

By Bill O'Grady

September 28, 2026

The Geopolitics of China's Energy Policy

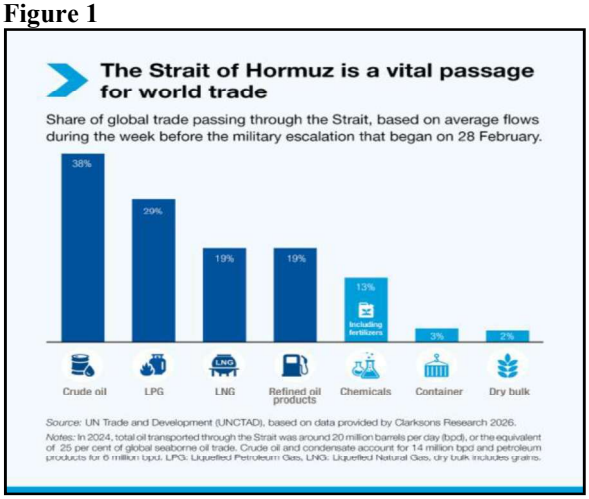
In our *Asset Allocation Bi-Weekly* from June 15, 2026, Confluence's Chief Market Strategist Patrick Fearon-Hernandez discussed China's unexpected decline in oil imports. That decline is one reason why the blockage of the Strait of Hormuz due to the war in Iran didn't lead to a catastrophic rise in oil prices, at least so far. In his report, he noted that analysts are not sure exactly why China's imports fell. Beijing treats its oil inventory data as a state secret, so we don't know if it was oil inventory drawdowns or some other factor that led to the slide in imports.

In this report, we first outline the importance of the Strait of Hormuz, update the information that we have, and focus on the geopolitical ramifications of China's actions. We examine China's behavior in a broader context and discuss whether that behavior portends similar effects on other commodity markets. As always, we conclude with market ramifications.

The War Shock

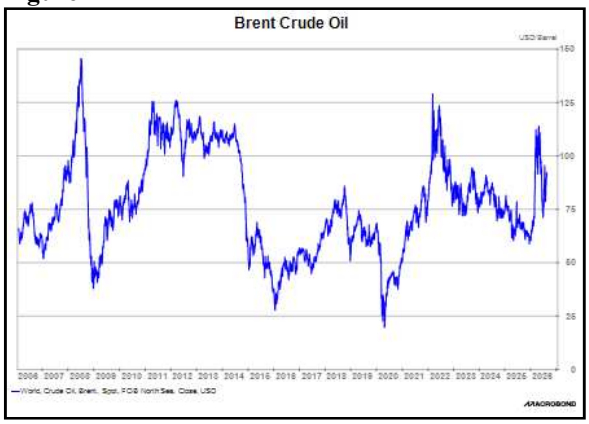
Market analysts are often asked, "What's the most bullish or bearish situation you could imagine?" For oil analysts, the most bullish would almost certainly be the closure of the Strait of Hormuz. In normal times, it's a key waterway for global energy commodities and petrochemicals, as shown in Figure 1.

Figure 1



When Iran closed the strait after Israel and the US launched a bombing campaign against Tehran, oil analysts projected that oil prices could reach extreme levels, perhaps as high as $200 per barrel. Other analysts rejected this idea, assuming "something" would happen to prevent the worst outcome. The "other analysts," thus far, have been correct. As shown in Figure 2, oil prices did rise following the start of the Iran war, but the increase was milder than the rally in 2007 and the jump that followed the Russian invasion of Ukraine.

