Bulk Commodities Market Update

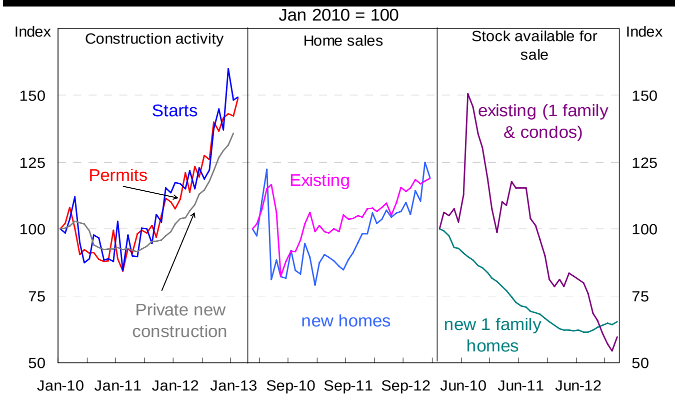
National Australia Bank

- **The recent rally in bulk commodity prices has stalled with both coal and iron ore prices giving back some of their recent gains; average monthly prices declined in March.**
- **Global steel production has continued to grow at a good pace in recent months, driven by increasing Chinese production despite pressure on margins from easing steel prices, record high inventories and the elevated cost of inputs. Rebar futures are showing uncertainty in end-user demand for steel, but recent improvement in PMI indicators is a positive signal.**
- **The average price for iron ore (62%) is estimated to have been around US$131 per tonne FOB for March, down from US$142 in February. The spot price is currently steady at around US$137 per tonne (CFR).**
- **The average spot price of thermal coal shipped from Newcastle (FOB) fell by 3½% in March, more than reversing the rise seen in February.**
- **We have revised our near-term price forecasts slightly lower for each of the bulk commodities reflecting adequate supplies in the market and the slower than anticipated recovery in Chinese steel demand and sluggish real economic activity across most parts of the globe. Nevertheless, an anticipated turn around in the global economy later this year (and accelerating Chinese growth in H1) will keep commodity prices elevated.**

Bulk commodities have experienced renewed headwinds in the past month with the temporary factors underpinning the recent rally washing out and confidence in China's economic recovery starting to waver. Iron ore prices have now dipped more than 15% below their February peak and futures markets indicate that the usual post-winter recovery in construction (and steel demand) may disappoint. Spot iron ore prices recently hit a low of around US$134 per tonne (CFR, Tianjin), but have stabilised in the past week. The relatively muted recovery (and recent softening) in coal prices further highlights the tentative demand for bulks and uncertainty over the outlook. Newcastle spot thermal coal prices have dipped back slightly below US$90 per tonne (FoB), and spot prices for premium HCC are now back below US$160 per tonne (FOB), down from a high of US$173 per tonne (FOB) in mid-February.

The influence on demand from the global economy has been relatively mixed over the past month or so. The banking crisis in Cyprus came to a head, again reminding everyone that Europe's problems are far from over. Even though a deal for funding of the Cypriot banking system was eventually struck between parliament and international organisations, the structure of the bail-out (and subsequent jawboning by authorities) has elevated concerns over the security of deposits in the region. In the US, despite expected headwinds from fiscal drag this year, March delivered mostly upside surprises that included a strong payroll report and resilient auto and retail sales reports. Of particular significance to the steel market were the upbeat housing data and a strong Markit PMI report on manufacturing activity. In contrast, the ISM PMI for March was well below expectations (but was still expansionary).

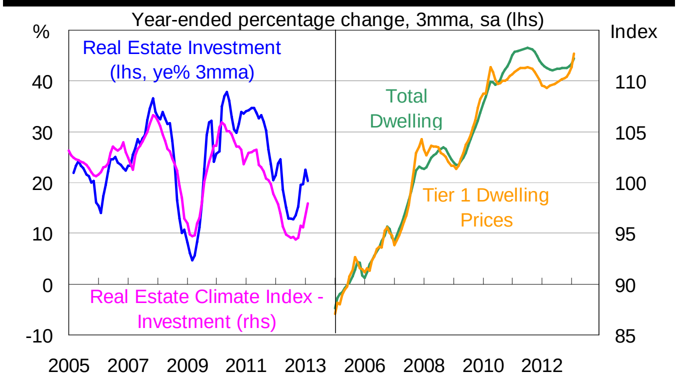
Fundamentals for US residential property upbeat



In Japan, disappointing export data along with still-depressed survey indicators pose some downside risk to the anticipated economic recovery, although we are holding on to this expectation and should start to see more signs of a robust expansion as stimulus measures and the devalued Yen helps to boost the economy and export demand.

