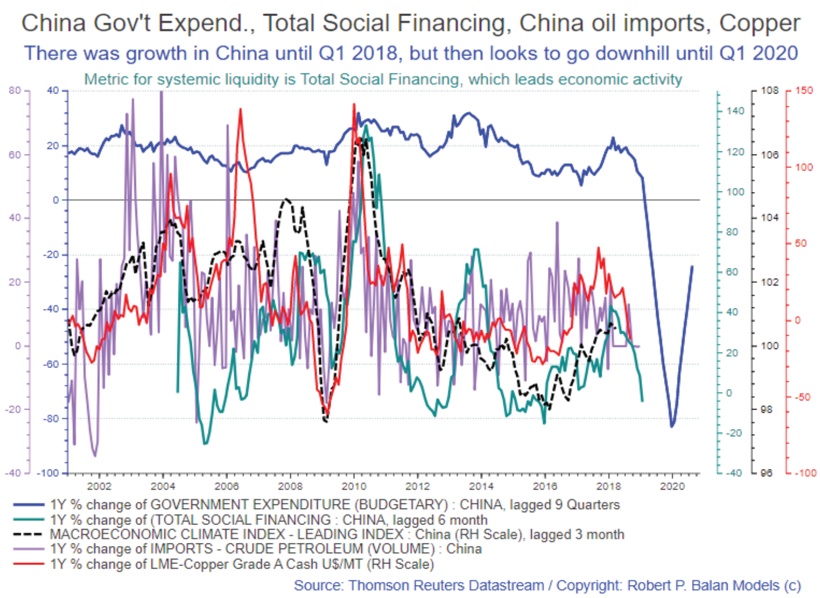
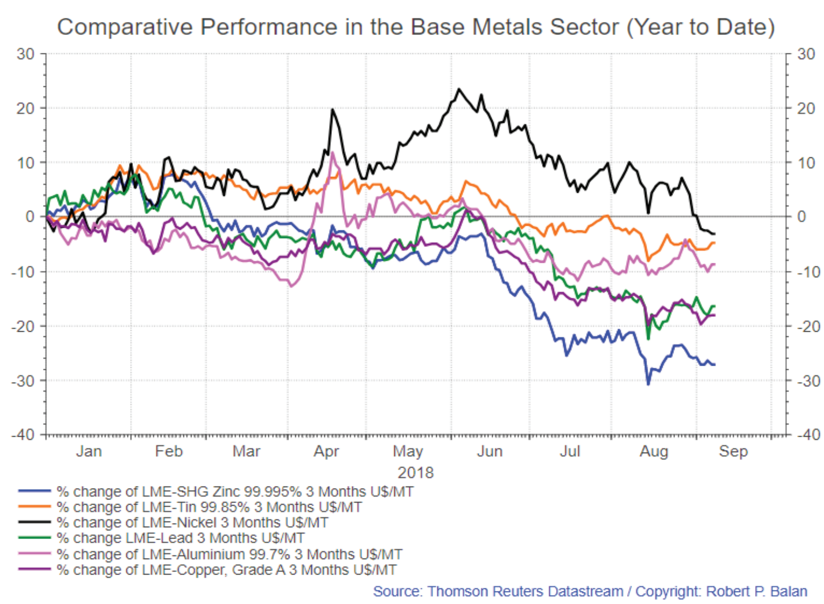
41 / Base metals face headwinds from China's slowing growth, firm US Dollar trend

