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The Carlyle Compass

By **Jeff Currie**
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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Jeff Currie, Chief Strategy Officer of Energy Pathways at Carlyle, who shares his insights on the state of commodity markets post the Chinese stimulus and why copper is still Dr. Copper and a reliable barometer of Chinese economic health.*

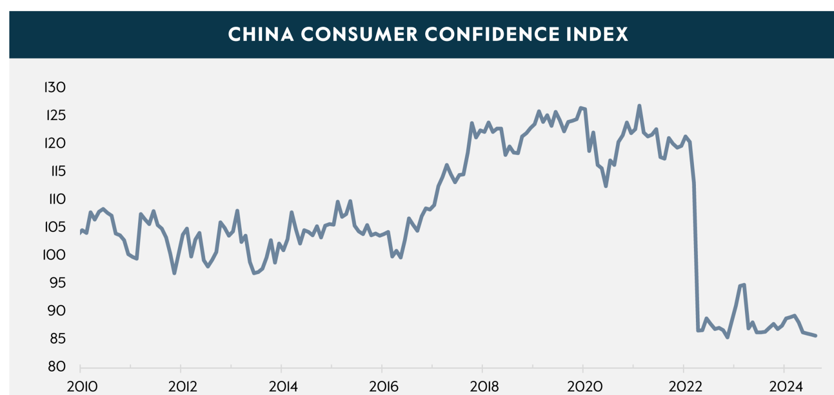
Have we only just begun?

Markets finally got the two big policy pivots from the US and China that they had been waiting for since the beginning of the year: a week after the US Fed cut rates by a larger-than-expected 50bps, the People's Bank of China (PBOC) announced in an "emergency" meeting a raft of policy easing measures, including lending support for equities, with talk of more to come on both the monetary and the fiscal side. Other policies have been announced (and more may be coming) by the government including RMB 1 trillion towards consumption subsidies via a consumer goods trade-in program and another RMB 1 trillion towards bank recapitalization. While it remains to be seen if this will be followed up by structural reforms and a reorientation towards domestic consumption as a growth driver, it is clear that this is a powerful cyclical stimulus.

Most commodities are well off their lows, with gold hitting its highest level in real terms since 1980 and copper also rallying 15% to break $10,000/metric ton, revisiting record highs on the long end of the curve. The rally in oil, however, lost steam over lingering concerns of a supply glut, with markets mulling the prospect of a return of Saudi and Libyan barrels alongside fears of demand destruction by electric vehicles.

Outside of Chinese equities, one could argue that the global market response was rather tepid relative to the importance of the Chinese economy and the size of the policy measures. Investors are aware that policy can only do so much, and that Chinese consumer and investor confidence has been rattled by the sharp decline in property prices (Figure 1).

Figure 1: After Collapsing in Early 2022 When China Locked Down, Consumer Confidence Remains Low



Source: Carlyle Analysis; NBS, Bloomberg, October 2024. There is no guarantee any trends will continue.

Certainly, the Chinese equity rally does help to restore consumer and investor confidence at the margin. However, unlike in the US, Chinese households do not have large equity holdings where the wealth effect from rising share prices can play a key role in boosting confidence and spending. Further, investment is predominantly driven by bank loans as opposed to capital markets, and simply cutting rates and increasing money supply doesn't increase lending (as the Europeans and Japanese, also with bank-centric capital systems, are very aware).

This is likely why the PBOC is aiming to stagger the stimulus announcements, potentially waiting for the US election to be resolved—as well as for further US policy easing. Not only does further US easing allow China to be more aggressive in its policy measures by preventing capital flight and reducing pressure on the yuan, but the outcome of the US election will provide important information on what type of stimulus would best suit China to restore confidence. A Harris outcome could suggest putting more emphasis on pursuing investment in green capex goods like EV, solar panels and batteries, while a Trump outcome could lead China to put more emphasis on domestic consumption.

This week's announcements from the PBOC and the Politburo may be just the first of many that will be aimed at shoring up confidence. The fact that the country has avoided a recession is remarkable, which may help to provide a better base for a recovery if this policy initiative succeeds. This would bode very well for Chinese demand for commodities, particularly copper.

Dr. Copper is back, but with a PhD in Environmental Economics

The term 'Dr. Copper' stems from the base metal's ability to predict turning points in the global economy and hence its reputation of having a 'PhD in Economics.' At first, this reputation was derived from copper's usefulness in signalling shifts in Western business cycles due to its widespread use across many sectors in the economy such as homes, factories, electronics and most importantly, power generation and transmission. As a result, the demand for copper, and thus its price, have often been viewed as a reliable barometer of economic health, which underscores the importance of copper's response to the recent stimulus announcements.

During the past two decades, Dr. Copper's field of expertise shifted to the Chinese property sector; however, with Chinese property at the center of Chinese economic weakness and copper prices retracing their highs, one must ask what is copper telling us now. China's large investment in the production of green capex goods like electric vehicles, solar panels and batteries was intended to offset their now-mature property sector, which is currently deflating and is the primary target of recent stimulus. With long-term copper prices peaking once again, we believe the read-through to economic growth is to China's new manufacturing engine: green capex goods. As a result, copper has a new major in Environmental Economics.

