Bulk Commodities Market Update

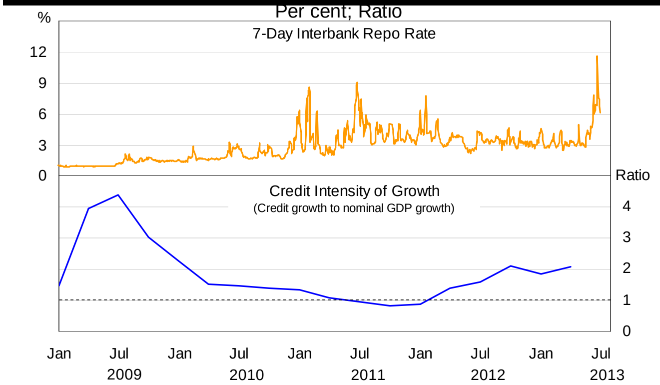
National Australia Bank

- **Bulk commodity prices remain under pressure from mounting concerns over the China growth outlook. Nevertheless, iron ore is receiving some support from tentative restocking activity, while a margin squeeze in the coal market could suggest that prices are approaching their bottom.**
- **Global steel production has eased over recent months in line with slowing steel production in China and overall sluggish industrial activity around the globe. Nevertheless, Chinese steel production has continued to grow in trend terms – albeit at a slowing pace – as mills attempt to maintain market share despite a slowing economy and elevated inventories.**
- **The average price for iron ore (62%) is estimated to have been around US$102 per tonne FOB for June, down from US$117 in May. Spot prices are currently around US$116 per tonne (CFR, Tianjin), having ranged between US$111-121 per tonne during June.**
- **Spot prices for coal shipped from Newcastle dipped below US$80 per tonne (FOB) in late June, the first time since November of last year. Prices averaged around US$85 per tonne (FoB) in June, down more than 5% from the previous month.**
- **We have revised our price forecasts for bulk commodities slightly lower to reflect our expectations for slower global growth – particularly in China. Marginal production costs are expected to provide support to commodity prices, but there are a number of factors contributing to the potential downside to prices. Subdued demand conditions are expected to remain in place for longer, while cost cutting and USD appreciation will add to price headwinds. Rising global supplies are also set to rise significantly, although these have been long expected.**

Bulk commodity prices remain under pressure from mounting concerns over the China growth outlook. Nevertheless, iron ore is receiving some support from tentative restocking activity, while a margin squeeze in the coal market could suggest that prices are approaching their bottom. Iron ore prices have been subject to large fluctuations in recent weeks after a rally since the start of June – seemingly encouraged by restocking activity – was brought to a halt by a dramatic liquidity squeeze in China's money markets. Spot iron ore prices are currently around US$116 per tonne (CFR, Tianjin), having ranged between US$111-121 per tonne during June, and down from a peak of US$159 per tonne recorded earlier in the year. Conditions facing coal producers continued to deteriorate over the month, although a floor to the price declines may now be in sight. Newcastle spot thermal coal prices dipped back below US$80 per tonne (FoB) in late June, while spot prices for premium HCC have remained around US$130 per tonne (FOB). September quarter contract prices for coking coal have been settled at around US$145 per tonne (FoB), the lowest since quarterly pricing was introduced in 2010.

The evolving outlook for the Chinese economy will continue to drive the direction of bulk commodity prices over coming months. The outlook has become increasingly uncertain due to the impact from government policies, while partial indicators of the economy have generally remained disappointing. The situation was further compounded by the recent disruptions to China's financial markets.

Fundamentals for US residential property upbeat



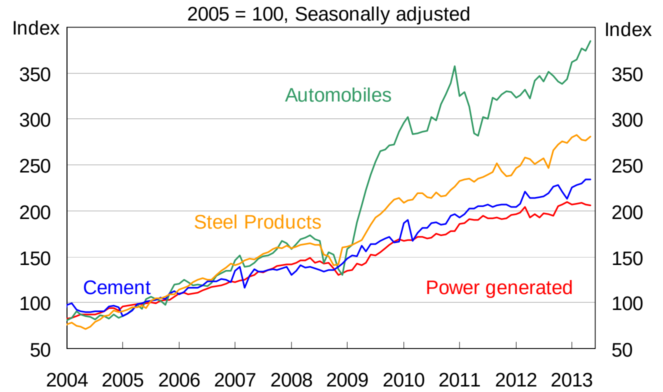
Source: CEIC

During June, a number of factors came together that generated a sharp spike in China's short-term money market rates that sent ripples through financial markets as fear of an imminent financial crisis started to take hold. The biggest surprise during the episode was the apparent reluctance of the central bank to intervene to alleviate the strains on the market. The central bank eventually implemented measures to address the situation and allay fears of a financial crisis, but in doing so authorities have expressed their intention to maintain tighter monetary conditions to help rein in credit growth, address the need for economic rebalancing, and encourage banks to improve their liquidity management. Consequently we can expect China to experience significantly slower credit growth than was recorded earlier in the year, which is likely to have significant implications for the economy which has become increasingly credit intensive in recent years.