Figure 2



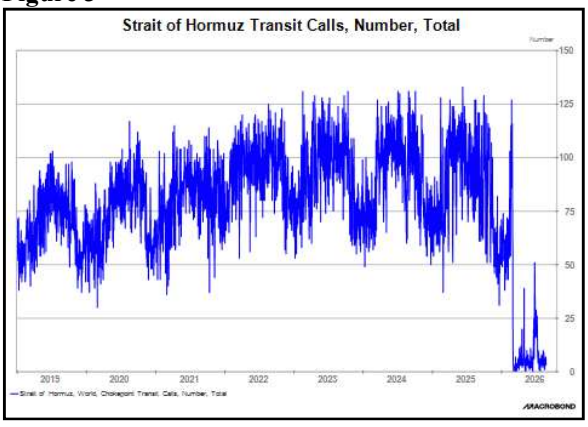
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As with most major events, there are multiple reasons why the worst-case scenarios have been avoided in the Iran war, thus far at least. The five prominent explanations are:

- The International Energy Agency organized a major release of oil from the global strategic petroleum reserve (SPR), which covered some of the estimated 20 million barrels per day of lost oil supply (see Figure 3);
- There was some "leakage" of barrels that escaped from the strait;
- Saudi Arabia utilized its East-West pipeline to ship crude oil to the Red Sea, which replaced 5-7 mbpd of the lost throughput;
- The Trump administration managed oil price expectations through announcement effects; and
- China dramatically cut its oil imports.

The SPR releases provided barrels to the world, and though there is always a fear that nations providing oil from their reserves will hoard them domestically, price spreads between various delivery points encouraged trade.

Figure 3

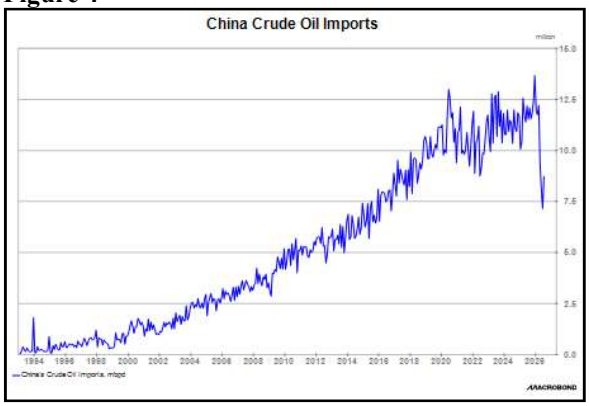


Although tracked shipping has declined, some barrels are escaping the region on ships with their transponders turned off.

Prior to the war, Saudi Arabia was exporting about 2.0 mbpd via the East-West pipeline; that has expanded to 5.0-7.0 mbpd. Looking again at Figure 2 shows how oil prices have endured significant volatility. This is due, in part, to the on-again, off-again conflict. A succession of announced ceasefire arrangements led to such a degree of whipsaw in the oil market that traders found it hard to maintain long or short positions. This factor helped prevent prices from reaching the levels widely feared.

But of the five reasons for the unexpectedly subdued price jump during the war, the last one was the biggest surprise. As shown in Figure 4, the decline in China's oil imports was shocking. How this happened isn't fully explainable because of gaps in China's reporting.

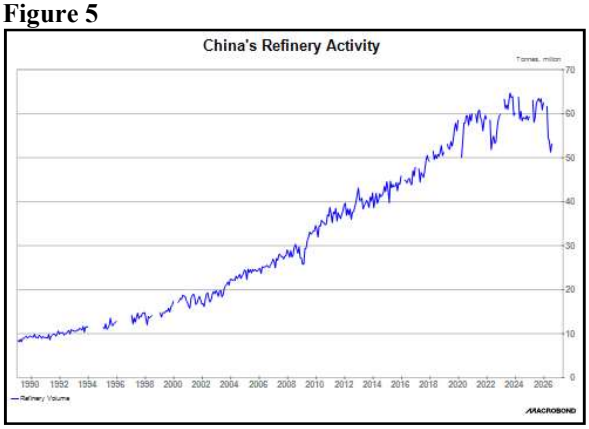
Figure 4



We do know that refining activity fell, which would have reduced demand for crude oil (see Figure 5, next page). This decline in refining activity was mostly a function of price controls. China has retail price caps, which tend to compress refining margins when oil prices rise. As margins compress, refining activity falls. Despite this decline, there have not been widespread reports of shortages.[1]

[1] The gas lines that occurred in the US during the 1970s were mostly a function of price caps. When they were lifted, prices rose but shortages ended.

