Minerals and Energy Update – November 2013

- **November's Third Plenum unveiled a wide ranging reform agenda from China's Government. Proposed deregulation would increase free market influence and could support a stronger medium term growth profile for the economy. That said, there remains some uncertainty as to the Government's capacity to implement these reforms.**
- **Business surveys in major economies have continued to strengthen – reflecting greater optimism in the United States, Japan and United Kingdom.**
- **Average oil prices fell for the second consecutive month in November. In addition to the bearish sentiment in the crude oil futures market, oil prices have generally returned to be more aligned with the reality of fundamentals where ample supplies, combined with seasonally weak global demand, have served to weigh on prices.**
- **Steel input markets have been relatively stable – with modest declines in metallurgical coal prices and slight gains in iron ore. With winter being a weak period for steel demand, there seems little prospect for major price movements in the short term. Thermal coal prices have recovered from recent lows but remain well below recent peaks.**
- **Base metals prices declined in November despite generally positive economic data. Metals markets appear to be in a state of flux as expectations over the future path of US monetary and government debt policies, as well as changes to warehousing rules, continue to evolve in respect to timing and magnitude.**
- **Market expectations regarding Fed tapering have reduced gold's appeal to investors as a 'safe haven' asset and inflation hedge. However, declining prices have kept physical demand strong in Asia, particularly China, although Indian demand continues to be weighed down by government policies.**
- **Overall, our forecasts for commodity prices have been left largely unchanged. We continue to expect only a modest recovery in demand over the forecast horizon, but the recovery is expected to be bumpy, ensuring ongoing volatility in commodity markets.**

Monthly Commodity Prices

November was the Third Plenum of China's Communist Party's 18th Congress. Historically, the Third Plenum – a meeting of the Party's Central Committee – is viewed as a milestone in the transition between China's governments, as at the third meeting, the new leadership has established sufficient control to enact their policy agenda.

This Plenum produced a wide ranging reform program, which has generated considerable excitement globally – with the belief that these reforms could be supportive of stronger Chinese economic growth over the medium term.

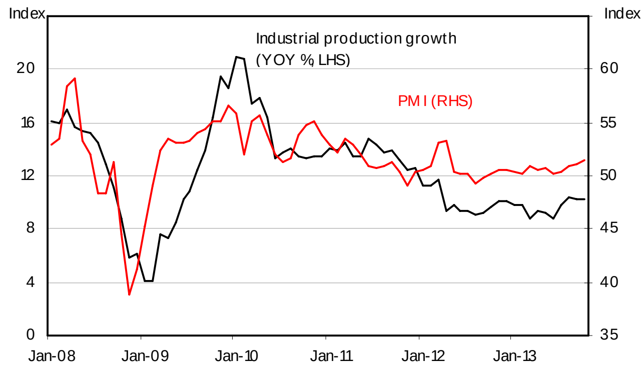
At the heart of the economic reforms is a broad deregulation plan which would expose more of the economy to the free market. Under these proposals, private sector firms will be permitted to enter most industries – with the exception of those impacting national security – allowing them to compete on a level playing field with State Owned Enterprises (SOEs). The regulation of prices across a range of sectors will also be gradually unwound. These changes should improve resource allocation across the economy and reduce the market shares of typically inefficient SOEs.

In addition, the Plenum proposed liberalisation of the finance sector and foreign investment – particularly in the services sector. In the case of the former, the Government will encourage the development of private small to medium sized financial institutions, accelerate deregulation of interest rates, and move towards improved RMB convertibility.

Labour mobility and social welfare may be improved by proposals for agricultural land reforms and loosening of the Hukou (residency permit) system. A relaxation of the long running One Child Policy has also been proposed – allowing couples to have more than one child if one of their parents is an only child (previously both parents had to be only children).

While the proposed reforms are very encouraging, there remains some uncertainty as to the Government's capacity to implement them. In particular, reforms to the SOE sector will not be easy – as there are powerful vested interests who benefit from the current policy framework and therefore would be resistant to change.

