WORLD STEEL DYNAMICS®

Truth & Consequences #76

The Truth: **Sustained Chinese steel overcapacity.**

The Consequence: **Mercantilism.**

Early Warning System

Background – Emphasis on Chinese steel

The precipitous decline in steel export prices this past year, which is largely the result of the Chinese steel mills' incredible export offensive – we call it the "Chinese steel exporting armada" – has brought about: a) massive and sustained losses for a number of steel companies the world over; b) accelerating steel company plant downsizings, abandonments and restructurings; c) the prospect for increased steel industry M&A activity; and d) a surge in steel trade suits against the Chinese steel mills. *(Note: Any governmental action to restrict delivery of a foreign manufactured product, including steel products, is mercantilism – with mercantilism defined as a government policy that seeks to promote the success of domestic industry.)*

WSD believes the following is likely regarding the outlook for 2016:

- **Today's export price for hot-rolled band is unsustainably low** because it's so far below the mills' costs. In fact, it's rallied in China in the past week. Hence, we expect the export price to rise at least $50 per tonne by next spring to perhaps $330 per tonne, FOB the port of export. This rise may occur even granted a further 10% fall in iron ore and steel scrap prices over this period. This price increase will ease, but not eliminate, the massive losses that many Chinese steel mills are incurring, especially when exporting their commodity-grade steel products. The Chinese mills' problem is the close linkage between their domestic and export price for hot-rolled band.

  "Death Spiral" Pricing

  When "death spiral" prices are in effect, the price should be expected to rally at times for inexplicable reasons. When the price is at or below a mill's variable cost, the penalty for the producer is so huge that output cuts are inevitable. And, since the buyer has a good sense of the producer's cost, the buyer may decide to step up purchases.

- **Hot-rolled band in the USA spot market seems poised to rally in early 2016** as the domestic mills' trade suits, past and present, begin to more significantly restrict offshore deliveries of sheet steel product. The USA mills are seeking to create a "Fortress America" situation for hot-rolled band, cold-rolled coil and galvanized coil. Our "most likely" scenario calls for the USA hot-rolled band price, delivered to the steel mill, to rise $50-70 per net ton to about $415-425 per net ton. If so, the premium versus the world export price would be about $135 per tonne, which would be relatively small versus that in recent years.

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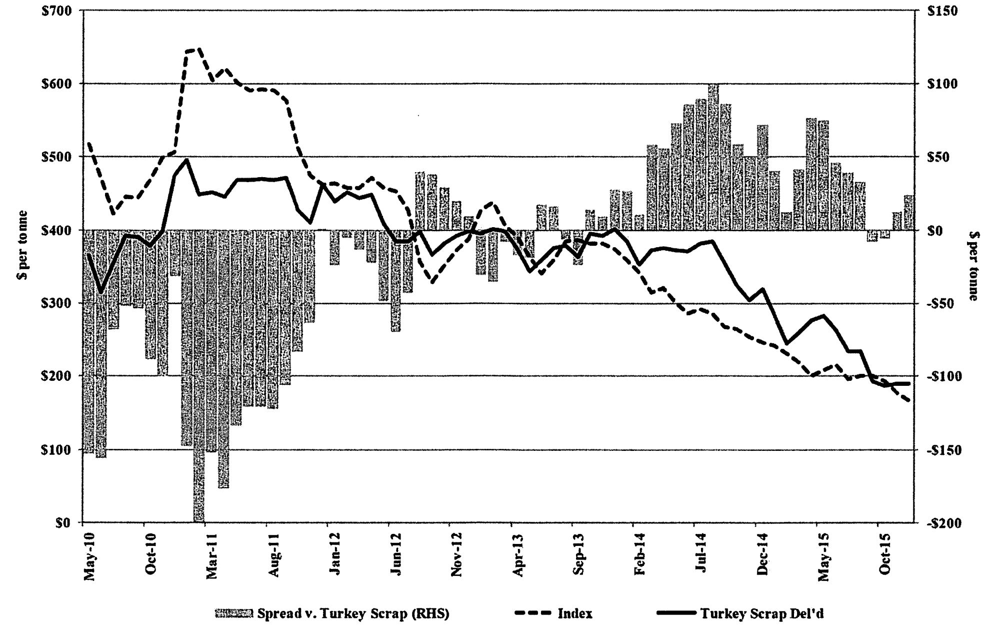
**80/20 HM Scrap Delivered to Turkey versus
Weighted Iron Ore/Coking Coal Price Index**



Source: WSD Estimates, Platts, Steelbenchmarker

- **Steel mills in many countries continue to file anti-dumping and countervailing trade suits**. In general, if they don't have trade protection, they die.

- **Steel demand in 2016 looks to be flat to down in most countries**, including China, Russia, Brazil and the Middle East. The Chinese government has just announced further actions to cut down on fixed asset investment as a share of GDP, pare back municipalities' debt and reduce excess capacity at state-owned companies. Overall, steel mills globally will be forced to operate at a fairly low rate of capacity – with adverse financial consequences given their high fixed costs and virtually non-existent profit margins.

- **Reductions in steelmaking capacity will become much more widespread.** Most steel mills lack the financial wherewithal to maintain idle capacity in a ready-to-operate basis. In only a few cases is steelmaking capacity still rising, including a new mega plant under construction in Vietnam by Formosa Plastics, and two sizable new and/or expanded steel plants in China at coastal locations.

- **The global economic environment in 2016 may not work to the advantage of the steel mills given their late-in-cycle and derived-demand characteristics.** There are uncertainties with respect to:

  - Oil prices and related capital spending on energy projects (which tend to be highly steel intensive).