Why we are short / underweight iron ore

This material is not for circulation to retail investors

Dr Nick Pashias

Co-Head of Equities and Portfolio Manager of the High Growth Shares Fund and Elite Opportunities strategy. Nick is responsible for researching stocks in the Metals & Mining and Telco sectors. He has 23 years industry experience and previously consulted on efficiency improvement & process streamlining in the mining industry. Nick holds a Ph.D. in Chemical Engineering and a Master of Applied Finance.

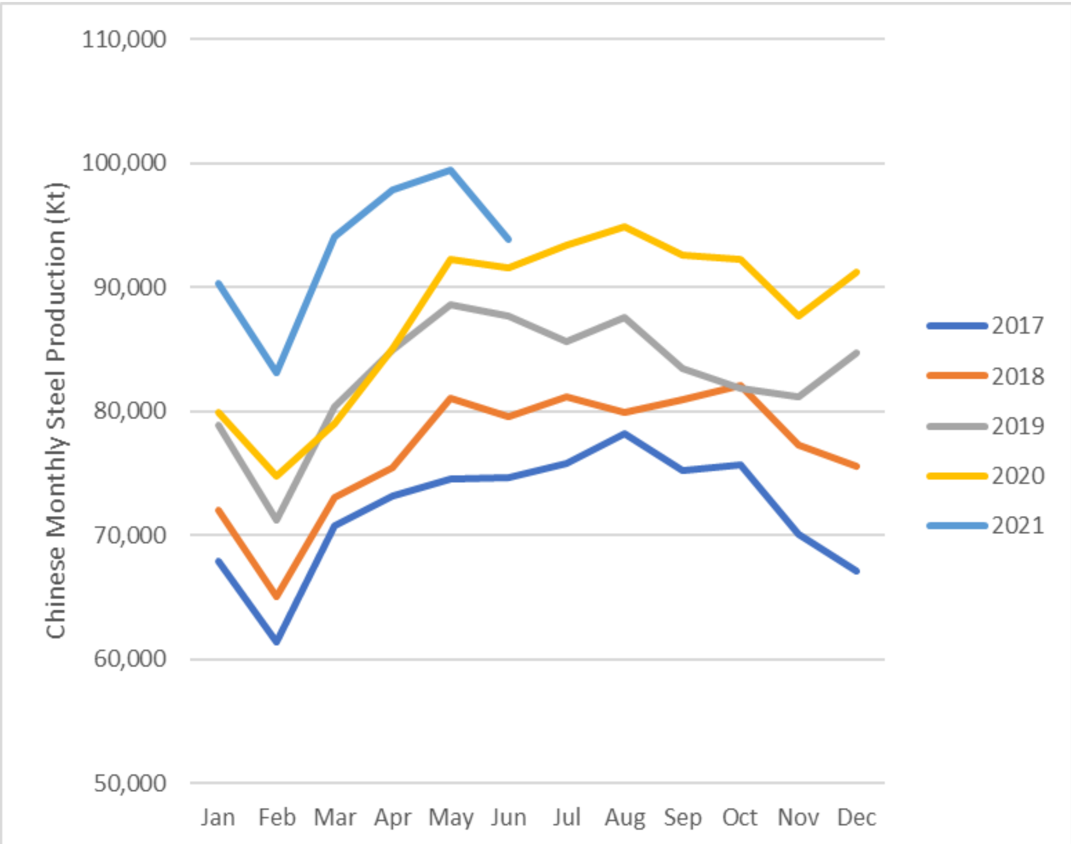
9 August 2021

We have been short or underweight iron ore for some time because our research led us to conclude that commodities and iron ore in particular, would come under pressure from the second half of 2021. Many of the factors that have led us to this conclusion are driven by China and include **unsustainably high steel production** in the first half of this year, **slowing credit growth**, **rising inventories** of steel and iron ore and a **growing environmental focus**. Also relevant is the **ramp up in production by Vale**. We discuss these factors in more detail in this article.

Chinese steel production was unsustainably strong in the first half (1H) of Calendar 2021.