China's Manufacturing sector and PMI

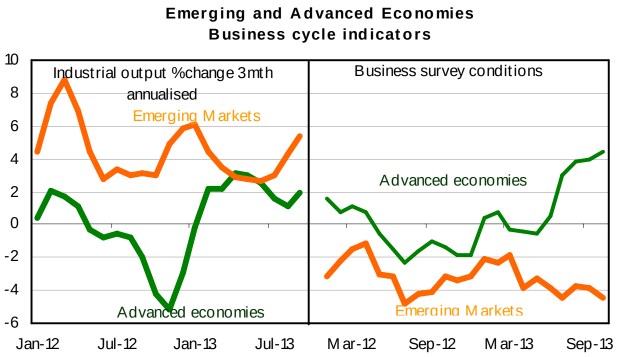


Source: CEIC, NAB Economics

If enacted, it will still take some time for these measures to have effect – with a target of 2020 for full implementation. That said, we will be watching survey measures and partial indicators to see if greater optimism from the proposed reforms flows into the business sector. Recent trends in China have been reasonable, with industrial production growth stable in October at 10.3% and the official PMI building on recent gains – up to 51.4 points. However, the HSBC Markit Economics flash PMI for November was a little less positive, down 50.4 points (from 50.9 points in October).

Outside China, there have been further positive signs with industrial output picking up globally. Advanced economies have recorded growth since the early part of the year (after weak conditions in 2012) and other emerging Asia contributed to strong gains in emerging markets. Business surveys in major economies have continued to strengthen – reflecting greater optimism in the United States, Japan and United Kingdom.

Emerging and advanced economies



Source: CPB

A further pointer to improving economic conditions among advanced economies was October's US employment report. The stronger than expected result, coupled with revisions to prior months, allayed fears of an employment growth slowdown, and the annual rate points to a solid growth trend. That said, positive signs in the US should be tempered by the still high rate of unemployment – which indicates that the US economy still has a long path to full recovery - and an inflation rate that is well below the Fed's target level. Moreover, there is still uncertainty about fiscal policy with October's deal pushing the issues of Government funding and the debt limit into early 2014. Reflecting this, our views that QE tapering won't commence until March 2014 and that the Fed Funds Rate will remain on hold until September 2015 remain unchanged, although the risk is that QE tapering will commence earlier as the Fed is considering a change in its policy mix towards greater use of forward guidance.

The direction of commodity markets over the past month has been mixed, but concerns over the scaling back of support from QE seems to be more than offsetting generally positive undertones in the economic data. Prices of bulk commodities have been relatively mixed, but range bound, as rising supplies are offset by robust steel production and rising energy demand ahead of the northern winter. Base metals prices ebbed lower but remain relatively range-bound, fluctuating with the ebbs and flows of economic data and changes in expectations for the Fed's QE. Similarly, market expectations regarding Fed tapering have reduced gold's appeal to investors as a 'safe haven' asset and inflation hedge. However, declining prices have kept physical demand strong. Supply side factors and seasonal weakness in demand have weighed on oil prices, while gas prices have gained momentum in line with developments in weather forecasts.

Summary of Price Developments

Oil

Average oil prices fell for the second consecutive month in November, with broad-based falls recorded in all three major oil indices that NAB monitors: Brent, WTI and Tapis. In addition to the bearish sentiment in the crude oil futures market, oil prices have generally returned to be more aligned with the reality of fundamentals where ample supplies, combined with seasonally weak global demand, have served to weigh on prices. Upon the release of the news that Iran has struck a historic deal with the US-led coalition in the UN towards the end of November which stipulates that the country curb its nuclear program in exchange for some partial relief from the economic sanctions imposed on it, oil prices dipped but the overall response was fairly muted. Under the deal, not much has changed in terms of fundamentals, as the precursory agreement does not include the lifting of the embargo on oil trade against Iran, with much of the sanction relief ($6 to $7 billion) taking the form of oil revenue that has been frozen in foreign banks. Furthermore, the scale of the relief is considered to be minor relative to the existing $100 billion in Iranian investments frozen around the world, and the government's deficit of US$35 billion a year.

