How Long Will Surge in Chinese OCC and Pulp Prices Last?

By Chip Dillon, Analyst, Vertical Research Partners

Mid-October 2017 - Recently, trade publisher RISI noted that the cost of purchasing Chinese pre-consumer and US-sourced (already in China) recyclable old corrugated containers averaged $523 per metric ton (tonne - including a 17% VAT). That price compares to $496/tonne just one week earlier and $443/tonne two weeks earlier. Note that these levels are more than double levels seen within the USA. We have identified a number of causes for the price spike of Chinese OCC, namely the lack of new import licenses for OCC since May, tougher environmental inspections of recovered paper (RCP) at Chinese ports, the revocation of import licenses from mills that still have capacity under their quotas, and the MEP's (Ministry of Environmental Protection) decision to reduce the maximum contamination level of RCP to just 0.3% from 1.5%.

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The Chinese authorities' actions have not only resulted in higher domestic OCC prices but also significantly lower imported OCC prices – which of course benefit just a handful, usually large, producers since most of them cannot purchase his material. The price of US-sourced OCC being exported to China has fallen sharply in recent weeks. Just this past July US-sourced OCC was imported for an average price of $295/tonne. As a result, recently Chinese mills paid a staggering $323/tonne premium (161%) for similar quality OCC that simply is already in China as opposed to imported. Even more interestingly, the "weird spread" we have mentioned in past reports (that is, the difference in price between high-quality imported US OCC and domestic low-grade OCC in China) recently reached $236/tonne from $100/tonne in the end of August. It goes without saying that this situation cannot persist for much longer.

Market Pulp – Strong Demand from China

Similarly, bleached market pulp prices have enjoyed a strong 2017 so far. Despite some softness in June/July, price increases have been announced and implemented on the Chinese market with much more severity since August. The spike in pricing has been surprising. Of course a "doomsday" scenario where pulp prices would collapse as new capacity in Brazil and Indonesia came online was farfetched. Yet we cannot deny that we view recent increases – especially the recently announced changes of $80 to $100 per tonne (depending on the pulp grade) – with skepticism.

In fact, the recent announcements by many producers represent that single-largest price increases in a decade. Many exporters to China announced recently a $100/tonne increase in NBSK (northern bleached softwood pulp), while Russian BSK (bleached softwood pulp) producers followed with an $80/tonne increase. These price changes appear to have gone through with no resistance, and are already reflected in RISI's September pricing; more specifically, imported NSBK is now at $795/tonne from $695/tonne in August and Russian BSK is at $745/tonne vs $665/tonne in August. For NBSK, prices likely rose further in October, as several North American producers such as Catalyst Paper slated price increases that likely brought their list prices to over $800/tonne.

Anecdotal evidence supports the conclusion that demand for pulp in China is strong, even at these price levels. According to RISI, for example, a major producer reported that his October pulp allotment was sold out "immediately" following the price adjustments. We note that import prices are simply playing catch up for now. Following some softness in the market in June/July, domestic resale prices increases have greatly outpaced import price increases; during the past two months NBSK prices, for example, are up more than 40% vs less than 30% for import prices of the same pulp grade. That created a wider than usual spread for Chinese traders, thus allowing them to pay up for imports. Just in early September, the price gap between resale and imported pulp skyrocketed to over $240/tonne; that has since narrowed to "just" $154/tonne as resale prices slightly ticked up in September at the same time that the $100/tonne price hike kicked in.

What's Behind the Spike in Domestic Pulp Prices in China?

With the spread between resale and import prices at a very high level, the reason behind stronger import prices is rather obvious. The real question is why have domestic prices in China expanded by 40%+ in just a couple of months? Unlike the OCC situation, here we struggle to find adequate answers. And, when the market moves that much without sufficient rationale, we remain skeptical of such move. For now we can only speculate. Among the possible reasons behind the price increases are:

1) tighter supply due to an extended downtime at CMPC's 1.3 mln tonnes/year BEK (bleached eucalyptus kraft) mill in Guaiba, Brazil, until November;

2) Chinese paper and board mills restocking;

3) Chinese paper and board mills agreeing to higher pulp prices in order to push their own price increases to their customers;

4) tighter environmental inspections by MEP curtailing domestic pulp supply.

Of these four reasons, we believe the first is not sufficient on its own to explain the recent phenomenon, although it could be part of the puzzle. The second reason could be true, although it would put a lot of pressure on pulp prices once said inventory build is complete. We note that a restocking "panic" could have been caused by expectations for ample supply once new mills came online; as a result paper and board mills held off purchases in spring/early summer in anticipation of lower prices, and were eventually forced to reenter the market with increased orders. The third reason has been "circling around" for a long period of time, but remains speculation. Lastly, the last possible explanation is quite likely. We have learned from RISI about stricter environmental inspections in paper and pulp mills (including containerboard mills) as authorities sought to curb pollution ahead of the Chinese Communist Party's 19th National Congress (held every five years) that began on October 18th.

Conclusion

Regardless of whether we are discussing OCC or pulp, we believe that prices will sooner or later move lower. We have laid out our thinking on OCC prices numerous times – we see the situation as unsustainable as it forces domestic containerboard producers to increase their prices to levels that are already stimulating containerboard imports from other Asian countries; forces many (smaller) mills to shut down due to significant losses; and lastly, hurts China's economy as corrugated boxes are a staple of its industrial base. We believe that by the end of 2017 (or early 2018), China will start issuing import licenses for 2018, and once that happens we expect a buying frenzy for much cheaper and higher quality US OCC that will drive US prices much higher than their current level.

On pulp, we do not see evidence of demand that would justify \$100/tonne monthly prices increases. While demand could be healthy and Chinese pulp prices should remain strong, the recent hikes do not appear sustainable either. Whether we are experiencing a restocking by Chinese mills or many domestic pulp facilities are curtailing operations due to environmental inspections, once things reverse we should see pulp prices – both resale and imports – move lower.

Chip Dillon is a Partner at Vertical Research Partners (www.verticalresearchpartners.com) covering the Global Paper and Packaging Industry. He is a Chartered Financial Analyst (CFA) and consistently ranks highly in the major polls/surveys of U.S. Packaging & Forest Products analysts, including a #1 ranking on eight occasions in the Institutional Investor (II) poll.