

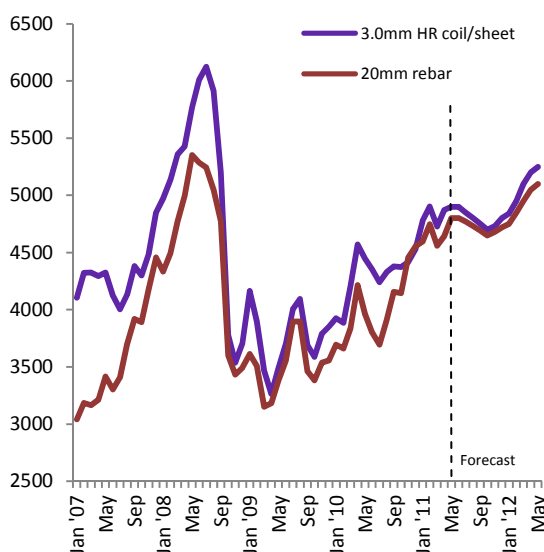
CHINA STEEL INSIGHT

May 2011

Slowing growth in apparent consumption of finished steel halted, amidst signs of further under-reporting

MEPS forecasts: HRC and rebar spot prices (Shanghai)

RMB/t (incl 17% VAT)	3.0mm HR coil/sheet	20mm rebar
May to date	4900	4800
Jun	4900	4800
Jul	4850	4770
Aug	4800	4730
Sep	4750	4690
Oct	4700	4650
Nov	4730	4680
Dec	4800	4720
Jan '12	4840	4750
Feb	4950	4850
Mar	5100	4950
Apr	5200	5050
May	5250	5100



Source: Mysteel, MEPS forecasts

Under-reporting affects March crude steel data but is more widespread for pig iron

- Discrepancies within reported crude production data and between crude and finished steel output suggests that production was under-reported in March. Unseasonal stock patterns would suggest that under-reporting was not as severe as implied from finished steel output. We estimate that crude production was under-reported by 2.6m t in March.
- With pig iron production at an inexplicable low against crude, we believe that under-reporting was more widespread. We estimate pig iron output was 9m t higher than the reported Q1 figure.

Slowing growth in apparent consumption of finished steel halted

- Long product output and flats apparent consumption rose to record levels in Q1. We see little support for the two bearish themes of steel oversupply and a tighter fiscal system negatively impacting steel demand. Inventories at traders continue to fall amid a positive outlook for Q2 demand, particularly for construction steel. Output has also been supported by a sharp rise in growth of urban FAI.

Steel prices losing momentum as mill margins improve and sentiment continues to corrupt

- Margins have improved for smaller mills purchasing raw materials on a spot basis. This will make it harder for larger mills buying on contract, to push through higher steel prices. We see prices fluctuating around current levels in coming months as negative sentiment amongst speculators continues to override strong real demand.

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1000 t	Actual					Forecast			Year		
	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	2010	2011	2012
Production*											
HRC	24,040	26,987	26,267	24,810	25,269	27,931	27,200	26,600	102,104	107,000	116,200
Plate	12,804	13,731	13,627	12,756	15,012	15,788	14,400	14,000	52,919	59,200	63,000
CRC	9,729	11,096	10,749	10,776	11,238	12,062	11,200	11,100	42,351	45,600	48,000
Metal coated sheet	5,269	6,292	6,020	6,146	6,164	6,536	6,250	6,250	23,727	25,200	27,000
Colour coated sheet	1,069	1,442	1,438	1,685	1,408	1,592	1,550	1,550	5,634	6,100	6,500
Silicon steel	1,377	1,394	1,385	1,528	1,496	1,554	1,500	1,550	5,684	6,100	6,300
Total flats	54,288	60,943	59,486	57,701	60,588	65,462	62,100	61,050	232,419	249,200	267,000
Rebar	27,653	32,316	31,505	32,054	31,964	34,736	33,500	34,300	123,528	134,500	144,000
Wire rod	23,268	26,153	25,130	24,991	27,171	29,129	27,300	26,900	99,542	110,500	119,000
Sections	10,683	13,987	12,832	11,765	12,588	14,012	13,100	12,800	49,266	52,500	55,000
Bar	14,295	17,356	16,441	17,394	17,182	18,118	17,200	17,000	65,484	69,500	74,000
Railway steel products	1,305	1,304	1,325	1,260	1,266	1,404	1,380	1,350	5,195	5,400	5,800
Total longs	77,204	91,115	87,233	87,463	90,171	97,399	92,480	92,350	343,015	372,400	397,800
Other finished	3,193	3,819	3,468	3,986	4,134	4,316	4,050	3,900	14,466	16,400	17,700
Welded tube	5,928	8,575	8,403	8,961	7,102	9,198	8,950	9,050	31,867	34,300	35,000
Seamless tube	4,870	6,236	6,249	6,351	5,603	6,797	6,650	6,650	23,705	25,700	27,500
Total	145,483	170,687	164,839	164,462	167,598	183,172	174,230	173,000	645,472	698,000	745,000
Imports											
HRC	572	522	486	566	598	602	520	530	2,146	2,250	2,150
Plate	318	374	366	360	406	434	390	370	1,418	1,600	1,500
CRC	1,200	1,269	1,172	1,106	1,286	1,314	1,250	1,150	4,747	5,000	5,000
Metal coated sheet	1,051	1,145	1,104	933	908	1,072	1,050	940	4,233	3,970	4,000
Colour coated sheet	94	101	93	116	118	112	105	115	404	450	430
Silicon steel	227	261	243	242	250	260	250	240	973	1,000	1,000
Total flats	3,462	3,672	3,464	3,323	3,566	3,794	3,565	3,345	13,921	14,270	14,080
Rebar	11	16	15	12	13	14	12	11	53	50	50
Wire rod	170	175	150	160	176	184	180	170	654	710	750
Sections	122	110	97	89	75	90	95	90	419	350	380
Bar	99	116	104	104	110	115	110	105	422	440	460
Railway steel products	68	28	43	48	41	44	45	50	186	180	200
Total longs	468	444	409	413	415	447	442	426	1,734	1,730	1,840
Other finished	67	86	77	71	71	74	80	75	301	300	300
Welded tube	49	60	51	61	75	80	75	70	221	300	280
Seamless tube	63	63	60	65	60	65	60	65	252	250	280
Total	4,109	4,325	4,062	3,932	4,187	4,460	4,222	3,981	16,429	16,850	16,780
Exports											
HRC	2,009	4,354	1,756	1,019	1,317	2,133	1,750	1,150	9,139	6,350	6,500
Plate	944	1,494	977	925	1,177	1,323	1,000	950	4,340	4,450	4,100
CRC	528	1,065	977	662	706	1,044	950	650	3,232	3,350	3,000
Metal coated sheet	932	1,617	1,315	1,031	1,328	1,412	1,300	1,010	4,894	5,050	4,900
Colour coated sheet	449	867	882	852	1,015	945	850	840	3,051	3,650	3,700
Silicon steel	33	36	44	43	39	46	45	40	156	170	180
Total flats	4,896	9,435	5,950	4,531	5,582	6,903	5,895	4,640	24,812	23,020	22,380
Rebar	58	49	56	63	56	64	70	70	225	260	280
Wire rod	448	902	576	425	684	726	580	460	2,351	2,450	2,500
Sections	593	729	314	287	555	585	420	340	1,924	1,900	1,800
Bar	500	831	675	610	814	826	640	590	2,616	2,870	2,650
Railway steel products	67	93	109	87	144	126	110	90	357	470	500
Total longs	1,666	2,604	1,730	1,472	2,253	2,327	1,820	1,550	7,472	7,950	7,730
Other finished	825	1,059	1,010	881	828	972	1,000	900	3,775	3,700	3,750
Welded tube	557	778	635	723	860	990	880	750	2,693	3,480	3,600
Seamless tube	766	997	1,036	1,006	981	1,089	1,000	980	3,806	4,050	3,900
Total	8,711	14,873	10,361	8,612	10,504	12,281	10,595	8,820	42,558	42,200	41,360
Apparent Consumption											
HRC	22,602	23,155	24,998	24,357	24,550	26,400	25,970	25,980	95,112	102,900	111,850
Plate	12,178	12,610	13,016	12,192	14,241	14,899	13,790	13,420	49,996	56,350	60,400
CRC	10,401	11,300	10,944	11,220	11,818	12,332	11,500	11,600	43,865	47,250	50,000
Metal coated sheet	5,388	5,820	5,809	6,049	5,744	6,196	6,000	6,180	23,065	24,120	26,100
Colour coated sheet	714	676	649	949	511	759	805	825	2,987	2,900	3,230
Silicon steel	1,572	1,619	1,584	1,727	1,707	1,768	1,705	1,750	6,501	6,930	7,120
Total flats	52,854	55,180	57,000	56,493	58,572	62,353	59,770	59,755	221,527	240,450	258,700
Rebar	27,605	32,284	31,464	32,003	31,921	34,686	33,442	34,241	123,356	134,290	143,770
Wire rod	22,990	25,425	24,705	24,726	26,663	28,587	26,900	26,610	97,846	108,760	117,250
Sections	10,212	13,368	12,615	11,567	12,108	13,517	12,775	12,550	47,761	50,950	53,580
Bar	13,894	16,640	15,870	16,887	16,478	17,407	16,670	16,515	63,291	67,070	71,810
Railway steel products	1,306	1,239	1,259	1,221	1,163	1,322	1,315	1,310	5,024	5,110	5,500
Total longs	76,006	88,955	85,912	86,404	88,333	95,519	91,102	91,226	337,277	366,180	391,910
Other finished	2,435	2,846	2,535	3,176	3,377	3,418	3,130	3,075	10,992	13,000	14,250
Welded tube	5,420	7,856	7,819	8,300	6,317	8,288	8,145	8,370	29,395	31,120	31,680
Seamless tube	4,166	5,302	5,273	5,410	4,682	5,773	5,710	5,735	20,151	21,900	23,880
Total	140,881	160,140	158,539	159,782	161,281	175,351	167,857	168,161	619,342	672,650	720,420