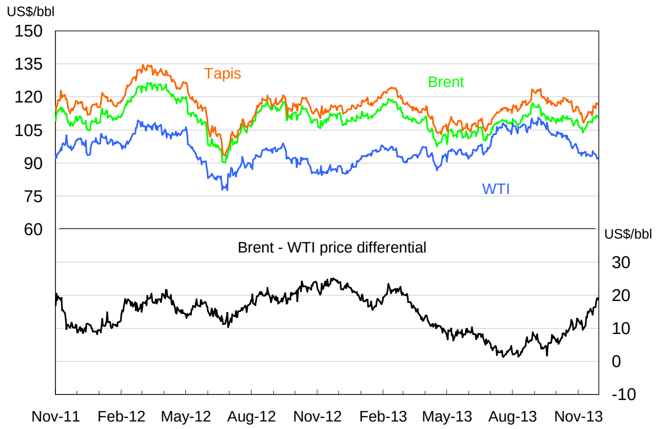
Earlier geopolitical premiums associated with synchronised, large-scale unrest in a number of key oil producers in the Middle East and Northern Africa such as Libya, Nigeria, Egypt and Iraq that have led to extreme supply disruptions in recent months have generally moderated, with gradual recovery in production evident in a number of these countries. This, combined with the return of North Sea oil fields production from maintenance, further exerted downward pressure on prices. In Asia, Middle Eastern distillate-rich grades traded below their official selling price formulas (OSPFs) for the first time in more than three months, amid weakening gasoil margins and rising supplies.

	Avg Price (US$/bbl) Nov-13	Monthly % change Nov-13	Nov-12 - Nov-13 % change
Brent	108	-1.3	-1.6
WTI	94	-6.7	8.3
Tapis	113	-3.3	-0.9

Sources: NAB Economics; Thomson Datastream

In the past two months, WTI has shown significant weakening relative to Brent, driven largely by the record crude production in the US, combined with a seasonal decline in refinery demand, which resulted in a sustained run of weekly increases in inventories. Since reaching its recent peak in the second-week of September, WTI has declined by around 16%, as opposed to just a 5% drop experienced by Brent and Tapis. Providing some support to Brent in the meantime had been the bouts of geopolitical uncertainty in the Middle East and positive economic data stemming from China. As a result, the Brent-WTI differential has widened from just US$2 post-FOMC meeting to the current level of around US$19, levels not seen since the first quarter of this year. More recently in November, WTI fell by 7%, compared to 3% in Tapis and 1% in Brent.

Daily Oil Prices



Source: Thomson Datastream

OPEC adjusted its quarterly estimates for non-OPEC supply upwards the second half of 2013. Non-OPEC supply is now expected to grow 1.18 mb/d in 2013 to average at 54.10mb/day, and rise further to 55.30mb/d in 2014. Contributing most to the increase in 2013 will be that of OECD Americas, with the projected growth of around 1mb/day for the US by OPEC the highest on record and for all non-OPEC countries for 2013.

On the demand side, global refinery runs have moderated from their peak in the summer months of the northern hemisphere, with throughput falling by 3.6m barrels a day since July, according to the International Energy Agency (IEA). A rising number of European refiners are facing risks of closure as developing nations such as China and India build their own capacity and increasingly prefer importing crude to refined products, while competition stemming from refined products exports from the Middle East also stiffens. According to the IEA, European refinery output fell 6% in October from a year earlier as plants cut production due to poor margins in addition to seasonal maintenance.

Without an extreme geopolitical event, we think that Brent and WTI will converge in the next month or two. The significant falls in WTI suggest that the index might have been oversold and any inventory increase from now on will have been priced in to some extent. Furthermore, the imminent pick-up in northern hemisphere winter demand is likely to limit the upward potential of inventory accumulation. Meanwhile, Brent is likely to moderate from its current level as the reality of a surge in non-OPEC supplies becomes more tangible and the Iranian deal lays the groundwork for the possibility for the country to ramp up its oil exports in the medium-term. Potentially weighing on Brent is also the current low levels of output in Libya also suggesting that there will be upside risks in terms of its contribution to global output. Taken together, the Brent-WTI is likely to narrow from its current levels of around US$19 to be closer to be below US$10 in the medium term.

