HORIZONS

The great reopening:

What the end of China's 'zero-Covid' strategy means for global energy and natural resources

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What the end of China's 'zero-Covid' strategy means for global energy and natural resources

China's uncompromising approach to eliminating Covid-19 ranks among the most ambitious social experiments in history. For almost three years, the country locked down its entire population to fight the virus, seemingly regardless of cost or consequence.

On top of the human impact, China's 'zero-Covid' policy hit its economy hard. Gross domestic product (GDP) growth slumped to 3% last year – aside from the onset of the pandemic in 2020, its lowest annual growth rate in almost half a century. This inevitably affected energy demand, leading to a contraction in Chinese oil consumption in 2022, while liquified natural gas (LNG) imports slumped 20% year on year. Meanwhile, low-cost domestic coal production – and China's carbon emissions – grew.

Then, with minimal fanfare, President Xi Jinping announced in December that China was in a "new situation" and would reopen its borders and abandon quarantine measures from 8 January.

This reconnection with the global economy will undoubtedly boost trade and investment. More deals will get done. Chinese consumers have three years of savings to spend and a substantial appetite for 'revenge travel'. Domestic energy consumption is already rebounding.

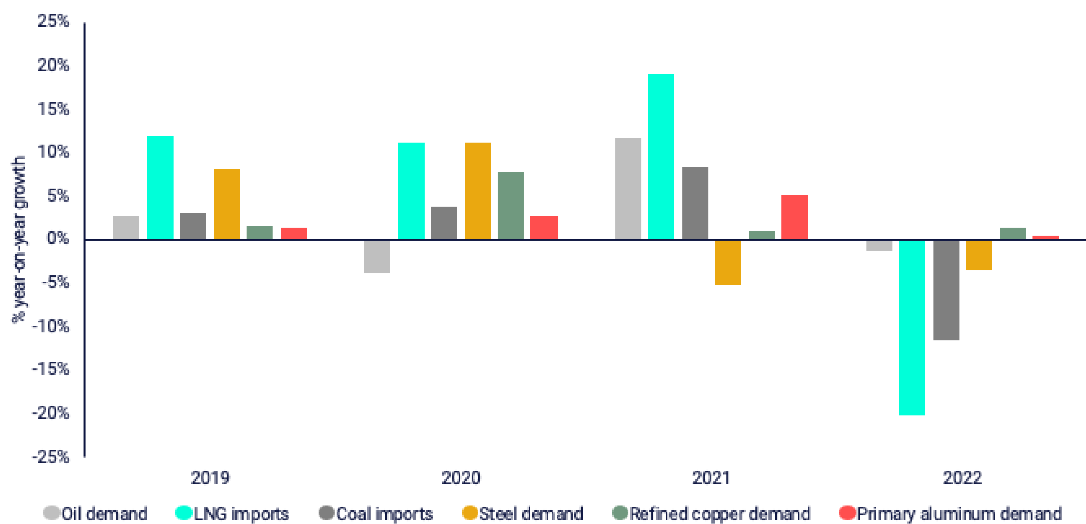
Yet China's leadership remains cautious. At the opening of the National People's Congress in early March, outgoing Premier Li Keqiang announced a growth target of "around 5%" for 2023. Under our base-case scenario, we now expect China's economy to grow 5.5% this year.

But this could still prove conservative. To understand what stronger growth might mean, we have developed a high-growth scenario for China in which the government pulls out all the stops to get the economy moving and win back lost ground over the last three years.

Our scenario is bullish for all commodities. Finely balanced markets for oil, LNG and coal are leveraged to a super-charged Chinese bounce.

In this month's Horizons, we assess the possible pathways for the Chinese economy and the impact of its reopening on global energy and natural resources supply, markets and prices.

China – commodity demand: year-on-year change



Source: Wood Mackenzie

The great reopening: managed recovery or economic boom?

Our base-case scenario for China sees GDP growth of 5.5% in 2023 and 5.1% in 2024. The recovery is driven by Chinese travellers taking to the roads and skies, a consumption boom that will ramp up from March and a turnaround in the property sector in the latter half of the year.

