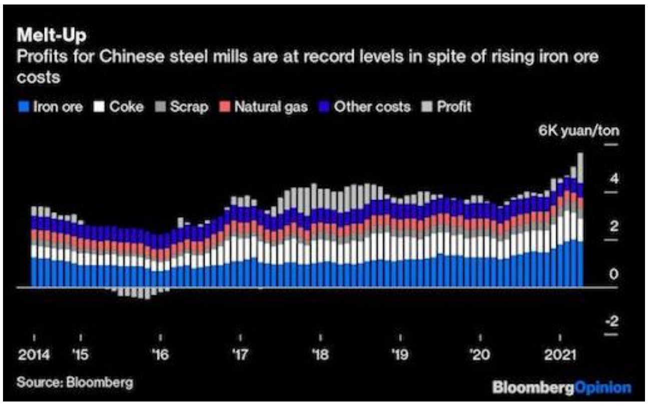
Iron ore prices surge as global economy rebounds, Covid-19 pandemic recedes

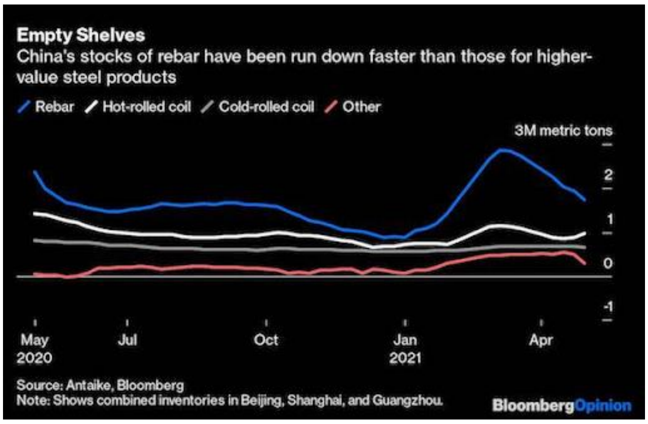
The rebound in the global economy as the Covid-19 pandemic recedes has sent rust on a wild ride. Prices for futures in Singapore have nearly doubled in the past six months to a record high of $226.55 a metric ton Monday. China's Dalian Commodity Exchange raised trading limits and margin requirements Tuesday after futures the previous day rose by the daily maximum of 10%.

Prices at those levels intuitively feel as deep in bubble territory as those of Dogecoin, GameStop Corp. shares or lumber. Still, anyone expecting a return to the sub-$80 prices seen last May needs to reckon with the underlying factors driving the market.



First, take a look at the material that it's getting turned into. Half the world's steel is made in China, and prices there have surged in recent months. Rebar used in construction is up 54% over the past six months, while the hot-rolled coil used in vehicles and consumer products has climbed more than 60%. As a result, even recent prices haven't been enough to deter mill owners from buying more ore: Profits in April, based on raw material and standard costs, came to a record 1,266 yuan ($197) a metric ton.

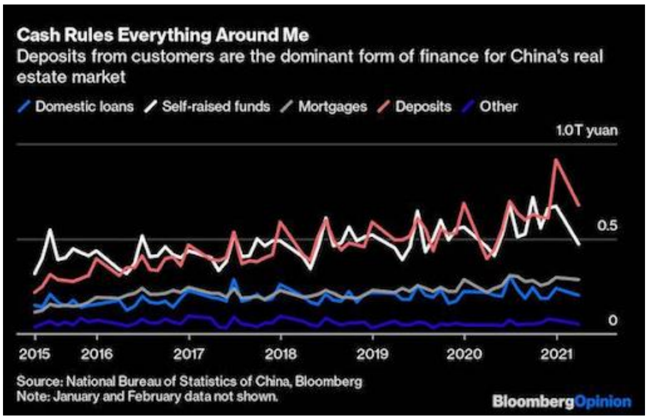
While Beijing has been pushing steelmakers to shift to higher-value flat products like hot-rolled coil, right now long products like rebar are still showing considerable strength. In March and April alone, inventories of rebar in Beijing, Shanghai and Guangzhou fell by some 1.2 million tons, accounting for about three-quarters of the total reduction in stockpiles in the three cities.



