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MILLS EYE MARGINS NERVOUSLY

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CAN CHINA STAVE OFF A SUMMER MELTDOWN?

AS CHINA'S STEEL MARKET PEAKS, MILLS ARE CAUGHT BETWEEN RISING RAW MATERIALS PRICES AND FALLING STEEL PRICES. BECAUSE THEY ARE STILL PROFITABLE HOWEVER, THEY ARE STILL PRODUCING AT HIGH RATES. UNLESS PRODUCTION FALLS OR DEMAND IS STRONGER THAN EXPECTED, INVENTORIES WILL INCREASE, PRICES FALL AND EXPORTS BECOME MORE COMPETITIVE.

THE QUESTION NOW IS, WILL DEMAND AND SENTIMENT BE SUFFICIENTLY SUPPORTED IN THE COMING WEEKS TO PREVENT PRICES FALLING TO DANGEROUS LEVELS?

CHINA STEEL INTELLIGENCE

MAY 2019

Can China stave off a summer meltdown?

As China's steel market peaks, mills are caught between rising raw materials prices and falling steel prices. Because they are still profitable however, they are still producing at high rates. Unless production falls or demand is stronger than expected, inventories will increase, prices fall and exports become more competitive.

The Chinese government meanwhile is weighing up its options in the face of the economic slowdown. The context of the trade , pressure on its currency and the prospect of rising inflation is only complicating its decisions.

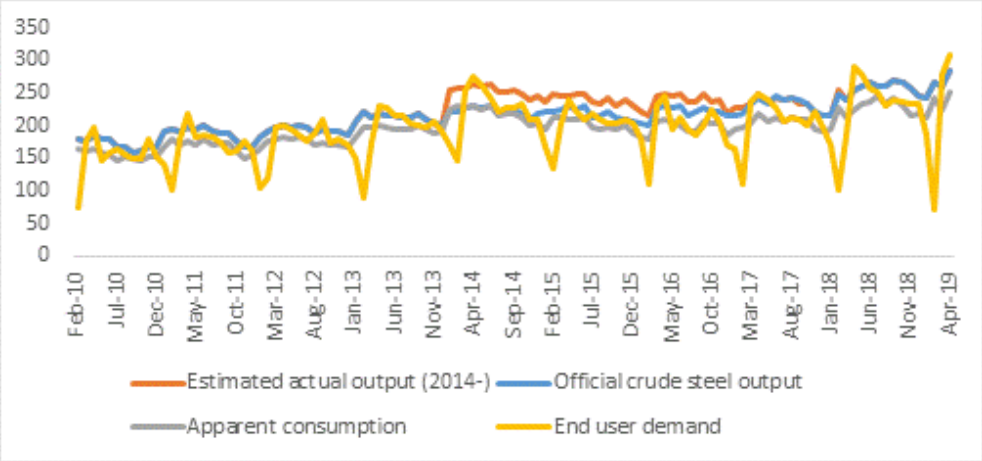
The question now is, will demand and sentiment be sufficiently supported in the coming weeks to prevent prices falling to dangerous levels?

Table 1. Supply and Demand (million tonnes)

	2018	2019 ytd	Y-o-y	2019 outlook	Y-o-y
Official crude steel output	928.3	315	10.10%	947.0	1.30%
Apparent consumption	825.5	279.8	9.87%	844	1.60%
End user demand	827.6	256.3	14.72%	845	1.00%

Source: Kallanish

Figure 1. Daily steel production and demand 2010-2019 (tonnes)



Source: NBS, Kallanish

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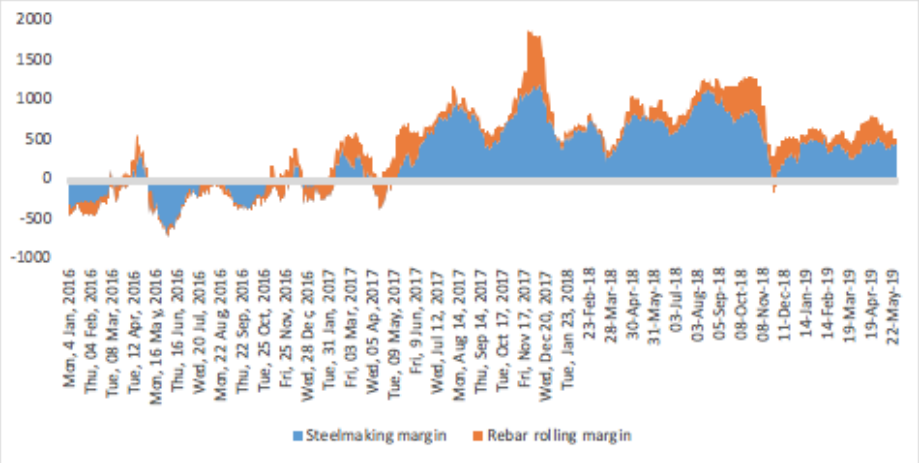
Mills eye margins nervously

Chinese mills have been profitable throughout the year so far but margins have nevertheless been squeezed. Margins are lower now than in both 2018 and the second half of 2017. One key reason for that has been higher raw material costs, in particular for imported iron ore. Margins have remained skewed towards steelmaking over rolling for most of the year however, despite the shift in raw materials prices. So far it seems, demand has been strong enough for steelmakers to continue to pass on costs downstream. Steelmaking costs have in fact been remarkably steady through the year, after recovering from a slump in Q4 2018.

What has changed since peak steel prices in April however is that now rolling margins are being squeezed while steelmaking margins have remained relatively robust. With rolling margins in the tens of CNY however, this is about to switch, with steelmaking margins again being squeezed. This will in part still be driven by the recent peak in iron ore prices, as we measure steelmaking margins adjusted for lead time. Steel prices, which are expected to slide further over the coming several weeks, will be the other edge of this steadily narrowing clamp on profits.

Figure 2. Profit margins pressured but positive



Source: Kallanish

Looking at BF-BoF steelmaking costs going out over the coming weeks, a worst-case scenario for steelmakers would mean margins dwindling steadily closer to breakeven over the coming five weeks. That would imply spot rebar prices falling some CNY 400-450/t and HRC prices by some CNY 650-700/t by mid-July. In this worst-case scenario output would likely decline, but mainly from EAFs which are both more flexible and face higher costs. Steelmakers overall would likely not be forced into serious losses.

Impact on exports of a worst-case scenario

Lower domestic Chinese steel prices will also have a knock-on impact on export volumes. In late May, mills were limiting export allocations because the domestic market was more profitable for them. This has been true by some margin for rebar for most of the year, while for HRC it has been true since early April. At the end of May however domestic steel prices were falling more quickly than export prices (and bids for rebar in Singapore actually increased noticeably). If domestic prices continue to fall, exports could again look more attractive to Chinese mills.

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