

Aluminium's decoupling markets

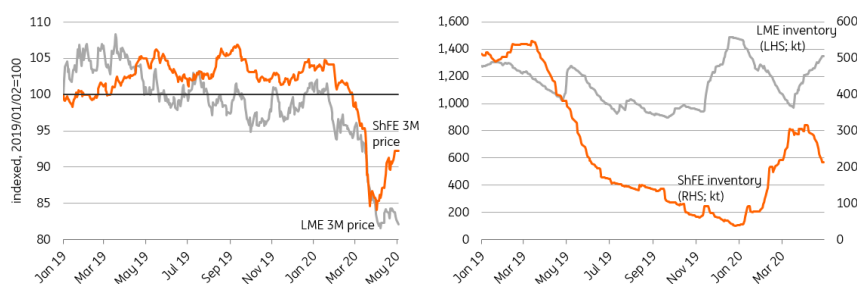
China's aluminium market rebounded from a multi-year low but the ShFE market has decoupled from the LME. The market divergence between China and the rest of the world says it all, but what comes next?



Source: Shutterstock

1. A further divided world aluminium market amid the Covid-19 pandemic

After inventories in major base metals and steel products peaked in late March, there was a strong rally in April, primarily dominated by China's market. ShFE aluminium prices outperformed the LME market, and the same was seen in other base metals.

Fig 1. Market divergence

Source: Bloomberg, ING

Since January, the Covid-19 outbreak has disrupted industrial activities across the world, although major economies are at different stages in the fight against the pandemic.

For aluminium, the market had long been looked at in two parts in terms of supply and demand. However, the underlying mechanisms of price divergence and convergence between LME and ShFE remained a more complex one. China holds the lion's share of both primary aluminium smelting and global demand and has been a major exporter of aluminium in terms of semis and finished products, which together account for two-thirds of primary aluminium consumption. The world aluminium markets are very much interconnected through trade.

Aluminium demand from major consumer markets has collapsed during the pandemic, as lockdowns have led to suspensions in the construction and auto manufacturing industries. At the time of writing, this is still the case in many countries outside of China.

2. A state of 'half fire and half ice'

The underlying market dynamics in the two exchanges explain the price divergence.

China's market started to make a comeback in mid-March, and by early April, the resumption rate in the nation's construction activities, a metal-intensive sector, returned to an average of 90%. Aluminium prices fell to their lowest level, at CNY11,355/tonne, at the start of April in the ShFE market, before recovering.

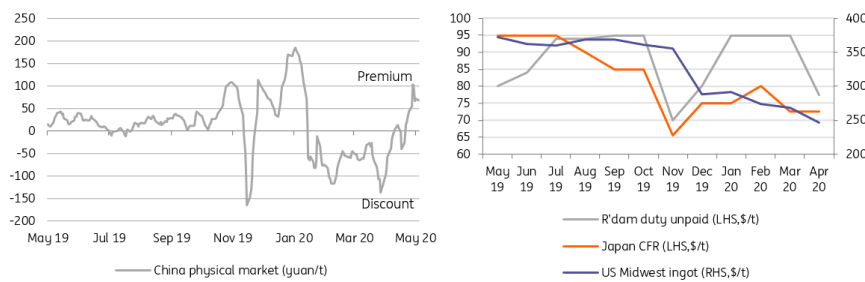
- Low prices started to cut into the smelting cost curve, and the market saw price-related curtailments. Up to mid-April, capacity had been curtailed by 700kt.
- Real demand, primarily from the nation's construction sector, has improved significantly.
- Aluminium scrap tightness led to increased demand for the primary metal, and as we mentioned earlier, this has helped to pull in additional demand of 150-200kt during last month.
- Low prices have attracted stockpilers including stockists and consumers. This has come against a backdrop of monetary easing from the central bank, as well as signals for further fiscal stimulus promised by the government. Consequently, the scale of the inventory drawdown has surprised to the upside, pointing to stronger-than-expected demand in the short term.

Additionally, provincial governments from China, including Yunnan and Gansu, both announced measures to support commercial stockpiling by companies in their region. The plan from provincial

governments could potentially encourage more stocks to be temporarily removed from the shelves for seven months to one year, according to the programme.

As countries in Europe and the Americas went into lockdown from March, demand from this side of the world stalled, however. The aluminium premia plunged from major markets in Europe and the US while the opposite was seen in China (see Fig 2).