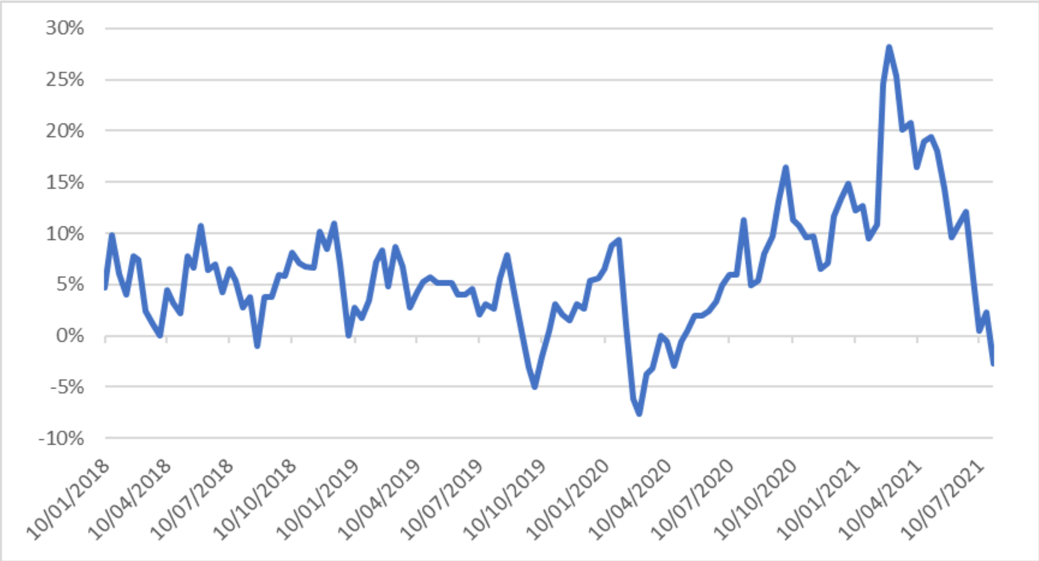
Chinese steel production has grown at almost 11% in 1H2021, a growth rate not seen in many years. If this rate of growth was sustained over the full calendar year, steel demand would increase by almost the total amount of steel consumed by the US (or India) in one year.

Figure 1: Chinese monthly steel production



Source: Antares, Bloomberg; August 2021

Figure 2: Chinese high frequency steel production (year on year growth)

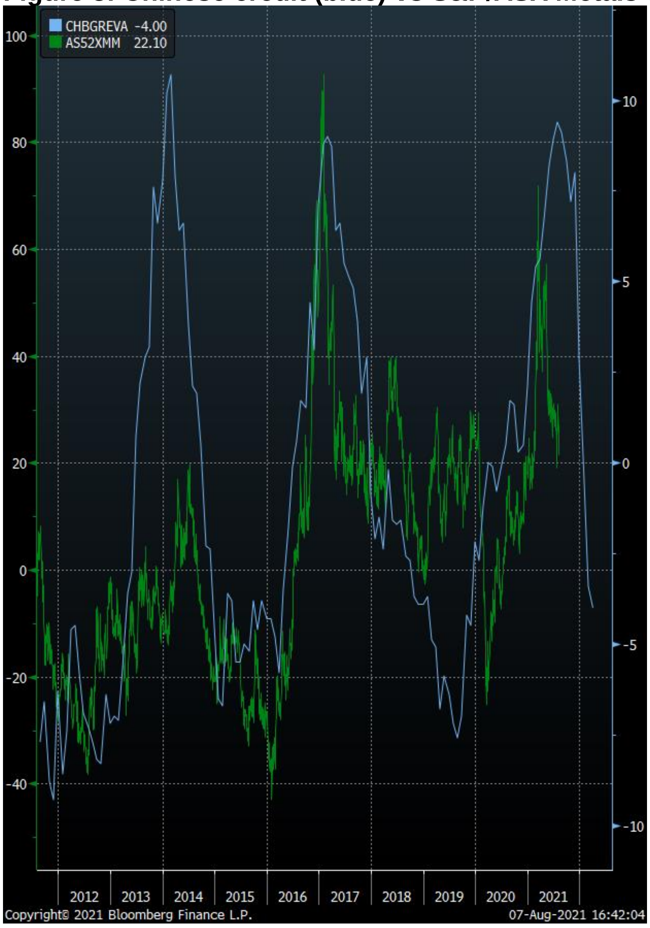


Source: Antares, Bloomberg; August 2021

China's credit impulse has been slowing for some time and should impact the real economy in the current half of 2021