But what if the government decides to push harder? China has set a target of 5% for 2023, but its historical GDP growth has a track record of outpacing government forecasts – in 12 of the past 18 years growth has exceeded the official target. This is likely another case of under-promising and over-delivering. Our China high-growth scenario centres on the economy growing by 7% in 2023 and 5.5% in 2024.

The key differentiator in our high-case scenario is that the recovery is more industry-intensive

This isn't heroic. After sluggish expansion during the pandemic, China's leaders could try to make up lost ground. In 2022, economic output was 3% below the pre-Covid trajectory, an output gap equal to US$1.2 trillion (in 2015 prices) over 2020-22. For context, China forfeited growth equivalent to more than the Indonesian economy over those three years.

The key differentiator in our high-case scenario is that the recovery is more industry-intensive. China turns to the familiar playbook of stimulating infrastructure investment by issuing local-government bonds, far surpassing last year's RMB4 trillion (US$600 billion, or 3.3% of GDP). In doing so, construction growth is catapulted to 10.7% in 2023 from our base-case estimate of 3.2%.

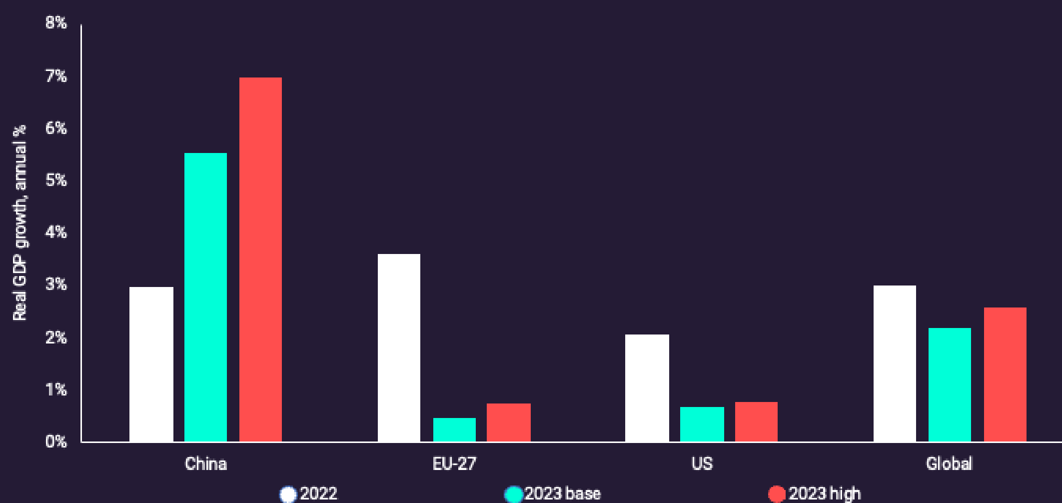
China's property sector endured a pretty horrid 2022. Completing stalled projects is the priority for H1 2023, with sales, prices and new starts recovering later. In our high case, removing restrictions on home purchases in many top-tier cities and offering greater discounts on mortgage rates bolsters the property market's resurgence. This stimulates construction activity in the residential segment into 2024.

While a household spending spree is baked in this year, greater exuberance would see savings unwound at breakneck speed. Some US$2.2 trillion (12% of GDP) of excess savings have been squirrelled away over the past three years. Inventories, which hit an all-time high last November, will meet most of this demand. Services will surge.

Our base case assumes China's rebound to be largely domestically contained, with only a muted impact on the slowing global economy. We don't anticipate a global recession this year, despite recent turmoil in global financial markets following the collapse of Silicon Valley Bank. But we do expect the economic slowdown across western economies to continue for several months before reaching a turning point in the second half of 2023.

The industry-intensive nature of the high case, instead, means there are positive ripple effects on the global economy. Exporters of capital equipment, resources and materials enjoy upside. The global economy grows by 2.6% in 2023 (versus 2.2% in our base case) and 3.4% (versus 3.2%) in 2024.