*all production figures are based on MEPS estimates. 2010 data is subject to revisions in line with amended production data released by NBS.

Source: ISSB, NBS, CISA, MEPS forecasts

The case for under-reporting in March 2011

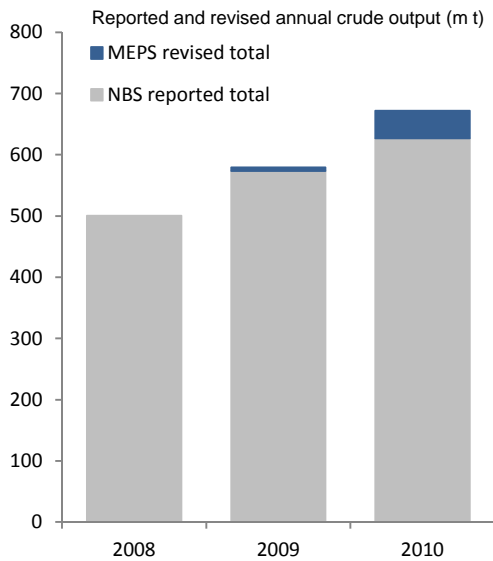
NBS reported and MEPS revised crude production totals, actual and forecast

m t	1Q10	2Q10	3Q10	4Q10	2010	1Q11	2Q11	3Q11	4Q11	2011	2012
NBS reported total	156	165	151	152	627	174	184	172	170	700	765
MEPS revised total	158	179	170	164	672	176				745	800

Source: NBS, CISA, MEPS forecasts

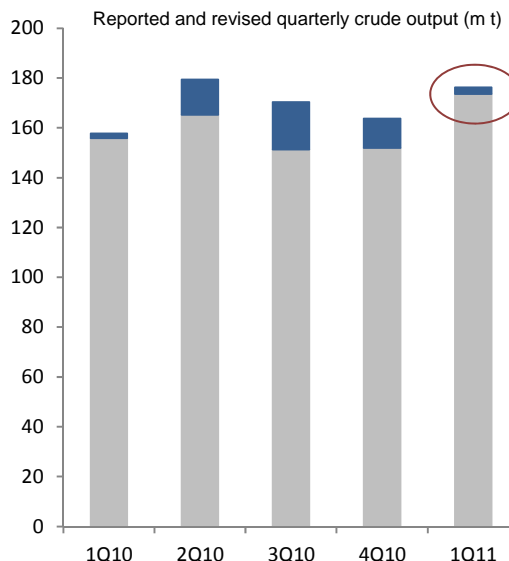
* Our model takes into account monthly revisions to crude production totals made by NBS. Consequently quarterly and annual totals will differ.

MEPS revisions suggest that Chinese crude production was under-reported by 45m t in 2010



Source: NBS, CISA, MEPS estimates

Most mills reported full crude production data for 1Q11

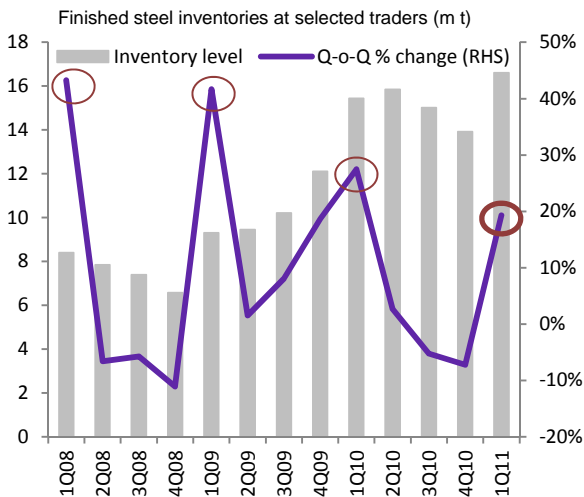


Source: NBS, CISA, MEPS estimates

- In our initial report (*China Steel Insight, March 2011*) we outlined our reasons for suggesting that output data for crude steel had been under-reported by some 45 million tonnes (m t) in 2010. Under-reporting was the result of political pressure on the steel industry to meet long standing targets for the closure of backward iron and steel making facilities by the end of last year. On paper this has been successfully achieved, but in reality many of these mills continued producing and avoided closure by not submitting crude steel and pig iron production data.
- This appears to have been less of a problem in 1Q11, suggesting that out-dated mills were under less pressure, with local authorities having 'met' their closure targets for last year. Whilst we believe that crude steel production was accurately reported in January and February 2011 the full 1Q11 total for crude production is 3.7m t lower than the sum of individual monthly totals. This discrepancy suggests that some mills did not submit monthly and year to date crude production data for March, at a time when local authorities were again under pressure to publish capacity closure targets for the steel industry. We estimate that crude production was under-reported by 2.6m t, taking crude output to 62m t in March and 176m t in Q1. We outline our reasoning overleaf.

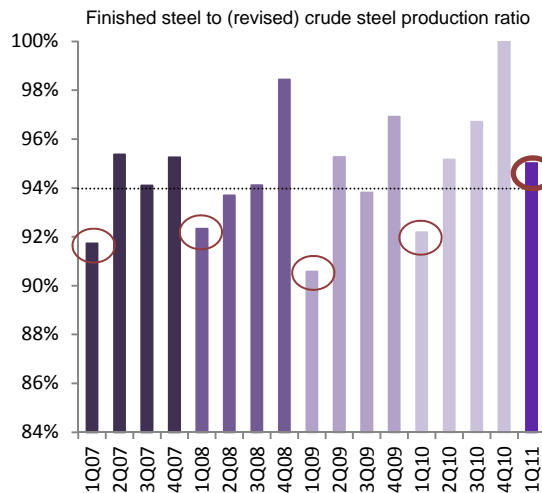
- As well as the discrepancy within NBS numbers, the reported crude steel total for March looks under-reported relative to MEPS estimated finished steel output. Chinese steel mills typically have a finished to crude steel production ratio of 94% (taking into consideration net imports of semi-finished steel). Statistically, however, this ratio fluctuates around this point, as our estimated finished steel output does not capture lagged production from stock. This ratio is particularly sensitive to changes in inventory levels at traders, which in China forms a substantial part of the distribution chain.
- Generally, traders (and mills) see a net stock build-up in Q1 and a net stock drawdown in Q4. This is reflected in crude to finished steel production ratios which are lower at the beginning of the year and higher at the end (see chart below right). A lower production ratio at the beginning of the year is also the result of many mills keeping blast furnaces running over the Chinese New Year period, but halting rolling operations.

1Q11 net stock build-up was lower than in previous years...