Natural Gas

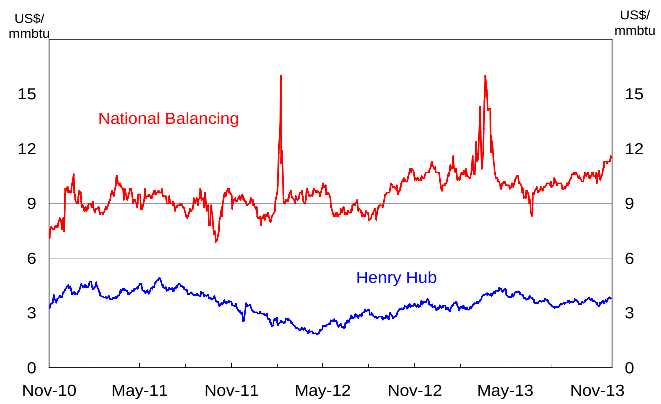
After a weak start to the month on reports of mild weather, US natural gas spot prices have gradually built momentum over the month, along with developments in weather forecasts which suggest colder-than-normal conditions likely during winter. Towards the end of November, the US Henry Hub index climbed to its highest level in five months to hit $3.86, but in overall average monthly terms, the index was 1% below the October average.

Meanwhile, supply-side factors remain comfortable, driven by record levels of natural gas production in the past few months even as natural gas prices moderated. In our detailed Natural Gas Market Update last month, we discussed in detail that the surge is largely attributable to productivity improvements in the Marcellus shale formation, which accounts for around 75% of the production growth over the past year.

The build-up of gas inventories maintained strong momentum throughout summer and autumn months for underground gas storage levels to remain slightly above 5-year average levels since early August. In what appears to be the first sign heralding the uptick in seasonal heating demand, US inventories fell by 45 billion cubic feet in the week ended 15 November to 3.789 trillion in the first decline since the first half of April, followed by yet another decline in the week after. The surplus to the five-year average narrowed to 0.5% in the last week of November, compared to an October average of 1.7%.

Looking ahead, we anticipate the recent strength in natural gas prices to consolidate going into the US winter. At the moment, winter is forecast to be colder than average for much of the continental US, which is likely to support heating demand, although not to the same extent as the past winter when prolonged chilly conditions were experienced. Also appearing to support prices is the slowing growth in production and inventory accumulation from their trailblazing pace from late 2011 through most of 2012, with actual monthly underground storage levels closely tracking their five-year averages.

Henry Hub and National Balancing Point Prices

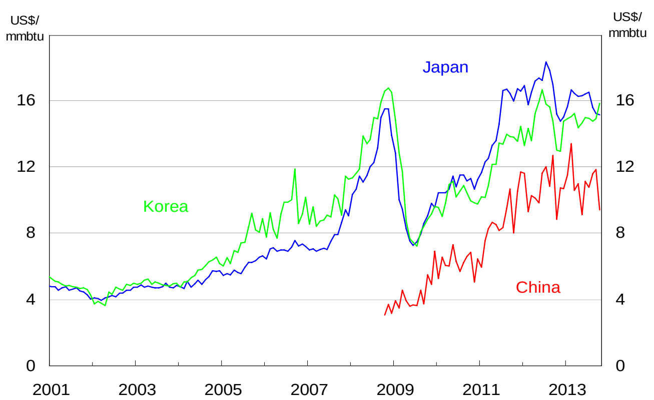


Sources: NAB; Thomson Reuters

In the UK, natural gas prices, indicated by the National Balancing Point (NBP) index, have risen by proportionally more than Henry Hub in the past few months, tracking steadily higher since late June. Neither did they exhibit as strong a seasonal pattern as Henry Hub. Since reaching its recent trough in the last week of June, NBP has risen by just under 40% to average around US$11.50/mmbtu, driven partly by the sustained strength in the Brent oil index since Q3. In the month, Brent prices also derived some support from the uncertainty associated with the outcome of the Iranian nuclear deal with UN powers prior to the agreement to offer Iran sanction relief amounting to US$7billion in exchange for the country to curb its nuclear plans. Increasingly, unplanned disruptions in supplies from Norway, the largest source of UK gas imports, have also served to prop up prices. An example of this took place as recently as the last week of November when power loss at Nyhamna plant in Norway, which processes gas from Ormen Lange field, caused disruption to supply to the UK which resulted in NBP rising to the highest level since early April.

