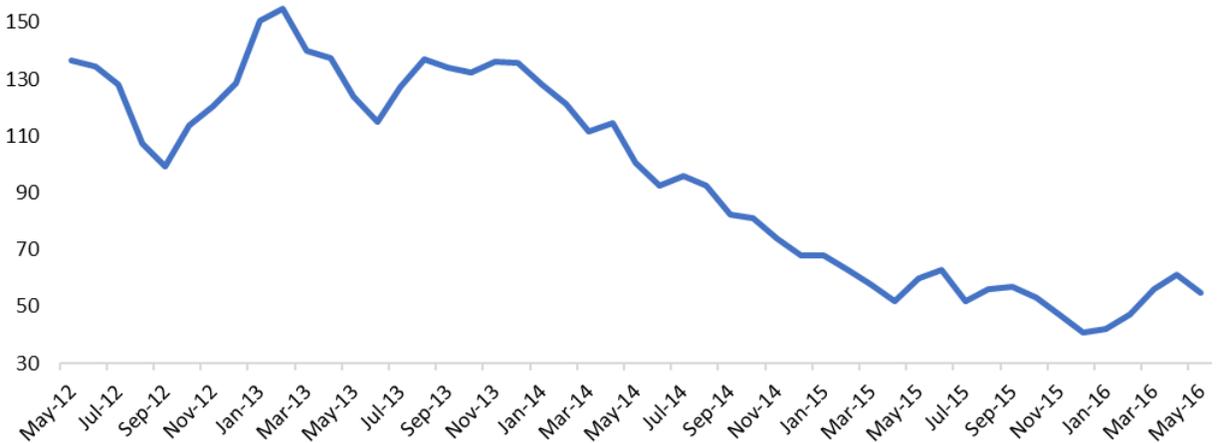


Bleak Horizon for Iron and Steel to Last Beyond 2017

Last year was a nightmare for the metal markets. Oversupply and decrease in demand had fingers pointing at the slowing Chinese economy. The picture doesn't look any better for 2016 and it's unlikely to recover before 2017 yet the world got excited in April when the iron ore closed at \$61/metric ton, up 45% compared to December 2015. However, the excitement was short-lived and in May it bounced back to \$55/mt showing that the road to recovery is long. Aluminum, copper and zinc followed roughly the same trend.

Evolution of Iron Ore Spot Price (Any Origin) – USD/metric ton



Source: World Bank

All metal producers have been forced to destock and lower their production costs but only the largest producers are still able to secure a margin under \$50/mt mainly due to their economy of scale and access to surface deposits that are less capital intensive to exploit. Some are facing the same inertia paradox as the oil and gas producers: it is cheaper to keep producing than to shut down operations. The rest face bankruptcy, consolidation and taking mines and production facilities off-line while waiting for better days.

No country is suffering more from China's economic downturn than Australia. China is Australia's main economic partner and the main export is iron ore. In 2015, iron ore accounted for 50% of all Australia's exports to China. The industry survives mainly because of the high production efficiency reached by the main players: BHP Billiton, Rio Tinto and Fortescue Metals which produce at around \$30/mt.

Iran was in 2012 the 10th largest iron ore producer. In the middle of this global capacity reduction and with sanctions lifted, the government, with the help of massive FDI has set out to boost capacity. With a little help, Iran, one of the richest countries in minerals, has the potential to rise fast to the top 5 producers of iron and steel.

Few Industry analysts still believe that we will witness soon a revival of the Chinese demand of metal but they cling to 2 demographic trends:

1. The migration from rural to urban areas should, at least theoretically, boost a steel-intensive construction industry. But the construction spree of the past years has already led to a property market saturation and a bouquet of “ghost towns” all over China. It is unrealistic to believe that demand for residential or commercial buildings will ever go back to the pre-slowdown figures.
2. The expansion of the Chinese middle class which and lead to a higher purchase rate of appliances and vehicles. However, both purchases of appliances and vehicles saw a weak performance in 2015. The Rural Appliance Rebate program had an insignificant impact on the boost of sales. The car sales in 2015 were 7.3% higher than 2014 but the growth is moderate compared to the compounded average of 20% over the previous 10 years. A McKinsey forecast estimates demand to slow down further to 5% annually through 2020.

