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HANDS-ON CHINA REPORT
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China's Commodity Hunger Still on Display

China's imports of major industrial commodities showed a slight pattern of moderation in September, although imports of crude oil notably reached a fresh monthly record. With China's latest industrial production and PMI indicators suggesting that the deceleration in growth is bottoming out, we expect demand for imported metals and oil to remain healthy even as the nation adjusts to a more sustainable level of trend growth. Imports of steel-making ingredients, however, may soften over the coming months, reflecting the moderation in construction and China's energy conservation campaign.

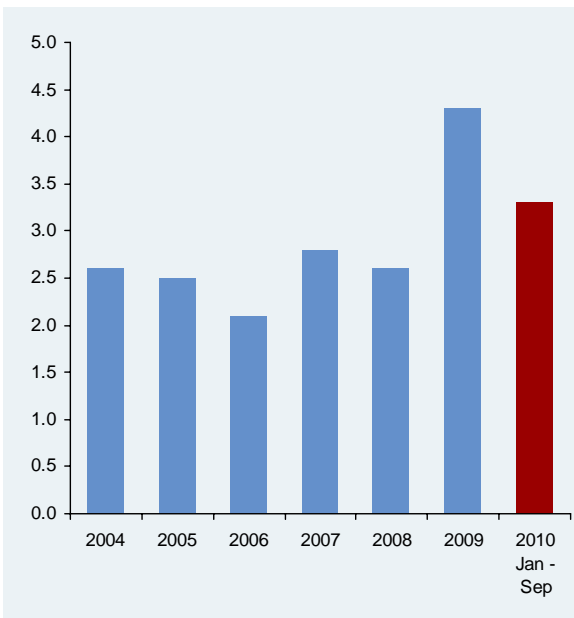
Metals traders and producers at LME week continued to be bullish on China's demand, and were near-unanimous on the bright outlook for copper in particular. The slowing economic momentum in developed countries is lending increasing weight to the prospect of further quantitative easing in the U.S and thus a stronger preference for hard assets. In the next 12 months, our global commodities team is optimistic about the pricing outlook for crude oil and copper, as a result of the relatively tight global supply and demand picture.

- **Copper imports affected by poor arbitrage.** China imported 368,410 tons of unwrought copper and copper products in September, down 2.9% from 379,527 tons in August and down 7.7% over year-ago levels. Despite the dip, import levels may still be considered relatively high, considering that the arbitrage between LME and the Shanghai Futures Exchange has been largely closed from late-July onwards. China's copper imports have surprised on the upside so far this year – off by only 1.3% from 2009's record level, despite aggressive de-stocking and the higher availability of scrap material in recent months.
- **Weak aluminum imports.** September imports of unwrought aluminum and aluminum products amounted to 65,800 tons, down 9.4% month-on-month and down 66.4% year-on-year. The other major component of aluminum-related imports by value, aluminum waste and scrap, fell 27.3% year-on-year, and 7.7% month-on-month to 240,000 tons. Despite aggressive production cuts to reduce energy consumption, the industry still suffers from serious overcapacity. At current spot prices, imported aluminum is priced at RMB 2601 premium to SHME after VAT.
- **Iron ore imports moderating.** September imports of iron ore totaled 52.6 million tons, contracting 18.5% YoY. China's iron ore imports have now seen year-on-year declines for 6 consecutive months. Following the implementation of recent energy efficiency directives, China's steel output declined for the first time this year in August, falling 1.3% YoY. The China Iron and Steel Association estimates that national restrictions on electricity may cause 25.7 million tons of steel production cuts, which in turn suggests softer iron ore and coking coal demand.
- **Oil demand continues steady rise.** China's crude oil imports reached a record 23.3 million tons in September or 5.67 mbpd, up 35% YoY. Net imports of crude oil were also a historical high at 22.9 million tons, representing a 10.9% increase over August, and a 36.2% increase YoY. Year-to-date net crude imports were 179.2 million tons, 26% higher than the same period last year.