The Chinese economy continues to be a relative bright spot, although early indications are that the anticipated recovery for H1 of this year may not be as robust as previously thought. In particular, we are seeing very few signs that private demand will ramp up enough to support growth later in the year as the impact from the recent public investment stimulus starts to wash out. Growth in industrial production and real retail sales both decelerated in the first two months of the year (although data in the first quarter needs to be interpreted with caution due to LNY distortions). However, there have been some positive trends in certain parts of the economy of late. Export demand appears to be in recovery, PMI indicators for manufacturing showed a marginal improvement in March and consumer confidence is at its highest level since mid 2010. It also appears as though we may have seen the bottom in China's real estate sector with investment and the real estate climate index both picking up.

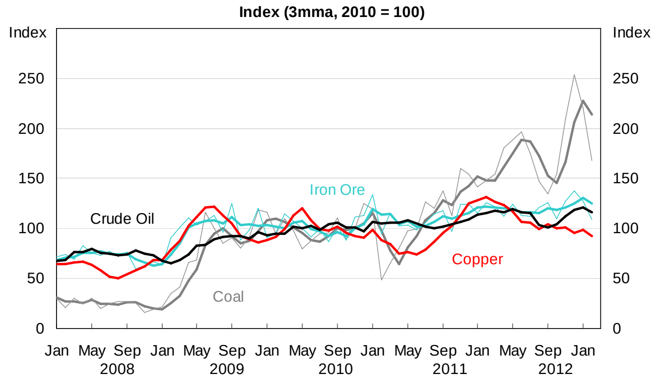
China's real estate recovery a mixed blessing



Source: CEIC, NAB

The potential fly in the ointment though is how authorities are likely to respond to the apparent turn around in the real estate market. We had expected a recovery in real estate to underpin some of the support to commodity demand this year, but authorities have been quick to discourage some of the recent improvements seen in the market by reiterating their commitment to housing affordability and reintroducing measures to curb speculative investment. Some of these measures have included the reintroduction (enforcement) of capital gains tax, further restrictions on second home purchases and increased land supply. On a more positive note for the construction industry, the government will also continue to press on with its affordable housing scheme with a plan to commence 6.3 million affordable housing units, while 4.7 million will be completed in 2013 (down from 7 million starts and 5 million completions planned last year).

China's commodity import volumes

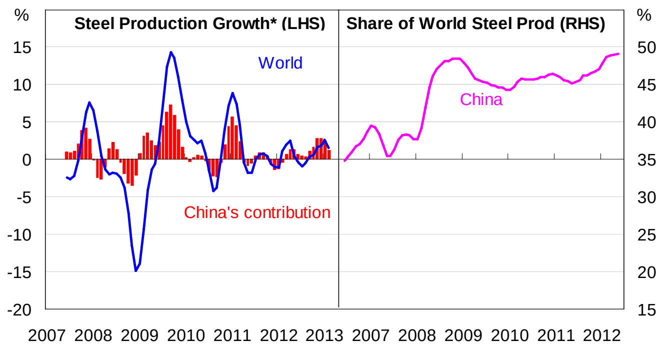


Sources: CEIC; NAB

China's demand for commodity imports picked up strongly in the later stages of last year, but with the restocking of steel now winding down and the growth outlook looking a little less certain, higher commodity prices started to weigh on import volumes in the early months of this year – iron ore, copper and coal prices all reached local peaks during February. Nevertheless, expectations are for improved growth in steel production compared to last year, albeit still at a modest rate by China's standards, which along with an expected increase in supply will see imports of steel inputs remain robust. Similarly, stronger economic growth this year should drive an increase in energy demand, supporting China's appetite for coal

