The iron laws and oily rags of the commodity complex

By **Stirling Larkin**

THERE are huge dissimilarities emerging and a possible disconnect between the conversations that Australian ultra-high-net-worth wholesale and retail investors are having on the investment themes of China, iron ore, oil and global energy.

These parallel narratives do not complement each other and the divergent views are grossly out of step with one another.

It has now become imperative for all Australian investors to better inform themselves about how others are approaching the investment challenges of risks versus rewards. As the Norwegian prime ministers Kjell Magne Bondevik said, “Knowledge of other people’s beliefs and ways of thinking must be used to build bridges, not to create conflicts”.

On one side of this debate, when discussing Chinese steel production and Australian iron ore supply, retail-focused commentary in Australia has heavily relied upon the opinions and forecasts provided by the iron ore suppliers. In contrast, UHNW and wholesale commentaries have attempted to gauge the demand by consumers — namely the Chinese steel manufacturers.

It is illogical and self-contradictory to ask in the public domain a supplier where they believe their clients’ demands and price points will be heading. Common sense would suggest that on every occasion these participants would take the opportunity to talk up the demand for their product and say that there was “price elasticity” at all levels of output. This is not to suggest we should not involve suppliers in the conversation, but rather that we should not solely base the conversation on their assertions, as appears is currently practised in Australia.

In our golden age of fast communications, it has become relatively easy for the UHNW investment community to listen to and hold meaningful dialogues with Chinese consumers who do not hasten to share their frank insight into real demand and price expectations. No doubt they, too, talk down demand and price expectations, but what participants on either side of the conversation say should always be taken with a grain of salt.

All being considered — as previously discussed here — China appears to be successfully transitioning from a manufacturing to a consumption-driven economic model, where steel is not required in such large quantities for the foreseeable future.

The irrational viewpoint of the current Australian commentary, which purports that the Chinese must continue to buy our iron ore at high prices when they no longer require as much, shows our narrative has become disconnected, uncommercial and has lost its way.

Under the proposition of globalisation that we sold to them, they are progressing to the next stage of their development.

Under our current thinking, we are now complaining they are no longer buying a product from us that they no longer need, at prices that were always profiteering.

The UHNW wholesale investment community has emphatically rejected this mindset and instead directed their focus on the "price discovery" process that market forces provide. Then, balancing this information with the tilted comments of both the demand (Chinese) and supply (Australia and Brazil) sides, they attempt to extrapolate and forecast where iron ore spot prices will be heading.

During the middle-most phases of China's focus on manufacturing, steel production was ramped up for both infrastructure components and manufactured products. Sino capacity soared from about 100 million tonnes in 1995 to about one billion today.

This denary increase represented a doubling of the global steel output, a sevenfold increase of what Japan, the then largest producer, was galvanising and a tenfold increase compared to the US. However, as China matured and began its transition towards the next phase of its development, which required less steel, the global investor observed that Chinese consumers reduced their demand for imported higher-grade iron ore.

They noted that, even though steel was being purposely over produced in certain provinces of China, and there was stockpiling occurring as pseudo-collateral for credit financing of real estate assets in the daylight and shadow banking markets, that, all being considered, aggregate demand was on the way down. The iron ore spot price, now pushing below the resistance level of $US90 a tonne, is down 34 per cent since December last year.

Also, there is no sign of restocking in the period preceding the Chinese New Year, which is a first in recent years.

Shanghai "rebar" (reinforcing steel used as rods in concrete) prices are at near-record lows while Chinese iron ore port inventories hit record highs, reflecting oversupplied imports and subpar steel production. Coupled with this, as the seaborne supply of iron ore from Australia and Brazil moves towards a structural surplus in coming months, continued pressure will push the spot price towards $US80 a tonne by 2015.

This continued fall is further exasperated by existing project ramp-ups in Australia and Brazil.

Regardless of the supplier's margins and capacity to cut costs from their tier-one assets, the consumers' demand is, without a doubt, declining. However, the global investor takes comfort in the view that this is a good outcome for them as well as for the Chinese. This is because as China's economy progresses, and as their markets open up ever faster to the world, newer and more sophisticated opportunities will present themselves to the astute global investor. Rather than fretting over the "normalisation" of iron ore within the global commodities mix, we should be seeing this transition as a welcome development, as a new, more mature market of more than one billion consumers who now want all the same goods and services that we have been enjoying since the end of World War II.

Equally, this dynamic mindset can be used when facing the alarming geopolitical events currently afoot in Iraq and Syria. Within this mindset, we would recognise that, separating the humanitarian implications of ISIS's coup, their influence over global oil production is marginal at best. This is because their occupied territory in northern Iraq accounts for only 10 per cent of Iraq's oil exports and the rest is still well garrisoned against future attacks. Also, as discussed in our May 31 article, the world's largest consumer, the US, is quickly becoming energy independent — thanks to the shale gas and tight oils revolution.

It is fundamental that all investment conversations involve input from demand and supply participants and that we not only collect all the dots, but also connect them.

Stirling Larkin is chief investment officer of Australian Standfirst
www.australianstandfirst.com