GDP: base case vs China high growth case

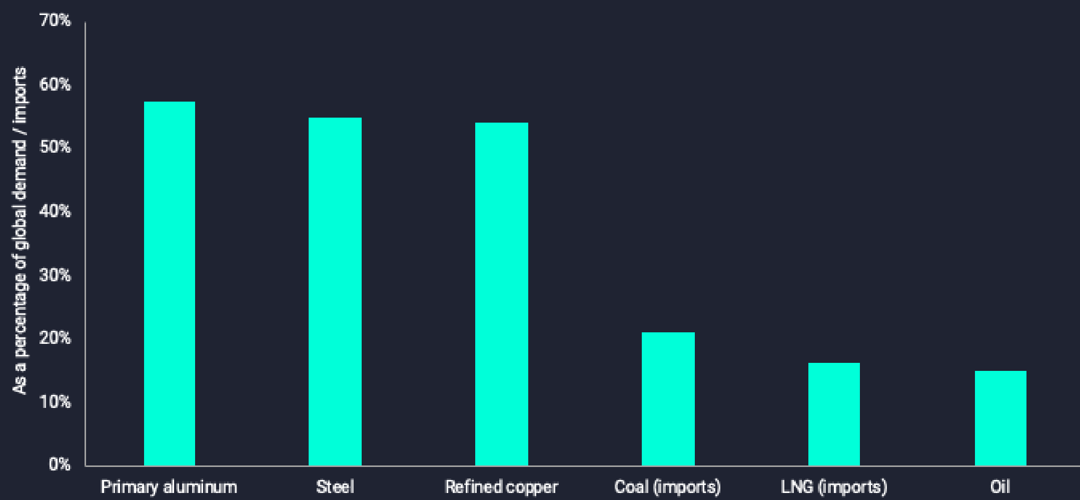


Source: Wood Mackenzie

Recovery vs boom: China demand and global pricing implications

What does this mean for energy and natural resources? China is the world's largest importer and consumer of virtually all major commodities, driving investment and price formation like no other country. Consequently, faster-than-expected Chinese growth would reshape short-term supply and prices dramatically. Few commodities remain unaffected, but some are more impacted than others.

China – percentage of global demand/global trade (2022)



Source: Wood Mackenzie

Oil prices are set to rise

In our base case, a strong recovery in global oil demand in 2023 drives a tightening of the global supply and demand balance and pushes prices higher. A return to normal mobility in China is the single biggest demand driver, accounting for 1.0 million barrels per day (b/d) of the 2.6 million b/d increase this year. Oil demand in Europe and the US is expected to remain resilient, despite the slow economic growth. Barring a significant recession, we see Brent rising from current levels to average US$89.40/bbl for 2023.

In our China high-growth scenario, the tightening of the supply-demand balance accelerates as the recovery gathers pace, particularly through H2 2023. Our analysis shows that increased construction activity results in China's oil demand growing by 1.4 million b/d on the year, or about 400 kb/d higher then our base case. This additional China demand in a year with very strong global growth tightens the market further. The effect on oil prices for 2023 would be a higher annual average of US$3 to $5/bbl than in our base case.

Refining margins in our base case are set to decline towards historical norms as global capacity additions outpace demand growth for transport fuels. Chinese demand for diesel/gas oil and petrochemical feedstocks is stronger in our high-growth scenario, so China's exports of gasoline, jet and diesel/gasoil will be lower, but the global balance is largely undisturbed. The combination of stronger crude oil prices and lower transport fuel exports supports global refining margins by just US$0.5/bbl or so, lifting the Q4 2023 global composite gross refining margin to US$6.6/bbl, still weaker than the Q4 2022 average of US$11/bbl.

Stronger-than-expected Chinese LNG demand is unlikely to lead to a repeat of the chaos seen in 2022

Booming domestic production and Russian pipeline imports limit LNG growth

Chinese gas and LNG demand growth hit the rocks in 2022. Gas consumption declined by almost 2%, while LNG imports fell by an astonishing 16 Mt (22 bcm) or 20%, displaced by increasing domestic production and a faster-than-anticipated ramp-up of Russian pipeline supply.

