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April 2016

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China's commodity conundrum

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After many years of rapid economic development, China is on the cusp of a transition from an investment-led economy to a consumer-driven one. In this article, we focus on China's impact on global commodity demand and assess the growth potential for its commodity demand after a long period of very rapid growth.[1]

[1] On a recent business trip to China, I had the opportunity to assess the state of the Chinese economy and the outlook for infrastructure investment.

China's commodity conundrum

China's commodity demand over the last 15 years

In order to understand China's fast growth and strong demand for commodities over the last 15 years, some context is needed. Prior to 1979, China maintained a closed, centrally planned economy aligned to Soviet-style economic policies. In 1978, the Chinese government decided to reform the economy, adopt free market principles and to open up trade with the West. The result of these economic reforms has been a phenomenal average annual real GDP growth rate of almost 10% from 1979 to 2014.

Of particular interest is the period from the turn of the century. In 2001, the contribution from investment in infrastructure to GDP steeply accelerated, increasing from about 24% the previous year to about 53%. This level of investment activity has been maintained since then, comprising of road networks, power stations, railway lines, new ports and airports, housing, offices and shopping malls. By comparison, South Africa's investment as a percentage of GDP has averaged about 19% over the same period.

China's infrastructure investment required large amounts of basic materials such as steel, copper, zinc and aluminium. In order to achieve this rapid growth, the country focused on building its own capacity to produce basic infrastructure items. The scale of China's investment programme meant that the government had to import the ingredients required to produce the basic infrastructure items. Almost overnight, there was very strong demand for commodities such as iron ore, zinc ore and copper ore. Supply from global mining companies could not keep up with this heightened demand growth, resulting in exponential increases in commodity prices (see iron-ore chart below as an example).

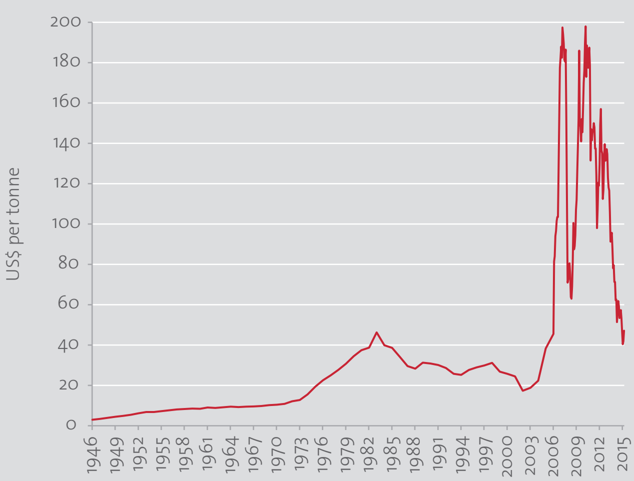
China's impact on commodity demand has been pronounced and it is currently by far the largest consumer and importer of commodities globally. Where China particularly leads can be seen in the right chart below: the top seven commodities and metals it dominates are used primarily in building infrastructure.

Overcapacity and the impact on commodity demand

Three issues seem to be particularly influencing commodity demand at present.

Firstly, there is large overcapacity in many areas of the Chinese economy. For example, the current demand for electricity is 600MW but it has installed capacity of 1 100MW. Current steel production is 800 million tonnes, but installed capacity is 1 200 million tonnes.

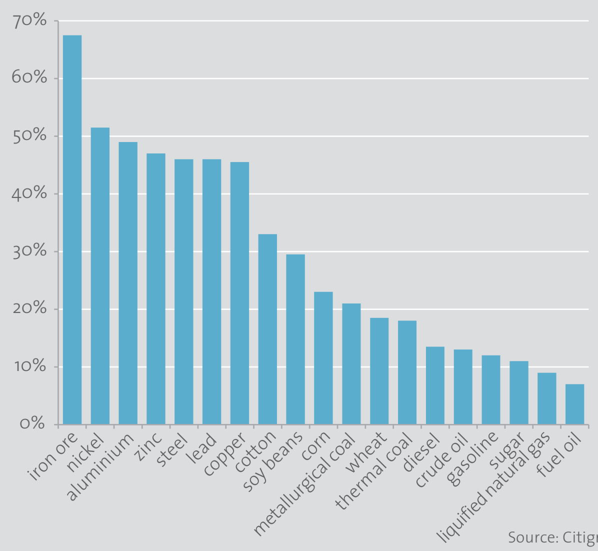
Iron ore* price history



*62% iron ore US$/tonne cost and freight China

Source: I-Net, Bloomberg and Kagiso Asset Management research

China's share of global commodity consumption



Source: Citigroup

Secondly, pollution is a serious problem, particularly in the major cities. This is a consequence of rapid industrialisation and is becoming a crippling factor for the future growth and public health of the country. Large industrial plants, such as steel mills and coal fired power stations in particular, are the major cause of the pollution problem. In order to reduce pollution, these plants would need to be shut down.

