MarketWatch

China faces steel-production paradox

By Chris Oliver
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A steel mill in the northwestern Chinese city of Jiayuguan.

HONG KONG (MarketWatch) — Steel prices are weakening, but Chinese steel mills are ramping up production anyway, adding to concerns of a serious price crash from analysts already worried about the sector.

The latest round of industry data tracking output over a 10-day period showed Chinese steel production increased 1.1% in early August, confounding expectations for a decline in output by volume.

The results prompted Nomura analysts to say in a note Tuesday said they were “very concerned,” having forecast a 5% decline in output for the output.

In fact, the results were so surprising, they raised the possibility that the data compilers had gotten their numbers wrong.

The China Iron & Steel Association (CISA) calculates the figures using actual data from 70% of affiliated mills and then estimating the output at non-affiliated mills.

Discrepancies over actual output have been a source of dispute in the past between the CISA and China’s official Statistics Bureau. It’s possible, Nomura said, China’s smaller steel mills have already cut back, and that CISA has failed to account properly for the cooling.

But a more ominous likelihood is that the Chinese steel producers are reluctant to throttle back their output in spite of softening demand.

China's appetite for Australian commodities fades

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Australia's economy faces a strain as China's appetite for resources diminishes and commodity prices fall.

Nomura appeared to accept this latter scenario, saying that In spite of softening conditions, Chinese steel mills aren’t responding to price signals.

The analysts placed the blame on industry already plagued with overcapacity and a fragmented ownership system ill-equipped to cooperate in setting production targets.

“As mills are structurally encouraged to over-produce, they compete away industry profitability, which in recent years has provided support for raw materials markets, but also increases the risk of periodic ‘inventory crashes,’ where excess steel production reaches a point where de-stocking is required to remove excess from the system,” Nomura said.

Nomura is by no means alone in taking a dim view of Chinese steel. Earlier this month, Citigroup reaffirmed its bearish outlook on China’s steel sector, warning of deteriorating fundamentals in the third quarter, which should see shrinking production and inventory write-offs.

It warned of that the sector would experience losses in every quarter of 2012, marking the first time in history an entire year has been a washout.

"We see excessive capacity becoming more excessive, capping the upside for a seasonal rebound," Citigroup said in an Aug. 14 note.

Citi added that previous rounds of government-led fiscal stimulus have in fact added to the excess supply problem now weighing on the sector.

According to CISA data, average daily steel output in the 10 days through Aug. 10 totaled 1.9699 million tons, up from a 1.9494 million ton daily average in the 10 days ending July 31.

Nomura said the mounting steel inventories would eventually result in liquidation, although it wouldn't venture a guess on how severe the coming hangover would be or how lengthy the production cutbacks would have to be to bring the industry back to heath.

Many of China's smaller steel mills are already unprofitable, operating under conditions which don't even enable them to recover the marginal cost of the iron ore used to make steel, according to Nomura.

Nomura said it was maintaining its reduce recommendation on major names Maanshan Iron & Steel Co. (323)(600808) MAANF, +14.63% and Angang Steel Co. (347) (000898) ANGGY, +4.13%

even as steel prices weaken, prompting warnings from Nomura of a coming inventory deluge that could send prices into a depression era style crash.

Nomura in a note Tuesday said it was "very concerned", saying the output data confounded its own expectations for a 5% decline in output.

So out of line were the results from its forecast that it even raised the prospect that data compiler, China Iron and Steel Association (CISA), which calculates the figures using actual data from 70% of affiliated mills and estimating output at non-affiliated mills, had got its numbers wrong.

Discrepancies over actual output have been a source of dispute in the past between the CISA and China's official Statistics Bureau. It's possible, Nomura said, China's smaller steel mills have already cut back, and that CISA has failed to account properly for the cooling.

Another possible explanation for the output rise is increased production among Chinese steel mills reluctant to throttle back in spite of softening demand.

In spite of softening conditions, Chinese steel mills aren't responding to price signals, according to Nomura, which cited industry overcapacity and fragmented ownership system ill equipped to cooperate in setting output targets.

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