Steel Production

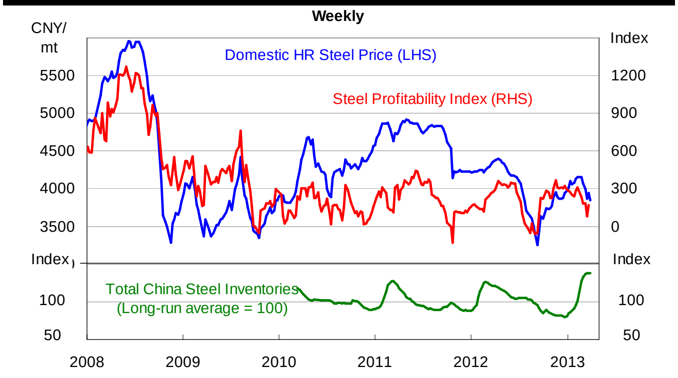
World Steel Production



* Calculated as the 3month/3 month percentage change of seasonally adjusted steel output.
Source: World Steel Association, NAB

Global steel production has continued to grow in recent months, driven by increasing Chinese production despite pressure on margins from easing steel prices and the elevated cost of inputs. Chinese steel production rose ¾% in February, following a 3½% rise in January (data are seasonally adjusted by NAB). More recently, daily steel production in China has remained robust at 2.064 million tonnes in mid March, slightly lower than earlier in the month, according to estimates from the China Iron and Steel Association (CISA). However, solid production has been associated with large increases in steel inventories, suggesting that end-user demand has been relatively more subdued; stocks at port have risen to an all time high in recent weeks. Similarly, CISA report that stockpiles at China's major steel mills hit a record high of 14.52 million tonnes in mid March, which means that we can expect to see these firms cut production further over coming weeks and months.

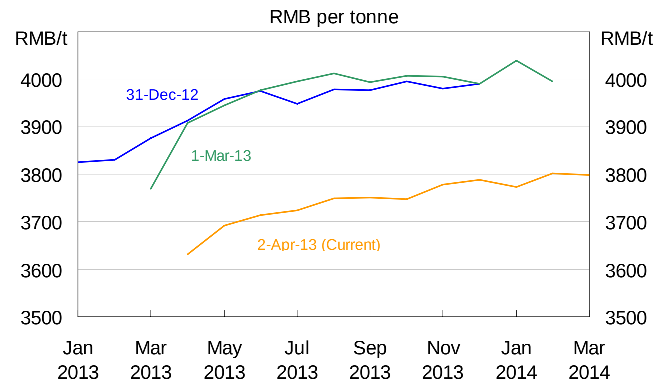
Conditions remain tight for Chinese mills



Sources: Bloomberg; NAB

Slack in the steel market has pushed the price of steel lower; the price of Chinese rebar has declined by around 5% since mid February. Futures prices for steel have also fallen, although high inventory levels have kept the curve in contango. With the cost of raw inputs remaining elevated (albeit easing), steel mill profitability dipped back down to its lowest levels experienced since around August last year when concerns over a China hard landing were still prevalent and iron ore prices had dipped below US$90 per tonne (CFR, Tianjin). Despite the downturn in profitability since early February, the PMI indicator for China's steel industry recovered almost 20 percentage points in February to 58.8 (from 49.3). The improvement was driven by a spike in output, but it was the sharp rise in new orders that is most promising to the industries near-term outlook.

Shanghai Rebar Futures



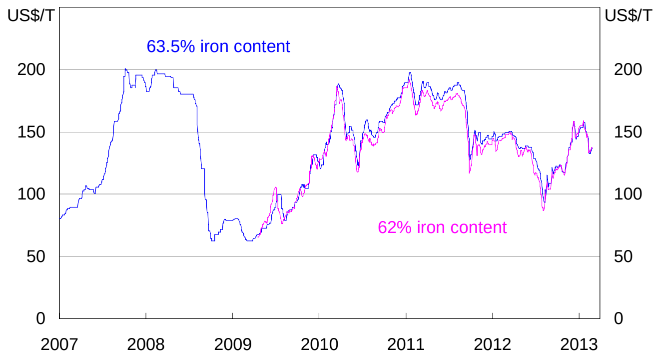
Source: Bloomberg

Iron Ore

In contrast to steel, reports show that the stockpiles of iron ore at steel mills have been depleted, particularly at small and medium-sized mills. While this is likely to support ore prices at elevated levels, it will only lend temporary support as increasing supplies of ore in seaborne markets and a running down of steel inventories cause prices to dip lower over coming weeks and months.

Softening steel markets will also discourage mills from holding significant stocks of ore.