China's credit impulse (blue line in Figure 3) measures the monthly change of the flow in new credit as a share of GDP. It has been slowing for some time. Historically it has led the performance of the S&P/ASX Metals and Mining Index (green line) by around 6-12 months.

Figure 3: Chinese credit (blue) vs S&P/ASX Metals & Mining Index (green)

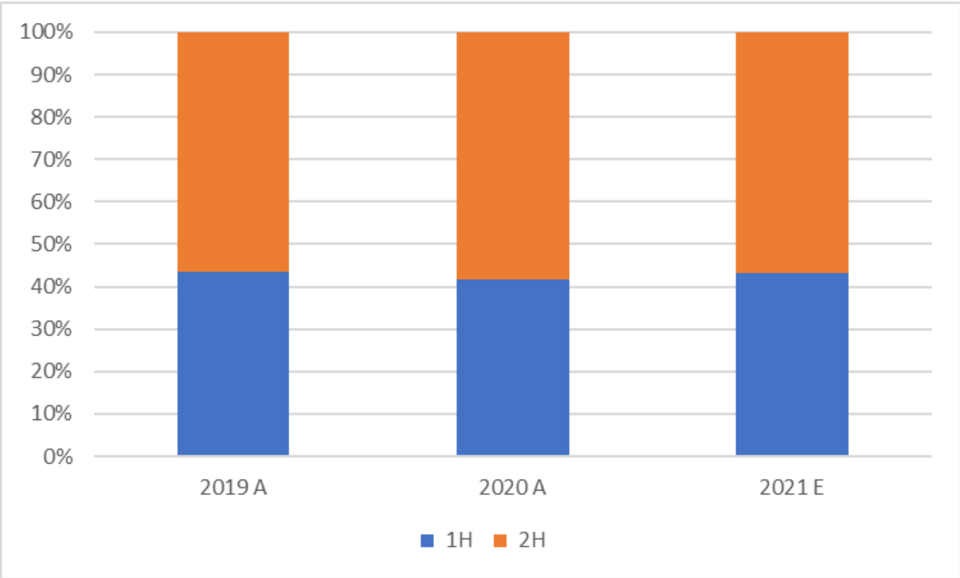


Source: Antares, Bloomberg; August 2021

Supply is seasonal: weak in 1H, strong in 2H.

Given the wet season in Brazil, iron ore exports accelerate in the second half of the calendar year. For 2021 this provides a mismatch as supply is increasing at a time when demand is weakening.