Aside from the clear headwinds to China's economy from the financial system, the government's determination to clamp down on the real estate sector will have ongoing implications for bulk commodities. Property prices have continued to grow rapidly in recent months, and while real estate investment has been stabilising, some of the activity may reflect a bringing forward of demand in anticipation of additional tightening policies. However, local government authorities continue to be reluctant to take the hard line view adopted by State Council on the sector, while slower credit growth is likely to take some of the urgency out of the need to restrain the sector.

These factors have all been weighing on China's industrial activity, particularly heavy industries which are battling with problems of excess capacity. Overcapacity and elevated inventories in construction related industries like steel and cement took a heavy toll on industrial profits over 2012, although the situation appears to be improving with industrial profits rising 12.3% year-to-date for May – ferrous metal smelting and pressing profits jumped 34% in the same period after falling by a similar amount for the whole of 2012. In another positive sign for demand, steel output rose 11.3% over the year to May, while cement production increased 8.5%.

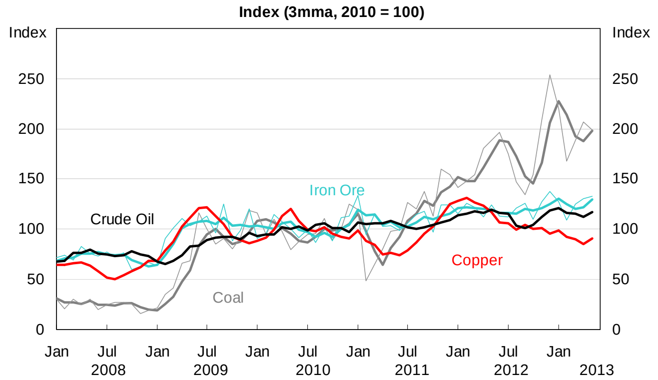
Chinese industrial production



Source: CEIC, NAB

China's demand for commodity imports has slowed since the end of last year, although some volumes have ticked a little higher more recently. Lower seaborne commodity prices and rising capacity of major commodity exporters may be encouraging restocking activity, while resilient growth in certain heavy manufacturing industries such as steel and cement – despite an uncertain upstream demand outlook – is contributing as well. Nevertheless, we do not expect underlying demand for bulk commodities in China to pick-up noticeably in the near to medium term, which means that loose market conditions will remain in place as global supply rises.

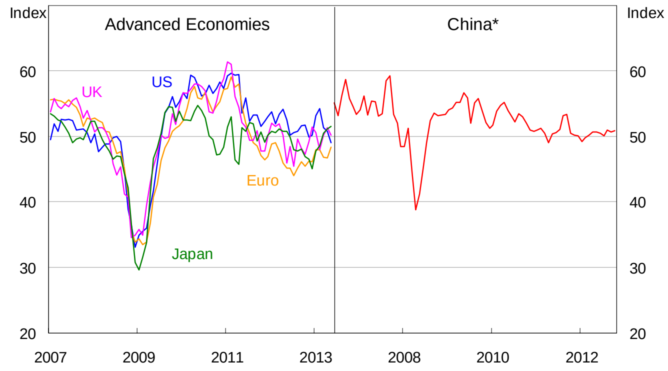
China's commodity import volumes



Sources: CEIC; NAB

Looking more widely, global manufacturing output appears to be grinding higher, although improvements tend to vary significantly across regions. Additionally, manufacturing PMI's suggest that activity remains relatively muted across most major markets. Conditions have improved in Europe and Japan – spurred on by currency depreciation and stimulus measures – but the US ISM is pointing to a much softer manufacturing sector than earlier in the year. Nevertheless, June delivered mostly upside surprises for the US economy, which saw several economic indicators such as new goods orders, retail sales, housing and construction exceed expectations. Unemployment claimant figures also saw improvements. Overall, the results are not spectacular, but moving in the right direction. In Japan, the long term success of stimulus measures remains unclear, but indications of near-term improvements are a good sign. Business and consumer sentiment has improved and we are seeing this feed through to economic activity. Retail sales, housing and public investment have all picked up, but the outlook for private investment is still up in the air