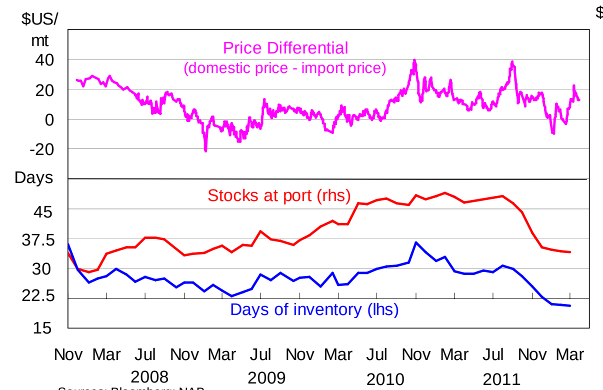
Chinese Iron Ore Prices*



* Includes the cost of freight
Source: Bloomberg, Thomson Datastream

Spot prices have fallen from their February highs, easing to around US$135 per tonne (CFR), with the uncertain outlook for steel demand in China encouraging buyer caution in iron ore markets; prices peaked at nearly US$160 per tonne in mid February. Nevertheless, spot prices remain 50% above the low recorded in early September and appear to have stabilised (and have started to rise) in recent days on reports that mills are starting to tentatively rebuild their depleted ore stocks. Demand for seaborne iron ore is also starting to receive support from a favourable price differential to domestic ore. Nevertheless, stocks of iron ore held at Chinese ports remain at very low levels due to robust steel production and lower imports. The stocks-to-use ratio implies that there is currently around 20 days of iron ore available at the current pace of steel production; the lowest level since 2007, but despite this, mills are likely to remain cautious with their restocking activities so long as demand for steel remains modest and steel stocks remain at high levels.

Chinese Iron Ore Stocks at Port

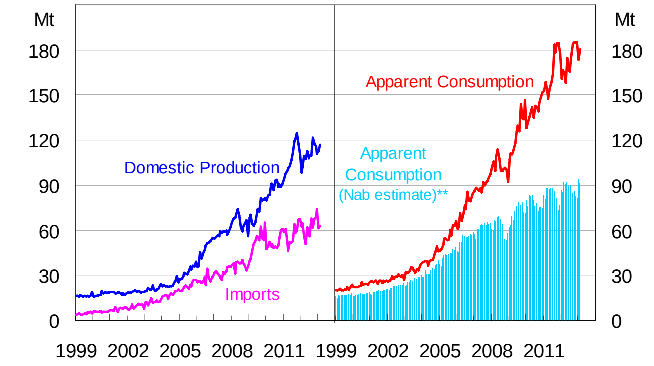


Sources: Bloomberg; NAB

Rising domestic iron ore prices in China over the first two months of the year have contributed to an increase in domestic ore production in recent months – domestic ore prices also became more competitive by the end of last year with the price differential to imports reaching its lowest level since 2010. Chinese iron ore production in February was more than 5% above production in December and was more than 6% above the 2012 average (data seasonally adjusted by NAB).

The rise in domestic ore production contributed to an increase in China's apparent iron ore consumption in February. Apparent consumption of iron ore rose almost 4% in February, partially recovering a decline in January that was driven by a fall in iron ore imports from the record high recorded in December (seasonally adjusted). Rising import volumes also contributed to apparent consumption in February, increasing 3% in the month once accounting for seasonal factors, but fell by 14% in unadjusted terms. Looking through LNY effects, average import volumes for January and February were 5% lower than in the December quarter.

Chinese Iron Ore Market

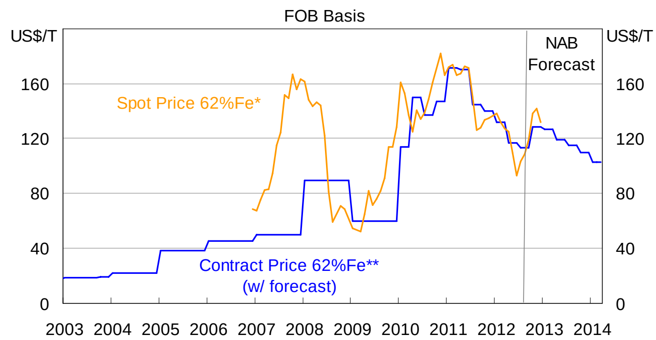


* Only imports data are available for January 2012 (but not fully adjusted for CNY).
** Based on pig iron production; accounts for declining domestic ore grades. Excludes changes in ore inventories.
Source: CEIC

An alternative estimate of apparent demand, derived from pig iron production, suggests that consumption of iron ore declined by almost 3% in February after reaching a record high in January. While this measure implicitly takes into account declining ore quality at Chinese mines it does not account for restocking activities or seasonal impacts. Overall, China's apparent consumption of iron ore remains at elevated levels, but the growth momentum appears to have stalled. While tentative restocking of ore by Chinese mills may keep demand elevated, this may only partly offset a slowdown in demand for steel production as elevated steel inventories are run down first.