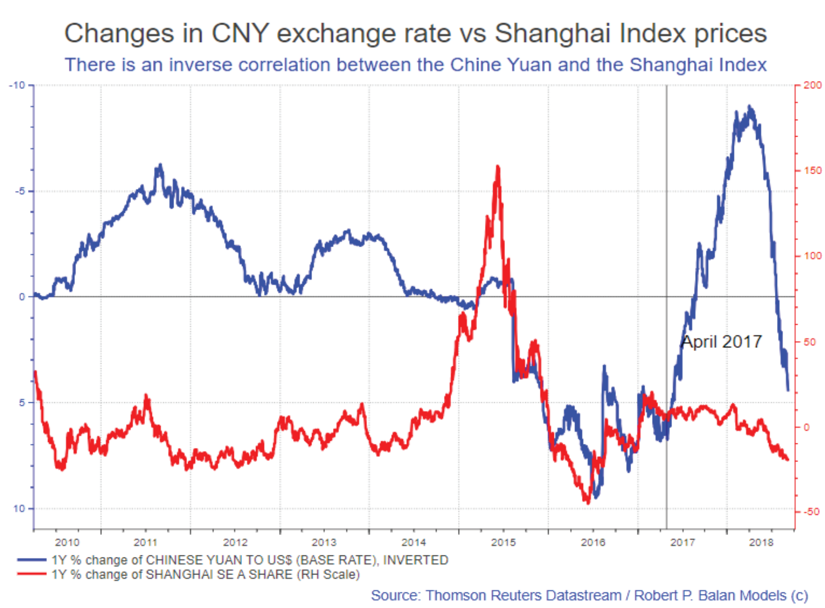
It was common to see headlines like "Copper rises on strong Chinese growth and China's industrial profits rise the most in four years on commodity prices"? It is easy to show that there is a mutually supportive cycle of Chinese strong growth fuels rising commodity prices, and rising prices fuels strong China growth. But since early Q2 2018, there has been a softening in commodity prices and the former explanation has dominated (e.g., "Chinese demand concerns hit metals and related stocks"). The recent Chinese slowdown in oil imports has been instrumental in undercutting oil and base metal prices (*see first two charts on this page*).

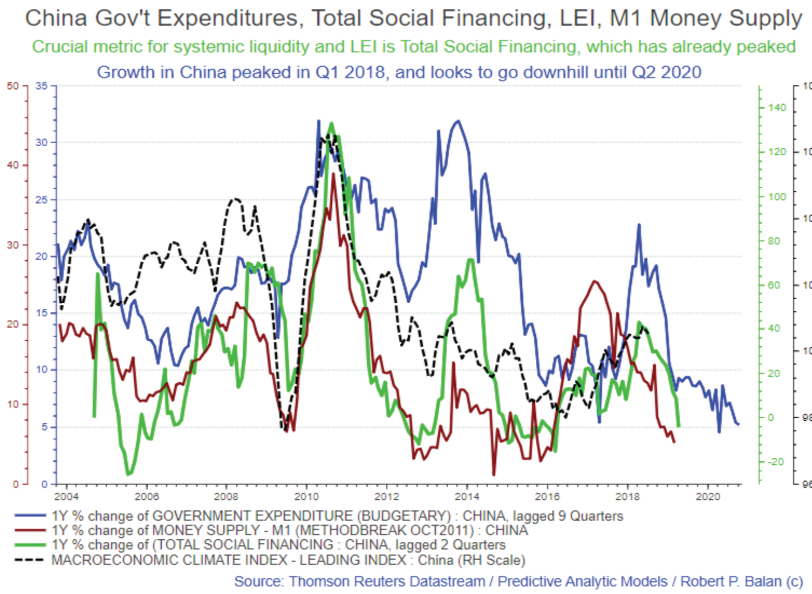
The voracious devourer of raw materials, and relentless growth machine that was China during the last two decades is finally and now truly showing signs of distress – something that even the most stalwart pundits touting China's prowess now accept. Ironically, it is not the failure of the country's long-term, export-led growth model that is to blame -- it has been increasing its exports imbalance with the US three months running, which could trigger another round of recriminations from the Trump administration, and layers of additional tariffs levied on US-bound Chinese exports. This of course can further add to China's angst.