Source: Mysteel

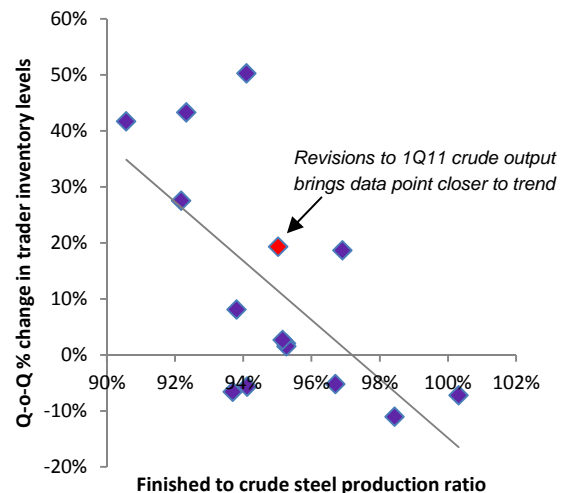
...consequently 1Q11 finished to crude production ratio was higher than we would expect



Source: NBS, CISA, MEPS estimates

- During 1Q11 however there was a smaller than usual stock build up (see chart above left). Moreover a historically high ratio between output of hot rolled products and crude steel in February suggests that many mills continued operating rolling mills through the holiday period. Whilst this would lead us to expect a higher than normal finished to crude steel production ratio, 95.0% suggested by our revisions is more realistic than the 96.4% implied from published data (see chart to right).

Finished to crude steel production ratio rises as trader inventories are drawn down



Source: Mysteel, NBS, CISA, MEPS estimates

Pig iron producers less incentivised to report true output

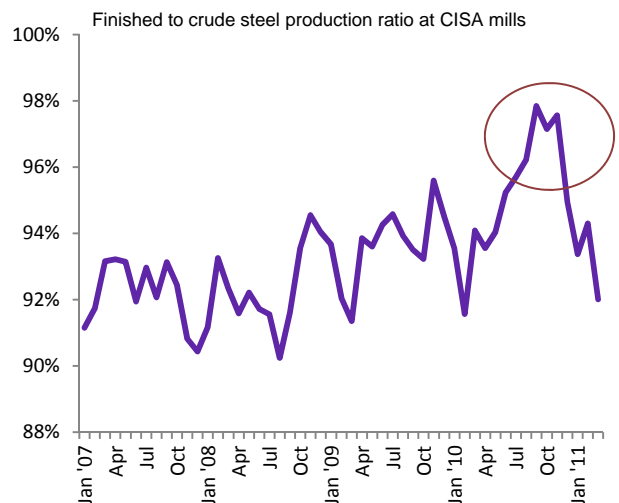
NBS reported and MEPS revised pig iron production totals, actual and forecast

<i>m t</i>	2010	1Q11	2011	2012
NBS reported total	590	157	660	720
MEPS revised total	632	166	702	753

Source: NBS, CISA, MEPS forecasts

- Historically, the ratio between pig iron and crude steel production sits at around 94%, but this was at 87% in January 2011, 93% in February and 88% in March (relative to our revised March crude figure). Rising iron ore prices can encourage mills to use more scrap in converters, and higher finished steel prices incentivises marginal EAF-route producers. However neither of these factors can adequately explain the substantial falls in reported pig iron output relative to crude during Q1.
- Our analysis suggests that pig iron production over Q1 was under-reported by 9m t, taking production to 166m t. We note that under-reporting was less of an issue in February, when smaller, out-dated, under-reporting mills would have been idled for the Chinese New Year holiday period.
- Following the completion of the 2009-10 campaign against out-dated capacity, pig iron producers appear to have been less incentivised to report full production data than crude steel producers. This is partly because pig iron producers are largely autonomous in terms of energy supply. In contrast, EAF-route crude steel producers (which form a large part of the under-reporting mills) are mainly reliant on the national grid, and so will have had a greater incentive to declare full output in order to justify greater electricity consumption. Mills will have been particularly mindful of this having been forced to halt production by enforced power shortages in 4Q10.
- Additionally, small pig iron producers came under increased central government scrutiny at the beginning of this year. The government is seeking to clamp down on companies producing pig iron for steelmaking, who are avoiding closure by declaring their output as foundry iron. The threshold for a reasonable sized producer in this sector is considerably lower than for steelmaking. Pig iron production statistics published by NBS do not differentiate between foundry pig iron and pig iron for steelmaking, so this did not directly lead to under-reporting in 2010. However as it became increasingly difficult for small mills producing pig iron for steelmaking to avoid closure by exploiting this loophole, it is likely that more were encouraged to under-report output.
- Another good indication that Q1 under-reporting was more widespread in pig iron than crude steel, comes from comparing CISA output data with national production data. We note that whilst under-reporting was in evidence at CISA mills during 2H10 (see chart to right), this was on a smaller scale than at non-CISA mills.

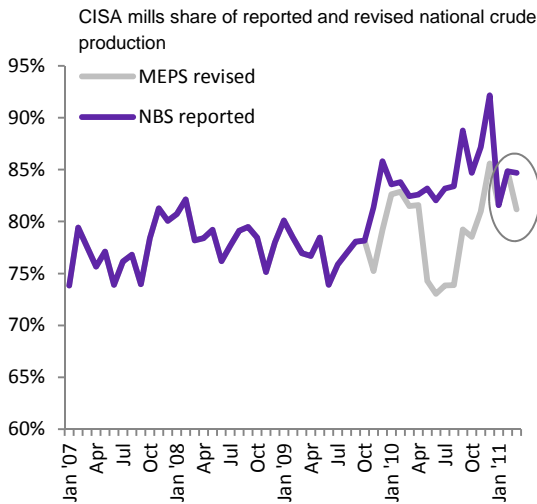
The finished to crude production ratio at CISA mills rose sharply in 2H10 suggesting under-reporting of crude output



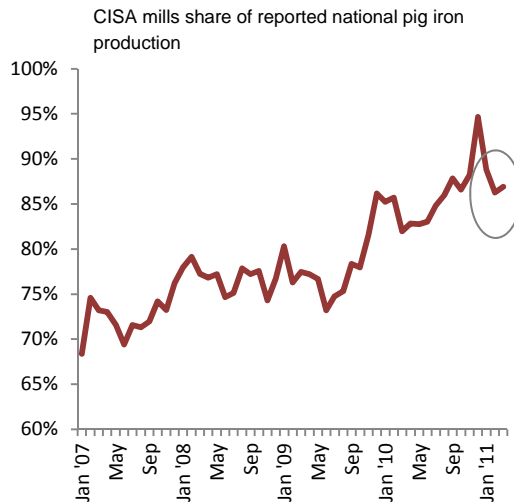
Source: CISA

- CISA mills taking an unrealistically high share of reported national production is therefore a good indication of under-reporting by non-CISA mills. We note that the period of under-reporting from the end of 2009 corresponds with an inexplicable rise in the share of total output taken by CISA mills (see *chart below left*). Similarly, in 1Q11 their share fell to more realistic levels, albeit slightly higher than historical proportions due to the expansion of CISA membership. The exception is March when, as we have outlined above, we believe national production was under-reported. We would expect CISA member mills to have taken a greater share of domestic output in February as non-CISA mills are more affected by shutdowns over the Chinese New Year holiday period.
- Whilst national production of crude steel in Q1 has returned to more realistic levels relative to output at CISA mills, this has not been the case with pig iron (*see chart below right*), suggesting that under-reporting for this product form was an issue for the whole quarter.

CISA mills share of national crude output returned to more realistic levels in 1Q11, but not for pig iron



Source: NBS, CISA, MEPS estimates



Source: CISA, NBS

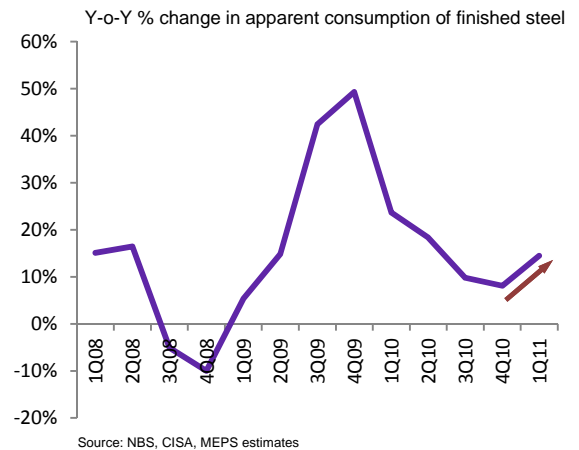
Slowing growth in apparent consumption of finished steel halted

- MEPS estimates of quarterly finished steel output suggests that the pace of growth in domestic apparent consumption of finished steel expanded for the first time since 4Q09. Y-o-Y growth was up 14% in 1Q11, substantially higher than the 8% seen at the end of 2010. This is partly the result of the lessening base affect of the fiscal stimulus plan, but should ultimately be seen as a solid indication that there is sufficient demand in China to support crude steel production run rates above 700m t/y, a central tenet of our under-reporting thesis.