Nevertheless, China's National Development and Reform Commission expects Chinese iron ore demand to increase by 50 million tonnes in 2013, although it states that this will not be enough to offset rising supply. The NDRC states that domestic demand is set to rise by 20 million tonnes this year, while major international producers will increase supply by around 100 million tonnes. This compares to a reported increase in Australian iron ore capacity of around 110 million tonnes, and market estimates of around 120 million tonne rise in additional global supply.

Iron Ore Prices



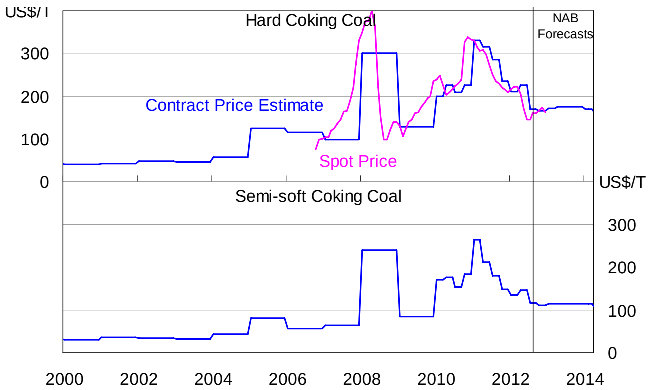
* Spot price is calculated on an FOB basis by subtracting Port Dampier to Qingdao shipping rates from the cost and freight price. 62% Fe spot price is an estimate from published 63.5% price.
** Up to Q3 2011, based on formulation that quarterly contract price equals previous quarters average spot price, lagged one month (eg. DQ = Average(Jun-Aug spot price)). Estimated using spot from Q4 2011.
Source: ABARE, Bloomberg, Thomson Datastream, NAB

The average price for iron ore (62%) is estimated to have been around US$132 per tonne FOB for March, down from US$142 in February. Although we could still see some near-term tightening in the iron ore market from additional restocking, prices are not likely to return to their most recent highs and we expect market conditions to loosen overall during the remainder of the year. Regarding demand conditions, our central forecasts still encompass a gradual recovery in the global economy later this year, and stronger Chinese growth in H1 – this is underpinning expectations of a modest improvement in steel production this year. However, some softer than expected economic data out of China (and Japan) in recent months could mean that a disappointing recovery in (or lack of) demand is still a possibility. Additional headwinds include elevated steel inventories, excess production capacity, uncertainty over potential changes to China's real estate policies, and ongoing difficulties in Europe (most recently in Cyprus). These demand side factors, in combination with significant additions to supply – partially mitigated by constraints on Indian exports – will keep conditions difficult for both steel and raw material producers – we expect to see iron ore prices trend lower over the remainder of the year.

Metallurgical Coal

The same demand factors tend to drive both iron ore and coking coal given their primary use in the production of steel products. However, plentiful supplies of coal have prevented the same degree of recovery seen in the iron ore market since late last year. Nevertheless, prices did record a modest recovery supported by solid steel production in China, supply disruptions and anticipation of a pick up in steel demand, particularly out of Asia. However, the post Lunar New Year period – normally associated with a ramp up in steel demand – has under whelmed the market, while some of the supply disruptions have also started to subside. Consequently, coal prices have given back some of the gains seen since late last year. Average spot prices for premium hard coking coal rose almost 4% in February, but have fallen by around 6% in March; the spot price is currently around 9% below its recent peak in mid February.

