically and are at a two-year low, while short positions are up sharply, a sign that hedging strategies are being set up on a bearish market.

A HIGHLY DEFENSIVE STANCE ON COPPER

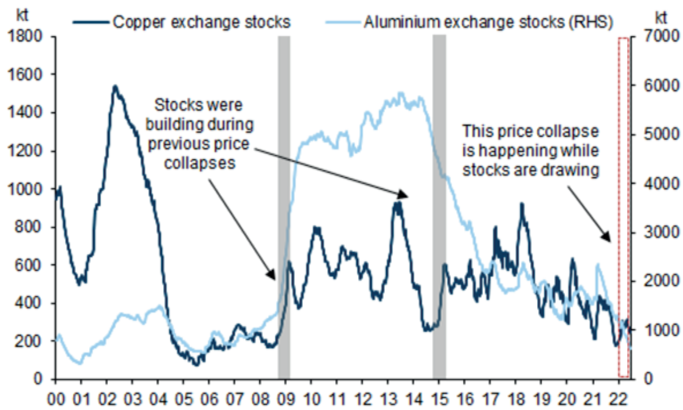


Source: Bloomberg, datas as of June 2022

Obviously, a sustained recession would mean weaker demand for commodities. But the global economy does not seem to be at that point yet, with end-demand having merely slowed after a robust recovery. As things currently stand, the steep drop in metals may be driven more by financial constraints, including hedging of a recession scenario or a need to raise cash as asset prices all decline in tandem.

Indeed, **fundamentals on the metals markets and supply/demand equilibria do not seem to have changed much.** The forward curve structure, for example, continues to show tight demand in most metals; inventories are at all-time lows on many markets and are showing no sign of rebounding.

A CORRECTION EVEN AS INVENTORIES CONTINUE TO SHRINK: THE EXAMPLES OF ALUMINIUM AND COPPER



Source: Goldman Sachs, datas as of June 2022

So, is it possible the market has gone too fast, too far in its recent correction for technical reasons or, rather, out of pessimism on future economic conditions?

The former is certainly possible, especially as China begins to reopen. China's cycle has become completely decoupled from the rest of the world. It was hit first by the Covid epidemic and lockdowns, as early as the end of 2019, before restarting more quickly than Western countries beginning in mid-2020. However, vaccination rates are too low, and the government has taken a tough line in combatting the virus, in order to head off a repetition of the 2020 scenario of unremitting waves of contagions and severe cases and packed hospitals. This is why the resurgence of the epidemic in early 2022 and the government's "zero-Covid" policy caused the country to shut down again in drastic lockdown conditions. Economic activity came to a sudden halt, with cities almost paralysed, factories closed, and travel banned. At the peak of the lockdowns, almost 70% of Chinese GDP was affected.

After two months of economic paralysis and tough restrictions on the population, the government appears, at least for the moment, to have brought the epidemic under control, with just 117 Covid cases detected in the past seven days, the lowest number since early February.

The authorities have therefore decided to phase out most of the measures it took during the spring. Since late May, economic activity has slowly recovered, and the government seems to be aware of the need to restart the economy before the consequences do too much harm. The lockdowns have nonetheless already made a big dent in growth, and the recovery will have to be guided and supported. The outlook is still uncertain, as the "zero-Covid" policy remains in place, raising the spectre of new shutdowns of the economy, depending on trends in the epidemic.

Two factors, however, could provide some visibility and open the door to a strong recovery:

1 - There are signs of an easing in the "zero-Covid" policy itself. For example, the quarantine for visitors arriving in China has been shortened from 14 to seven days. Mandatory testing frequency has been eased in many cities. The ban has been lifted on domestic travel from cities having reported at least one case. There have even been official criticisms voiced of "excessive" lockdown measures in certain cities. While the authorities do not seem to want to change their overall strategy, they could adjust it to allow the country to function more normally.

2 - The government has served notice of its plan to for strong stimulus measures. Despite the sudden slowdown of this spring, there has been no change to the official growth target for 2022. During a recent speech, Xi Jinping mentioned a 5.5% projection for the year, which was the same figure put out prior to the lockdowns and currently looks unrealistic to economists. The government is making more and more announcements of support both to individuals and to many economic sectors, laying out a stimulus plan that economists are calling the third largest in China's history, after those of 2008 and 2020.