According to anecdotal evidence ahead of official statistics (the latest data available are for October), Asian LNG prices surged in November as Japan, Korea and China vied for cargo supplies to stockpile ahead of winter demand, which is earlier than the usual spike in mid-December. Asian spot prices are now nearing US$19/mmBtu compared with less than $14/ mmBtu at this time last year. The unresolved nuclear issues in Japan and Korea portend elevated demand from the top two world importers in the months to come. The timeframe for any resumption in nuclear generation capacity in Japan remains highly uncertain, with the opposition coming from former Prime Minister Junichiro Koizumi who was once a strong advocate for Japan's nuclear capabilities. Meanwhile, the government of Korea is still reeling from the nuclear corruption scandal which started late last year that has resulted in six reactors still being shut-down and around 100 people being indicted, potentially raising the risks of blackouts in parts of the country during times of peak demand this coming winter. Meanwhile, China's LNG import demand is also increasingly voracious, demonstrated by the 10% jump in imports figure in the year to October, as the country continues to expand its import capacity via the construction of a number of receiving terminals which will double its total capacity to 35-40 million tonnes by 2015.

Asian LNG Prices



Sources: Thomsons Datastream; CEIC; NAB Economics

Also fuelling upward price pressure on LNG in the month has been the full shutdown at Angola's export plant and the awarding of the second tender by Argentinean authorities for 11 cargoes to be supplied in 2014, after the first tender for 48 LNG cargoes was awarded last month.

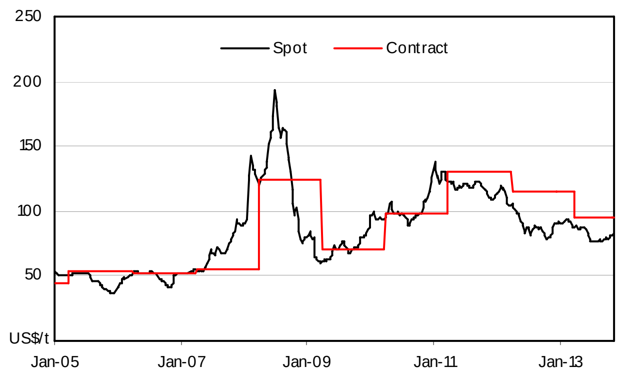
In the coming months, natural gas prices in the US and UK will continue to be largely driven by heating demand during winter months, with the former bearing the additional risks of supply shortages due to the unpredictable disruptions of gas flow from the North Sea. In Asia, the ramping up in LNG stockpiling activity ahead of winter and synchronised move towards natural gas as the preferred fuel away from coal and nuclear energy is going to keep both prices and demand elevated in coming months.

Overall, we have left our forecasts largely unchanged as they have managed to track actual outcomes and seasonal patterns reasonably well to date.

Thermal Coal

Thermal coal prices have trended slightly higher across November, reflecting modest tightening seaborne supply and strengthening in seasonal demand as consumers restock ahead of the northern hemisphere winter. That said, prices remain below the levels recorded at the start of the year.

Coal Prices



Source: McCloskey's, BREE, NAB Economics

Spot prices at the port of Newcastle reached US$82.80 a tonne FOB for the week ending 22 November, the highest level since mid June. This level was broadly similar to spot prices in November 2012, but remains well below the recent peaks at the start of 2011. Similarly, there has been a gradual upward trend in prices at Qinhuangdao (to RMB 562.50 a tonne), China's largest thermal coal port, with prices up from lows in September but still below levels recorded in late May (RMB 607.50).

Seaborne supplies have tightened modestly in recent months, as persistently low prices resulted in production cuts at higher cost mines across a number of regions. In a September investor briefing, Glencore Xstrata suggested that at prices around US$77 a tonne (the spot price at that time) around 30 per cent of global thermal coal production was unprofitable. However, take or pay contracts with infrastructure partners has limited the scale of production cuts in Australia, with the third stage of the Newcastle Coal Infrastructure Group's port facilities commencing operations in September.