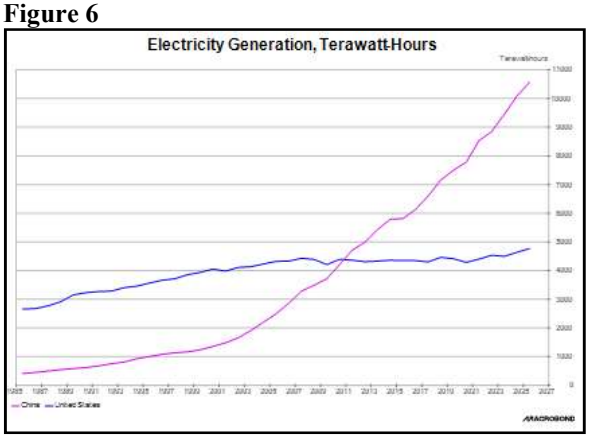
Figure 5



So, what happened? The data that could give us the best answers would be inventories, but the Chinese government doesn't make those available. So, we are left to speculate. Here are some hypotheses:

- China has used its strategic oil reserves to balance the internal market. Although the known reserves are above ground and can be observed by satellite, it's possible there is oil being stored in salt caverns similar to those in the US, which are not observable. Best estimates suggest that China has reserves of 1.2 billion barrels of oil, by far the world's largest. So, for a time, it could control prices by drawing down inventories.
- China has large inventories of refined product as well. This might be the best explanation.
- China's economy is weaker than reported. The data that we see doesn't suggest a problem, but there are serious concerns about the veracity of China's official data. Capital Economics' China Activity Proxy, designed to approximate GDP growth, is running at 3.6%, which is less than the official numbers but certainly not recessionary.
- China's "everything" approach to energy buffered the oil crisis. China has moved aggressively in recent years to electrify its economy, adding nuclear, solar, and hydroelectric power, while maintaining natural gas and coal production. The result is that China has created various ways to use electricity in place of oil. As shown in Figure 6, China's electricity generation is expanding rapidly and is now more than twice that of the US.

Figure 6



The combination of the above factors kept oil prices from reaching critical levels. At present, the conflict has evolved into a stalemate of sorts, with the US reducing kinetic action and Iran remaining content to solidify its hold on the Strait of Hormuz. This equilibrium appears unstable, but as long as both sides avoid major escalation, it can remain in this state for an extended period. The longer it lasts, the greater the likelihood that the world can adapt and avoid a spike in crude oil prices.

China's Strategy

Nations usually produce strategy documents that are designed for multiple audiences, both foreign and domestic. These reports provide goals that a nation is trying to accomplish related to national and economic security, but it can be difficult to determine if these are mere goals or imperatives. Until tested by circumstance, we really don't know with certainty how committed a country is to an outlined goal.

In May 2020, General Secretary Xi discussed an idea called "Dual Circulation,"

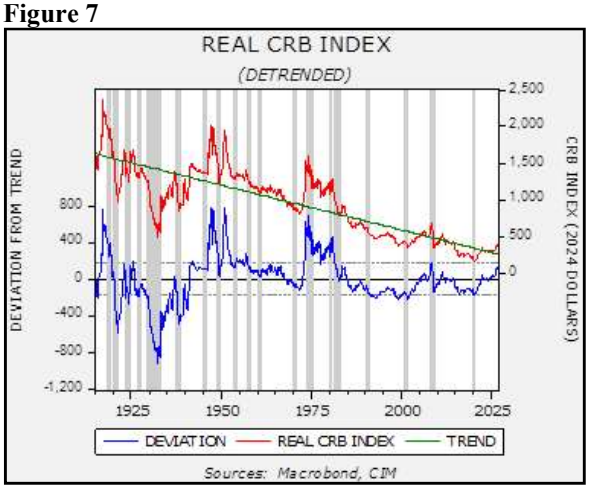
which aims to create circumstances where China would reduce its dependence on other nations while simultaneously engaging in actions to encourage other nations to depend on China. The policy was formalized at the Fifth Plenum of the 19th Central Committee meeting in October of the same year. Essentially, China wants to prevent other nations from using supply chains, financial infrastructure, or other factors to limit the Communist Party of China's (CPC) policy choices. This policy partly explains China's drive to create industrial capacity (and, in many cases, overcapacity) in numerous industries and has also led China to build sizeable inventories in key commodities, including oil.

