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CHINA HAS JUST COME OUT OF A YEAR OF VOLATILITY AND HIGH STEELMAKING MARGINS. IN 2019 HOWEVER THE VOLATILITY MAY STAY BUT THE MARGINS ARE LIKELY TO SHRINK. CHINA FACES A WIDE ARRAY OF CHALLENGES, OF WHICH THE TRADE WAR WITH THE USA IS ONLY ONE. WEAKER CONSUMER DEMAND, INDEBTED DEVELOPERS, LOWER CORPORATE PROFITS ARE ALL LIKELY TO ACT AS A DRAG ON DEMAND THIS YEAR.

CHINA STEEL INTELLIGENCE

DEC 2018

The state sets the tone in 2019

China has just come out of a year of volatility and high steelmaking margins. In 2019 however the volatility may stay but the margins are likely to shrink. China faces a wide array of challenges, of which the trade war with the USA is only one. Weaker consumer demand, indebted developers, lower corporate profits are all likely to act as a drag on demand this year.

Overall however we expect demand to increase on the back of a growing reliance on infrastructure investment and measures to improve local government finances. Beijing is fighting back, perhaps not with a massive stimulus plan but certainly with a wide selection of the tools at its disposal.

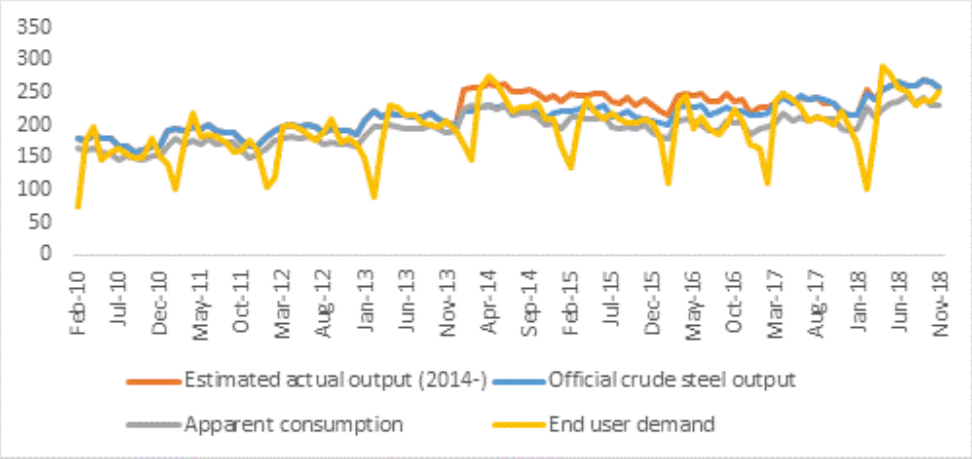
The question now is, will Beijing do enough and how will the steel sector respond?

Table 1: Supply and Demand (million tonnes)

	2017	2018 ytd	Y-o-y	2018 outlook	Y-o-y
Official crude steel output	831.7	857.4	6.70%	935.0	5.80%
Apparent consumption	737.4	762.7	6.66%	831	2.70%
End user demand	745.5	759.9	5.37%	831	3.10%

Source: Kallanish

Figure 1: Daily steel production and demand 2010-2017 (tonnes)



Source: NBS, Kallanish

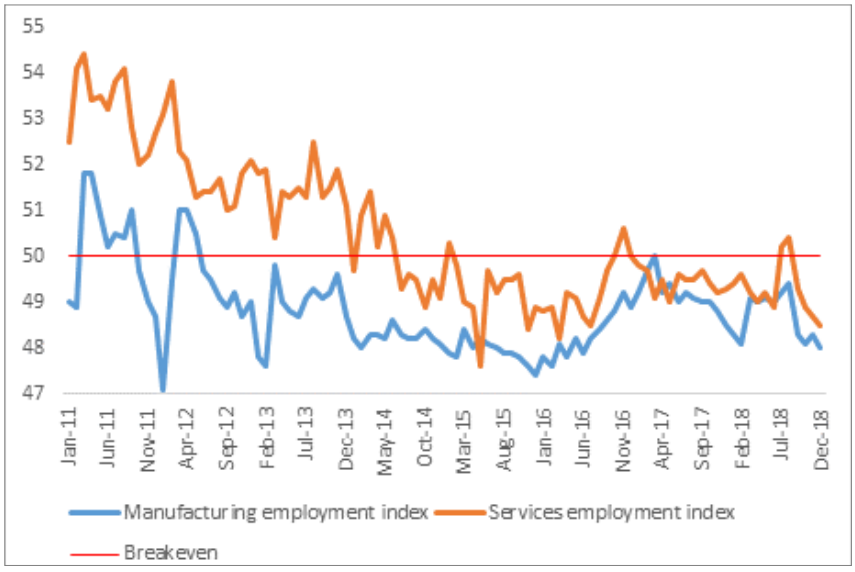
The state sets the tone in 2019

Chinese growth faces a wall

China's economy is set to slow down in 2019, just as the positive impact of capacity reductions in recent years starts to wear off. At the same time, the global economic environment is becoming increasingly complex and vulnerable its own slowdown. But it isn't all bad news for steel, despite the weaker environment, steelmakers in China are likely to be able to keep margins positive. While China's economic problems are real, its is worth remembering that a slowdown in China often triggers a period of strong demand as Beijing turns away from restructuring and towards fiscal spending.

The trade war with the US has dominated headlines but is only an exacerbating factor to the slowdown in the economy. Issues of debt have been the key driver of both policy and economic trends. China used supply-side reform to boost profit margins as an aid to reforming the overall debt burden. That included shifting debt from corporations onto citizens and pushing local governments to regularise their debt by switching away from illicit fund raising to government bonds. The steel industry has been reaping the benefits of supply-side reform since late 2016 and margins have soared. Deleveraging has not been achieved however and the impacts of slower credit growth and the shift in credit to consumers are already being felt.

Figure 2.Official PMIs warn on employment levels



Source: NBS

Restructuring, reversed

An area that Beijing is particularly concerned about is manufacturing and employment. This is undermining the myth that China can move seamlessly from an investment and export driven economy to a consumption driven one. China is addicted to investment to sustain the employment and rising wages needed to support consumption. A trend of offshoring had already begun as Chinese labour costs steadily increased relative to Southeast Asia, and a slowdown in credit supply to small and private companies exacerbated this. On top of that, this is a sector that could be vulnerable to a trade war with the USA if China's manufacturing exports take a hit. The Caixin manufacturing purchasing managers' index (PMI) has recorded falling headcount at manufacturers surveyed for 62 months in a row to December 2018 and even the official PMIs have been warning of lower employment for some time.

This may perversely be a good thing for steel demand in the medium term. The strategy to deal with this is to draw more of China's 250 million-strong floating workforce back to smaller cities, and just as urbanisation drove steel

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