James Syme
Senior Fund Manager

Paul Wimborne
Senior Fund Manager

Ada Chan
Fund Manager

April 2023

Emerging Markets Spotlight

Hidden Risks and Opportunities in China's Recovery

Chinese oil demand has largely been correlated with GDP growth, but the nature of that relationship is changing.

KEY POINTS

- Chinese economic demand could see oil consumption and oil imports pick up sharply
- Producer discipline remains strong with OPEC maintaining production quota cuts
- Changing nature of Chinese economic growth may see oil intensity of GDP growth decrease further...
- ...but rest of Emerging Asia is also recovering, and that is another major source of oil demand growth

One area of the macro landscape that received intense attention in 2022 but less so in the last few months, is the oil price. From the covid-driven lows of April 2020, the oil price climbed steadily until the Russian invasion of Ukraine in February 2022, but since June 2022, the benchmark Brent crude oil price has declined from USD 125/barrel to USD 77/barrel.

Yet, there appear to be some major changes in the supply/demand balance underway. China's re-opening is driving a recovery in oil consumption, with road transport and aviation major contributors to the increase. Leading energy research firm Wood Mackenzie has said this month that China's reopening will be the single biggest driver of recovering oil demand this year, with 40% of the global demand change coming from China.

Other agencies agree with this perspective. The IEA increased its forecast for global oil demand growth for 2023 to 2mbpd, largely on "resurgent" Chinese demand, OPEC forecasts China's oil consumption to rise 600kbpd in the first half of 2023 as ground and air travel see strong recoveries as lockdowns end, and the EIA expects China's oil consumption to be 700kbpd higher in 2023.

At a more immediate level, one of the features of the seaborne fuel transportation sector in February and March 2023 has been huge demand for the largest crude oil tankers for shipments of oil from the US to China. Costs of hiring these vessels have doubled, with reports that 41 tanker bookings occurred during the first 10 days of March, compared with 62 for all of February.

How this plays out will be enormously important for the global oil market as well as for incomes in oil producing nations and inflation prospects in oil importing nations. Like many countries, Chinese oil demand has largely been correlated with GDP growth, but with the nature of that relationship changing.

From 1980-2004, Chinese oil consumption grew at three times the rate of USD GDP growth; from 2004-2016 consumption grew at about 55% of the rate of USD GDP growth; and since 2016 consumption has grown at 48% of the rate of USD GDP growth.

In February 2023, Chinese oil imports (using customs data and including imports of refined products) were 10.8mbpd, a level first reached in November 2019. Even with a 48% relative growth, the IMF's forecast for 2027 Chinese USD GDP to be 49% higher than in 2021 implies 23% growth in Chinese oil consumption, or an extra 3.7mbpd. With Chinese domestic production essentially flat since 2009, that marginal demand is likely to all be met by imports.

In that light, the OPEC decision in October 2022 to reduce their oil production quotas by 2mbpd until the end of 2023, alongside Russia's 0.5mbpd cut in production in retaliation to Western sanctions, suggests that oil prices may experience upward pressure as 2023 progresses.

Two other factors are going to prove critical. The first is that changing relationship in China between growth and oil consumption. An ongoing shift in the drivers of economic growth drivers away from manufacturing, construction, and infrastructure and towards services may see the relationship shift yet lower. Further, China has been aggressively investing in renewable energy sources, including wind and solar (the portfolio has exposure to the Chinese solar power industry), as well as electric vehicles and power storage solutions, which are also likely to reduce demand growth.

The second, which goes the other way, is that the next few years are likely to see an ongoing recovery in India and Indonesia, and eventual recoveries in other sizable Emerging Asian economies. In 2021, the breakdown of Emerging Asian oil consumption was 52% China, 13% Taiwan and Korea and 35% the rest. Recoveries in India, Indonesia, Malaysia, Philippines, and Thailand can be significant marginal sources of demand, particularly if tourism and air travel recover with borders reopening.

An economic recovery in China is of global significance, but we feel that the relative lack of focus on the oil market may overlook the challenge it represents for oil importing nations and the opportunity for oil producing countries, including Brazil, Mexico, Indonesia and UAE, all of which we are overweight in the portfolio.

Source: Bloomberg/JOHCM. BP Statistical Review of World Energy, June 2022. IMP World Economic Outlook, October 2022. China Customs General Administration, February 2023.