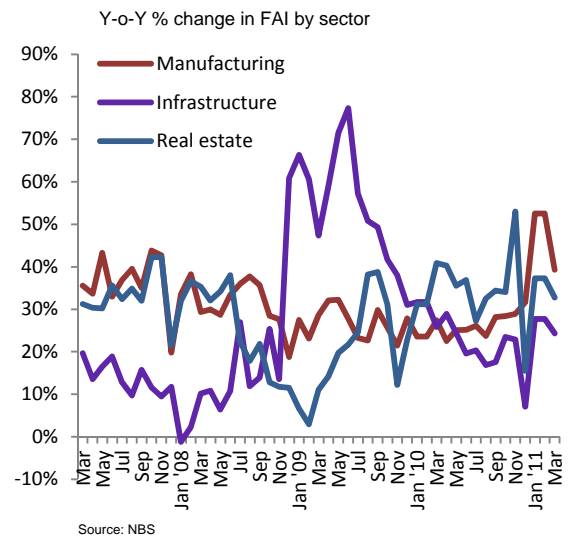
Flat products apparent consumption at record high

- Domestic apparent consumption of flat products rose to a record high in 1Q11 of 58.57m t. This was supported by continued growth in output by end users. Production of white goods was up 19% y-o-y and motor vehicles 10%. The HSBC China Manufacturing Purchasing Managers' Index remained solidly above 50, indicating continued growth in this sector.
- Additional support came from a strong uptick in the pace of growth of urban fixed asset investments (FAI) in the manufacturing sector (see chart to right). Whilst FAI rose across the board over this period, manufacturing is now growing faster than both infrastructure and real estate FAI, with a return to growth patterns seen before the fiscal stimulus plan. As well as supporting consumption of flat products, rising growth in manufacturing FAI, following two years of lacklustre levels, is likely to have encouraged a stronger than usual Q1 stock build at end users.
- Despite this, CRC has performed relatively poorly versus other flat products through Q1. The material is suffering a declining price premium over HRC, and traders are holding more of the product in stock relative to HRC (see chart to right). Similarly, CRC inventories at CISA member mills rose in March, despite an overall 2% decline in the volume of flat products held in stock. Last week Wugang Iron and Steel cut June delivery prices for its commercial grade CRC by RMB 40/t, whilst raising HRC prices.
- This is partly a consequence of lower than expected demand from the auto industry. This does not mean less demand for CRC, but more of this material hitting the market, as reduced orders for auto sheet leaves more capacity to produce cold rolled material for other uses. Relative oversupply of CRC has also been exacerbated by maintenance work on HRC mills over the quarter. Reduced HRC output has meant a lower supply of the material to the market because a larger proportion was re-rolled into higher priced CRC. Output of HRC grew only 5% y-o-y during Q1 despite domestic apparent consumption rising 9%. Meanwhile CRC production jumped 16%.

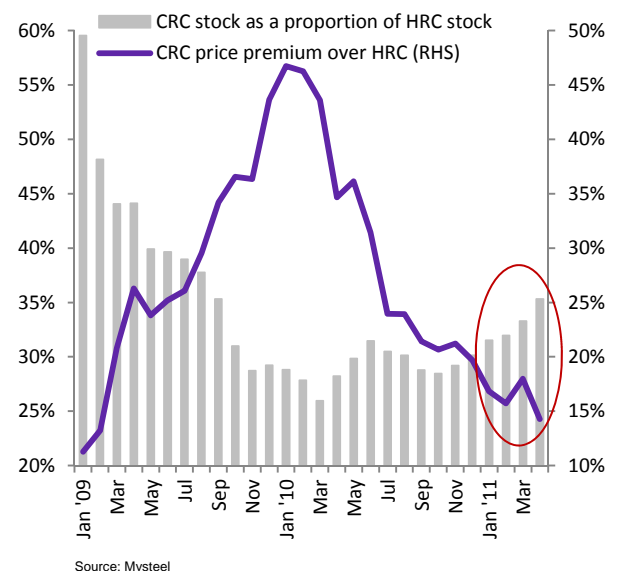
The rate of growth of finished steel AC expanded in 1Q11



Manufacturing sector leads FAI growth



CRC prices are achieving less of a premium over HRC, whilst traders' stocks are rising proportionally higher

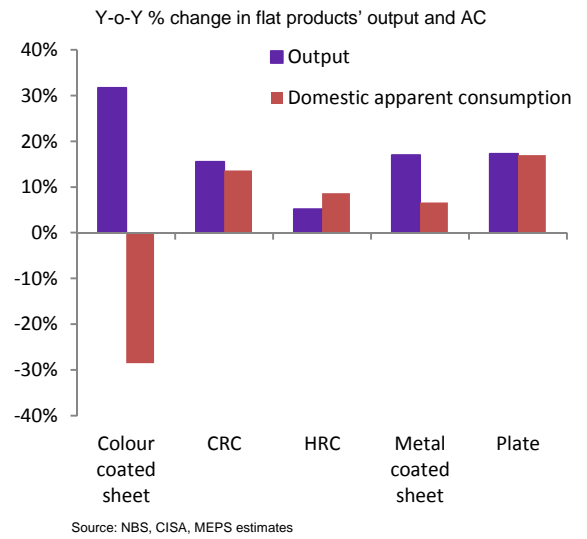


- Mills have been increasing HRC supply from April as maintenance work comes to an end, and slowing growth in demand from the auto sector is likely be less extreme in 2H10. Baosteel has blamed poor sales of its auto sheet through Q1 on the low availability of auto parts from earthquake stricken Japan but Toyota has announced that it intends to increase car production to 70% of normal levels from June. We therefore remain positive on the long term prospects for CRC.
- Growth in output of other flat products has risen sharply where there has been support from high export volumes. Exports of colour coated sheet in Q1 were up 126% y-o-y which led to production jumping 32%. The exception is plate, where both output and domestic apparent consumption rose by 17%. Shipbuilding, which was up 13% in Q1, contributed to this. Growing domestic consumption of plate is also a result of the sharp rise in fixed asset investment, particularly in infrastructure.

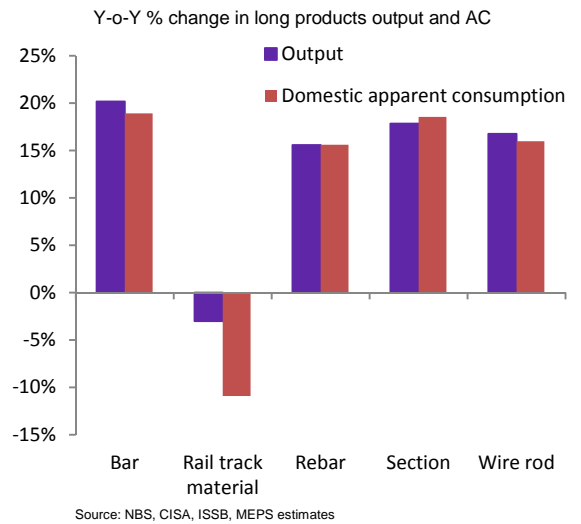
Long products leading growth

- Strong growth in output was recorded for the majority of long products in Q1. Demand for railway material has, however, been adversely affected by the dismissal of the head of China's railway ministry on corruption charges. Reports suggest that the government has reduced targeted railway infrastructure investment for 2011 from RMB 700bn to RMB 600bn. This is a higher level of investment than many were expecting in the wake of the scandal, and we anticipate that less uncertainty about future levels of demand for railway steel will boost output. This should fall more in line with growth in other long products, which recorded y-o-y growth of around 20%. Rising export levels offered some support for production, particularly for bar and wire rod, but, generally, output was driven by domestic consumption (see chart to right).
- Q1 is traditionally a time of stronger production of flat than long products, as end user restocking boosts demand for the former and falling temperatures restrains consumption of the latter. 1Q11 was no exception with output of flat products rising 5% q-o-q and long products 3%. However this is a historically low growth margin between the two, pointing to the unseasonably high output of long products, which rose to record levels in March. Consequently y-o-y growth in production of long products hit 17%, up sharply from 2010 and above that achieved in flat products (see chart to right).
- This is partly a result of suppressed output in 4Q10. Production cuts, to meet energy consumption targets, disproportionately impacted on producers of long products, who are generally less independent in energy supplies and with less energy efficient production facilities. This led to y-o-y growth in output dropping to 5%, the lowest level since 4Q08.