Figure 4: Vale shipments seasonal split

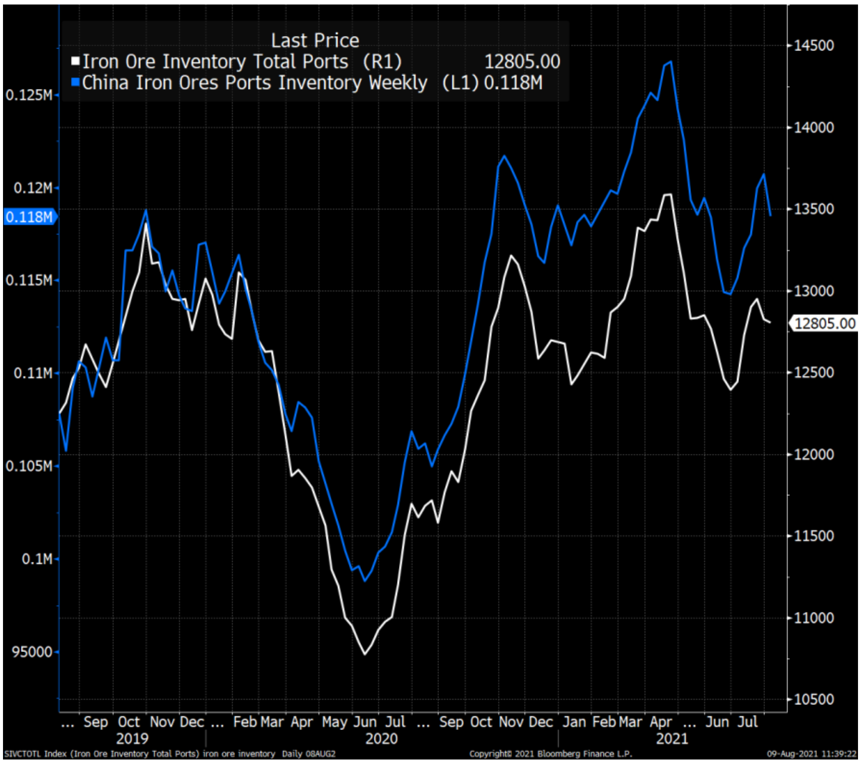


Source: Vale, Antares Estimates at August 2021

Finished steel and iron ore inventory have been rising

Iron ore inventory has been rising at a time when steel production has been very strong.

Figure 5: Iron ore inventory

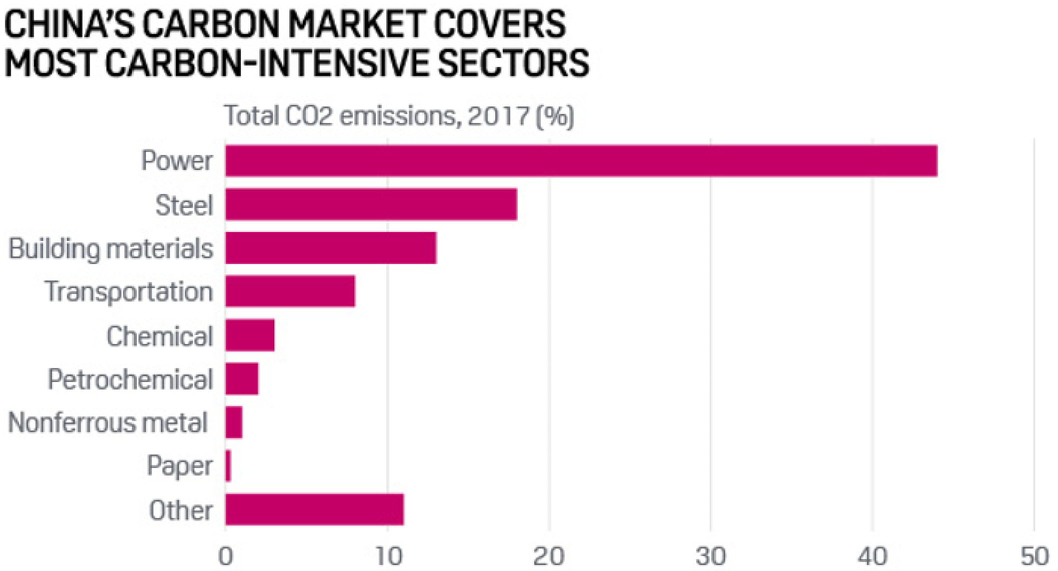


Source: Bloomberg; August 2021

Steel production, especially steel produced in a blast furnace (requiring iron ore) will inevitably be curtailed given China's environmental focus.

China has introduced a carbon trading scheme. At this stage steel making is exempt, but our industry contacts suggest that over the next year or two the steel industry will be included. China's policy seeks to reach peak carbon output by 2030 and become carbon neutral by 2060.

