03 JUL, 2019

Iron ore surges past $US120 but softer China demand looms

Australian Financial Review, Australia

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The iron ore price hit a high of more than $US120 per tonne on Tuesday but fears of a weakening Chinese economy are driving expectations of a reversal later this year.

The iron ore price rally has been triggered by supply constraints, beginning with production cuts in Brazil after the tragic dam disaster at the start of the year and continued by Rio Tinto's production estimate downgrade two weeks ago.

Australian iron ore producers have been among the big winners from the high iron ore price. On Tuesday, Rio finished up 1.62 per cent at $106.45, BHP added 86 basis points to close at $42.04 while Fortescue Metals group closed up 3¢ at $9.18. It took year-to-date gains for the miners to 41 per cent, 28 per cent and 139 per cent respectively.

Even so, supply-side factors have been a primary driver of the high iron ore price, and signs of a slowing Chinese economy and softening demand could see prices drop back before the end of the year.

"Overall, if you look at downstream sectors [in the Chinese economy], it's been weak," CBA commodities analyst Vivek Dhar said. "Your construction indexes in the property sector – it's actually turning more negative on a pure volume basis ... I'm concerned that demand is fundamentally weak."

Chinese demand for steel has reached a record this year, driving the sustained demand for Australian iron ore. But with supply from Brazil falling at the start of the year, China's steel producers have been turning to stockpiles.

"Falling port stockpiles is being cited as a key reason as to why iron ore prices are rising," Mr Dhar said.

However, he said when you had all supply-side changes, it could give the illusion of stronger demand. He did not think the iron ore price surge was demand-led.

Hui Feng, a research fellow at the Griffith Asia Institute and expert on the Chinese economy, said two factors would support the steel-hungry construction sector.

"I will still expect a mild, mild growth of that sector, at least for the next two or three years," Dr Feng said.

Beijing's stimulus spending programs had supported construction spending domestically while China's Belt and Road initiative, which is predominantly carried out by Chinese firms, had added to construction investment outside of the country, Dr Feng said.

On the other hand, the tariffs imposed by the US on Chinese steel would likely have some negative effect, he said. Demand in China is also

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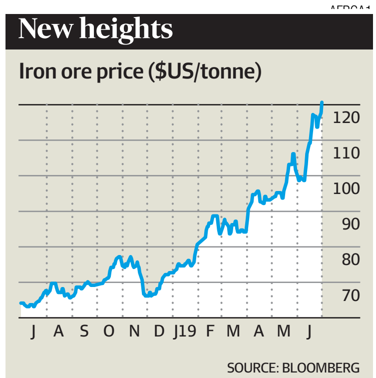

CBA commodities analyst Vivek Dhar.
PHOTO: SIMON SCHLUTER

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affected by controls aimed at addressing air pollution created by emissions from steel smelters.

"We've seen curtailments, or capacity cuts coming from Tangshan, which is your main steel-producing hub in China. That area is about 11 per cent of steel capacity, so they've been told you have to decide to cut 20 to 50 per cent of your production," Mr Dhar said.

The high iron ore price is also a positive for government revenue. In the case of iron ore, it is almost exclusively the Western Australian government in line for the increased royalties.

Chamber of Minerals and Energy of WA chief executive Paul Everingham said the boost to the state's budget from the high iron ore price was significant, but this was different to the previous mining boom.

The increased margins for iron ore producers had resulted in some conversations about reconsidering mining projects that until recently had not been viable, but the industry had learnt lessons as the last mining boom declined.

"I just don't think you're seeing the same people make the same mistakes," he said.

"It's not 'oh look, we've got iron ore and we've got the mine in moth balls, but now that the price is high, we're gonna go straight back into production'."

Some projects are being reconsidered due to increased margins for iron ore producers. PHOTO: MICHELE MOSSOP