Industrial activity still looking soft

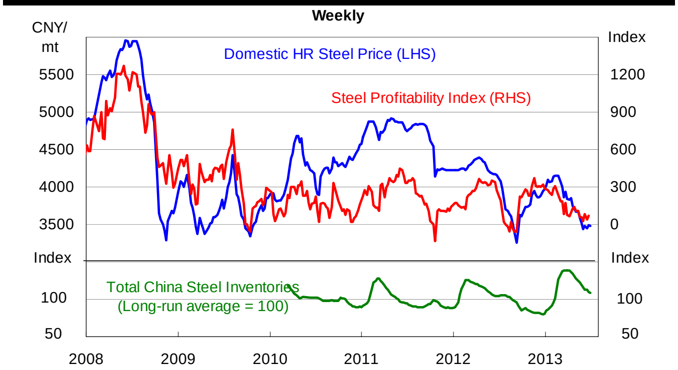


* Official PMI published by China's NBS.
Sources: Markit Economics; NAB; NBS

For emerging markets the tables appear to have turned with many of these economies now contending with an outflow of capital – a result of the shift in expectations for US quantitative easing. As the shift in global liquidity restrains emerging economies such as China, trading partners within the region such as Korea are likely to feel the pinch. India's manufacturing sector has also been losing momentum despite a significant depreciation of the INR. While monetary easing by the RBI may help to re-stimulate the economy, policymakers remain concerned about the prospects for imported inflation, particularly with the lower currency, which may limit the scope for further interest rate cuts. Overall, we expect global demand conditions in bulk commodity markets to remain somewhat unsettled which, along with rising supplies, poses significant headwinds to prices. However, cuts to marginal production and an improving global economy should see prices stabilise in 2014.

Steel Production

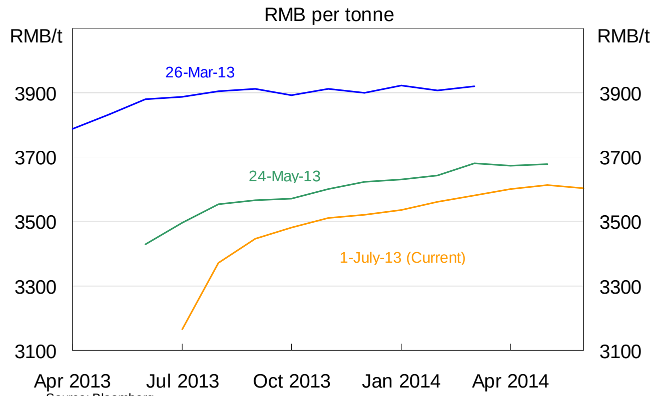
Conditions remain tight for Chinese mills



Sources: Bloomberg; NAB

As it becomes increasingly apparent that Chinese authorities mean business with respect to addressing some of the overheating sectors of the economy, prospects for a meaningful acceleration in steel demand are fading further. Downstream demand for steel remains sluggish, and while there have been production cuts at some steel mills – helping to accelerate the recent de-stocking – there continues to be an oversupply in the market that is expected to persist for some time. Given these conditions, steel prices slumped further in the month. The price of Chinese rebar fell around 4% from the end of May and is now more than 20% below last years peak (recorded in April). Futures prices for steel have also shifted lower, although high inventory levels have kept the curve in relatively steep contango. Resilient prices for raw materials has exacerbated the tough conditions facing steel producers, stifling profitability which will likely lead to further cuts to steel production. This is consistent with the steel PMI for May, which despite showing a slight improvement on the previous month is still suggesting a contraction in the industry.