Gas demand is now rebounding. We expect more than 30 bcm (9%) of demand growth, supported by stronger GDP growth and lower prices. However, booming domestic production (up 14 bcm) and continued growth in Russian pipeline imports (up 7 bcm) will constrain LNG imports to 71 Mt (97 bcm) in 2023. This is just 7.4 Mt (10 bcm) more than in 2022 and still far lower than the 80 Mt imported in 2021.

Our China high-growth case sees gas demand rising even more. Increased construction activity boosts power demand and the energy-intensive sectors, including cement, bricks, glass-making and ceramics, all of which were targeted for coal-to-gas switching. The result is gas demand growing by an additional 10 bcm, which will have to come from spot LNG imports. Yet our high-growth-case LNG demand only reaches 78 Mt in 2023, still short of LNG imports in 2021.

Our base case sees a delicately balanced global market with prices in a range of US$15-20/mmbtu. Stronger Chinese LNG demand will drive up competition for supply at a time when no new projects are expected to be commissioned before 2025. Prices will inevitably increase, although moderating demand elsewhere will limit price upside to US$25/mmbtu.

This is not to suggest that the global gas market is out of the woods; it is a structurally tight market and prices are volatile. But with demand trimmed by high prices, recent mild weather and markets proving resilient in a world without Russian pipeline exports to Europe, stronger-than-expected Chinese LNG demand is unlikely to lead to a repeat of the chaos seen in 2022.

In our high-growth scenario, China sets a record for global coal demand

A potential record-breaking year for global coal demand

Chinese seaborne coal imports fell by 38 Mt in 2022. The 16% decline from 2021 was largely down to China's prioritisation of domestic coal production over more expensive seaborne coal and LNG imports.

Our base case sees significant growth in China's coal demand in 2023: 85 Mt (4%) in the power sector and 17 Mt (1%) in the non-power sector. However, with domestic supply expected to increase by 85 Mt, we see only 17 Mt of import increases this year. As a result, seaborne coal prices remain relatively low, ranging between US$86/t and US$118/t through 2024 (benchmark Newcastle high-ash (HA)).

Coal demand is far higher in the China high-growth case. Demand in the power sector, where coal accounts for 60% of generation, increases by 158 Mt (7%) from last year. Demand for steel and cement, both major coal consumers, also rises, boosting non-power demand to 56 Mt from 2022. Total Chinese coal demand is 112 Mt more than our base-case estimates, 98 Mt for thermal coal and 14 Mt for metallurgical. In our high-growth scenario, China sets a record for global coal demand, exceeding 2019 demand of 8,512 Mt.

Although this increase in demand would primarily be sourced domestically, particularly for thermal coal, China still needs an additional 49 Mt of seaborne coal, including 40 Mt of thermal – a 4% increase from our base-case scenario for global seaborne demand. This would put pressure on a market that remains finely balanced and could potentially cause another spike in coal prices. We see a 37% increase in benchmark Newcastle HA coal prices over our base case by Q2 2023, to US$151/t.

Metal consumption growth tied to recovery in China's property sector

Global metal markets are inextricably bound to China's economy. In our high-growth scenario, where growth is driven by more intensive industrial production and an outperforming property sector, the impact is greatest among the metal market's heavyweights – steel, aluminium and copper.

China accounts for almost 900 Mt of finished steel consumption, just over half the global total. Nearly two-thirds goes into the construction sector. Our base-case scenario already has Chinese steel demand recovering through the second half of the year, partly supported by an uptick in the property sector. However, our high-growth scenario boosts consumption by a further 25 Mt.

In our base case, additional supply over time of steel's key raw materials – iron ore and coking coal – leads to a softening of prices. In our China high-growth case, however, export markets would be unable to adequately respond to a near-term surge in Chinese demand, sustaining higher prices for longer.