Figure 6: China's carbon emissions by sector

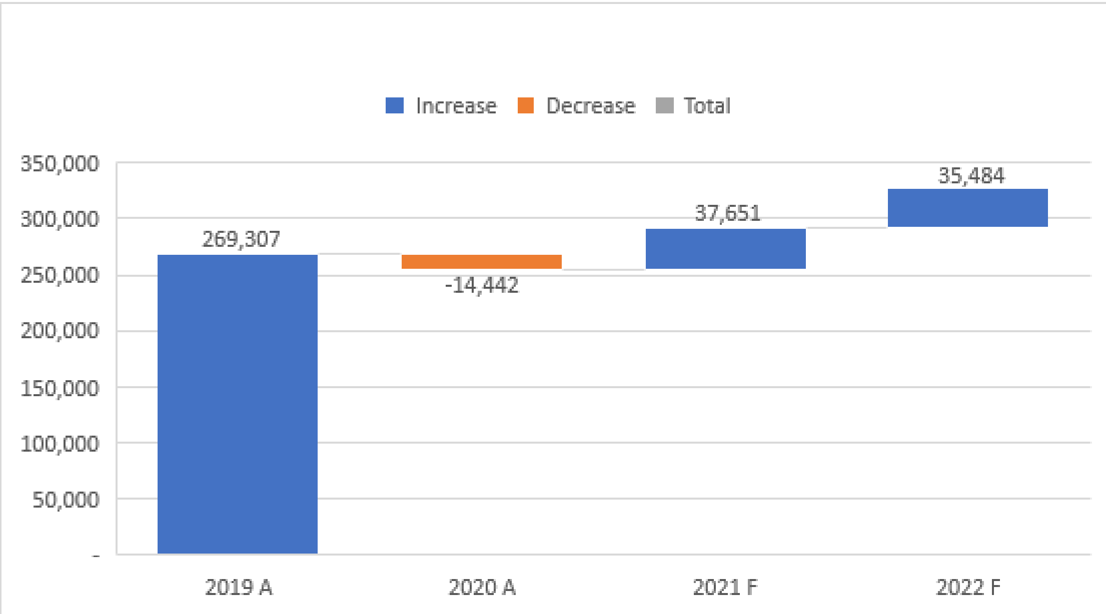


Source: Peking University, China; 2018

Vale couldn't possibly produce less iron ore than in 2020

Over the last few years Vale has failed to produce to its capacity and this may also be the case in 2021. However, our focus is the incremental growth that Vale is able to produce each year and we are confident that Vale will deliver additional iron ore tonnes to the market this year and in the years ahead.

Figure 7: Vale iron ore shipments ('000 tonnes)