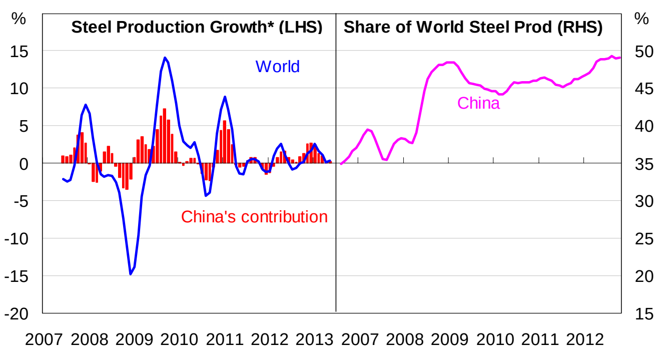
Shanghai Rebar Futures



Source: Bloomberg

Global steel production has eased over recent months in line with slowing steel production in China and overall sluggish (although gradually improving) industrial activity around the globe. Even in the US where confidence in the economy has been improving, the manufacturing ISM has now dipped below 50 indicating a contraction. On a more positive note, the US housing recovery looks to be on track, although new housing starts have dipped from their recent peak. Chinese steel production recorded a surprising pick up of 2% in May, following a 1% decline last month, continuing the trend of choppy production growth since last year. Looking through some of the volatility, trend production has continued to grow – albeit at a slowing pace – as mills attempt to maintain market share despite a slowing economy. However, data from the China Iron and Steel Association (CISA) for June indicates that mills were tentatively cutting production in the second half of May – partly through conducting plant maintenance and an environmental crackdown. According to CISA daily steel production in China was broadly unchanged at 2.1563 million tonnes in early June (up just 0.1%), following the declines recorded in mid and late May. CISA also report that finished steel stocks fell in early June to 12.867 million tonnes.

World Steel Production

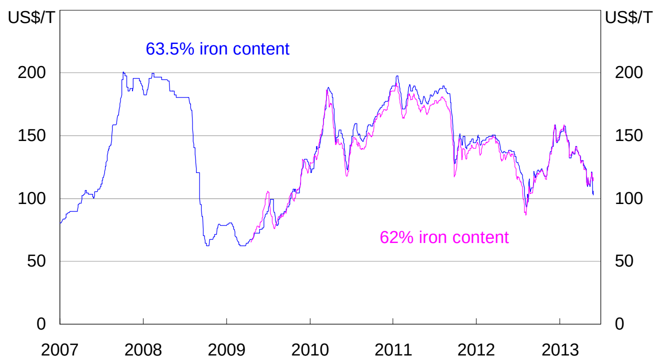


* Calculated as the 3month/3 month percentage change of seasonally adjusted steel output.
Source: World Steel Association, NAB

Iron Ore

Iron ore markets have experienced large fluctuations in recent weeks as competing factors gain prominence. Spot prices are currently around US$116 per tonne (CFR, Tianjin), having ranged between US$111-121 per tonne during June, and down from a peak of US$159 per tonne recorded earlier in the year. After reaching a recent low of US$110.4 in late May, prices experienced a small rally as mills looked to re-enter the market to restock inventories, however after breaking through US$120 per tonne, the rally came to an abrupt end after turmoil in Chinese financial markets ignited fears of an imminent financial crisis. Subsequent actions have helped to allay some of those fears, but the intention of policymakers to keep monetary conditions tight (to necessitate a structural improvement in the financial system) presents a significant risk of policy error.

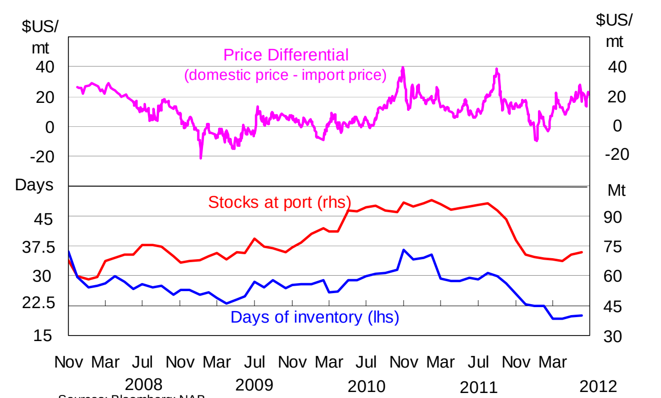
Chinese Iron Ore Prices*



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

As iron ore inventories remain quite low relative to current steel production rates, financial disruptions may have only brought a temporary halt to restocking activities. Certainly local governments have an incentive to keep steel production ticking over at a solid pace given the importance of steel mills to local labour markets. Furthermore, demand for seaborne iron ore is also continuing to receive support from a favourable price differential to domestic ore; iron ore imports rose 2% in May following a 4% rise in April. However, the current headwinds facing the global economy suggest that there will need to be some adjustment to steel production rates, while expectations of a boost to global iron ore supply in H2 2013 – likely lowering seaborne prices – creates an incentive to manage lower inventories (and tie up less funds).