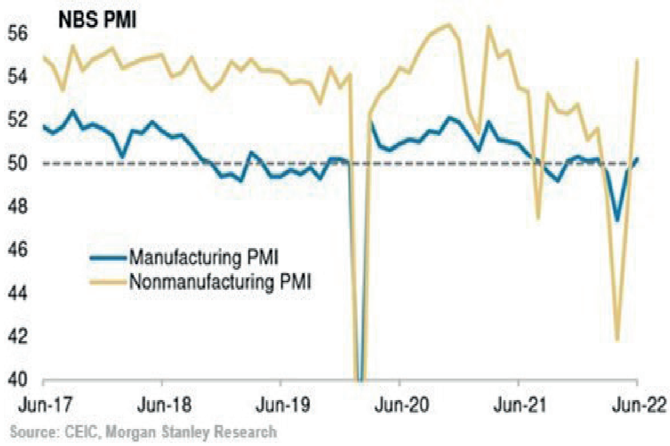
But this time, it won't be in the form of a massive quantitative easing[1] or a steep cut in interest rates, as the PBoC has made clear. China's low rate of inflation is currently an outlier but could catch up with other countries in the event of a robust recovery and as it reopens to the global economy. Moreover, some of the private sector is still in the process of deleveraging. Measures will therefore have to remain targeted.

Indeed, the government will be focusing on sectors that have been weakened or that are deemed strategic to long-term development. These include real estate, infrastructure, and electric vehicles, on which a large number of announcement have been made in recent weeks. One government measure has been to ask public-sector banks to raise a total 800bn yuan (119bn dollars) in credit lines for a series of infrastructure projects.

In the transport sector, there is a clear determination to boost electric car sales. Measures include extending the 10% purchase tax exemption to 2023 and easing registration rules. A total of 200bn yuan in assistance to the sector has been announced. Real estate has also received many assistance measures at the local level, including a boost in lending, purchasing subsidies, and an easing of homeownership terms.

The initial effects of stimulus are being felt. The June Purchasing Managers Index (PMI) rose back above 50 for the first time since March, pointing to an expansion in activity. Within the manufacturing PMIs[2], the production component rose the most, reflecting the ongoing return to normal on production and supply chains. Demand has also improved, with new orders up and inventories down.

PMIS BACK IN EXPANSION TERRITORY IN JUNE



Sources: Morgan Stanley, CEIC, datas as of June 2022

The construction PMI has also taken off, at 56.6, a sign that support measures are helping the sector to recover. And, indeed, real-estate sales are back up, even though the market remains week and depressed. Time will tell whether the sector continues to recovery in the coming months.

[1] *Quantitative Easing: massive purchases of debt securities by a central bank.*
[2] *Manufacturing PMI: index measuring the business activity of Purchasing Managers in the industrial sector.*

RESIDENTIAL REAL-ESTATE SALES IN CHINA'S TOP 30 CITIES: CATCHING UP FAST

Sources: Citigroup, Wind, datas as of June 2022

The auto sector is also looking better. From 1 to 26 June, 1.4 passenger cars were sold in China, up 27% from one year earlier. Electric vehicles sales were especially strong. The China Passenger Car Association expects sales to exceed 500,000 units in June, a new record.

So, the recovery looks to be on track in China, pending a continuation of these encouraging signs. The epidemic is currently under control but could take off again and, although the government probably wants to avoid a new shutdown in the economy, it will probably put in new restrictions. Meanwhile, confidence indices are still at historically low levels, as individuals are still being constrained by lockdowns and are lacking visibility on the line that the authorities will take in their healthcare strategy.

This rebound in economic activity is nonetheless encouraging for metals demand, especially as the sectors targeted by the stimulus plan are among the most consumer-oriented, and as China continues to account for 50% of global demand. To take one example: China has historically always been a net importer of zinc but has become a net exporter in recent months due to the very steep drop in domestic demand. It is thus sending a portion of its output to the rest of the world and helping to ease tensions on this market. The restarting of China's economy should naturally turn it back into a net importer, thus sucking back up a portion of global supply and exacerbating the imbalance between supply and demand.

So what trend will prevail? So far, the market continues to focus on the slowdown that is beginning in parts of the world and seems to be pricing in a highly pessimistic scenario. And yet, given the uncoupling of the cycle in China, a synchronous slowdown of economies is unlikely. As a result, Chinese stimulus is likely to provide a major reserve of demand for metals on a market that is already suffering an imbalance between supply and demand. Remember that in early 2022, before the latest lockdowns in China, all LME metals were in backwardation, suggesting strong tension on short-term demand. Even so, the ongoing strong uncertainty regarding the health and economic situation in China could stoke short-term volatility on these markets.

The long-term outlook, meanwhile, is still just as clear. Demand for metals needed for the energy transition and decarbonisation of economies is set to boom, particularly with the scaling up of renewable energies and electrified transport. Both of these sectors are heavily subsidised in China… as in the West.

The figures cited deal with past years. Past performances are not a reliable indicator of future performances.

OFI ASSET MANAGEMENT • Portfolio management company • RCS Paris 384 940 342 • Certified under N° GP 92-12
S.A. with a board of directors and share capital of €42,000,000 • APE 6630Z • FR 51384940342