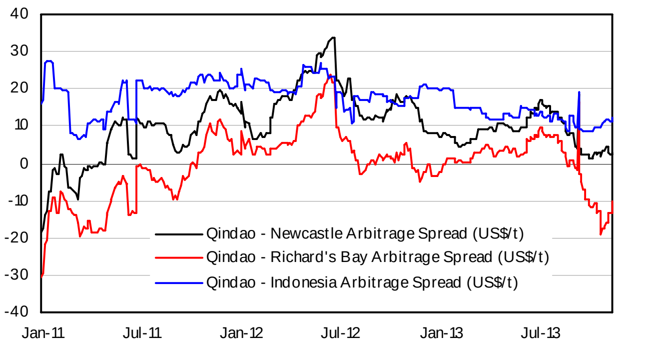
In the short term, global production could be impacted by policy measures in Indonesia and China. The Indonesian Government has proposed increasing the royalty payments for licensed coal miners as well as cracking down on illegal mining and port operations, with estimates that illegal mining could total 56 million tonnes a year. In China, the poor safety record of small scale mines has prompted further efforts to restrict these operations. There are around 7500 mines in China that produce less than 90 000 tonnes a year according to the State Administration of Coal Mine Safety, with plans to close more than 2000 of these mines by 2015.

That said, new projects are expected to add around 31 million tonnes to seaborne production capacity in 2014 – around 3.5 per cent of the total seaborne trade.

Coal demand has improved more recently, however this largely reflects seasonal patterns, with major utilities in the Northern Hemisphere restocking ahead of winter. China's demand for thermal coal remains robust, however expansions to domestic freight capacity have improved the distribution of coal from mines in the northern provinces to key markets on the eastern coast. This is demonstrated by the steady downward trend in estimated arbitrage between domestic and imported fuel since mid-2012.

A key uncertainty in China's coal market is role of low calorific content brown coal from Indonesia. While the product is relatively low cost (when compared with higher quality black coal) it is considerably more polluting. Chinese authorities are keen to improve air quality in major cities, but despite rumours of a ban on these imports from mid-year, imports have remained strong.

Thermal Coal Arbitrage Window - China



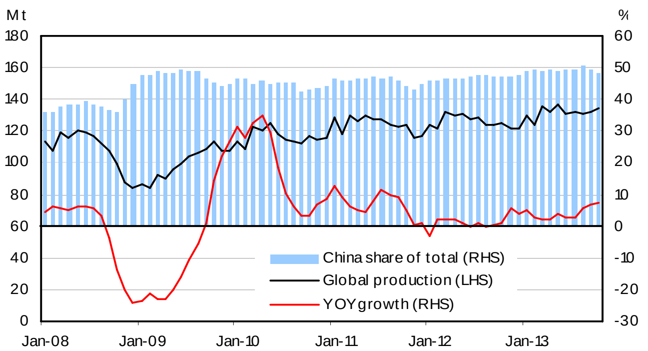
Qindao price adjusted for 17%VAT; Newcastle & Richard's Bay prices adjusted for freight
Source: Bloomberg Industries

Reflecting current idle production capacity along with new capacity being brought online in 2014, there seems little likelihood that that there is sufficient potential growth in seaborne demand to support a major rebound in thermal coal prices. As a result, we expect the 2014 Japanese financial year contract to decline – down to US$86.50 a tonne (from US$95 in JFY 2013).

Metallurgical Coal & Iron ore

Global steel production has continued to strengthen in recent months, rising to 134 million tonnes in October – up 7.3% year on year. This was despite a modest decline in output in China – the world's largest steel producer – with China's share of global output easing back to 48.5% (from 49.4% in September). That said, in year on year terms, China's steel production was around 10% higher than October 2012.

