Chinese Demand Bailed Out Base Metals Prices But Is A Property Red Flag Rising?

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It has been roughly six months since the Bloomberg Industrial Metals Sub-index hit a low on March 23. The nearly 30% rebound from the low has essentially fully unwound the 23% free-fall in prices from late-January through March. The sharp 1Q20 sell-off fully met the technical requirements of a bear market for base metals. However, market developments since have bucked the traditional recession playbook. Typically, a recessionary collapse in commodities demand is so extensive that it pushes prices low enough for long enough to breach through cost support levels, eventually triggering a rebalancing response from supply. Though this time around, the swift and impactful deployment of metals-heavy stimulus in China has driven a sharp V-shaped recovery in base metals prices without significant cuts in global production.

So Very China in 2008-09

The COVID-19 crisis has led many governments to massively boost spending, in as little time as possible. For its part, Beijing has released a flurry of stimulus measures to offset the economic shock caused by the pandemic and revive the economy. Among the measures, the government unveiled a fiscal package of nearly RMB 3.6 trillion ($506 billion) and approved RMB 1 trillion of unconventional special treasury bonds, the first issuance of these types of bonds since 2007. It also boosted the borrowing limits of local governments by another RMB 1 trillion by increasing the total issuance of special purpose bonds to RMB 3.75 trillion, another source of infrastructure funding (see Figure 1 on the next page).

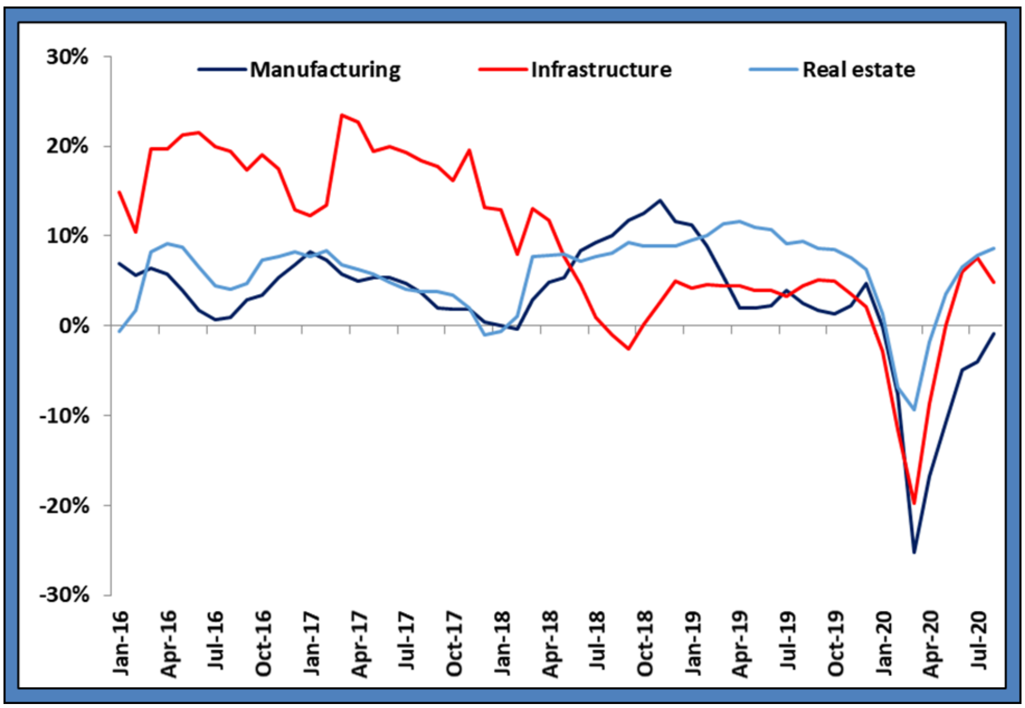
China's fiscal stimulus package is significantly smaller than that of the U.S., which has already approved close to $3 trillion in spending. But unlike the U.S., where the recovery package propped up household incomes (and hence consumption), China's economic performance so far suggests that most of China's policy support has gone to the traditional cyclical drivers of housing and infrastructure – a vital precondition for a cyclical upturn in commodities markets. Although policy support has been conservative in overall size, these sectors are still leading the recovery with August economic activity data showing continued recovery in export, infrastructure, real estate and the auto sector amid a widening recovery in lagging consumer demand (see Figure 2 on the next page).

