The China Effect on Metals, and, on Metals related, Share Prices

written by Jack Lifton | September 23, 2021

Perspective is the key to objective valuation. There are three global Metals' market classes; **base metals**, such as iron and aluminum; **precious metals**, such as gold, silver, and the platinum group metals; and **critical technology metals**, such as copper, lithium, cobalt, and the rare earths, in descending order of value to society. Today the majority demand for the physical metals in all three classes comes from China, which now accounts for nearly 60% of the physical demand for all metals!

You're reading and seeing, in the financial news, about the troubles of a Chinese property developer called Evergrande, and how its vast overleveraged (more debt than it can ever repay) position is collapsing and may soon spread through out the Chinese money and stock markets just as a contagion does if there are no remedies put forward for the disease. The talking heads in the mainstream media love this analogy, because it enables them to use their aging covid scare tactic system to characterize this as a Lehman moment in the Chinese economy.

China does not have a free market economy. All of its companies and banks are overseen from Beijing on a daily basis by China's State Council, regularly and incorrectly called China's cabinet by our mainstream media, but, in fact, it is the operational power center of China's foreign and industrial policy. In its turn, the State Council takes its direction from China's President, Xi Jinping, who dictates China's foreign and industrial policies.

The newsletter, Sinocism, addresses the Evergrande effect this way:

"… Xi [has] set out three tough battles for the government-poverty, pollution and financial risks. Significant progress has been made on the first two, but the battle against financial risks has lagged. Perhaps Evergrande will mark a turning point in that battle, or perhaps the problems run so deep that they will have to back off from the most stringent efforts to rein in real estate, as they have had to do after previous attempts to lance the festering economic and political boil that is PRC real estate.

The "advantage" of the PRC system in dealing with messes such as Evergrande is that regulators have significant powers to "persuade" other companies to help out, and a robust stability maintenance system to ensure that creditors, employees and apartment buyers will accept the best haircut on offer and not cause too much of a fuss. Yes there have been small protests, but if things play out as they have in other similar cases, protests will be allowed for a bit, as people need to vent, then organizers will be warned if not arrested, then the rest of the unhappy people will take what they are offered and "like it", with no recourse. Equity owners and foreign creditors don't really fit into that equation, they will likely get nothing.

So we have a big mess with a lot of people losing money but not one that is going to cause a systemic financial crisis inside the PRC. But as many analysts have been saying over the last few days, ***we should expect a bigger than expected slowdown in GDP growth*** (Italics and boldface mine), It is going to be an interesting year between now and the 20th Party Congress…."

So, as the Austrian emperor said to Mozart in Amadeus, "There you have it." In this case the very real probability of a

sharply reduced demand for almost all metals due to China's "expected slowdown in GDP growth."

The price for the ores of the most produced metal in the world and the most produced in history, iron, are a good predictor. China produced 1 billion tons of steel in 2019. This was 55% of all of the world's steel production. President Xi has stated that (ordered, in other words) the Chinese steel industry must reduce its output. The net effect has been a yo-yo'ing of iron ore prices, which in the last year doubled and has recently dropped by 25%. That kind of price variation will surely net out tracking China's GDP's gyrations. In fact, China's GDP really is the controlling factor in iron ore pricing.

China needs 1.67 billion tons of 62% (contained iron) ore per year to produce its current steel output. At today's prices that is nearly $300 billion of cost. Compare that to the less than 0.5 million tons of ore concentrates needed to produce its official 130,000 mta of rare earths. At today's ore prices that comes to less than $2 billion or just enough capital to supply the Chinese steel industry with ore for 2 days! Note well that the value of the official rare earths' production even when measured as processed high purity separated oxides would be less than $5 billion. Only enough capital for 5 days of ore supply to the Chinese steel industry.

Better yet, look at gold. China was, again, in 2020, the world's top gold producer with an output of 365 tonnes, the market value of which was $20 billion. China's gold reserves are now officially about 2,000 mt, which today has a value of $125 billion. The average price of hot-rolled coil steel futures, so far, in 2021 has been $1,000/mt, so that the output of the Chinese steel industry based on this average price will be $1 trillion this year, before any value is added to it by its use to make industrial and consumer products. Think of that, China's

gold reserves are very large, but its steel production is worth many times more. I note that it is speculated that Chinese gold reserves are likely some 14,000 mt, which would be nearly a trillion dollars at today's dollar price of gold. Note also that the US steel output for 2019 was 77 million tons, or just 8% of China's, and the US' gold holding at 8,000 mt would be worth $500 billion compared to the $77 billion that its steel production is worth. Just the opposite of China?

As a last example, lets look at lithium production in China. In 2020 it was approximately 300,000 mt of lithium carbonate (60% of world total). The current price of lithium carbonate is $16,000/mt, so China's output is valued today at around $5 billion, about the same as for its rare earths production.

If the Evergrande effect is to lower China's GDP then the demand for all three classes of metals will decline as will the prices of the raw materials necessary to produce them and the value of any additional supplies to be added by junior miners.

Do not consider just the selling prices of any one of the metals' classes ores or of the prices of the "finished" industrial and consumer raw materials when you are looking at an investment in a junior miner. Look at the overall market for the class or the total market for all of them. Metallic ores are a buyer's market, and 60% of all of those buyers are in China.

China's goal is to make its currency a, or the, global reserve currency, so watch out, because if and (probably) when metals and ores are priced in RMB then dollar inflation will be a very big factor in the pricing of metals and their ores. And, I believe, that whichever metals and ores of all of the classes are not produced or controlled domestically by any country in sufficient quantities for its own needs will after the conversion of pricing to RMB never be so produced after that.

China’s rulers are not ready to let the RMB float, i.e., be convertible freely to other currencies in markets not controlled by China, and so its status as a reserve currency is not going to happen anytime soon.

But China’s plans for the long term and security not profit is the driver of its Capitalism with Chinese Characteristics. The openly stated plan is for state capitalism to be replaced by socialism with Chinese characteristics. China has achieved self-suffciency in the acquisition, processing, and fabrication of metals in all three classes. It is said that he who has the gold makes the rules. It would be better said that only he who is self sufficient in raw materials and energy makes the rules.

In the metals’ markets if China sneezes the world catches a cold.