Prices Of Industrial Commodities Rebound On Demand Recovery In China

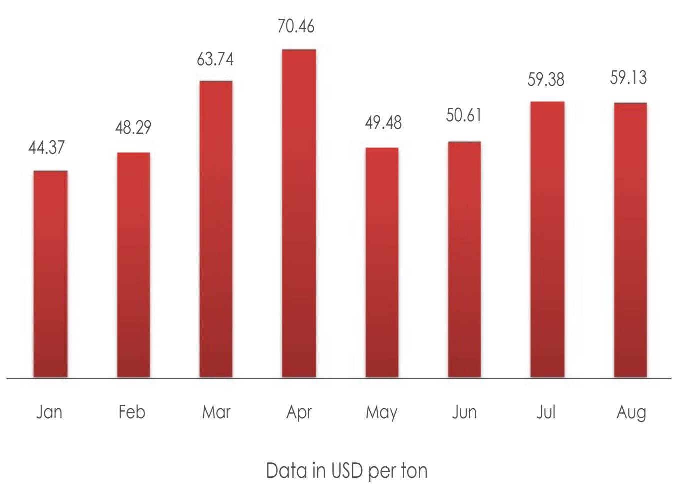
Prices of industrial commodities have seen a sharp rebound from their lows at the beginning of the year, and optimism about further price gains have increased. Spot iron ore prices surged more than 50% from a multi-year low set in January, before correcting during the second quarter. Iron prices have recovered again more recently on increased demand expectations. Similarly, zinc prices have seen a sharp rebound while gold and coal have recovered more than 20% year to date. However, prices of copper have been relatively more subdued. As supplies for many of these commodities are expected to remain strong, further price upside could be limited. Nevertheless, miners that are able to extract further cost efficiencies should be in a better position to limit an earnings decline in the short to medium term.

Industrial commodities have strongly rebounded from the gloom that prevailed at the beginning of this year, when their prices slipped to the lowest in several years. There was no sign of a demand recovery even as supplies from newly opened mines continued to grow. The economies of commodity exporting countries slowed down sharply, and a few tripped into recession. The downturn was seen as a dramatic end to the 'commodity super cycle' that lasted several years and brought substantial riches to the exporters.

KEY TAKEAWAYS

Commodity prices started recovering from March and have continued to advance during the second quarter. Spot iron ore surged to over $70 per ton by April, from around $40 per ton at the start of the year. The price of iron ore retreated in May, before recovering again and is currently trading around $60 per ton.

Iron ore prices have rebounded sharply this year



Data source: Bloomberg

The demand supply trends for the primary industrial commodities indicate that the recent price gains are less sustainable than widely believed. That need not necessarily mean prices could slip back to their January lows, but potential for further upside from the current levels appears limited.

However, belying the pessimism, commodity prices started recovering from March and have continued to advance during the second quarter. Spot iron ore surged to over $70 per ton by April, from around $40 per ton at the start of the year. The price of iron ore retreated in May, before recovering again and is currently trading around $60 per ton. Similarly, zinc soared from $0.7 per lb in January to over $1.0 per lb by August. Gold, another metal that has rebounded, has gained nearly 25% from its lows earlier this year.

Among the other industrial commodities, coal prices were range bound during the first half of the year before rallying nearly 20% since June. The price of copper, however, has only seen a modest gain from the beginning of the year.

Impressive as the price recovery is so far, it is unclear if the uptrend is sustainable. The demand outlook for many of these industrial commodities has not seen any appreciable improvement in recent months. Unexpected demand recovery in China, which imports nearly two-thirds of global iron ore shipments, has boosted prices so far this year. Chinese ore imports have increased nearly 10% during the first eight months of the year, as more construction activity fueled demand for the metal. In the absence of additional fiscal spending by the Chinese government, this demand is likely to wane in the winter months. Elsewhere in the world, public investments in infrastructure have not picked up enough to compensate for any fall in Chinese demand for iron ore.

The more recent rally in coal prices was also partly fueled by the increased Chinese steel production, which uses coking coal as fuel. Here as well, the major drivers of higher prices appear more short term. The Chinese government had last year introduced measures to limit its domestic coal output. Further, domestic Chinese coal production during the first half of this year was also hampered by adverse weather. Higher prices could bring more supplies to the market in China, when demand from steel makers could be slowing, and limit further gains for coal prices.

It is also notable that the price of copper, which has not seen any short-term demand spurt this year, has lagged other industrial metals. Supplies from Latin American sources such as Chile and Peru continue to increase, as they try to make up for low prices through higher output. In addition, global copper inventories remain high relative to the subdued demand. Finally, the Chinese copper market remains oversupplied and domestic producers have increased their overseas shipments so far this year. Unless demand from construction increases substantially in major markets, it is doubtful that copper could see a meaningful price increase in the short to medium term.

These demand supply trends for the primary industrial commodities indicate that the recent price gains are less sustainable than widely believed. That need not necessarily mean prices could slip back to their January lows, but potential for further upside from the current levels appears limited. This period of low prices has already reduced investments in new capacity, and slower output gains could support prices in the long run as global demand improves.

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