Fig 2. Aluminium regional premia



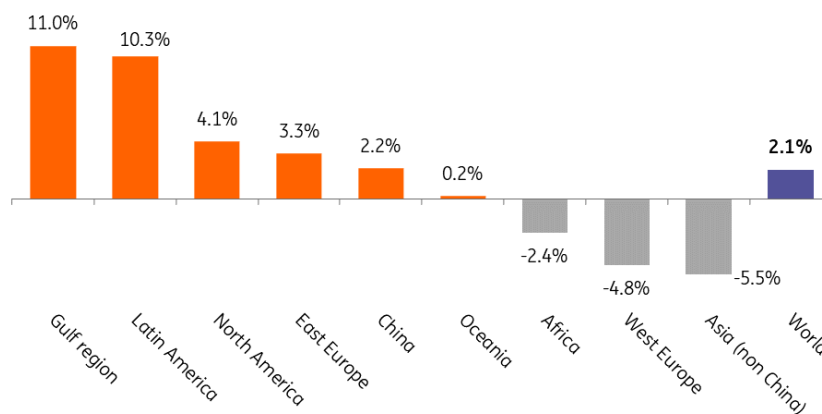
Source: Bloomberg, ING

3. Have we seen enough supply response?

With demand growth falling into negative territory this year, and the market seeing a large surplus, a reduction in supply could help. However, so far this hasn't been the case.

According to IAI, global aluminium production grew by 2.1% year-on-year in 1Q20, with the most significant growth from the Gulf region and Latin America (see Fig 3). Output from the world's largest producer, China, has increased by 2.2% YoY, and this is despite the many reported operating difficulties, as the nation was in deep lockdown back in February.

Fig 3. World aluminium production change 1Q20 (YoY)

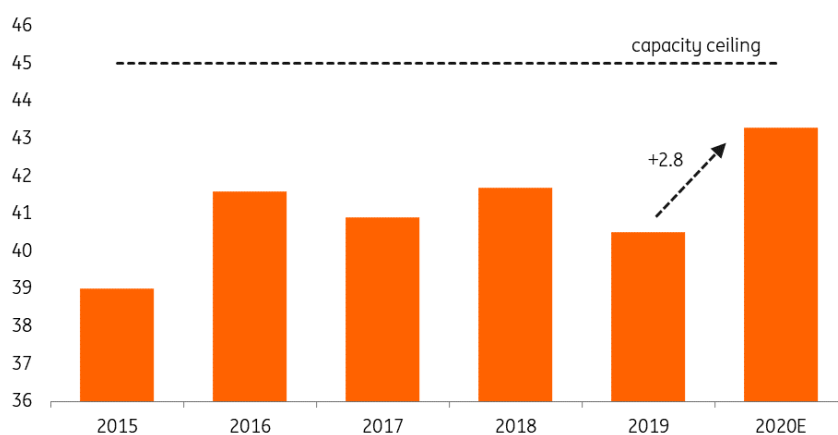


Source: IAI, ING

As mentioned above, plans to curtail production have been quieter following the market rally. According to Bloomberg data, there are an additional 2.8 million tonnes of additional capacity in the pipeline to come this year (see Fig 4). So far, there are no plans to put this on hold. Therefore, unless aggressive price-related curtailment is announced or new capacity is put on hold, we expect

aluminium production to continue to grow in China as well as in the Rest of the World.

Fig 4. Aluminium smelting capacity change (mln tonnes)



Source: Bloomberg, ING

4. Low prices- the cure for low prices?

Low prices would, in theory, lead to lower supply and hence reduce the pressure on prices. However, this has not yet proved to be true for aluminium. The unexpected Covid-19 pandemic did change a lot in the market but the net effect points to a larger surplus of 1.5 million tonnes, according to our current estimates. Back in March, we expected low prices to persist for longer, squeezing out more production and postponing starts. We assumed that prices (LME 3M) would recover to the US\$1,600/tonne level somewhere during late 2Q20, along with a recovery in demand from most of the countries. So far, there has clearly been less supply contraction than we expected, which adds downside risk to the forecast.

This month will be critical for aluminium as we wait and see if China's market can continue its recovery, and whether demand growth from the rest of the world finds a bottom. We think prices, particularly in China's market, have yet to fully appreciate the damage in trade, suggesting the risk of another leg down. If the speed of destocking slows, this might convince the market that real demand may be inflated by stockpiling. Meanwhile, the scrap market should recover to substitute part of the demand in primary aluminium. How would LME aluminium respond? Well, LME aluminium was not impressed by what was happening in China's market but the downside scope is relatively limited from here. The steep contango market suggests there remains too much supply as demand remains low over the near term. The key point, in our view, is how quickly European and other major consumer markets get back on track.