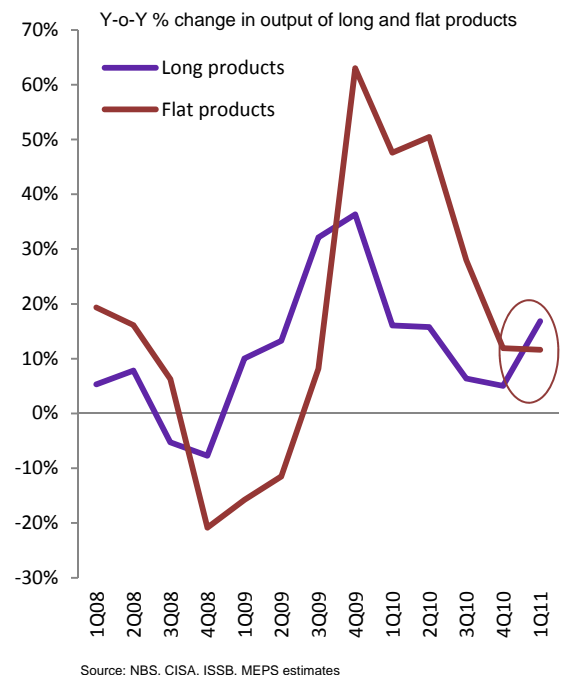
Maintenance work has restrained HRC output growth



Growth in railway steel down on corruption scandal

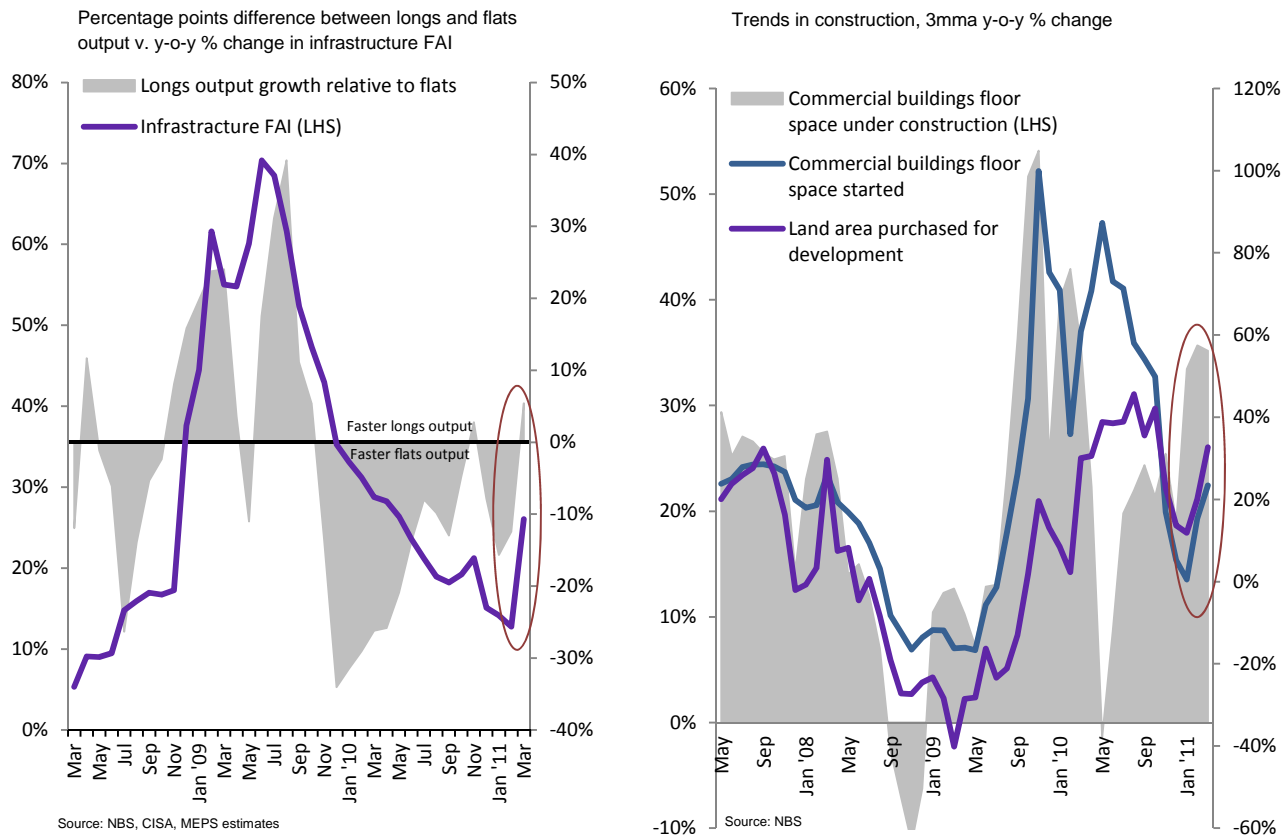


Output growth in long products has overtaken flats



- Restocking at end users, following a period of tight supply will have been further encouraged by rising y-o-y growth in infrastructure investment, which was up 26% in Q1. This historically has incentivised long product manufacturers to raise output relative to other material (see chart below left). Long product mills will have been further encouraged to ramp up production by increased demand from the construction industry. Indicators of current and future demand from this sector all rose during the quarter (see chart below right).

Unseasonably high output of long products has been driven by growing infrastructure FAI and construction activity

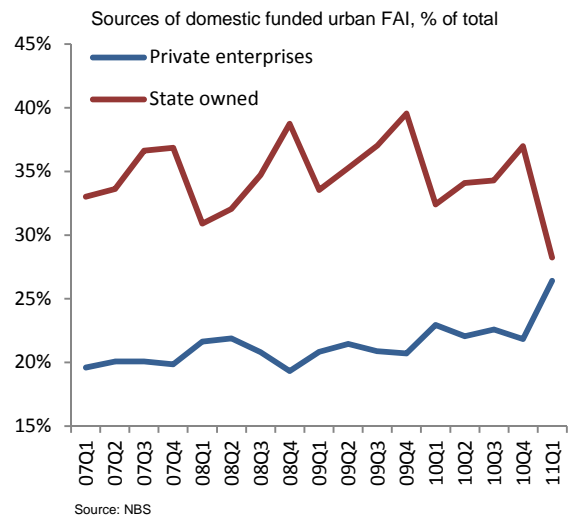


- Mills anticipating strong future demand for long products, as construction activity increases in a warmer Q2, was therefore a key factor in unseasonably high production levels. However there is little indication that supply has run ahead of demand. Long product inventories at traders have continued to fall, and are currently 24% below end of February levels. Similarly, spot prices for rebar have gained strongly in recent weeks, outpacing growth in HRC prices (see page eleven).

