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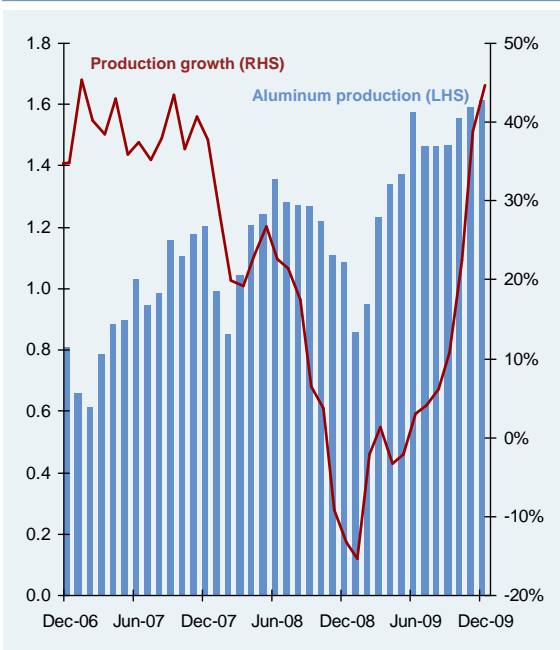
China's aluminum sector still grappling with overcapacity and large stockpiles

With net imports amounting to 1.45m tons of primary aluminum in 2009, the remarkable scale of Chinese demand for imported material (although skewed by arbitrage buying) helped lift international prices by 45.7% in the midst of the financial crisis. According to a recent discussion with Chalco, domestic aluminum consumption is expected to increase 23% in 2010 as demand from the real estate and auto sectors (which in aggregate consume more than 50% of China's aluminum) remains buoyant. However, the discussion highlighted an alarming scale of stockpiling and overcapacity in the sector.

- **High inventory levels add further pressure to price outlook.** According to Chalco, current inventories held by traders and warehouses amount to 400,000-500,000 tons (including inventories in Shanghai Futures Exchange). While China's State Reserve Bureau is understood to have stockpiled 600,000 tons of aluminum last year, local governments also purchased approximately 500,000 tons of aluminum over the course of 2009, bringing total government stockpiles to ~1.1 million tons.
- **Undisciplined domestic production adds pressure to aluminum price.** While total primary aluminum production in China fell 1.3% in 2009, the YoY growth rate surged over the course of the year, reaching 40.7% in December. By December, the industry's annualized production output was approaching 17 million tons, compared to 11 million tons in January (see Figure 1a). Since producers are still able to earn a positive margin at current prices, domestic production volumes are likely to stay elevated, thereby ensuring a continued supply surplus. This is likely to exert pressure on prices, especially if global restocking and/or Chinese demand slow later in the year.
- **Consolidation not materializing.** Although the government has been advocating industry consolidation, Chalco noted that M&A in the aluminum industry has not made material progress in recent years and thus the industry remains decentralized. Few synergies can be realized from the merger of smelters and each company would prefer for capacity reductions to be made by its competitors. The Ministry of Industry and Information Technology estimates industry capacity is currently at 20 million tons, exceeding demand by 7 million tons.

Looking forward, recovery in global demand will need to play a much bigger role in order for investors to see further gains in aluminum prices as Chinese appetite for imported aluminum wanes.

Figure 1a: Growth in production of aluminum products (mn tons, %)



Source: CEIC, Bloomberg

Figure 1b: Aluminum prices – SHME vs. LME (RMB/ton, incl. VAT)



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