The act of creating these inventories adds a reflexive element to the market. The ability of China to reduce its oil imports prevented the forecast jump in prices and stabilized the market. If we refer to the oil imports chart above (Figure 4), note that China had been increasing its imports at a furious pace for a couple of years before the Iran war. At the time, there were concerns that this buildup was in anticipation of an attack on Taiwan. But given China's recent behavior, it's more likely the inventory accumulation served to provide optionality, positioning China to cope with a severe supply shock regardless of the source.

Inventory management reflects perceived risks. In wartime, supply security is at risk, so economic actors will tend to hold higher levels of storage. But holding inventory has costs: the goods must be warehoused and protected as stockpiles are vulnerable to theft, fire, deterioration, and other hazards. These risks can be insured, but that obviously carries costs as well. On the other hand, having supplies available allows production to continue with less risk of disruption. In peacetime, the calculus changes. For the past 45 years, "just-in-time" inventory practices have dominated. Essentially, just-in-time inventory management attempts to push the cost of inventory onto some other part of the supply chain.

Another word for inventory accumulation is "hoarding." Increasing inventory levels is a form of demand, and if all else is held equal, boosting inventory should lead to higher commodity prices.

Figure 7



In Figure 7, we show a trend regression of the CRB commodity price index, deflated by the US consumer price index. The red line on the upper part of the graph indicates the real CRB index; we have regressed a time trend through the data. The lower line represents the deviation from trend. As the chart depicts, real commodity prices tend to decline over time. This outcome is one of the features of capitalism — consumers and producers constantly work to use fewer commodities in production and consumption.

While the overall trend is clearly declining, there are obvious periods where commodity prices rise relative to trend. These are usually tied to wars or periods of monetary debasement. The last period of above-trend

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prices was the commodity bull market that ran from 2000 to 2007. This period was unique in that it was mostly a demand-driven bull market. China's rapid development led to a sharp rise in commodity consumption. Although it seemed impressive at the time, compared to early bull markets, it was obviously weaker.

China at War?

As noted earlier, China's inventory information is spotty at best, but a case could be made that China seems to be preparing for supply disruptions. It's possible that Beijing's Dual Circulation policy is tantamount to a war footing. This doesn't necessarily mean that China is preparing to engage in military action. Instead, it may expect an increasingly unstable world and wants to protect itself from potential supply problems. Increasing inventories and having multiple supply sources do offer some degree of protection. In addition, being the dominant supplier of key industrial components gives China market power to use as a deterrent against sanctions, quotas, and tariffs. It may not be a war footing in the traditional sense of building stockpiles to support invasions, but rather it offers protection in a world of uncertain hegemonic power.

It's worth remembering that mutual interdependence was a factor in the last great period of globalization between 1870 and 1913. Norman Angell outlined this situation in his book *The Great Illusion*. Angell's thesis was that globalization had led to a level of interdependence that made war so expensive as to make it futile. Sadly, that warning was not heeded. Globalism expanded gradually during the Cold War but rapidly after the fall of communism. China's Dual Circulation policy could be seen as a way to prepare for the end of globalization, which began to falter in the wake of the Great Financial Crisis.