Chinese Iron Ore Stocks at Port

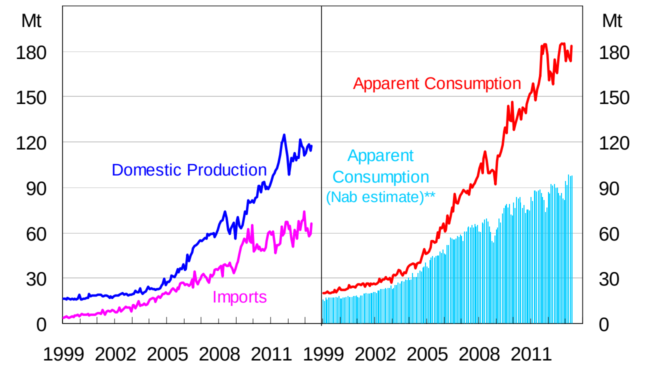


Sources: Bloomberg; NAB

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. Increases in both domestic ore production and imports implies that the Chinese consumption of iron ore rose almost 6% in May, but backing out the ore necessary for the volume of steel produced in the month – abstracting from changes to iron ore inventories and quality – implies an increase of just 0.8% in the month. In May, domestic ore production rose 2.8% and was 6½%

above the average monthly production for 2012 (data seasonally adjusted by NAB).

Chinese Iron Ore Market

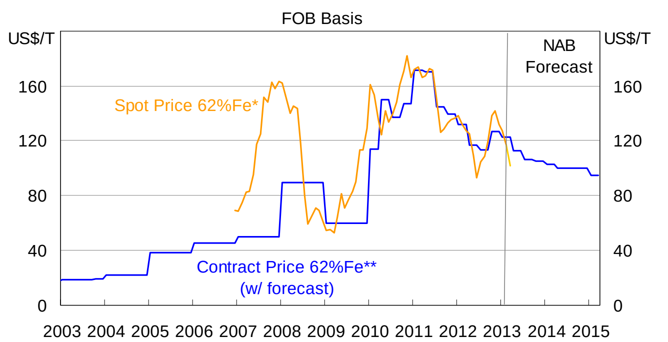


* Only imports data are available for January 2012 (but not fully adjusted for CNY).
** Based on pig iron production; accounts for declining domestic ore grades. Excludes changes in ore inventories.
Source: CEIC

Overall, the average price for iron ore (62%) is estimated to have been around US\$102 per tonne FOB for June, down from US\$117 in May. We expect prices to remain relatively range bound as tentative restocking activity is offset by sluggish downstream demand for steel and likely cutbacks to steel production. We are likely to see spot prices ease during the September quarter, which is traditionally a soft period for iron ore, but a seasonal rebound in the final quarter could still be on the cards – albeit more moderate than previous years due to the more benign economic environment in China which is expected to persist.

On the supply side, market conditions are expected to loosen considerably following the completion of new capacity by major iron ore exporters. In the latest quarterly report from Australia's Bureau of Resources and Energy Economics (BREE), iron ore exports from Australia were forecast to rise by 16% in both 2013 and 2014, driven largely by expansion undertaken by Australia's largest operators. Brazil's exports are expected to rise by a more modest 3% this year before picking up 10% in 2014. In contrast, BREE expects government bans on Indian mining to reduce exports further over the next two years, with India becoming a net importer in 2014. Overall, we expect to see new supply start to outstrip demand growth over the medium term which will see contract prices for iron ore average close to US\$100 during 2014 (less than BREE's forecast of US\$112 per tonne).

Iron Ore Prices

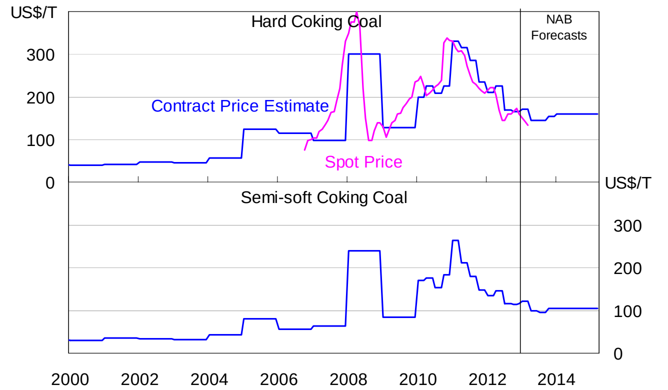


* Spot price is calculated on an FOB basis by subtracting Port Dampier to Qingdao shipping rates from the cost and freight price. 62% Fe spot price is an estimate from published 63.5% price.
** Up to Q3 2011, based on formulation that quarterly contract price equals previous quarters average spot price,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

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. It is not surprising then that coking coal prices continued to come under pressure in June. June also saw the commencement of negotiations for coking coal contract prices for the September quarter. It has been reported that Nippon Steel and BHP settled the Q3 contract price for premium coking coal at US\$145 per tonne (FoB), slightly below our expectation of US\$150 per tonne and 16% lower than the June quarter contract. The outcome from the negotiations can be seen in two lights. On the one hand, the difficult conditions facing the markets has seen reported quarterly contract prices plummet to their lowest ever levels (quarterly pricing commenced in 2010). Nevertheless, on a slightly more positive note, contract prices appear to have settled at a premium to prevailing spot prices.

