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HD **Time to prepare for China's big steel scrap**

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Rarely has scrap metal loomed so important to the future health of the Australian economy.

In an increasingly fractured discussion over the state of global iron ore markets there is general agreement that the most critical unknown is exactly when China's boom will start eating itself.

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"If you think iron ore is bad now, wait until the market goes to negative growth – which it will as the scrap kicks in," a senior miner warned me last week. As things stand, there appears to be subtle but distinct divergence of opinion between Australia's two masters of the iron ore universe over whether China's scrap cycle has started.

Australia's biggest iron ore miner, Rio Tinto, remains cautiously comfortable that the immaturity of the Chinese scrap metal industry will leave it unable to exert dampening structural influence over the iron ore market until well into the next decade.

Rio's view, informed by a broadly sourced bottom-up analysis that starts on Chinese factory floors and ends with complex scenario modelling, is that China currently does not have the volume of mini-mills needed to recycle metal in the volumes necessary to put a pre-emptive cap on growth in raw steel production.

This narrative leaves Rio still wedded to a long-standing conviction that iron ore demand will peak between 2025 and 2030. And that informs a view that the current price shakes down short-term supply-side dynamics rather than a shift in the longer outlook for demand.

BHP Billiton, on the other hand, appears to have down-shifted its outlook to a more defensive setting.A big deal?

For some time the Big Australian has warned of the recovery of routine price cycles in the bulk commodity markets. But it has also pondered whether China's iron ore demand would peak earlier and at lower volumes than imagined just two years ago. How could this be such a big deal? China uses recycled scrap steel at a quarter the rate of the rest of the world and at 14 per cent the rate of the US. Yet over the past decade, China has added steel to its economy at three times the rate the US did during the 20th century.

As Christian Lelong from Goldman Sachs reported this week: "On a per capita basis, the average household in China is accumulating steel at a rate equivalent to the purchase of a new car every eight months (without disposing of its older cars). In other words, the volume of steel stock in China is racing towards the US level of 13 tonnes per person."

According to Lelong, this means "the day when steel production in China will peak gets even closer".

The Lelong assessment is echoed in a Macquarie note that forecast iron ore prices would orbit the $US90 a tonne level for the next two years and the corollary of that is that profits for Australia's big three producers would fall $US8.6 billion ($9.5 billion) shy of previous forecasts. Ahead of this analysis, a former senior BHP executive offered a more colourful and blunt assessment of where global markets are and what that means for bulk commodity miners specifically, and Australia generally.

Alberto Calderon is presently a director of Orica and has plans to be a serious private investor in resources. He is also a former chief commercial officer at BHP and most recently ran its aluminium and nickel businesses.

On Tuesday he offered a presentation that, it seems to me, most likely channelled much of the state of thinking inside BHP. And freed from the commercial shackles of recent executive life, Calderon left nothing to the imagination.

The joyride for bulk commodities is over; there is potentially lethal pain ahead for anyone but the biggest and cheapest producers (Rio and BHP) and Australia's political classes need to acknowledge and adapt to the crisis already in play.

Calderon says it is "not difficult to see why **iron ore** prices have collapsed, and will go even lower during the next years". The Yale-trained economist, once touted as a future president of Colombia, says the oversupply in the seaborne market will hit 100 **million** tonnes this year, will grow to 250 **million** tonnes in 2015 and to 340**million** tonnes in 2017.Ballooning surplus

To put that into context: that 2017 surplus is slightly more than the 330 **million** tonnes that Rio hopes to be shipping into the global system by then. It is about 30 per cent of the current seaborne market.

There are two reasons why this surplus will balloon. First, even with prices travelling in the $US80 range, the big diggers sitting at the bottom of the cost curve, such as Rio, BHP and Vale, are still incented to grow. Deutsche Bank estimates Rio's move from 290Mtpa to 330Mtpa will drive cash costs down below $US20 a tonne by 2015 and that, even at $US84 a tonne, its FY15 **iron ore** margins would run at 50 per cent.

The other driver is that, surprise, surprise, **China** is not responding "rationally" to the pricing signals.

It is not closing down the 120 **million** tonnes tonnes of high-cost **mining** capacity with the alacrity that was predicted. "The conventional wisdom was that the production tonnes that would be displaced would be in **China**," Calderon reports. "This is probably not true."

Calderon reckons **China**'s production will hold at 400 **million** tonnes during the next years. "**China** will repeat what it has done already with aluminium and thermal **coal**," he predicts. "[That is] create an oversupply of **iron ore** that will benefit them as a consumer country. I won't go in to details, but their strategy in aluminium has knocked $US1000 off the aluminium price and created a gain of $US250 **billion** for **China**."

If **China** will not budge then the rest of the market must. And if we chop **Chinese** production from the **iron ore** cost curves guess where the first big breaking point is? You guessed it. About $US80 a tonne.

The reason this matters to us all is that **iron ore** makes up 22 per cent of our exports by value, while the resources sector last year generated 55 per cent export earnings. Even as the sun was setting on the boom during the second quarter of 2014, Australia's current account deficit was already close to 5 per cent of GDP. "If current trends continue, the deficit may reach unsustainable levels of 7 per cent to 8 per cent," Calderon says.

If he is right, our terms of trade will wither rapidly, the Aussie will break, reversing our currency wealth effect and Australia will take a decade to regain its competitiveness, in part, because our various parliaments are incapable of manufacturing solutions.

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