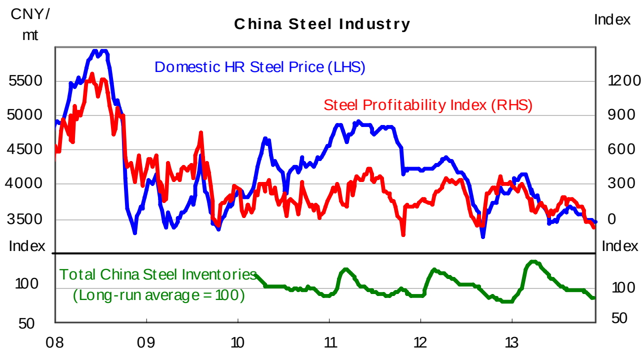
Global Steel Production



Source: World Steel, NAB Economics

Overcapacity in China's steel sector remains a critical challenge. In November, authorities in Hebei Province – the country's largest steel producing region – commenced a demolition program for old blast furnaces. The program should cut capacity in the province by 10 million tonnes a year in the short term, with an overall goal of reducing capacity by 60 million tonnes by 2017. It remains to be seen whether these measures will impact on physical output – with some observers arguing that these were obsolete facilities that were not in active production. According to the China Iron and Steel Association, around 90 million tonnes of new steel making capacity is currently under construction across the country.

Chinese steel market conditions

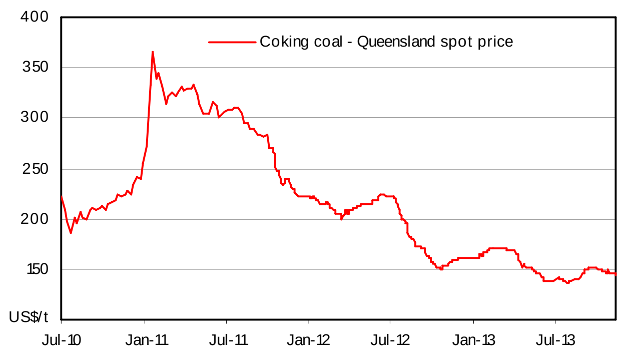


Sources: Bloomberg; NAB

Conditions within China's steel industry continued to soften across November – reflecting downward trends for steel prices and relative stability in raw input costs. That said, there is a seasonal component to this trend – with a typical period of destocking in the steel sector towards the end of each year. Demand for steel is typically weaker during the northern winter, with lower levels of construction activity.

Spot prices for metallurgical coal pulled back a little across November – down to US$142 a tonne CIF for prime Australian coking coal (according to Shanghai SteelHome). This level is below the quarterly contract level (settled by BHP Billiton at US$152 a tonne) and below the estimated cash-costs of higher cost mines in Queensland – which should limit any further downward pressure on prices.

Metallurgical coal prices



Source: Energy Publishing, Bloomberg

In contrast, spot iron ore prices trended marginally higher in November, at around US$136 a tonne CFR at the port of Tianjin (62% iron fines) – up from an average of US$132.6 a tonne in October and well above the lows of June. Some of this increase may reflect a brief period of steel mill restocking at the start of the month – with a gradual increase in stocks at China's ports (both in tonnage terms and days inventory).

Chinese Iron Ore Prices*

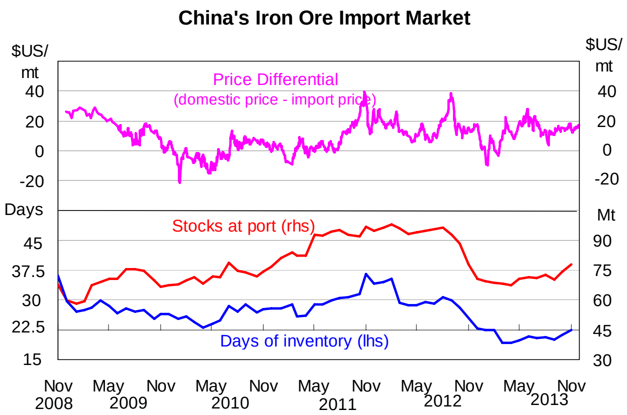
* Includes the cost of freight
Source: Bloomberg, Thomson Datastream

Iron ore supply is continuing to increase, with BHP Billiton and Fortescue Mining currently expanding production and export capacity in Western Australia, following on from recently developed projects by Rio Tinto. Similarly, Vale – the world's largest iron ore producer – commenced operations at its Carajas expansion, which will add around 40 million tonnes of capacity. The Brazilian miner intends to expand capacity by 50% by 2018. As new capacity reaches full production, it will add some downward pressure to iron ore prices, with the potential for some oversupply from the second half of 2014.

Demand for seaborne iron ore has remained strong – with Chinese imports in October up over 20% from the same time last year. For the first ten months of 2013, China's iron ore imports totalled 669 million tonnes, an increase of around 9.9% on the same period in 2012.