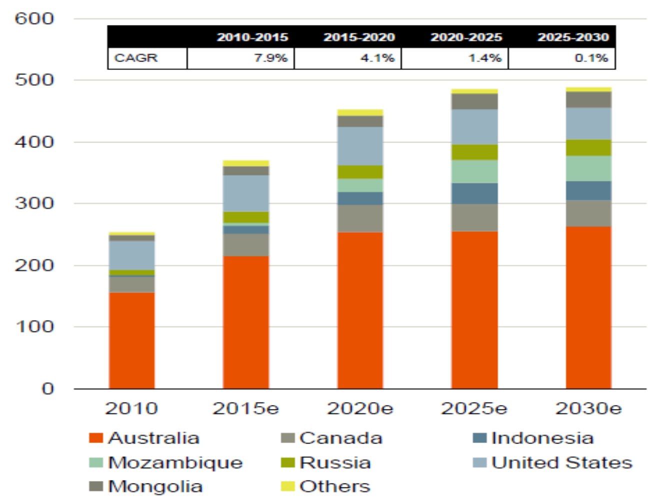
Metallurgical Coal Prices



Sources: BREE; AME; NAB

Average spot prices for premium hard coking coal fell by 5½% in June, following a 6% decline in May and are now 25% below the peaks achieved in February. The current spot price of around US\$130 per tonne (FoB) for premium coking coal is well below the contract price set for the September quarter (10% below), suggesting prices could dip even lower later in the year if conditions in steel markets fail to turn around. With that said, conditions in the steel market are expected to remain subdued for some time, and with coal supply conditions improving, stockpiles of coking coal have remained high and should limit near-term demand for imports. China's coking coal imports fell in May, but have picked up by almost 70% since May of last year.

Metallurgical Coal Seaborne Supply (million tonnes per annum)

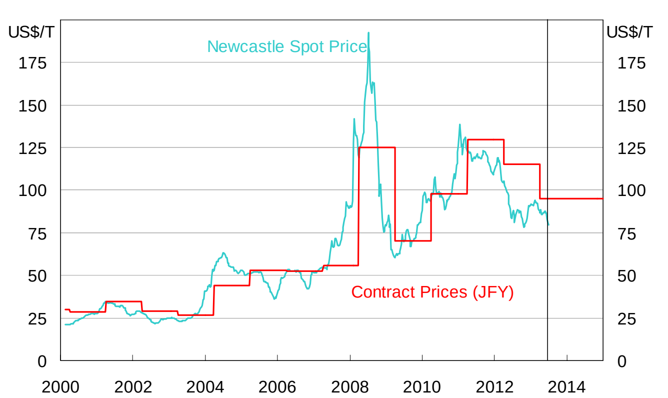


Sources: BHP Billiton; Wood Mackenzie; GTIS

With prices continuing to fall, some higher cost coal producers are coming under considerable margin pressure. In response to the deteriorating conditions some producers have elected to scale down their higher cost operations. For example, Anglo American announced in June that they would be placing their Aquila coal mine in central Queensland into care and maintenance mode from July 30. Some industry estimates suggest that at current spot prices up to a quarter of global production capacity could be uneconomic. With spot prices now well below the Q2 benchmark, we are likely to see further capacity reductions that should help to stabilise prices going into 2014. Nevertheless, a lower AUD and successful cost cutting should help Australian coking coal producers maintain reasonable market share – although over a longer time horizon some market share will be lost to emerging producers in places like Mozambique (chart above). BREE are forecasting Australian coking coal export volumes to rise 6% in 2013 and 10% in 2014.