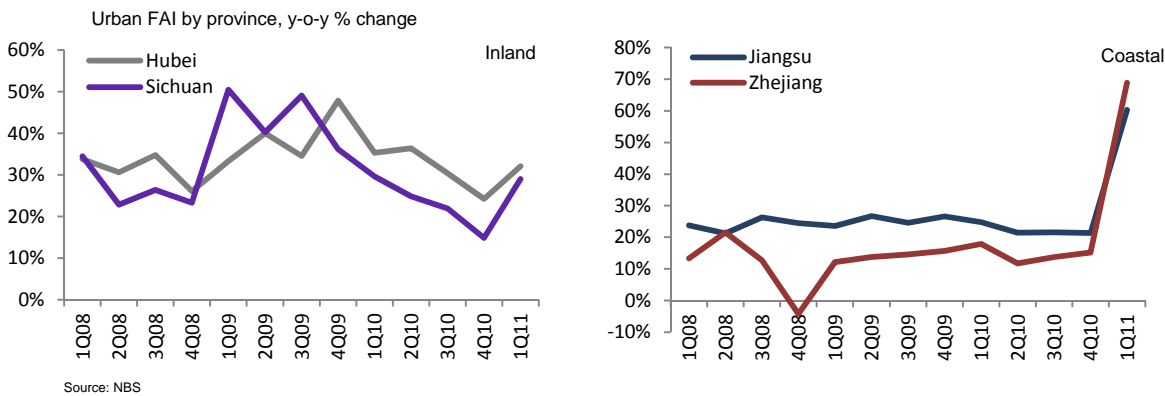
Short term demand outlook is strong

- Closer examination of the fundamentals behind record levels of steel production suggest that there is little substance behind the two dominant bearish themes of oversupply and tightening credit lines. Increased supply is being well met by demand, with inventory levels falling not rising. Meanwhile growth in urban FAI has increased despite government tightening measures, with the sharp jump in 1Q11 driven by private not state owned enterprises (see chart to right). Moreover growth in FAI is still being driven by traditional investment hotspots on China's East coast (provinces such as Zhejiang and Jiangsu). There is still considerable untapped growth as inland provinces, such as Hubei and Sichuan, develop as manufacturing hubs in response to rising wages in coastal areas.

Private enterprises key to Q1 jump in FAI growth

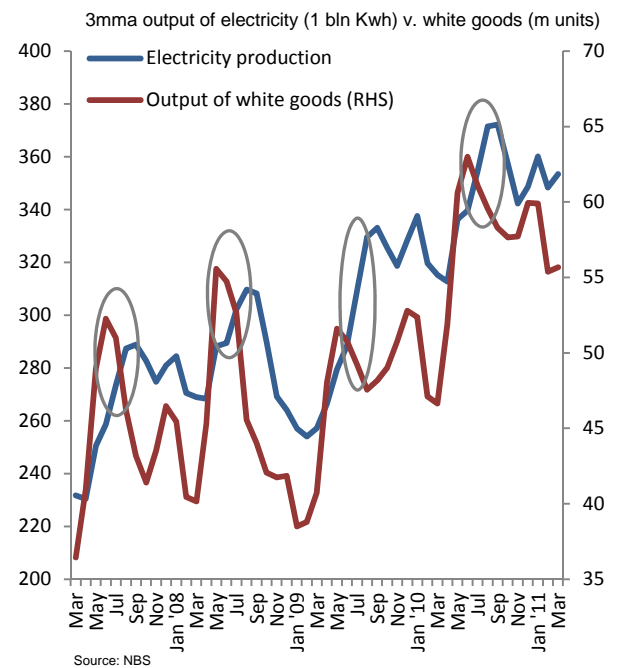


Q1 jump in FAI growth was driven by growth in costal provinces - inland provinces are still an untapped source of growth



- Whilst both of these trends indicate long term support for steel demand we anticipate steel production slowing towards the end of Q2 and dropping 5% q-o-q in Q3. This, however, is a seasonal slowdown not a collapse in demand, with hotter and wetter weather reducing steel consumption. Historically demand for steel from the manufacturing sector also declines during this period, as growing demand for electricity leads to shortages and restrains output (see chart to right).
- We do not anticipate a deeper than seasonal fall in steel production, despite reports that electricity shortages will be earlier and more intense this year. Mills will be anticipating falling orders from end users, with a sharper than usual decline in manufacturing output likely to have only a negligible impact on steel consumption. Although some provinces have already seen power supply restricted, ahead of the usual summer cuts, this has had no impact on steel output, which will only fall when demand does. Cuts are less likely to impact inland steel producing hubs such as Hebei province, where most power plants are also located. Steel mills which are more likely to be affected, such as those in Jiangsu province, are generally integrated producers with captive power supplies. We note that this is not a resurfacing of the Q410 political campaign to reduce energy consumption, nor is it part of efforts to shut-down out-dated capacity. Rather power plants, caught between rising coal prices and capped power tariffs, are being forced to reduce output due to falling margins.

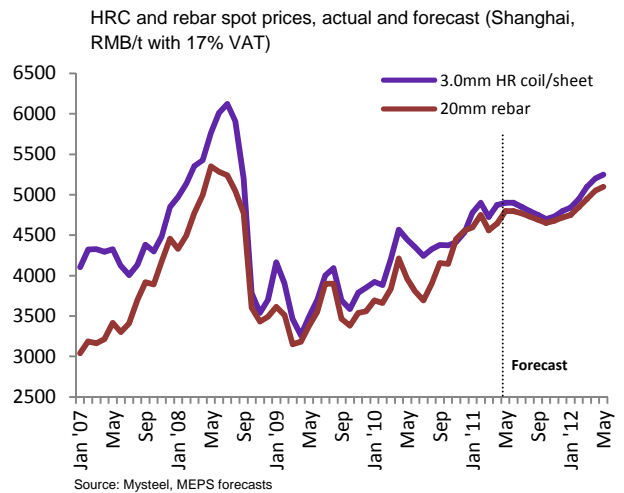
White goods output falls as electricity demand rises



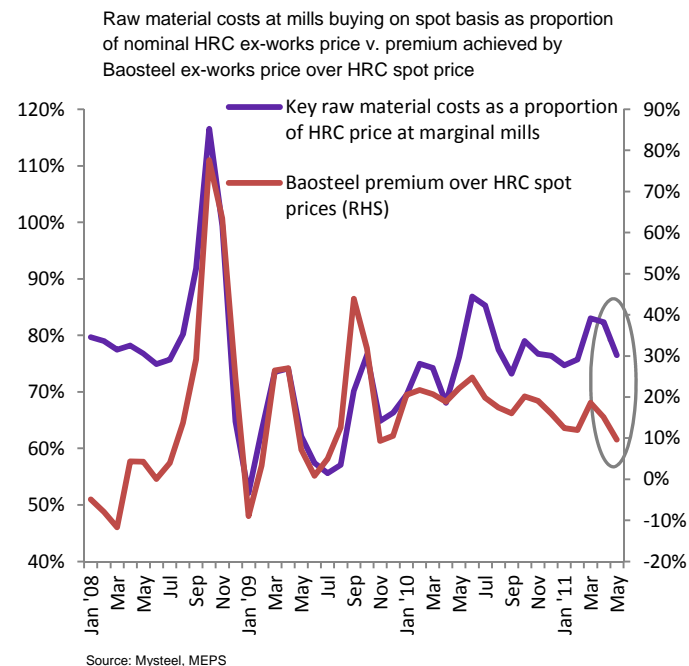
Steel prices losing momentum as margins improve and sentiment continues to corrupt

- Finished steel prices have continued to rise in May. At the end of last week, spot HRC at RMB 4880/t (including 17% VAT) and rebar at RMB 4780/t, returned to levels seen before Chinese New Year. As we had anticipated (see *China Steel Insight, April 2011*) with consumption of construction steel increasing as warmer weather returns, rebar has made rapid gains relative to HRC, with the latter only achieving a faltering premium of RMB 100/t over rebar.
- However spot prices for both products ended last week down RMB 40/t, influenced by the global fall in commodity prices. There was also continued concern over the impact on demand for steel of tightening measures within China, with the reserve requirement ratio for commercial banks raised by another 0.5% at the end of last week, following the announcement that inflation grew by 5.3% y-o-y in April.
- Tightening measures leading to lower steel consumption is now the dominant narrative amongst steel traders and speculators, increasingly over-riding the fact that steel demand fundamentals remain strong. This is having a particularly adverse impact on HRC prices, which are less responsive to better demand than the tighter long product market (see *China Steel Insight, April 2011*). In the short term we see this as having more of an impact than we initially anticipated. We forecast prices oscillating around current levels for the remainder of this quarter (see *chart to right and table overleaf*). Gains driven by physical demand will be lost as economic concerns and (misplaced) anxiety about steel oversupply continue.
- Steel prices now have less cost support, with margins at mills who are purchasing raw materials on a spot basis improving. As key raw material costs (Indian iron ore lagged two months and domestic coke lagged one month) take a smaller proportion of selling prices at these marginal mills, larger producers such as Baosteel achieve smaller premiums over spot prices (see *chart to right*). This will make it difficult for steel producers buying on a contract basis to push through higher ex-works prices during this quarter, despite facing rises of over 20% for iron ore and just under 50% for hard coking coal. We note that Baosteel has been forced to keep its June delivery price for commodity grade HRC steady at May's level.
- We continue to forecast a seasonal price correction in July, with rising temperatures and increased rainfall reducing steel consumption. We do not anticipate that finished steel prices will find much support from electricity cuts. Even if these are on a more severe scale than we expect, they will still be occurring during a seasonally weak period for steel demand. Any cuts in steel production beyond those we would expect on a seasonal basis, is likely to be met by even less demand from electricity consuming end users, with little net gain for prices.