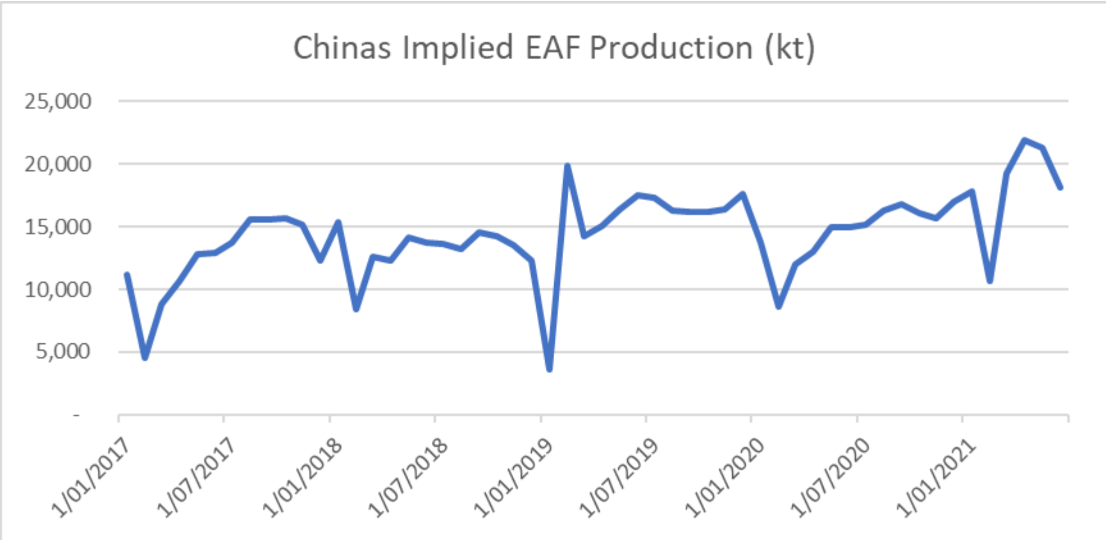


Source: Vale, Antares estimates at August 2021

The move to Electric Arc Furnace's will limit iron ore demand

There are two basic methods to produce steel: one that requires iron ore and one that requires scrap steel. The scrap steel process or Electric Arc Furnace (EAF) path is being increasingly favoured by China given its relatively lower carbon emissions. Although currently only a small percentage of total steel production, EAF's have gained in popularity over recent years - a trend we believe will continue.

Figure 8 China's implied EAF Production ('000 Tonnes)



Source: Vale, Antares estimates at August 2021

LEGAL DISCLAIMER

Antares Capital Partners Ltd ABN 85 066 081 114, AFSL 234483 (‘ACP’ or ‘Antares’), is the Responsible Entity of, and the issuer of units in, the Antares Australian Equities Fund ARSN: 090 827 802, Antares Dividend Builder ARSN: 115 694 794, Antares Elite Opportunities Fund ARSN: 102 675 641, Antares Ex-20 Australian Equities Fund ARSN: 635 799 530, Antares High Growth Shares Fund.

This document has been prepared for financial advisers. This document must not be distributed to ‘retail clients’ (as defined in the Corporations Act 2001 (Cth)) or any other persons.

This report has been prepared in good faith, where applicable, using information from sources believed to be reliable and accurate as at the time of preparation. However, no representation or warranty (express or implied) is given as to its accuracy, reliability or completeness (which may change without notice). This communication contains general information and may constitute general advice. This report does not take account of an investor’s particular objectives, financial situation or needs. Investors should therefore, before acting on information in this report, consider its appropriateness, having regard to the investor’s particular own objectives, financial situation or needs.

An investor should consider the current Product Disclosure Statement and Product Guide for the Fund (‘PDS’) in deciding whether to acquire, or continue to hold, units in the Fund and consider whether units in the Fund is an appropriate investment for the investor and the risks of any investment.

We recommend investors obtain financial advice specific to their situation. Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document. Any projection or other forward looking statement (‘Projection’) in this report is provided for information purposes only. No representation is made as to the accuracy or reasonableness of any such Projection or that it will be met. Actual events may vary materially.

ACP is part of the IOOF group of companies (comprising IOOF Holdings Ltd ABN 49 100 103 722 and its related bodies corporate) (‘IOOF Group’). The capital value, payment of income and performance of any financial product offered by any member of the IOOF Group including but not limited to Antares, are not guaranteed. An investment in any product offered by any member of the IOOF Group including but not limited to Antares, is subject to investment risk, including possible delays in repayment of capital and loss of income and principal invested.

Any opinions expressed by ACP constitute ACP’s judgement at the time of writing and may change without notice. In some cases the information is provided to us by third parties, while it is believed that the information is accurate and reliable, the accuracy of that information is not guaranteed in any way. None of ACP, any other member or the IOOF Group, or the employees or directors of the IOOF Group are liable for any loss arising from any person relying on information provided by third parties. This information is directed to and prepared for Australian residents only. ACP disclaims all responsibility and liability for any loss, claim or damage which any person may have and/or suffer as a result of any persons reliance on any information, predictions, performance data and the like contained within this document, whether the loss or damage is caused by, or as a result of any fault or negligence of ACP, it’s officers, employees, agents and/or its related bodies corporate.

Bloomberg Finance L.P. and its affiliates (collectively, ‘Bloomberg’) do not approve or endorse any information included in this publication and disclaim all liability for any loss or damage of any kind arising out of the use of all or any part of any such information.