Stronger physical demand should underpin a recovery in metals prices, but levels also hinge on sentiment

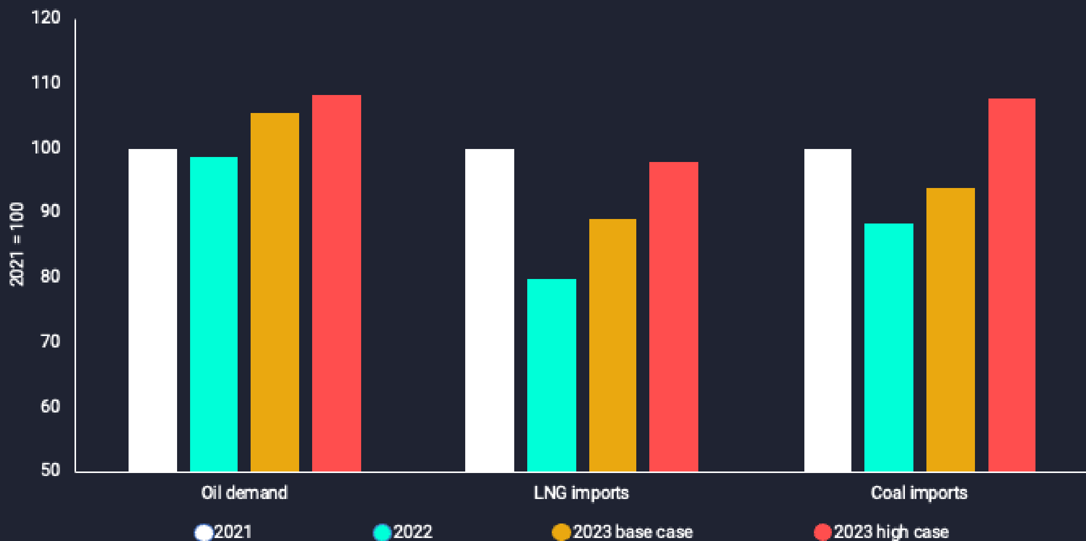
For copper, the key barometer is property completions rather than building starts. Consumption, generally in the form of wire, is skewed towards the later stages of the construction cycle. Consequently, more supportive housing policies in China this year will spill into higher physical demand by the construction industry for 2024. A further impact of our high-growth scenario is a boost in demand for copper for appliances and machinery, though to a lesser extent than in construction. Combined, we estimate an additional 215 kt of copper demand, or 1.6% of total consumption, over the next two years.

Around a quarter of global aluminium consumption is driven by China's construction sector. A stronger property market recovery would therefore support a healthy increase in aluminium demand in 2023 and 2024, adding over 500 kt, or 1.3%, to primary consumption.

Stronger physical demand should underpin a recovery in metals prices, but levels also hinge on sentiment. Positive signals often trigger a flow of speculative money into the sector, turbocharging prices in the short term.

There is a further twist for metals. Higher energy demand could lead to a repeat of the power-related supply disruptions experienced across China and Europe over the past two years. These led to production curtailments in zinc, primary aluminium, steel and nickel.

Commodity demand in China: base case vs China high growth case (2021 = 100)



Source: Wood Mackenzie

Oil is a big winner, with prices set to rise

Trading and investment opportunities abound

China's re-opening is inevitably boosting global demand for energy and metals. This is despite weakening economic growth in Europe and the US. And the faster China grows, the more it consumes. Predictions of an imminent 'peak China' – the year Chinese commodity demand reaches its high point – look premature, in our view. In the near term at least, China remains a capital- and resource-intensive economy as it regains its position as the main driver of global demand for energy and natural resources.

This is even more apparent in our high-growth scenario. Commodity and metals prices run a little hotter for longer, but there is no sting in the tail for inflation, which is past its peak in the major economies. Monetary policy will maintain a more hawkish stance in the high case, but there will be no return to the double-digit inflation of 2022. Our China high case provides a net benefit to the global economy, though it fails to prevent worldwide GDP growth slowing this year.

The outlook will vary from commodity to commodity, however, as it will from company to company.