MEPS forecasts anticipate monthly prices holding level in short term as spot market fluctuates around current prices



Improving margins at smaller mills make it harder for larger mills to achieve higher list prices



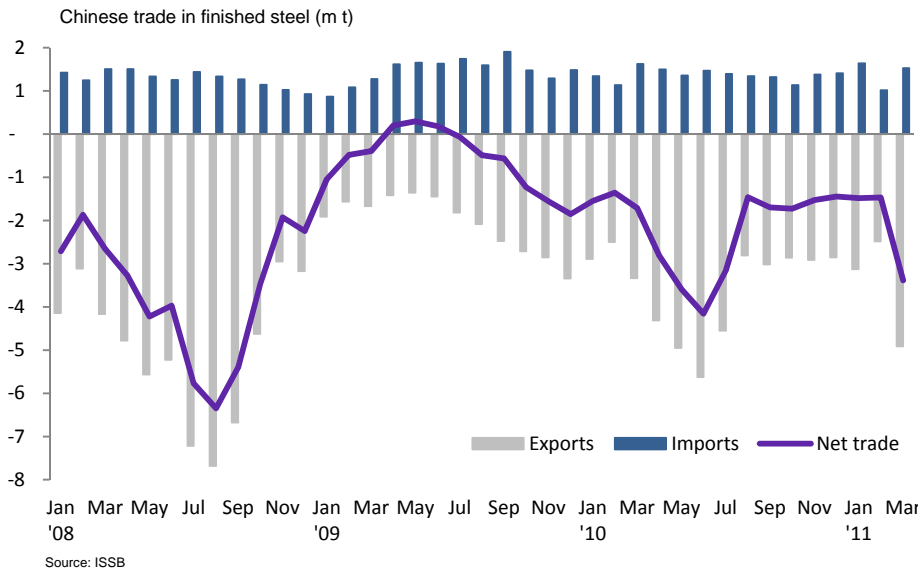
HRC and rebar spot prices, actual and MEPS forecast (Shanghai, RMB/t with 17% VAT)

Actual			Forecast						
<i>RMB/t (with 17% VAT)</i>	3.0mm HR coil/sheet	20mm rebar		3.0mm HR coil/sheet			20mm rebar		
				Forecast	Upper limit	Lower limit	Forecast	Upper limit	Lower limit
Jun	4353	3803	Jun '11	4900	5157	4643	4800	5212	4388
Jul	4242	3694	Jul	4850	5107	4593	4770	5182	4358
Aug	4328	3905	Aug	4800	5057	4543	4730	5142	4318
Sep	4378	4158	Sep	4750	5007	4493	4690	5102	4278
Oct	4374	4144	Oct	4700	4956	4444	4650	5062	4238
Nov	4415	4455	Nov	4730	4986	4474	4680	5092	4268
Dec	4532	4556	Dec	4800	5055	4545	4720	5132	4308
Jan '11	4778	4595	Jan '12	4840	5095	4585	4750	5162	4338
Feb	4903	4749	Feb	4950	5205	4695	4850	5262	4438
Mar	4728	4560	Mar	5100	5355	4845	4950	5362	4538
Apr	4872	4642	Apr	5200	5456	4944	5050	5462	4638
May to date	4900	4800	May	5250	5506	4994	5100	5512	4688

Source: Mysteel, MEPS forecasts

Finished steel exports surge in March

Chinese exports of finished steel rose sharply in March, driven by demand in Asia



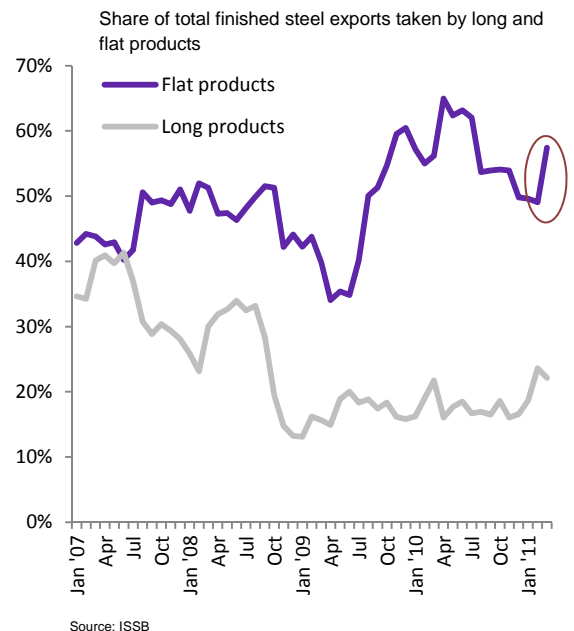
Top five export destinations for Chinese finished steel in March

1000 t	Volume shipped	M-o-M % change	Y-o-Y % change
South Korea	1274.3	107%	40%
India	302.3	109%	-5%
Vietnam	254.0	184%	43%
Thailand	209.3	143%	136%
Singapore	173.7	172%	133%
Total	4905.3	98%	47%

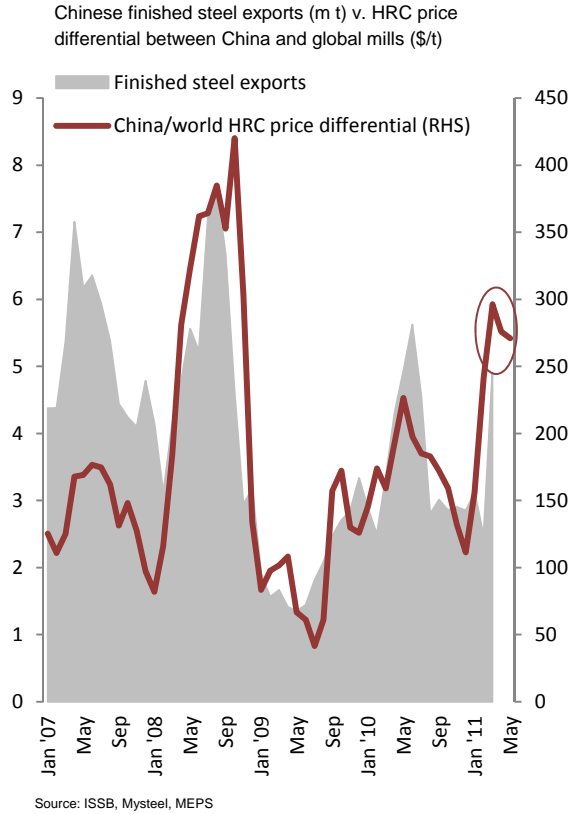
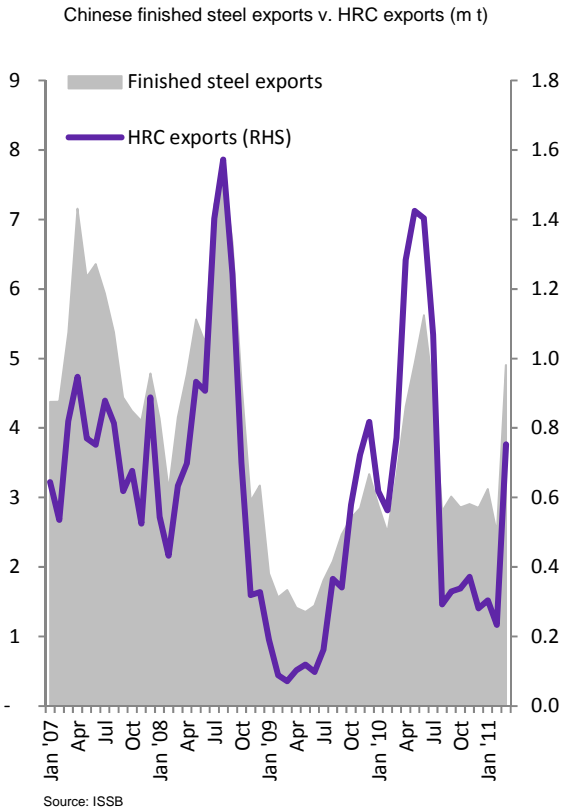
Source: ISSB