■ Copper Imports Reflect Poor Arbitrage, but YTD Inflows Remain Robust

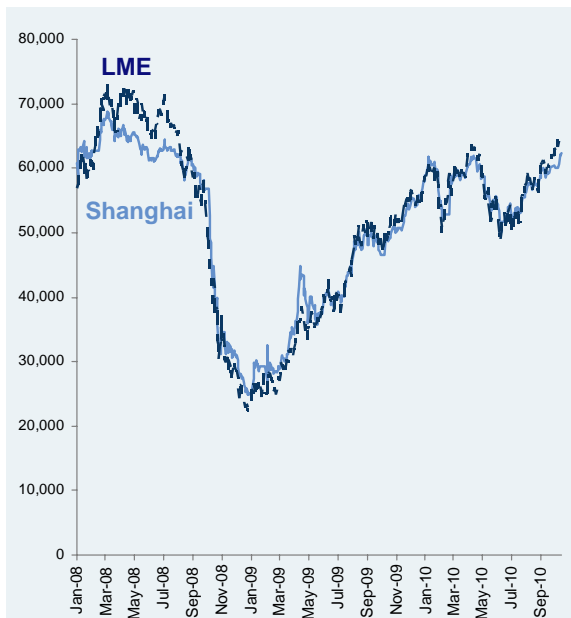
China imported 368,410 tons of unwrought copper and copper products in September, down 2.9% from 379,527 tons in August and down 7.7% over year-ago levels (see Figure 1). Despite the dip, import levels may still be considered relatively high, considering that the arbitrage between LME and the Shanghai Futures Exchange has been mostly closed from late-July onwards. Following a 13% rally in LME copper prices from August 25 to end-September, the price gap between Shanghai and LME copper widened to as much as RMB 4,413 on October 6, resulting in losses for spot importers. China also imported 410,000 tons of scrap copper in September (+3% MoM, -0.4% YoY), bringing year-to-date imports to 3.22 million tons, or 7.6% higher than the corresponding period in 2009. The increase in scrap imports this year has partially offset demand for refined copper and we expect the recent strength in copper prices will further underpin scrap demand.

Figure 1a: Imports of unwrought and semi-finished copper products (mn tons)



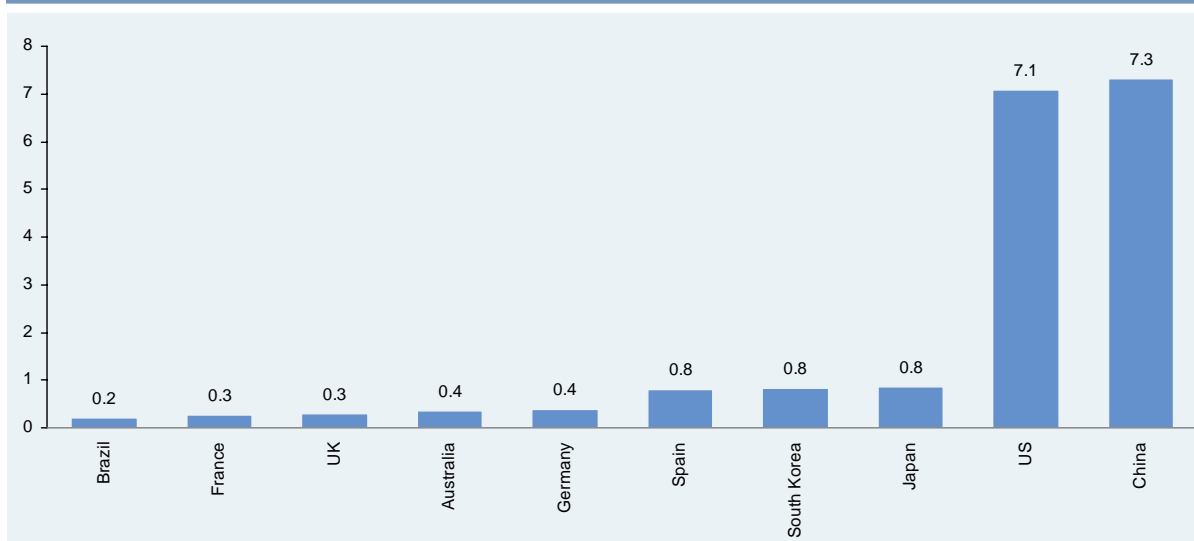
Source: CEIC, Bloomberg

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



China's copper imports have been remarkably resilient so far this year – down only 1.3% from 2009's record level, despite aggressive de-stocking and the higher availability of scrap material in recent months. Copper's fundamentals remain tight, and despite the moderation in Chinese real estate investment growth (40.9% in March, compared to 32.5% in August), ambitious plans to upgrade the power grid, build affordable homes and expand the railway network have resulted in large-scale construction work that will help underpin demand. Additionally, structural consumption changes are bringing increased household demand for durable goods and passenger vehicles – both of these categories are highly copper-intensive.