Oil is a big winner, with prices set to rise. Most of the growth in demand, even in our base case, is predicated on a return to normal Chinese mobility. An even higher Chinese demand equals even higher prices. Simple equation.

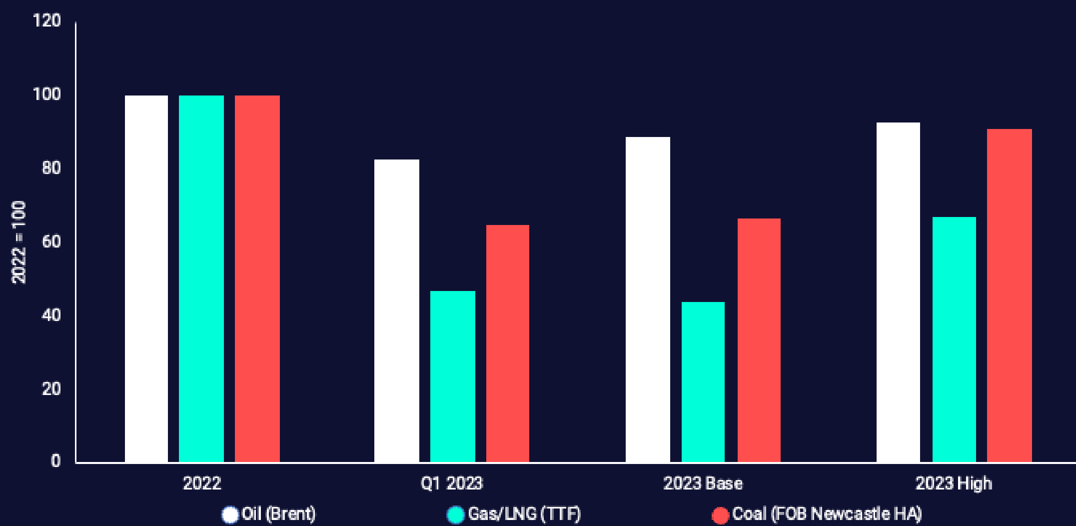
China's reopening means there will be no hard landing in 2023

We also see upside for global coal and gas/LNG prices, though it is arguably less pronounced. Prices have already come down substantially amid the dissipating impact of disruptions following Russia's invasion of Ukraine and as Europe emerges from a warmer-than-expected winter.

At the same time, the outlook for investment in new Chinese coal and gas production has improved, with security of supply at the top of the political agenda. Consequently, it takes the major construction-led boom in our high growth case for China to massively skew prices to the upside. This is particularly true for coal, given China's bigger role in global traded coal than LNG. For metals, too, much of the upside relies on the pace of the Chinese construction rebound, though trading and sentiment will also figure.

For many companies across the energy and natural resources sectors, profits probably peaked in 2022 as the world enjoyed a post-Covid recovery. But China's reopening means there will be no hard landing in 2023. International oil companies are more likely to see a crescendo of quarterly profits throughout the year as oil prices surge, with some upside to gas/LNG prices in our China high-growth scenario. With the fate of coal and metals prices increasingly dependent on China's construction sector, profits for commodity traders will be closely bound to Beijing's macroeconomic and housing-sector policies.

Commodity prices – base case vs China high-growth case (2022 = 100)



Source: Wood Mackenzie

Conclusion:
Commodity prices could yet surprise to the upside

As the Chinese economy reopens, commodity prices will not return to the extreme highs of 2022. Markets have now adapted to the chaos brought about by Russia's war on Ukraine.

But energy and natural resource markets remain finely balanced and commodity prices could yet surprise to the upside this year. Producers will need to watch market signals closely to see just how strongly demand from China will be coming back against the backdrop of weakening western economies. The prospect of volatility across a range of commodities will suit traders.

Our high-growth scenario is far from locked in. China's leadership has indicated an inclination towards continued caution on monetary and fiscal policy and the country's recovery may be more micromanaged. But faster growth can't be discounted. Depending on its consumers' appetite to spend and the ambition of government policy, China's reopening could once again turn up the heat on prices across the energy and natural resources spectrum.

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