Thermal Coal

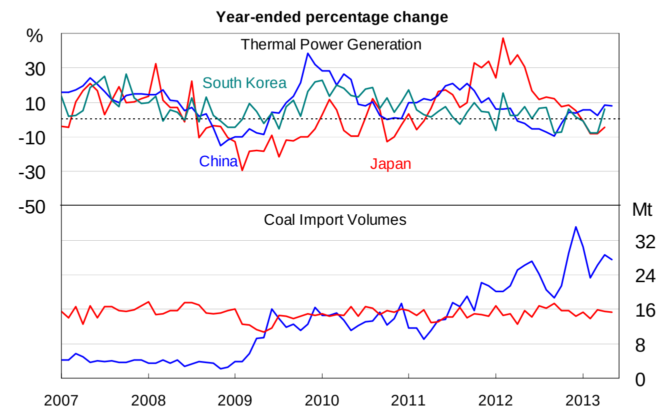
Thermal Coal Prices



Source: McCloskey's, ABARE,

In line with other bulk commodities, prices for thermal coal have eased over the past month – largely unwinding the rally since late last year – with the global market remaining well supplied despite considerable margin squeeze. Persistently soft and slowing industrial activity in most major markets is contributing to the headwinds on energy demand. Growth in thermal power generation has remained muted, although there has been some improvement in recent months.

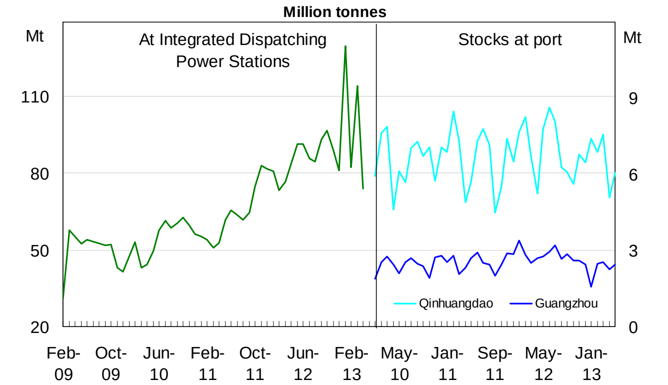
Thermal Coal Demand



In light of the soft conditions facing the market, spot prices for coal shipped from Newcastle dipped below US$80 per tonne (FOB) in late June, the first time since November of last year. Spot prices at these levels are well below the contract price for the Japanese fiscal year, which were settled at US$95 per tonne (FoB) earlier in the year. At these levels, industry estimates suggest that around a quarter of global production, and more than a third of Australian thermal coal production, is unprofitable. Even at the higher contract prices (around 30% of seaborne coal is sold on contract), around 20% of Australian production is expected to be running below cash costs. Higher cost production is being shut down in response to falling prices, while expansion plans are also being wound back, downsized or delayed.

Looking through the daily volatility, the average spot price of thermal coal shipped from Newcastle (FOB) fell by 4½% in June, following a moderate rise in average prices during the previous month. While current cost structures suggest that thermal coal prices are probably approaching their bottom, expectations for moderate economic growth to continue in China suggests that there is still very little upside to seaborne coal prices – despite seasonally stronger demand expected over summer. China's thermal power generation rose just 6% over the year to May, although this was an improvement from earlier in the year and utilities appear to be tentatively running down their coal stocks.

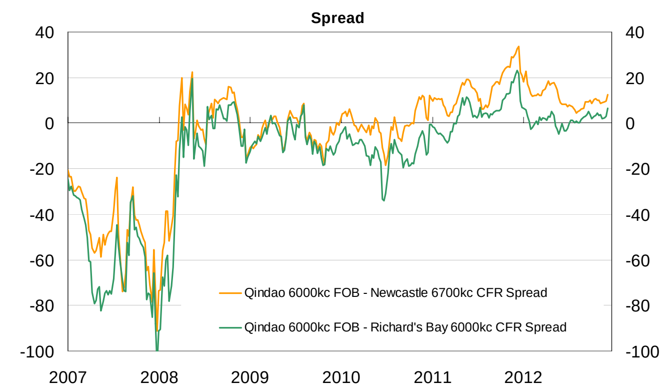
Coal inventory at Chinese utilities



Source: CEIC

The arbitrage window in China has remained favourable to coal imports, while nationwide safety inspections of coal mines in China will help to keep domestic production contained in the near-term. Further out however, anticipated policy support to local producers could have a big impact on global markets ***if implemented***. In particular, proposed bans on low quality coal imports – initially thought to be a positive for high quality exporters like Australia – could actually see some knock-on effects. For example, Indonesia currently exports around 50 million tonnes of low quality coal to China, which will need to find a new buyer outside of China. Although India would likely take up some of the slack, much of the volume may be diverted to places like Japan where buyers are considering the use of inferior coals to cut costs (reducing demand for Australian coal). At the same time, Chinese buyers may resort to low quality domestic supplies rather than boost demand for Australia's higher quality exports.