Figure 2: Top 10 countries by total smart grid investment (est. 2010 US\$ bn)



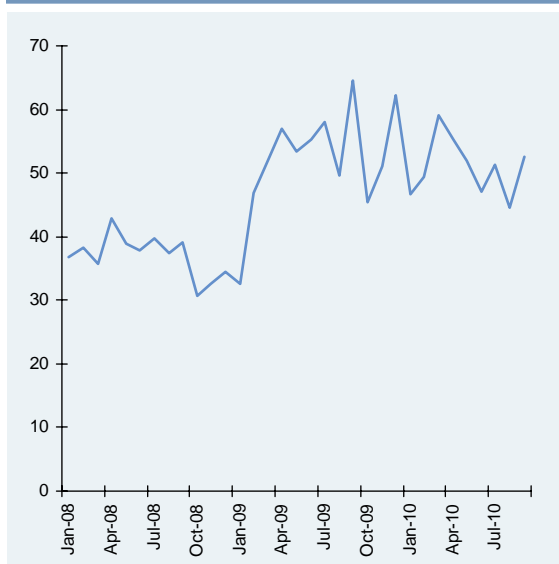
Source: Zpryme Research and Consulting

Despite the possibility of monthly volatility, we believe the medium-to-long-term prospects for Chinese copper imports are strong, particularly since the moderation in industrial production appears to have bottomed out.

■ Iron Ore

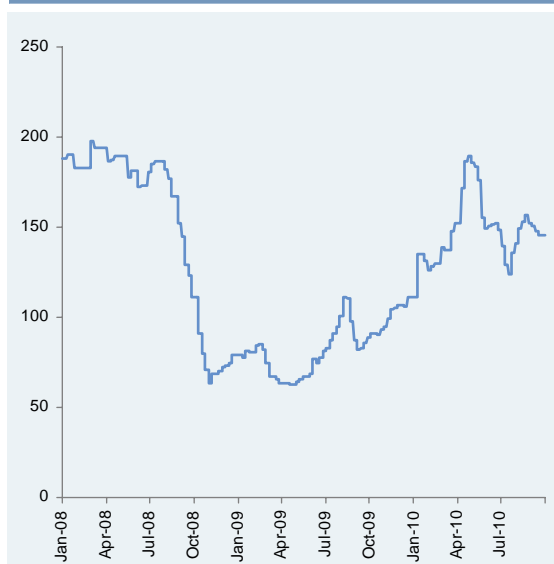
Electricity supply cuts and enforced facility closures contributed to a 1.3% YoY decline in China's steel production in August, compared to 27.6% growth in April and 2.1% growth in July (see Figure 3).

Figure 3a: Iron ore imports (mn tons)



Source: CEIC

Figure 3b: Iron ore spot price (RMB/ton)



Meanwhile producers' steel inventories have continued to grow, albeit at a slower pace, which suggests that production growth may remain modest even when energy restrictions are eventually lifted (see Figure 4).

Figure 4a: Crude steel production growth (%)

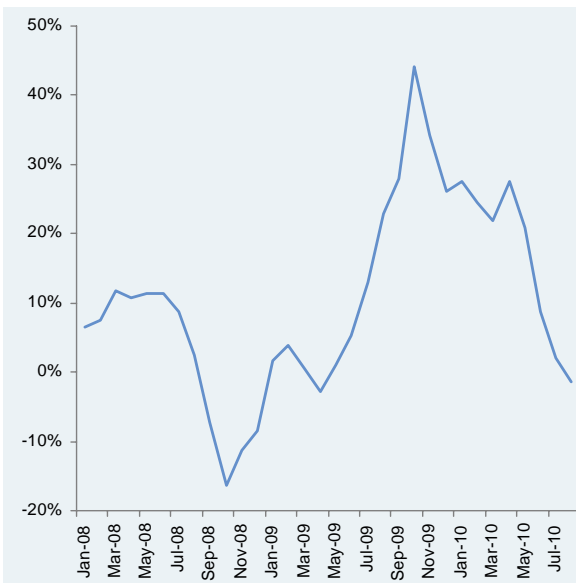
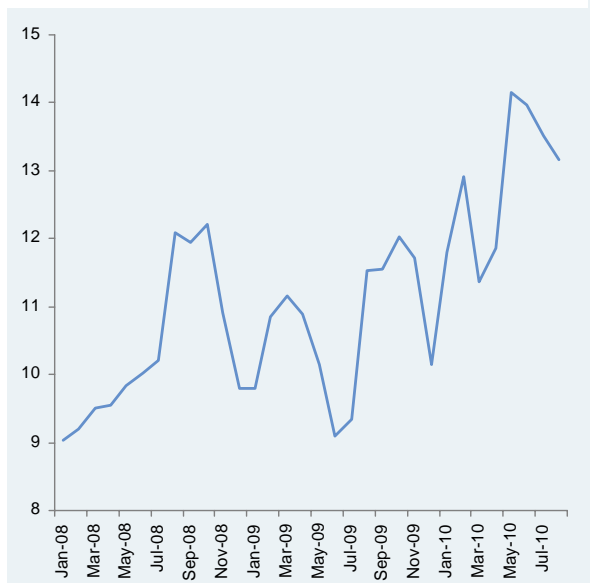


Figure 4b: Producer level steel inventory (million tons)



