

Copper: Flying blind over the summer

The changing macro narrative and the unwinding of reflation trades is rippling through the metals market. With the strengthening in the dollar, gains in nominal prices are capped, while a weaker yuan also undermines demand expectations from the world's largest consumer



Source: Shutterstock

The gloom in the bond market has clearly rippled through the metals markets, with Monday's rout spreading across the board. However, LME base metals are posting moderate gains on Tuesday as macro markets steady. Copper has been vacillating in a narrow price range of around US\$9,200/t to US\$9,500/t ever since mid-June when the metal was hit by the Federal Reserve's hawkish shift as well as China's announcement to release stocks from state reserves.

One way to look at this is through the lens of reflation trades. Copper has been the main beneficiary of the reflation trade since last year, with money piling into assets exposed to the reopening. Massive stimulus packages and the pivot to 'green' technology has also burnished the red metal, making it stand out among its peers.

However, the macro narrative has quickly shifted as some market participants question whether growth has peaked. As investors unwind their reflation trades, copper has come under pressure. Price action has gone hand-in-hand with market-based inflation indicators. These indicators may

have peaked in May although there is very little visibility on this.

Meanwhile, the dollar has strengthened as the trade-weighted dollar index has gained more than 2% since mid-June, making dollar-denominated raw materials more expensive for holders of other currencies. The dollar rally is weighing on nominal prices and at the same time, the weaker Chinese yuan against the dollar has undermined demand expectations for metals.

A slump in China's intake of copper has already confirmed this ([China's waning appetite for copper might not be the only reason for concern](#)). When copper prices hit a record high in May, the Yangshan premium, a barometer of onshore buying interest, hit a low. As a result of the reduced appetite for importing copper, Shanghai bonded warehouse inventories have risen to a near two-year high of almost 440kt.

At the beginning of the year, investors were betting on market tightness, with some expecting a large deficit. But those expectations have been fading;

- Tightness in mine supply started to show signs of easing as we moved into the second half of the year, broadly in line with our expectations. Spot treatment charges (TCs) have regained their staggering losses this year, returning to levels last seen in September 2020.
- LME refined copper stocks have surged to more than 225kt, the highest since June last year.
- Refined copper production from the world largest producer, China, has grown by 12.2% YoY during 1H21, according to NBS. And don't forget that the state reserve started its release programme last month by adding supply to the market at the end/beginning of each month throughout the rest of the year. The first batch of copper stock releases, 20kt, was taken by some consumers earlier this month. Assuming that stock releases continue at this level, supply (via stocks release) would increase by 120kt during the second half of this year.

As copper has retreated from its record high and money managers have trimmed long positions, there are signs of life from real consumers, as some physical buyers return for restocking. The Yangshan premium is a tad higher after the import arbitrage window reappeared for onshore traders. This may lead us to think that the negative feedback loop of price surges undermining real demand is behind us. Outside China, the recovery in demand continues despite setbacks from chip shortages in the auto market and a recent resurgence in Covid cases. However, Chinese policymakers are committed to curbing any excessive gains in commodity prices, which may deter some financial investors from re-entering the market, especially considering the uncertainties in the broader market as the Fed moves to taper asset purchases. Though copper is still cruising above its long-term average, short-term price action may follow the macro narrative, as there is an absence of new fundamental information to digest. As a result, we may end up drifting around somewhat blindly this summer before further downside risks emerge in late 3Q21 and 4Q.

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