Ramifications

China's inventory behavior could bring changes to commodity investment. Generally speaking, an investor can either buy the commodities or the companies that produce them. By adding to inventory levels when prices are low and selling into the market when prices are high, China removes the "tails" of the price distribution. For affected commodities, investment in commodity-producing companies will likely be a better path. Why? Because companies often perform better with elevated but stable prices. A price higher than a pure market-clearing price will tend to support well-managed commodity-producing companies by creating a form of economic rent. Price stability can contribute to earnings stability, which is often prized by equity investors. On the other hand, China's price buffering activities will make investing in the commodity itself less attractive by removing the spikes that usually accrue to the commodity holder.

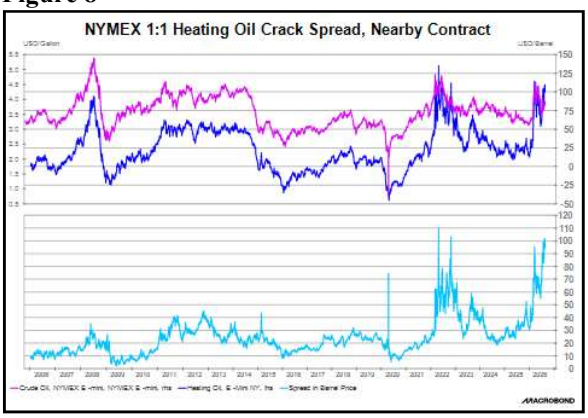
Of course, China may not be successful in stabilizing all commodities. For example, if the Chinese are trying to contain copper prices, it hasn't worked so far. In addition, it's important to remember that many commodities are processed into other products. Although China did play an important part in dampening crude oil prices, it hasn't stopped product prices, especially diesel, from rising rapidly.

In Figure 8 (next page), we show the price spread (light blue line) between a barrel of heating oil (with low sulfur content, a reasonable proxy for diesel fuel) and crude oil (pink line). The current spread is $100 per barrel, well above the normal $30 per barrel, suggesting that if the crude oil price

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is approximately $80 per barrel, it would be $150 per barrel with a normal spread. China's inventory management has successfully held down crude oil prices but has had less success with product prices. Thus, in the emerging commodity regime, investors may need to look at products rather than the raw commodity.

Figure 8



Finally, there may be another underlying reason for China's behavior beyond Dual Circulation: China is a communist nation. Although it appears capitalist in its behavior, the Communist Party of China espouses Marxism. Marx was a classical economist; like Ricardo and Smith, Marx discussed "use-value" and "exchange-value." All the classical economists were troubled by how these two values sometimes diverged. Think of use-value as a product's intrinsic value and exchange-value as the market price. This problem was "resolved" by Alfred Marshall by jettisoning value and focusing on marginal utility and price. In other words, economics solved this paradox by ignoring intrinsic value and focusing solely on exchange-value.

In a modern microeconomics class, it would be unusual to hear the terms use-value and exchange-value. Value is determined by price, which should act to maximize profit to the supplier and satisfaction to the consumer. Marshall's resolution is important because it allows price to become a distribution instrument. The price provides signals to consumers and producers. This idea was foreign to the classical economists, who were more concerned about equating use-value and exchange-value.

It's possible that Chinese leadership is more focused on use-value, because their behavior actually distorts the Marshallian resolution to the value problem. By not allowing prices to reach $200 per barrel, consumers and producers were not allowed to take the necessary steps to adjust to the dire supply situation. A Marxist would likely remark that "oil isn't worth $200 per barrel." By intervening to prevent the price from reaching this level, oil's use-value is preserved, but the "proper" signal isn't being sent.

If our speculation is correct, China is engaging in this aggressive inventory management not just because of Dual Circulation but also because it is consistent with Marxism. As a result, commodity markets will tend to be less volatile, with somewhat higher prices than what would be signaled by a pure clearing price. As we noted above, this stance would likely favor companies over the commodity itself. There are two known/unknowns to consider. First, will China continue to expand this inventory practice to other commodities, and second, can it be sustained? That's what we will be monitoring going forward.

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