Figure 1
China's Stimulus Measures

Years	Size of stimulus: Trillion RMB	Size of stimulus: as % of previous year's GDP	Policy focus	Infrastructure investment growth	RRR cuts	Interest rates cuts	TSF growth	Augmented fiscal deficit as % of GDP	Easing in housing regulation?	USD/CNY performance	Base Metals index performance
2008-2009	4.0	11.5%	Infrastructure and real estate	47.2% in 2009	3x, 200bp	5x, 216bp	17.5% in Oct'08 to 35.3% in Jan'10	4.9% in 2008 to 13.7% in 2009	yes	flat	+112%
2012-2013	-	-	Infrastructure	4.3% in 1H12 to 16.7% in 3Q13	3x, 150bp	2x, 56bp	15.7% in May'12 to 21.6% in Apr'13	7.7% in 2013 to 10.6% in 2014	no	~3.0% appreciation	-6.0%
2015-2016	4.0	5.4%	Infrastructure and real estate	17.2% in Dec'15 to 27.3% in Jan'17	5x, 300bp	6x, 165bp	12.3% in May'15 to 16.1% in Apr'16	8.1% in 2Q15 to 11.0% in 2Q16	yes	~12% depreciation	+20%
2018-2019	5.6	5.6%	Consumption through tax cuts	3.8% in 2018 and 2019	6x, 400bp	1x, 5bp	10.3% in 2018 10.7% in 2019	10.5% in 2018 to 11.9% in 2019	no	~7% depreciation over '18 & '19	-16% over '18 & '19
2020 announced to date	8.51	8.6%	Stable employment, protection of market entities, targeted credit support to sectors like SMEs and manufacturing	-0.3%oya ytd in Aug; expect 3.1%oya in full year 2020	1x, 50bp cut in Jan	2x, total 30bp cut in 1Y MLF	13.3%oya ytd; expect 13.5%oya by end-2020	From 11.9% of GDP in 2019 to 15.1% of GDP in 2020	Local support	~2% depreciation ytd	+1% ytd (+25% since end of 1Q20)

Sources: National Bureau of Statistics, J.P. Morgan Commodities Research.

Figure 2
Growth in China Fixed Asset Investment by Type
Percent change, yoy (3mma)

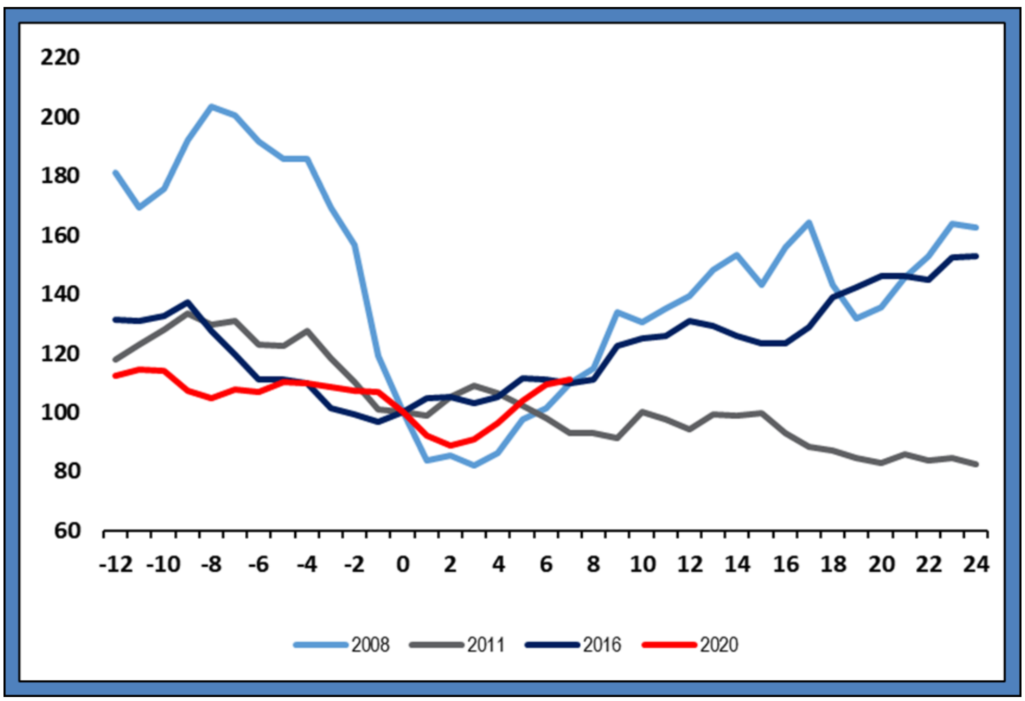


Source: National Bureau of Statistics.