Metallurgical Coal Prices

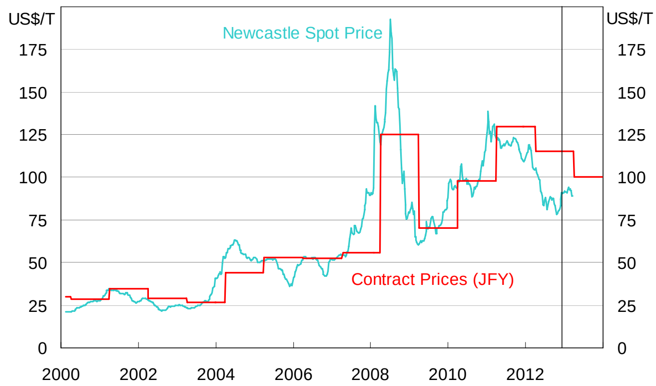


Sources: BREE; AME; NAB

Spot prices for premium hard coking coal have now fallen well below the reported US$172 per tonne FOB contract price set for the June quarter between BMA and Japanese steel producers; the current spot price is 8½% below contract. According to AME, spot prices for premium hard coking coal were around US$157 per tonne FOB in late March, 8½ per cent lower than the February average. Conditions in the steel market are expected to remain subdued for some time, and stockpiles of coking coal may limit demand for imports. However, changes to railway allocations for coal and domestic coal pricing in China will help to bolster the near-term appetite for coal imports. China's coking coal imports fell in February, but when taken together with January, were 55% up on last year. The delayed impact of the investment stimulus in China should assist prices back toward US$175 per tonne late next year.

Thermal Coal

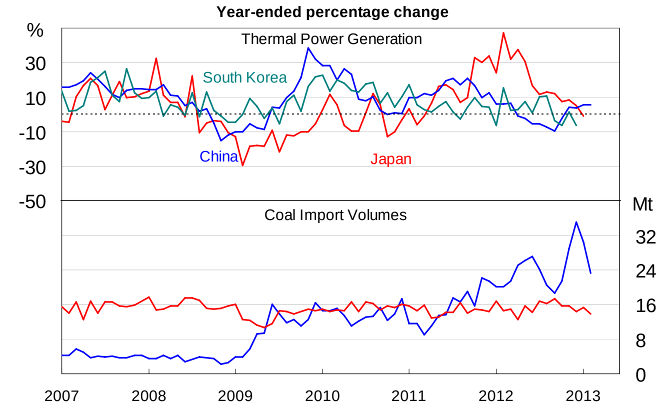
Thermal Coal Prices



Source: McCloskey's, ABARE,

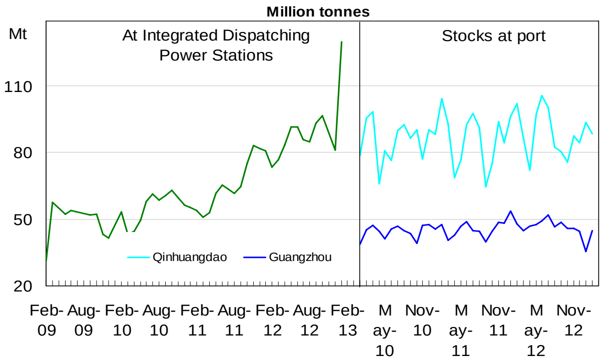
The recovery in thermal coal prices also lost some steam during the month despite supply disruptions from floods in Mozambique and an industrial dispute at Columbia's Cerrejon mine (reported 3 million tonnes in lost production). Softer than expected industrial activity in major coal importers is also weighing on thermal energy production and keeping coal stocks elevated. Spot prices dipped back below US$90 per tonne (Newcastle FOB) this month after reaching US$94 per tonne in early February. Spot prices at these levels will mean quite a bit of downside risk to our long held expectation of US$100 per tonne FOB for JFY coal contracts, although Japanese contracts often settle at a premium to the market.

Thermal Coal Demand



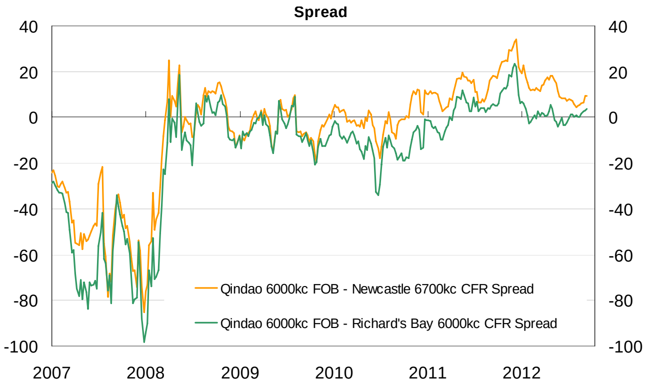
Looking through the daily volatility, the average spot price of thermal coal shipped from Newcastle (FOB) fell by 3½% in March, more than reversing the rise seen in the previous month. There appear to be very few factors at play that are inclined to drive spot prices much higher from current levels, although a better Chinese manufacturing PMI index for March sends a more positive signal. Nevertheless, LNY and elevated coal stocks at port and power stations have weighed on China's thermal coal demand with imports falling for the second consecutive month. The arbitrage window is also turning more in favour of domestic producers, but while recent reforms to China's resource markets may work to keep the arbitrage window closed by putting downward pressure on domestic spot prices, the reforms will also help to drive out high cost producers, simultaneously raising demand for lower cost seaborne coal. China have also recently released plans for further reforms to the coal market that will include eliminating excess production capacity (64.18mt of capacity at 1,256 mines will be shut down, upgraded or consolidated per year).