Source: Bloomberg, J.P. Morgan estimates

- Lower visibility for construction demand. The uncertain outlook for construction activity, both as a result of fading infrastructure stimulus and the government's property tightening stance, is now reflected in softer Chinese iron ore demand. According to the World Steel Association (WSA), China's apparent steel use is expected to slow considerably in 2H10, after expanding 24.8% in 2009 and 9.2% in Jan-Aug. The WSA estimates 2010 and 2011 apparent consumption growth of 6.7% and 3.5%, respectively. Although we acknowledge poor visibility in near-term demand, there are still a number of factors that are supportive of steel demand in the medium to long-term, including China's structural consumption boom, aggressive affordable housing plans and policy-support for the accelerated development of Central and Western provinces, which should feature prominently in the 12th five-year plan.

- Rising domestic production. With spot iron ore prices surging by almost 70% YoY, domestic mines have been ramping up production to take advantage of higher prices. Between Jan-Aug, domestic iron ore production grew 15% YoY, while import volumes remained flat over the same period. Assuming that domestic iron ore grades are half the quality of imported ore, China's import dependence is estimated to have declined from 59% to 54.3%.

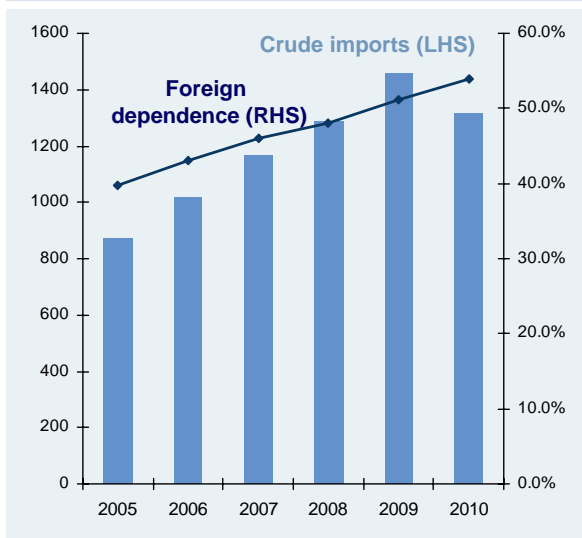
- Scrap recycling picks up. According to CISA, China will recycle 100 million tons of steel scrap in 2010. This is approximately 20% more than the 83.1 million tons recycled in 2009 and should contribute to a reduction in raw material demand. The increased recycling of steel is also consistent with government efforts to lower industrial demands on scarce electricity and water resources.

■ Oil Imports Continue Steady Rise

Recent reports have linked the increase in China's net imports of oil to the nation's Strategic Petroleum Reserves. China's oil reserve program is still in its nascent stage, in contrast to the country's oil demand, which already ranks second in the world at 10.3% of global demand, according to the EIA.

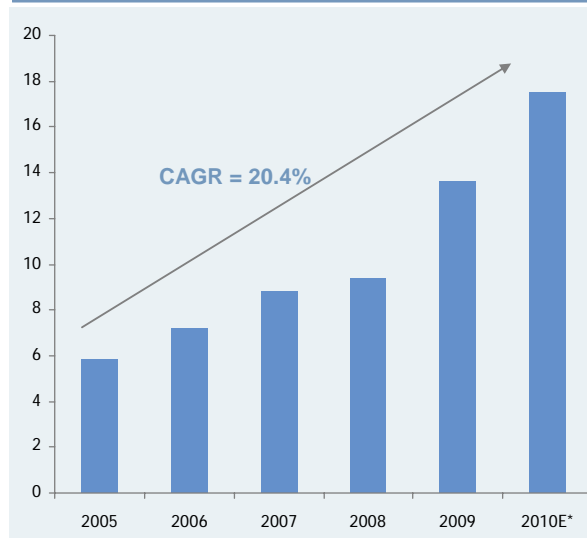
Another contributor to the rise in demand is the booming domestic auto market. Chinese auto sales exceeded 13.1 million units during Jan-Sep and could reach 17 million by the end of the year. This compares to 7.8 million units in the US between Jan-Sep.

Figure 5: China's crude oil import and foreign dependency (mm bbl, %)



Source: CEIC *2010 based on annualized data for Jan-Sep 2010

Figure 5: Automobile sales (mn vehicles)



- Foreign oil dependence on the rise. With domestic crude oil production growth at 6.8% YoY in August while apparent demand increased 11.2%, China's foreign oil dependence has moved beyond the 50% warning threshold. The oil dependence ratio increased from 49.9% between Jan-Aug 2009 to 53.9% in the first 8 months of 2010, indicating a high likelihood that China's reliance on foreign oil will continue to rise above last year's level by the end of 2010. China's foreign oil dependence was 46.8% in 2007.

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