Thirdly, China's corruption crackdown is large and widespread and is having a material impact on continued spend on non-essential projects. Many of these projects, which were commissioned by corrupt government officials, artificially inflated the demand for commodities and have added to the overcapacity problem.

The negative impact of these three issues on commodity demand is profound. While the second and third points are perhaps of a shorter-term nature, we believe current massive overcapacity in many sectors of the economy will dampen commodity demand going forward.

The chart below shows the total amount of office space in some of China's major cities and the percentage of those offices that are vacant.

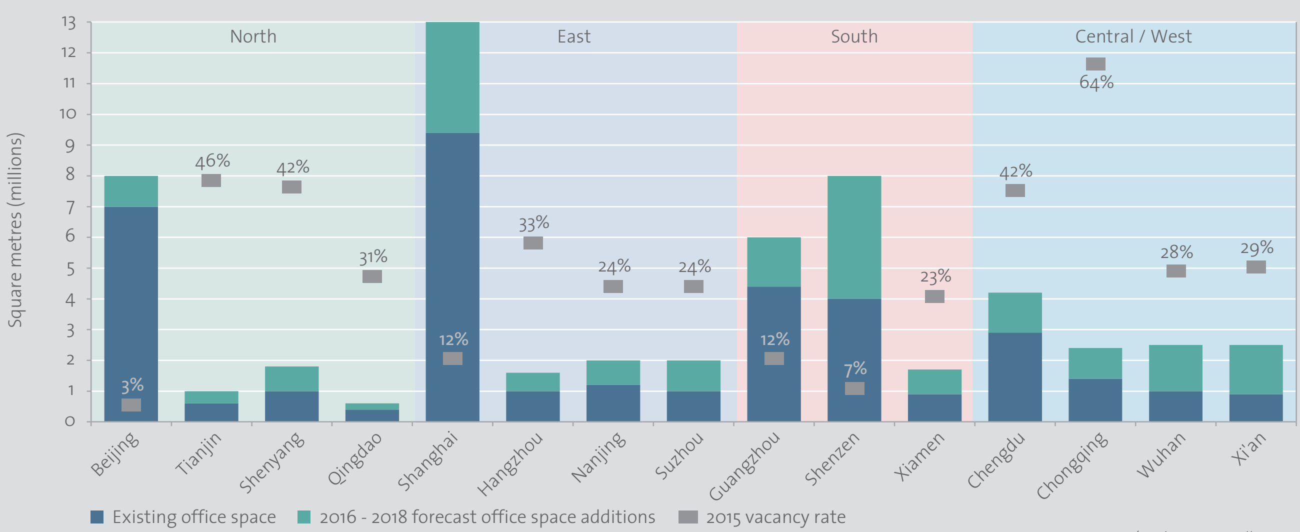
China's huge investment programme over the last few years has created a large base of new infrastructure that exceeds its current needs. Therefore, continued growth in new infrastructure is no longer a big requirement. Mining companies have increased supply quickly over the last seven years in anticipation of continued growth in infrastructure investment but have failed to anticipate the slowdown. For example, global iron ore production destined for export markets has increased by 56% over the last seven years and is forecast to continue growing over the next three years.

Complicating the global supply and demand equation is domestic Chinese production of commodities and metals, which are not governed by the need to meet Western metrics of return on investment. Companies appear to be more concerned with maintaining production and jobs than about incurring financial losses.

Transitioning from an investment-led economy

China will continue to spend on infrastructure investment. It is likely that the rate of spending growth will slow and possibly turn negative. Therefore, the absolute level of ongoing infrastructure investment could well be flat to lower over time.

China's office space and corresponding vacancies



Source: JLL (Real Estate Intelligence Service)

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As the Chinese economy transitions from an investment-driven to a consumer-driven one, the change in demand for commodities will be substantial. We expect commodities that are more geared to consumer products, such as electronics, appliances, cars and jewellery, to attract higher demand.

Outlook

China has been a major force in the global economy over the last decade, contributing materially to global growth and trade. This should continue but the country will trade in different products. It is inevitable that economic growth will moderate from very high levels, given China's rapid ascension to the world's second largest economy.

We don't think that China will experience a recession but rather a lower level of growth fuelled by consumerism, new technological developments and new areas of trade. We are wary of mining stocks that do not have inherent competitive advantages, such as low operating costs, and are instead focusing our portfolios on commodities stocks such as diamonds, copper, platinum and nickel that are linked to consumer products. UP

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