Commodities Corner

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Commodity markets look for hero in China

By Myra P. Saefong, MarketWatch

Reuters

A laborer at a steel mill in Jiayuguan, China.

SAN FRANCISCO (MarketWatch) — Economic stimulus plans announced by China this month have swooped in to provide a sizable lift to copper and iron-ore prices, but they won't be the hero the demand-hungry commodities market is looking for.

In the first week of September, reports said China's top economic planners approved a fresh batch of major infrastructure-investment projects, including those on highways, ports and rail transit — with Nomura economists pegging the value of the projects approved that week at 1 trillion yuan ($159 billion). See: China adds highways to stimulus plan.

"China's latest economic stimulus plan appears to be primarily centered upon projects to improve urban infrastructure," said Sharath Sury, founder of the Sury Initiative for Global Finance & International Risk Management (SIGFIRM) at the

University of California, Santa Cruz.

HGZ2 **3.78**, +0.02, +0.65%

December copper

That focus “bodes well particularly for industrial metals, especially copper,” he said. China’s stimulus plans, along with the European Central Bank’s bond-purchase program and a third round of quantitative easing in the U.S., has driven copper prices up “as investors anticipate its use in ‘global retooling’ projects around the world,” he said.

Since Sept. 6, copper futures (CNS:HGZ2) have climbed around 7% to $3.76 a pound on the Comex division of the New York Mercantile Exchange.

Prices for imported iron ore at 25 major ports in China, meanwhile, also increased in the week ending on Sept. 17, according to a report released by the Xinhua News Agency on Tuesday, which attributed the rise to the investment projects. The price index for 63.5%-grade iron-ore imports rose 15 points to 109 points, from a week earlier.

Together with recent Fed and ECB stimulus measures, China’s initiatives “are certainly adding a tailwind to aggregate demand in general, and production-oriented commodities in particular,” said Sury. See: Fed to launch QE3. See: Draghi unveils ECB bond-buying plan.

But the excitement over the stimulus news may soon wane.

The “speculative bid,” particularly in copper, will “give way as markets digest the actual impact that specific stimulus measures will have,” said Sury.

Sizing up aid

How exactly the stimulus measures in China help its economy will be difficult to gauge.

“Translate open-ended stimulus to mean subsidies from the Chinese central and mostly provincial governments to favored industries,” said Usha Haley, author of the forthcoming book “Subsidies to Chinese Industry” from Oxford University Press, adding that the subsidies include loans that never need to be repaid, free electricity, land and reduced-cost inputs.

China's growth continues to slow

The latest lag in China manufacturing data proves the country's growth is slowing.

“In our research spanning several years of the steel, glass, paper, auto-parts and solar industries, we found that stimulus money often transfers into huge spikes in fixed-asset investment or excess capacity for these favored provincial industries,” she said.

As these industries picked up steam, their reliance on imported commodities picked up as well, lifting global commodity prices amid unplanned shortages in the supply chains, explained Haley, who’s also professor of international business at Massey University in Auckland, New Zealand.

But “because of murky accounting data, we know very little about where these flows of capital go,” she said.

And global economic weakness and slower demand for end products will likely result in “accentuating the existing glut for several products,” she said. “With piling inventories, prices for end products will plummet as will prices for commodities.”

Will it work?

So far, China’s overall economic plan is helping the nation stay on track to meet its growth expectations, but some analysts still suspect that the nation’s economy is headed for a hard landing.

Chinese Premier Wen Jiabao said last week that China will meet its official target for 7.5% growth for 2012 gross domestic product, in line with the nation's long-term average growth forecast as set out in the latest Five-Year Plan for the economy, covering 2011 to 2015. Read: Investing around China's Five-Year Plan.

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Still, "from a fundamental perspective, we are seeing continued signs of deterioration in the Chinese economy," said SIGFIRM's Sury.

"The Chinese trade balance has been declining, corporate profits have turned negative, property starts have fallen significantly, and industrial output growth is slowing," he said. "GDP growth continues to slow."

On a global level, William Gamble, author of "Investing in Emerging Markets: Rules of the Game," said most of the demand for commodities has come from fast-growing economies in emerging markets, especially China — not from "printing money in developed countries."

With China headed for a hard landing, "no amount of QE from the Fed, the ECB, [Bank of Japan], Bank of Korea or even from the Standing Committee of the Politburo [of the Communist Party of China] will change that," said Gamble, who's also president of Emerging Market Strategies.

But for China, Sury pointed out, recent growth "has come less from exports and more from internal stimulus."

That offers somewhat of a dilemma for the commodities market.

"This stimulus is not 'free' — it has to be paid back, one way or another," Sury said, and that "can have a negative long-term impact on consumer credit, corporate investment and the balance of payments."

So while the stimulus will provide a "real boost to demand for commodities ... when this stimulus 'band-aid' runs out, if the consumer has not experienced organic growth, China may very well continue to experience the effects of the hard landing," he said.

Dulling the blow

For now, China's initiatives will probably help, though they might not provide a lasting boost to the nation's economy or to commodities markets.

"The stimulus will reduce, but not eliminate China's present economic deceleration — at the price of constraining future fiscal flexibility," said Philip Romero, a finance professor at the University of Oregon and former chief economist of California.

He emphasized that his opinion is based on an initial assessment of news reports on the measures. "Many of the details of China' s plans have not been explicated, so it is difficult to distinguish real demand from hyped demand."

Still, he expects "the greatest benefit of the Chinese stimulus will be moderating wide price swings."

China's initiatives will "greatly slow the downward trajectory of many industrial commodity prices," Romero said, but probably won't be enough to fully counter "continued retrograde forces in developed economies."

So, "coal prices will continue to fall, unless some development hampers growth in its big substitute, natural gas," he said. See: Romney, Obama coal clash won't help natural gas.

Romero said that iron ore, meanwhile, will be highly dependent on the construction outlook, which he believes will moderate for at least a year,

Reuters

A worker monitors molten iron pouring into a furnace at steel plant in Hefei, China.

though a little less so due to China's announcement.

He's most bullish on copper which, in the past, has been used "pervasively in China's economic expansion."

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