Copper in a soft patch, but should rally once China recovers from Covid

Copper prices have fallen as the demand outlook has been overshadowed by growing fears of an economic hard landing. Consumer demand has cooled while government and corporate-led projects could continue to provide an offset. Chinese demand will pick up once Covid is brought under control

As lockdowns and logistic constraints paralyse short-term demand, Shanghai prices have weakened against its peer in London

A double whammy hit demand sentiment for copper

Copper has lost all the gains it made this year as sentiment has soured after a double whammy hit the demand outlook, and funds appeared to have added back shorts, while longs are being liquidated.

On the one hand, the overall risk appetite has remained vulnerable as the US Fed started its tightening cycle. In particular, it has turned increasingly hawkish over the last few months after dual supply shocks related to the Russia-Ukraine war and suppressing Covid in China added more fuel to inflation pressures, which creates a more difficult job for the central bank in taming inflation while not having something break down. Concerns have grown over the Fed's more aggressive tightening cycle that inevitably hit demand, and some have started to worry about a potential recession. In Europe, elevated energy prices have continued to leave businesses struggling and this raises the risks of demand destruction.

On the other hand, sentiment quickly deteriorated when China appeared to be falling into a wider and longer lockdown. We were wrong when we previously said we thought there would be snap lockdowns in Shanghai, similar to what had happened earlier in Shenzhen, which lasted only seven days. Instead, the city remains under lockdown as of early May. Even worse is that the capital city of Beijing has also fallen into partial lockdown, along with some other smaller cities in China. Hence, fears have been mounting over demand destruction, which was further reinforced by the latest macro data, including manufacturing PMI and property and car sales. Confidence over China's economy was hit hard after China's benchmark 10yr bond yield premium fell below that of its US counterpart, followed by a period of quick devaluation in the Chinese yuan along with mounting pressure of capital outflows.

As lockdowns and logistic constraints paralyse short-term demand, Shanghai prices have weakened against its peer in London, creating a window of opportunity for China to export the red metal. And these exports have started to hit LME warehouses, which further weighs on sentiment. Therefore, copper slipped below the US$10k mark in late April and remained in a soft patch into May as fears grew over whether policymakers in the US and China could engineer a soft-landing in their economies, though this appears unlikely for different reasons.

Some demand less elastic, although consumers cut demand for discretionary goods

Soaring inflation and rising rates have started to hit consumer confidence in major developed economies as households have chosen to stick with consumer staples while cutting their demand for discretionary items that will eventually hit demand for such things as cars, white goods or leisure goods. Some industries have also seen supply shortages leading to output losses, hence demand destruction for metals.

However, there is a structural issue with copper demand. Households' demand may start to cool, but some demand may be less elastic from those large corporate or government-led projects as they tend to be counter-cyclical. Meanwhile, energy transition-related spending may be also be less sensitive to the current tightening cycle. Major economies haven't given up their green targets and policies are still in place to drive the growth of, for example, renewable energies, particularly in Europe which is faced with the major task of replacing Russian oil and gas with other sources. We expect major economies to continue to prioritise the growth in those energy transition areas which will underpin demand for copper and other energy transition metals, therefore offsetting some weakness in household discretionary demand.

China demand to recover once Covid is under control

Despite all the doom and gloom in the short-term picture, we are cautiously optimistic about copper in the medium term once China brings the virus under control and becomes more confident in easing lockdowns. However, the magnitude of demand pick-up will depend largely on the scale of the stimulus and, in particular, the policies relevant to those copper intensive sectors, such as the power infrastructure and the property market.

At the beginning of this year, China State Grid had planned for a record budget of more than 500bn yuan for power infrastructure this year. The sector accounts for almost half of Chinese copper consumption. Since the Covid outbreak has taken a heavy toll on the economy, Beijing has been vocal about the stimulus as President Xi Jinping vowed an 'all out' construction spending spree to save the economy. The current Covid situation may only provide leeway to stimulate the economy more aggressively than originally planned. However, it's hard to unleash the stimulus before bringing Covid largely under control, and millions of people are still being locked inside their homes.

It's hard to map out the path of China's Covid cases and its strategies. But Beijing has been working out some unique ways in order to learn to live with the virus while avoiding mass destruction to the economy in the future. For example, Shanghai has started to roll out fast nucleic acid test stations on the street and is training volunteers from the organisations on getting testing samples. This will likely be rolled out in all major cities in China and brings hopes that it could avoid hardcore lockdowns in future by massive testing which better facilitates the so-called dynamic clearing strategy.

Rising mine supply risks looms longer term supply

While the market focus has been primarily on demand, supply-side risk has risen but mainly in the mine supply stage. Major miners have reported a lower-than-expected production for the first quarter of the year; meanwhile, some have cut their 2022 production guidance.

Anglo American saw copper production fall 13% quarter-on-quarter to 140kt due to low ore grades, though it keeps its full-year guidance unchanged at 660-750kt. Codelco also reported lower production in the first quarter, falling by 5.7% year-on-year to 364kt, while the largest drop was seen from Los Pelambres, with less production from Escondida, co-owned with BHP. BHP slashed its full-year guidance range from 1.57 to 1.62 million tonnes (previously 1.59-1.76) on the back of lower-than-expected production from Escondida. Glencore also cut its annual copper guidance by 13% or 40kt after first quarter production fell by 14% to 258kt due to geotechnical constraints at the Katanga mine. Disruption rates have also turned out to be higher than historical levels due to social protests in Peru and operational issues in Chile. This hasn't been felt in the refined copper supply yet. The energy crisis in Europe has had little impact on copper production in the area, though there may be risks with mine supply from Russia as sanctions risk mines' longer-term outlook.

Our base case average prices remained unchanged for 2Q at US$10,000/t from the previous update, but some potential upside episodes driven by a demand recovery may be delayed into late 2Q22 or 2H22 rather than sooner. And currently, our price forecasts remain unchanged for 3Q at US$9,900/t and 4Q at US$9,800/t (LME 3M quarterly average).

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