What does the China ‘trilemma’ mean for metals?

China may want commodity prices to stabilise but its environmental and economic goals suggest demand will remain strong. This is the trilemma facing the market and the more officials bang the drum on these conflicting aims, the greater the risk of imbalance

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We noted earlier that policy divergence between the US and China post-pandemic may lead some investors to rethink the market's trajectory and we highlighted the potential downside to prices. But in this note, we discuss the challenges that China faces in pushing commodity prices significantly lower.

With record high prices for copper and iron ore adding to increasing imported inflation pressures and downstream manufacturers pushing back, Chinese officials have repeatedly called for stability in commodities prices. As the world's largest metals consumer, China reserves the right to intervene in the commodities markets. But stabilising prices of copper, aluminium, and steel (and raw materials) will be difficult when the country is also trying to reduce emissions and achieve carbon neutrality across major industries, and simultaneously maintain medium to high speed economic growth.

Medium to high speed economic growth, with a focus on 'new infrastructure', including the development of electric vehicles and renewable energy, would mean solid demand growth for metals, especially copper. In the meantime, China has also vowed to cut greenhouse gases, pledging to hit peak carbon emissions by 2030 and carbon neutrality by 2060. Efforts on this front would cap the capacity growth of some metals in the medium-to-longer term, and there are risks of short-term supply disruptions, especially in aluminium, due to administrative cuts (Aluminium: China's march towards 'net-zero' flips market expectations). To align with the nation's target of achieving carbon neutrality, the Nonferrous Metals Industry Association (CNIA) set a provisional goal of bringing emissions to a peak by 2025 and cutting them by 40% by 2040. The aluminium industry set a ceiling (45m tonnes) for capacity back in 2015 amid supply-side reform. There is no ceiling for the copper industry like the one for aluminium smelting. By the end of last year, total smelting capacity was 8.34m tonnes of smelting capacity and 12.08m tonnes of refining capacity. This should still grow, with some new projects scheduled in the pipeline. For copper, officials have said that 'China's copper smelting capacity will come soon'. With mounting pressure to decarbonise, a cap on capacity growth is clearly on the horizon.

Currently, the world is seeing a strong demand recovery post-pandemic that dovetails with a traditional strong demand season in the second quarter in the northern hemisphere. Meanwhile, investors are contemplating strong growth in the future, underpinned by ultra-loose monetary policy and massive stimulus. Against this backdrop, the more officials bang the drum from both sides of the supply and demand equation, the greater the risk of imbalance. Demand is pointing to more upside potential; however, the supply constraints are becoming more evident due to administrative cuts in the near term, and capacity caps. As for commodities like copper and steel, China is largely reliant on imports of raw materials. Currently, the outlook for copper mine supply growth from major mining countries remains vulnerable due to Covid-19 and labour-related strikes.

Meanwhile, a trade spat with its major supplier certainly adds to the rising supply risks and fans the flames of speculation in the derivative market. Last week, China said it would suspend economic dialogue with Australia amid heightened diplomatic tensions. This is adding to fears of supply risks for iron ore, bauxite, zinc and copper concentrate. With the trilemma in China and large reliance on certain commodities such as iron ore and copper (concentrate), the markets can be very sensitive to supply risks.

It won't be easy to strike a balance when bringing all the targets together, and sometimes there are confusing signals to interpret. Investors seem to be focusing on the positives for now- the rising risks of supply constraints due to the decarbonisation goal and stronger demand growth. Expectations of stronger demand elsewhere are fuelled by the ultra-loose monetary policy and massive stimulus in the US and the 'green' narrative rooted in some metals fundamentals. As long as the Federal Reserve is comfortable with the economy running hot and is tolerant of rising prices, we think upside risks still dominate over the next three to six months (Copper: Upside risks dominate in the second quarter).

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