That tallies well with the demand we're seeing from key industries. The cumulative 7.98 billion square meters (86 billion square feet) of property under construction in March was about 25% higher than the average for that month over the five years through 2019. Car sales, an archetypal driver for flat products, were about 8.3% below the equivalent five-year average.

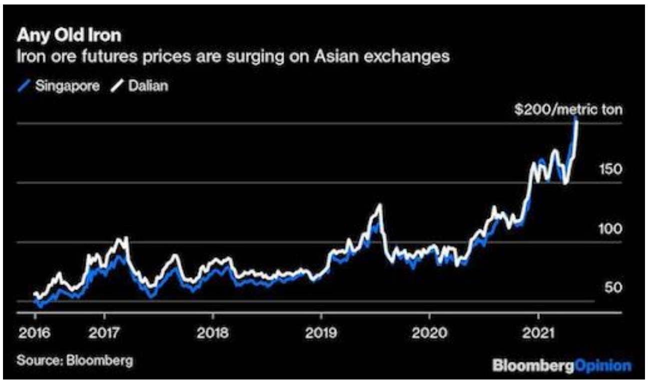
Construction accounts for about a third of China's steel consumption, so a huge increase in building activity will have inevitable knock-on effects on steel and iron ore. The bear case for iron ore prices is that the retrenchment of the credit stimulus rolled out last year will bring such activity to a halt, sending metal prices crashing down to earth.

Don't count on that happening. Conventional credit channels only finance a relatively small share of China's real estate investment, with loans to developers and mortgages combined rarely exceeding a third of total funds to the sector. Funding levels from those sources have been relatively stable.



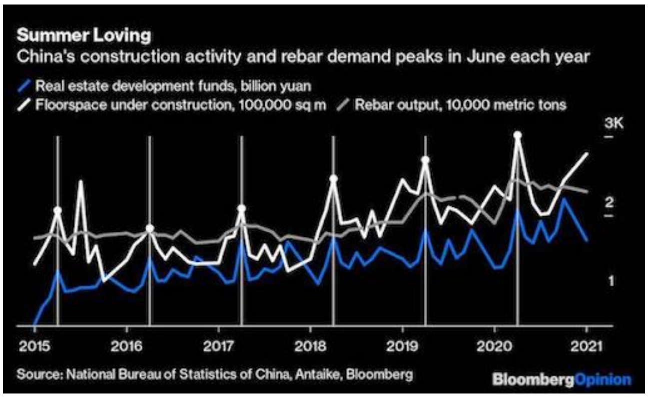
The place where the squeeze is showing up instead is in off-balance sheet entities, such as wealth management products and local government financing vehicles, as my colleague Anjani Trivedi has written. In China's real estate credit statistics, these get grouped with developers' reinvested profits as "self-raised funds," and finance via that channel has indeed been trending downward in recent months.

On its own, that hasn't been enough to rein in the pace of credit growth. Total real estate funding in March was up 1.4 trillion yuan from a year earlier to 4.7 trillion. In the first three months of the year alone, more finance has been extended to China's property market than in the whole of 2008.



The driver of this has been the one credit channel that's hardest to control — customer deposits and pre-sales, which in recent months have amounted to about 40% of housing finance, compared to levels of around 25% a few years back.

What appears to be happening is that Chinese families and businesses, unwilling to see their savings molder away in 1.5% deposit accounts, and finding the alternative investment products they'd previously shoveled money into getting withdrawn from the market, are putting their cash into down payments on real estate. So long as those funds are flowing, construction activity will remain elevated — and with it, steel and iron ore prices.



There are certainly ways this rally could be tamed. Beijing wants to halt capacity and output growth in the steel industry after last year's huge increases, for instance — but industry figures are already predicting that this would simply shift consumption from domestic metal to imports, with little net effect on steel demand.

It's possible, too, that credit tightening could be drastic enough to rein in the construction boom going on in China's cities right now. Still, the likelier bet is that credit, construction and rebar demand don't start to decline until they hit their usual annual peak in June. If Chinese policy makers really want to cool iron ore prices, they're going to have to ensure the country's savers have a more attractive avenue of investment than real estate.

Iron Ore