Risk Rising of China's Property Market Overheating

That being said, the latest data out of China also raised a red flag for us: the risk that housing policy support in China could be curtailed amid signs of overheating. China's property market is single-handedly responsible for up to 40% of China's copper demand (if adding supplementary demand sources like home appliances and grid connectors) and 20% of global consumption. As such, the health of the sector is paramount for industrial metals returns. The performance of base metals over three previous episodes of Chinese stimulus (2009, 2012, and 2016) are telling in this regard (see Figure 3). China's reluctance to stimulate the housing market during the 2012 intra-cyclical slowdown was followed by 20% declines in industrial metals prices, one year into the Purchasing Managers' Index (PMI) uplift. During the second intra-cycle rest of 2015-2016, China opted to stimulate the property market. The performance for the industrial metals complex was decisively more impressive, returning 31% one year after the bottom in global manufacturing PMI.

Figure 3
BCOM Industrial Metals Sub-Index Performance 36 months around a Bottoming in China's Manufacturing PMI Index, 100=month of Bottom in Chinese Manufacturing PMI



Source: Bloomberg.

Despite policy rhetoric shifting towards a tightening stance, credit growth accelerated further in August. This is mostly due to local government bond issuances, which more than quadrupled from RMB 272 billion in July to RMB 1.2 trillion in August, ahead of the end-October deadline. With China's recovery solidly on track, local governments have been ordered to stop issuing special-purpose bonds by October 31, with the likely outcome being strong issuances in September and October, but lower levels in the last two months of the year.

In a change of pattern, the funding seems to now be shifting more heavily into the property sector rather than infrastructure. Infrastructure investment growth slowed, decelerating to 7.1% yoy in August, down from 7.7% in July, while property investment stepped up further, rising 11.8% in August, up from July's 11.7%. The frothy state of the market is reflected in property sales but also in housing and land prices. Total property sales volumes rose 14.7% yoy in August, well above the pace averaged before the pandemic broke out. After a small dip in July, the 70-city new housing price index accelerated to a 7.4% mom annualized rate in August, the fastest pace in 12 months.

Surging land prices are of particular concern for the government as they might signal speculative overbuilding by developers similar to the period in 2014-15 that created a massive inventory overhang and took a year and a half to normalize. Land price inflation also usually tends to translate into further acceleration in housing prices. According to Gavekal Dragonomics, the purchase price in land auctions has averaged 15-20% above the starting price in recent weeks – a premium close to levels reached in 2019, which prompted government intervention. We have already observed policy tightening at a local level over the recent months. Already in July, the Hangzhou and Ningbo governments scaled back their local property supports to contain speculation and a few other cities are gradually phasing out their incentive schemes. Moreover, a broader recovery in China's consumer goods and services in August will likely allow policymakers more leeway in cracking down on property speculation without jeopardizing China's wider economic recovery. So while property investment remains strong for now, too much of a good thing can have future consequences and we will be closely watching property policy in the coming months given the potential drag it could add to the base metals sector.

Despite these early red flags rising in the property sector, we expect Chinese metals demand to remain strong until China's credit cycle peaks, somewhere in 3Q21. Coupled with the cyclical post-recessionary demand recovery in the rest of the world, we expect base metals prices to remain well-supported through 1H2021 on the back of these bullish demand dynamics.

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Ms. Natasha Kaneva, Executive Director at J.P. Morgan, is Head of the Global Commodities Strategy team. In her role she drives and oversees the global commodities research activities, setting the firm's views across energy, base and precious metals and agricultural commodities. The team integrates detailed fundamental commodity analysis with J.P. Morgan's macroeconomic forecasts, linking leading indicators of global economic activity with pricing models.

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