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Commodity Wildcard: What Is Happening in China?

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When someone asks where commodity prices are headed, they're really asking: what's the outlook for China?

Last year, China consumed more coal than the rest of the world combined and imported 70% of the world's seaborne iron ore. In 2012, China accounted for half of the global growth in oil demand. It's a commodity behemoth and the recent slow-down in the Chinese economy is a big reason for weakness in prices for this sector. Should we be worried?

China's economic growth is definitely slowing, but the real concern is that official estimates of China's GDP growth are overestimated. Economists are scratching their heads and coming up with widely varying estimates:

China GDP Growth in Q1 2015	
Source	**Estimate**
China's Official Govt. Statistics Bureau	7.0%
Citibank	6.0%
Capital Economics	4.9%
Conference Board China Centre	4.0%
Lombard Street Research	3.8%

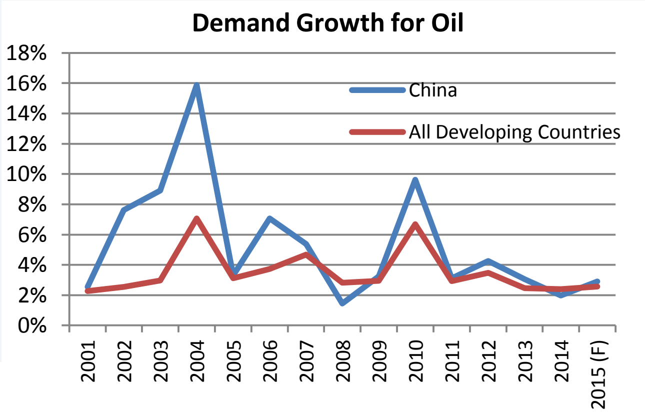
Why all this guessing? China's growth numbers are always suspiciously consistent and always within 0.2% of the government forecast. Moreover, skeptical analysts see hard data, such as industrial production, energy consumption and construction, which are much weaker than GDP, and are using it to create their own estimates of what is going on. But it's not just the data that is worrying.

The big question is China's real estate. Property prices in 70 Chinese cities have fallen for more than a year, and 60 million empty apartments await buyers.

The Chinese government is well aware of the risk and has taken action. The Central Bank has lowered interest rates three times and it has twice reduced the amount of reserves that banks must hold, while easing mortgage rules. Still, new construction starts have fallen 16% in the first five months of 2015, a significant hit to the economy.

The challenge is that China is trying to shift the focus of its economy away from exports towards domestic growth, all while gently deflating a housing bubble. China has lots of resources, $4 trillion of reserves and its tight control of the banking sector gives it policy levers that other governments could only dream of. The Chinese government can intervene to stimulate demand, but China's economy will grow a slower pace.

What does it all mean for commodity prices? The following graph shows China's demand growth for oil, which has been massively volatile, oscillating from 16% growth to 2%. And that was during times of smooth sailing. We believe commodity prices should improve in 2015, but producers should brace themselves for more volatility as the world's biggest consumer of natural resources has a bumpy road ahead.



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