Coal inventory at Chinese utilities



Source: CEIC

China's thermal coal arbitrage window



* Qindao price adjusted for 17% VAT; Newcastle & Richard's Bay prices adjusted for freight
Sources: McCloskey, Bloomberg, Industries

Demand from Japan may improve this year and into 2014 as aggressive fiscal stimulus and supportive monetary easing gain traction to drive economic growth. However, the future of Japan's nuclear program remains a major unknown for the coal industry. Demand for coal has grown in the years following the 2011 Tsunami that disabled Japan's nuclear capacity. The government is likely to bring some additional nuclear capacity back on line some time in the future, although the recent scrapping of plans to build the Namie-Odaka plant (from 2016) suggest that opposition to reopening existing plants is still effective.

In contrast, the outlook for Indian thermal coal demand is relatively bright. In its most recent commodity outlook, the Bureau of Resource & Energy Economics (BREE) project India's coal consumption to increase substantially over coming years as coal fired electricity generating capacity is expanded significantly, while domestic coal production is not expected to be sufficient to meet the added demand.

Outlook

We have revised our near-term price forecasts slightly lower for each of the bulk commodities, reflecting adequate supplies in the market and the slower than anticipated recovery in Chinese steel demand and sluggish real economic activity across most parts of the globe. Nevertheless, we expect that China's new leadership will continue to ensure that the economy ticks along at a solid pace, while investment measures introduced in the second half of last year should see Chinese growth continue to accelerate – albeit modestly – in the first half of the year. Similarly, aggressive fiscal stimulus, supportive monetary policy and stronger exports growth will underpin a solid recovery in Japanese growth later this year and into 2014.

Outside of Asia, the protracted and confusing process of dealing with Cyprus's banks eroded financial market confidence in late March and the decision to "bail-in" depositors has only added to the confusion. It is too early to tell how the effect on confidence will play out on the real economy, although we were already expecting poor economic growth in the Eurozone this year before this most recent episode. The US on the other hand has shown more positive signs. Despite expected headwinds from fiscal drag this year, March delivered mostly upside surprises including a strong payroll report and resilient auto and retail sales reports. Importantly for steel demand, housing data has also become more upbeat and is set to improve over coming months.

On balance, iron ore prices are expected to ease from current levels as new supply outstrips modest increases in steel production growth compared to last year. Prices may see some near-term support as stocks are rebuilt, although sluggish conditions in the steel market suggest that mills may prefer to hold less quantities of ore. Prices of coking coal are expected to increase modestly this year in response to supply curtailments and slightly stronger global steel production that is expected to outstrip new additions to mining capacity. However, China's new leadership and its determination to curb speculation in the real estate sector remains a source of significant uncertainty for steel inputs. Thermal coal prices for this JFY will be settled shortly and are expected to be set at a premium to market prices at or slightly below US$100 per tonne FOB. Over the longer term however, shifts towards alternative energy sources (including caps on Chinese coal consumption) will likely limit potential price gains. Similarly, increasing coal supplies will restrain prices, particularly if planned port expansions in the US North West come to fruition, expanding export capacity to Asian markets (as competition from natural gas reduces demand in the local market).

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Quarterly Contract Price Profile ($US/T)

	Actual	Forecasts							
	Dec-12	*Mar-13*	*Jun-13*	*Sep-13*	*Dec-13*	*Mar-14*	*Jun-14*	*Sep-14*	*Dec-14*
Iron Ore*	114	128	127	119	115	110	103	100	100
Hard Coking Coal	170	165	172	175	175	175	170	160	150
Semi-soft Coking Coal	117	110	115	115	115	115	115	105	100
Thermal Coal	115	115	100	100	100	100	95	95	95

Source: NAB

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