As we have argued in the past, copper has become a key strategic commodity in electrifying the world in the pursuit of energy transition, due to its superb properties as a conductor of electricity. In other words, copper is the new oil. While copper was a barometer for the Chinese property market in the previous cycle, today it's becoming a barometer for the green capex goods sector. And since China is now the dominant player in green capex goods, copper is once again the new bellwether for Chinese economic health.

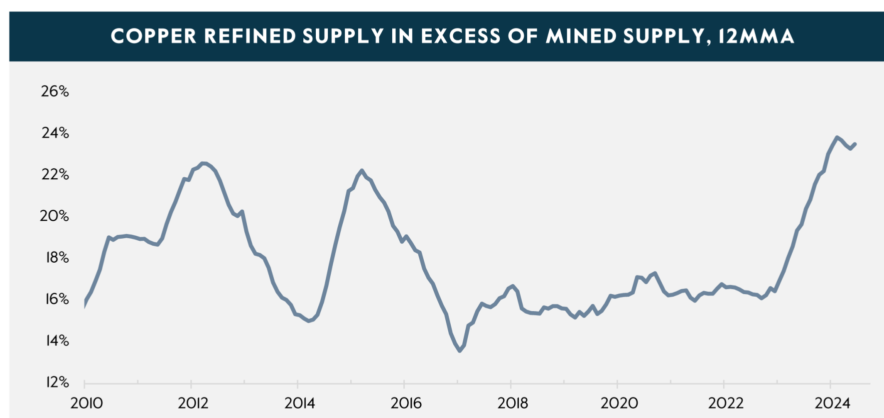
The consensus view of most economists, including our own, is that at a minimum the policy measures announced by China will stabilise the Chinese property market. Putting a floor under the property market in China and encouraging domestic consumption will help copper demand, though it is worth noting that the Chinese focus on green infrastructure and the grid had already been partially offsetting weaker property and industrial demand since 2021.

Near-term surpluses reinforce long-term shortages

Right now, however, spot copper is simply *not* tight, which is why prices have surged to record levels on the backend of the curve but not in spot prices (Figure 2). Exchange inventories have swelled this year to early 2020 levels, and the market contango is again approaching a full carry. Nonetheless, long-dated copper forward on the London Metal Exchange has reached all-time highs, which is a vote of confidence by the market in robust future demand growth.

The start of the US rate cutting cycle has an obvious benefit for the cyclical demand for copper, but high interest rates have also magnified the short-term bearishness in the markets as it encourages destocking throughout the supply chain. In copper, for example, scrap and concentrate destocking have helped keep metal production up despite flat mine production (Figure 2). This combined with renewed property market weakness has been a big driver of the observed rise in refined copper inventories. We believe these dynamics have mostly run their course given US rate cuts and aggressive Chinese stimulus.

Figure 2: Growth in Refined Copper Production has Recently been Supported by Destocking of Concentrate and Scrap Inventories



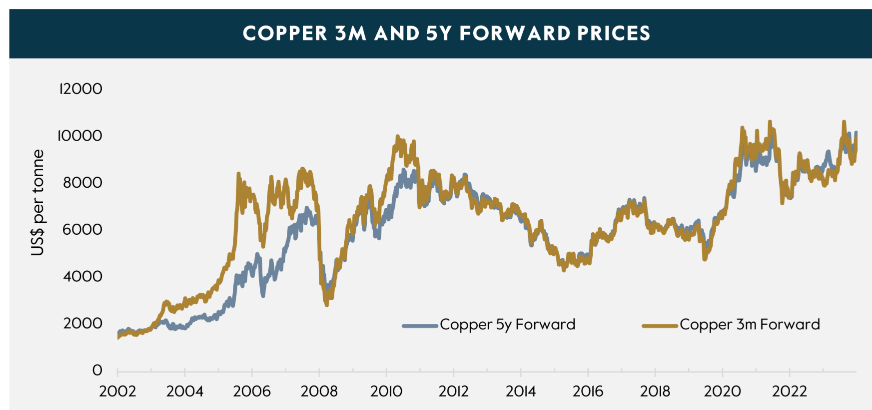
Source: Carlyle Analysis; Bloomberg, October 2024. There is no guarantee any trends will continue.

Looking forward, there is a broad consensus that electrifying energy consumption, expanding grids, and satisfying demand for artificial intelligence will substantially boost demand for copper in the years to come. Given mine projects currently in the pipeline, it is likely that there will be extremely large deficits in years to come, which would also mean potentially explosive price spikes in order to clear the market in the future.

Nonetheless, in the near-term the weight of today's surplus market keeps the long-dated forward price too low to allow investment in fresh supply which would satisfy that demand. Given the time needed to build new mine supply, it seems likely that a period of extreme tightness in the copper market is very likely. One might argue that the real question is when, not if.

This is why the copper market has responded so positively to Chinese policy announcements and Fed cuts. If cyclical demand picks up in the coming quarters, it pulls forward the deficit market and starts to reduce inventory overhang. Given that neither demand nor supply trends are likely to change, this pulls forward timing for a potential explosive rally in copper, potentially in the next year, which is why we maintain our view of a long-term price above $15,000/metric ton (Figure 3).

Figure 3: Copper is Approaching Record Highs Because of Long-dated Prices, the Opposite of What Happened in the Early 2000s



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