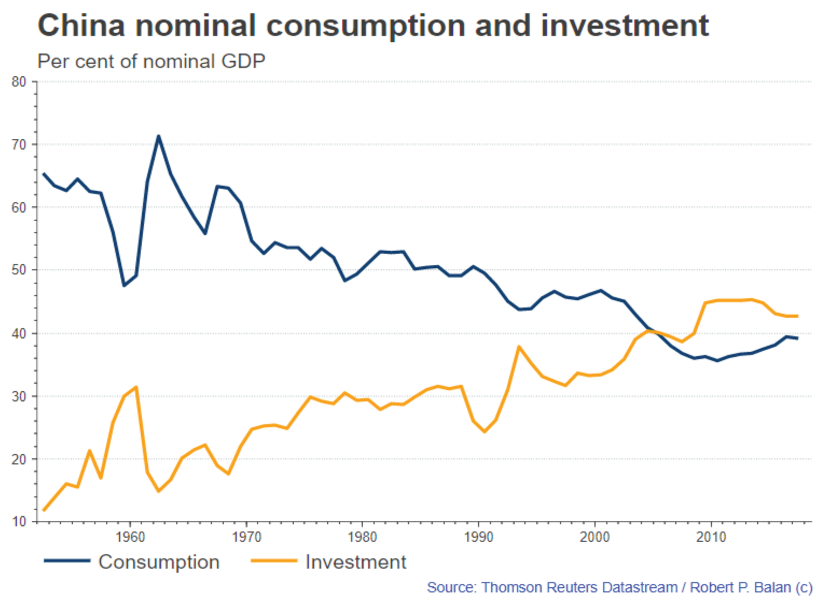
The culprit is slowing domestic consumption. The trade spat with the US has darkened consumer sentiments, and the sharp decline in the value of the CNY has curbed significant part of imports for goods and luxuries. Retail sales this year have grown at their slowest pace in more than a decade. Wages in the private sector are growing at their slowest pace since the global financial crisis. The stock market has fallen by one-fifth, a victim of deteriorating sentiment and the sharp decline in the value of the domestic currency.











Most of China's current woes are self-inflicted. Government expenditures in China have virtually collapsed since January 2016. And like everywhere else, if the government does not spend, economic activity slows down in proportionate degree. And the government tightening in China had been severe. The heady rise of the central government expenditures from January 2015 to January 2016 has been essentially erased over the past two years (*see 1st graph on this page*).

The key illustration of the link between fiscal spending and growth in China can be seen in the graph above. This is key element in this illustration: the impact of fiscal and budgetary expenditures is being transmitted to the real economy via the Total Social Financing (TSF) expenditures. This leading indicator has already peaked, has declined sharply, and is about to fall further. These have been the consequence of the (TSF) slowdown: (1) As a consequence, China's Leading Economic Indicator (LEI) will also declining faster soon, and (2) the fall in M1 Money Supply dropped precipitously from January, this year, and no bottom in sight, so far, while the (TSF) keeps on falling (*see 2nd graph on this page*).

TSF is a very reliable indicator of future economic activity in China and is therefore an excellent tool in forecasting the future direction of commodity prices. Where commodity prices go, the metals and mining sector will follow. The impact of the TSF is pretty much "baked in the cake" and so its negative trend should be a headwind for commodities and metal prices well into H1 2020. The TSF as a harbinger of Chinese activity, and therefore of future price of resource materials, has been discussed in great detail at this current and past issues of the Capital Observer.

Nonetheless, it is not an unmitigated disaster for commodities and base metals. China has been moving heaven and earth to refocus the economy from export-led growth to domestic consumption. It also did a lot to curtail corporate debt and excesses in it "shadow banking" industry – part of the reasons for the slowdown in monetary (liquidity) growth. There is growing international resistance to China's mercantilist trading approach. Unfettered creation of systemic liquidity also fuelled massive and often inefficient or wasteful investment in the country's industrial sector. Therefore, steering the economy toward meeting domestic consumption and a more rational investment program are logical steps in the maturation of the domestic economy (*see 2nd graph on this page*).

The current woes are therefore temporary, and even if China economy has been slowing, it has decelerated from nominally higher levels that it has been five years ago. There is still nominally significant propensity to consume raw materials, produce electric power, and goods are still moving. These data comprise what has been called the "Li Keqiang Index," three indicators reportedly preferred by the current premier of China as better indicator than the official numbers of GDP, which almost everyone acknowledges as unreliable and overstated (*see 1st graph on next page*).

Base metals and the rest of the commodity universe (which include a wide swath of the Emerging Markets) also face stiff headwinds from the resurgence of the US Dollar, which we expect to be ascendant until Q1 2019. There are multitude of reasons for a new USD upsurge, and primary are the stated objective of the US Federal Reserve to keep raising rates unit they are deemed "normal", and the lagged impact of a massive inflow of repatriated and foreign capital. This has caused favourable changes in the US Capital Account, which in the final analysis, is the real macro data which ultimately determines the course of US interest rates and the domestic currency (US Dollar), *see 2nd chart on this page*. We have extensively discussed these correlations in the current and past issues of the Capital Observer.

But all of these will come to pass, and even if we expect base metals and commodities to mark time over the next few quarters, a new upwards cycle in global and US growth probably awaits in the later part of 2020. That could initiate a widely expected new cycle of boom times for resource materials.