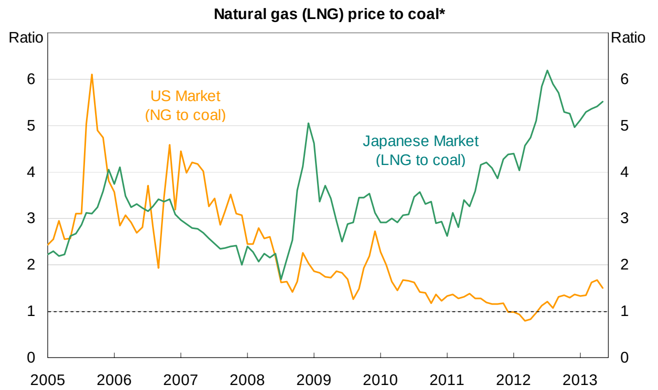
China's thermal coal arbitrage window



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

Regardless of any potential impact from Chinese policy, Japan's coal consumption may still see a pick up as the lower Yen encourages the pursuit of lower cost alternatives to oil and LNG, while recent government stimulus measures will also help to bolster overall demand for energy – at least in the near to medium-term. The outlook for Indian thermal coal demand is also relatively bright, particularly over the longer term. In 2012, India's consumption of coal for power generation rose at its fastest pace in 31 years. However, we may see demand growth taper off over coming months as partial indicators are showing softer conditions in the Indian economy. Depreciation of the INR and signs of a good wet season (boosting hydro generation) also provide headwinds – although flooding may have the opposite impact. In their recent commodity outlook, BREE project India's coal imports to rise 12% in 2013 and 10% in 2014, highlighting its growing importance to the global market, although recent reforms to domestic gas prices potentially introduces another layer of uncertainty. India plans to add generation capacity of 88.54 gigawatt in the 5 years to end-<arch 2017, compared with almost 55 gigawatt in the previous 5 year period.

Japanese utilities may turn to coal as cheaper import option



* Proxies for each region converted to USD/MMBTU
Sources: Bloomberg, NAB

Outlook

We have revised our bulk commodity price forecasts lower in the near term to reflect both the slightly softer than expected prices during the June quarter and revisions to our global growth outlook – particularly cuts to our China and US forecasts. Although the risks to China's outlook stepped up to a new level following the recent financial disruptions, we are still reasonably confident that China's new leadership will continue to ensure that the economy ticks along at a solid pace in order to prevent the potential for social discontent. Nevertheless, authorities will need to address the overcapacity that has emerged in some sectors, which along with a cooling economy will have ramifications for bulk commodity markets. Similarly, steel producers and power utilities (not just in China) will be looking for ways to lower cost, such as greater use of lower quality coals. Expectations for improved growth in the rest of the world later in the year may help to support prices, although the effectiveness of Abenomics in Japan is still an uncertainty. While measures to date may see an end to deflation and a pick up in growth, unresolved structural problems are likely to limit growth in Japan over the long-term.

On the supply side, expectations are for export quantities, especially from Australia, to pick up strongly over the next two years. This is likely to keep the market balance loose and bulk commodity prices broadly at (or below) current levels. 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 and concerns over the 'credit crunch' abate, but steel makers are still facing difficult conditions which could prompt them to hold less quantities of ore.

Prices of coking coal will also continue to feel the strain from a soft steel market, although with miner's margins coming under pressure and coal supplies starting to respond, spot prices may be approaching their bottom. Thermal coal markets are expected to gradually become more balanced in 2014 as buyers look to cheaper alternatives to LNG and oil and US coal exports slow. There is also likely to be a supply response to current thermal coal prices, although lower currencies for coal producing countries will help to keep more supply viable. Chinese policy changes are a big uncertainty facing the market, particularly those relating to bans on lower quality coals. Over the longer term however, shifts towards alternative energy sources (including caps on Chinese coal consumption) will likely limit potential price gains.

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Quarterly Contract Price Profile ($US/T)

	Actual	Forecasts							
	Mar-13	*Jun-13*	*Sep-13*	*Dec-13*	*Mar-14*	*Jun-14*	*Sep-14*	*Dec-14*	*Mar-15*
Iron Ore*	127	123	113	106	105	103	100	100	100
Hard Coking Coal	165	172	145	145	155	160	160	160	160
Semi-soft Coking Coal	116	121	100	95	105	105	105	105	105
Thermal Coal	115	95	95	95	95	95	95	95	95

Source: NAB

* Calculated using weighted average of quarterly lag formulation and spot prices. Weights reflect industry information on ongoing composition changes to the contract porfolios of major Australian miners.

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