- Chinese exports of finished steel rose sharply in March to 4.9m t. This was driven largely by growing demand for Chinese material in Asia, with the top five export destinations all within the region.
- Demand was especially strong in South Korea, exports to which were at their highest level since September 2008. Trade in 2010 with South Korea largely rested on purchases of flat products. However surging exports of long products to the country have been recorded in 2011. These were up 129% q-o-q with growth in flat products at 35%. Reports from South Korea suggest that this level of purchasing is not sustainable with indications of oversupply in the domestic market amidst softening demand from the construction sector.
- Overall, exports of long products were up 85% m-o-m in March, but the sharp jump in total foreign sales was due to flat products, which took an enlarged share of the total volume of steel leaving the country (see chart to right). This in turn was driven by foreign purchases of HRC which, historically, has been the driver of overall export growth (see chart overleaf).
- Purchases of hot rolled coil continue to be driven by the price play between domestic values in overseas and Chinese markets, with this margin governing export levels (see chart overleaf). The differential between MEPS global HRC price and nominal Chinese ex-works price rose sharply in March, corresponding with rising export levels. This margin has stayed high in April and in the first half of May and we expect Q2 total exports to be up substantially from Q1. We forecast a rise of 17% to 12.3m t. Preliminary trade data shows that Chinese finished steel exports in April were 4.77m t and we expect levels to fall again in coming months but to remain at a relatively high volume of just under 4m t/month.

Export recovery was driven by flat products

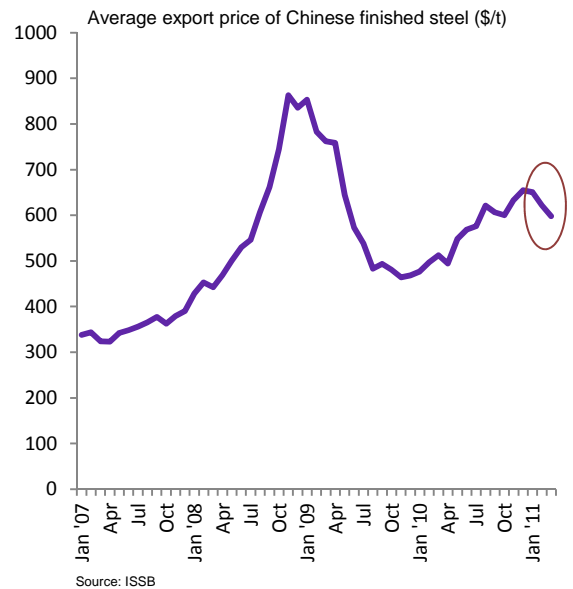


HRC exports are key to overall steel export volumes, with HRC price differential between Chinese and global mills driving trade



- One downside risk to these forecasts is that the increased volume of commodity products leaving the country will encourage the government to remove or reduce VAT rebates for steel exports. This has been rumoured for several months but we note that the stimulus may well come from the falling value of exported steel. The Chinese government is keen to promote exports of value added goods and there has been some success within steel exports. The average export price rose from 2H10 when the government reduced VAT rebates for many steel products. However if the dip in value seen in 2011 is sustained the government could well take action again.

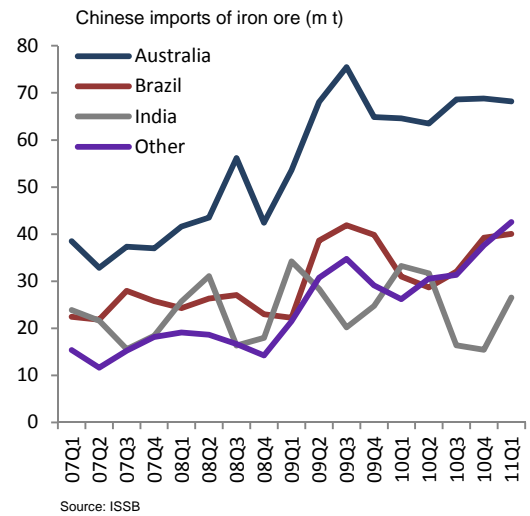
The value of Chinese steel exports are falling



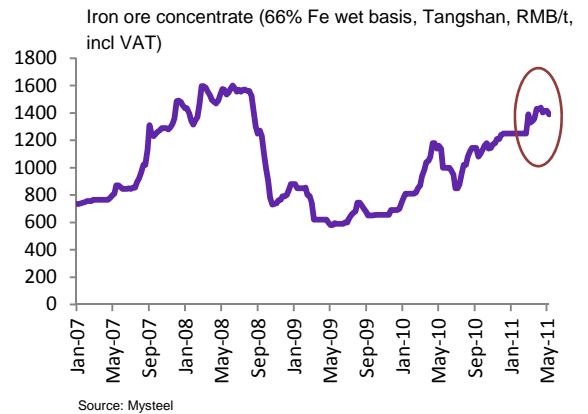
Iron ore imports up, but coking coal down over Q1

- Imports of iron ore into China rose 10% in Q1 from 4Q10 levels. Weather disruptions held back output in Australia, but there were sharp gains in the volume of material shipped from India and other second tier countries (see chart to right).
- Rising steel production in Q1 benefited foreign iron ore miners rather than the domestic iron ore industry which was held back by cold weather. Our revised pig iron numbers suggest that the share of China's total iron ore requirements sourced from domestic mines fell to 28% from the 2010 average of 35%.
- Prices of iron ore concentrate in the domestic market have slipped slightly but insubstantially in recent weeks (see chart to right). Prices are more than sufficiently high enough to incentivise domestic miners, now that warmer weather has returned, and we note that preliminary trade data shows iron ore imports dropping 11% m-o-m in April.
- In contrast, Chinese imports of coking coal fell 24% on a quarterly basis. Material from Mongolia fell sharpest, although freezing weather in Q1 has historically led to imports from this country taking a lower share of total tonnage. Mongolian imports were however up 62% y-o-y compared with a dip of 47% in imports from Australia. This partly reflects more extensive weather disruptions in Australia than in previous years, but is also a good indication of the long term shift from Australian to Mongolian material.
- Ultimately imports were restrained by the rising cost of imported material (see charts below), with steel mills preferring to source material domestically.

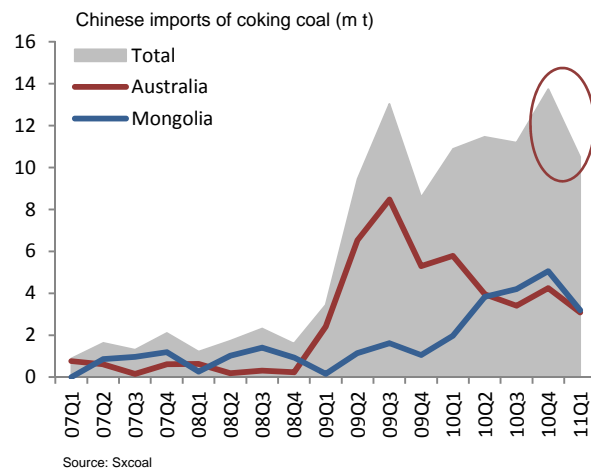
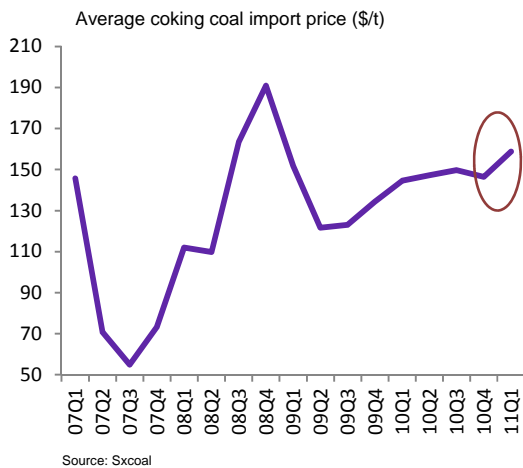
Chinese imports of iron ore rose over Q1



Rising iron ore prices should incentivise domestic miners



A sharp rise in the price of imported coking coal led to falling import volumes



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