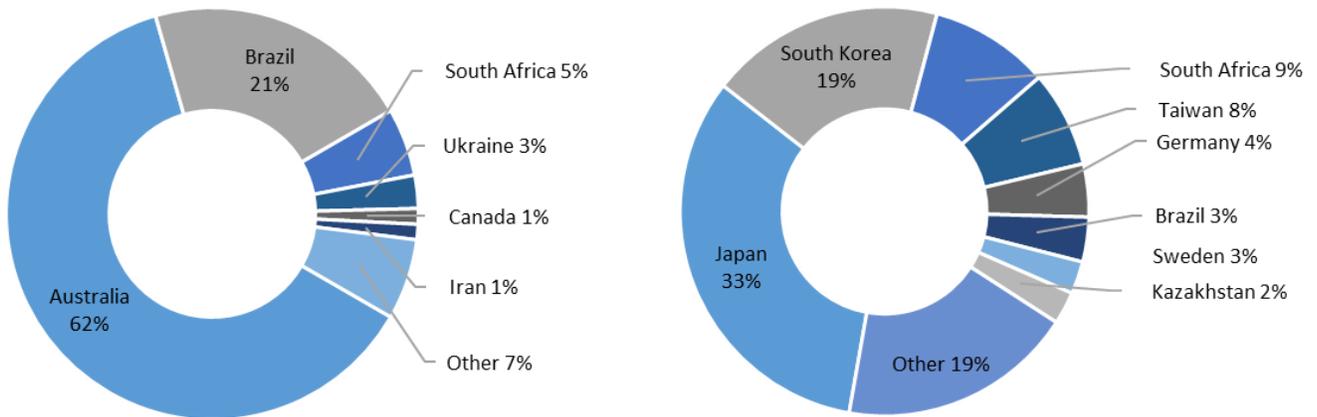
According to the World Steel Association, the decline in steel demand in China is expected to be -4.0% in 2016 followed by -3.0% in 2017.

Instead, many look hopefully at India which is the only country in the top 10 importers of iron ore and iron and steel to have increased imports compared to 2014 by 14% and 4% respectively. However, India is very far from catching up with China in demand. India’s imports are just a small fraction of China’s (less than 1%) and the hurdles of outgoing land reform, infrastructure and bureaucracy continue to linger despite Modi’s government efforts.

Africa has also been regarded as the next big market for metals but and nobody believed it more than China which invested substantially in infrastructure and industrialization. After all, Africa is incredibly rich in iron, copper and zinc among others. While the investment pipe tightened when China started slowing down, it is safe to assume that when/if Africa will start importing, the imports will come, at least until everyone else catches up, from China.

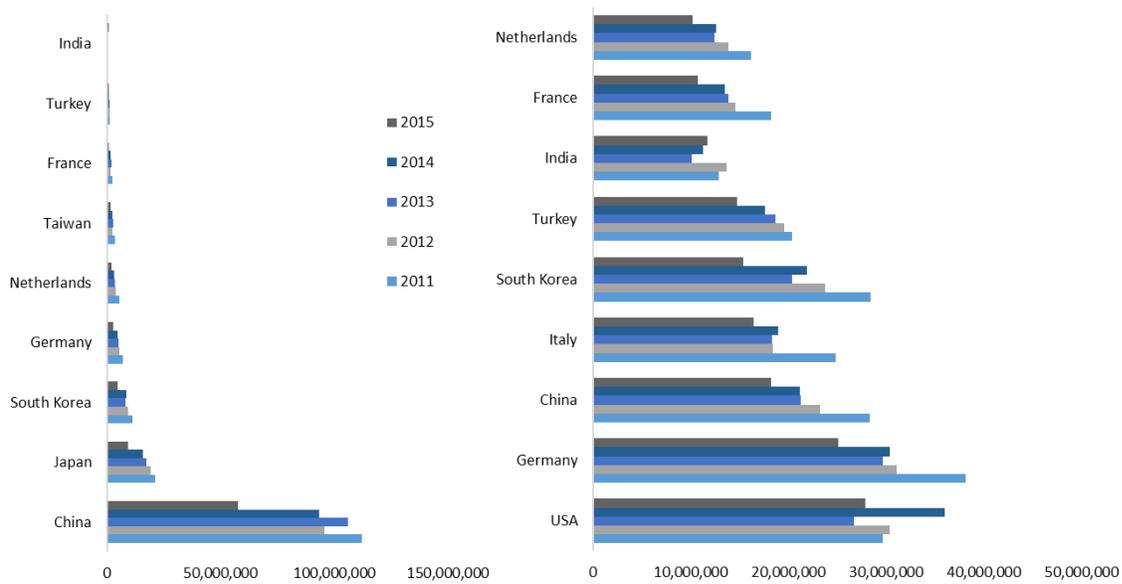
All signs indicate that there is no quick fix, that the combination of oversupply and flat demand is here to stay beyond 2017. Even with the moderate growth of demand in India and the rest of the world, there is no replacement for China. Low prices will continue to be a reality crippling investments in the industry and forcing producers to become production efficient or throw in the gloves.

2015 China's imports of iron ore (left) and iron and steel (right) by country of origin



Source: Trade Map

5-year evolution of imports of iron ore (left) and iron and steel (right) in thousands of USD.



Source: Trade Map