The supply-demand balance for metallurgical coal has shifted towards surplus, as production capacity in Queensland recovered following flood-related interruptions and industrial action, while a range of new operations have commenced across the past six months – including BHP Billiton's Daunia mine and Yancoal's Austar Underground stage 3. New projects in 2014 are expected to add around 13 million tonnes of capacity to the seaborne market , however lower shipments from the United States should limit downward pressure on prices.

China's iron ore import market



Sources: Bloomberg; NAB Economics

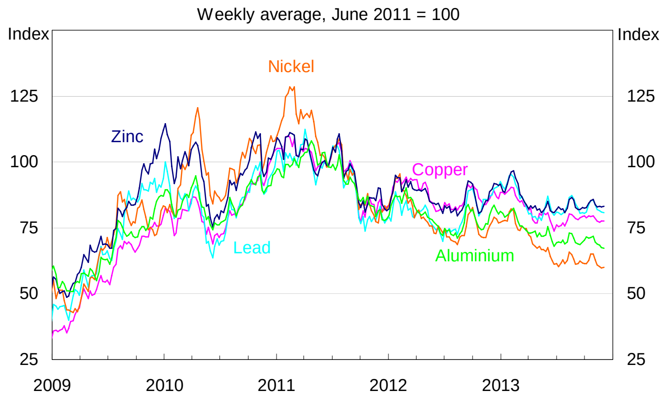
Our price forecasts for both metallurgical coal and iron ore are unchanged – with the stronger supply of iron ore set to push prices marginally lower in the second half of 2014 – down to US$100 a tonne. Hard coking coal is forecast to remain firm – edging up to US$160 a tonne by the end of 2014. There may be some downside risk to semi-soft coking coal prices from the relative weakness in thermal coal markets.

Base Metals

Metals markets appear to be in a state of flux as expectations over the future path of US monetary and government debt policies continue to evolve in respect to timing and magnitude. There has also been mixed macroeconomic news over the past month which has left base metal prices lacking any clear direction. The Chinese economy is showing further signs of improvement, although the momentum that has been building in recent months may now be starting to taper as authorities become more confident that growth targets for this year will be comfortably achieved. Promising policy announcements following the 3rd Plenum in China helped to generate optimism over the economic outlook, but the implications for economic rebalancing and infrastructure spending may not be supportive for commodities – the response in commodity markets has been relatively muted. Elsewhere, the business surveys show a ramping up in activity and confidence across all of the big advanced economies since early 2013. Industrial activity is now growing in all regions with a particularly solid upturn in Japan and the UK.

The flow of relatively positive news on the global economy and expectations that very loose monetary policy in the major advanced economies is going to remain in place, at least for the time being, saw base metals prices rise modestly in October. However, subsequent comments from the Federal Reserve and more positive retail sales numbers have again pared back some of these expectations on the future of quantitative easing. China's renewed focus on economic rebalancing reforms have also had a mixed reception in commodity markets, while hot property prices, tightening monetary conditions and recent property policy announcements are renewing concerns over government headwinds to Chinese real estate construction. On the supply side, announced changes to LME warehousing rules are raising expectations of metal supply in physical markets, contributing to a back-track in base metal prices during November.

Base Metals Prices



Sources: NAB; Thomson Reuters

In aggregate, base metals prices on the London Metal Exchange (LME) have fallen by around 3% in November, following a 1¼% decline in October, to be more than 10% lower over the year. The performance of metals prices over the year has been consistent with expectations for softening market balances as supply steadily increases in an environment of still relatively tepid demand. While physical demand conditions look set to improve, we can expect to see ongoing policy distortions to market pricing, although these competing factors are likely to be largely offsetting to keep prices relatively range bound in the near term.

Base Metals Prices*

	Avg Price (US$/tonne) Nov-13	Monthly % change Nov-13	Nov-12 - Nov-13 % change
Aluminium	1748	-3.7	-10
Copper	7071	-1.8	-8
Lead	2090	-1.2	-4
Nickel	13684	-3.1	-16
Zinc	1866	-1.0	-2
Base Metals Index		-2.2	-10

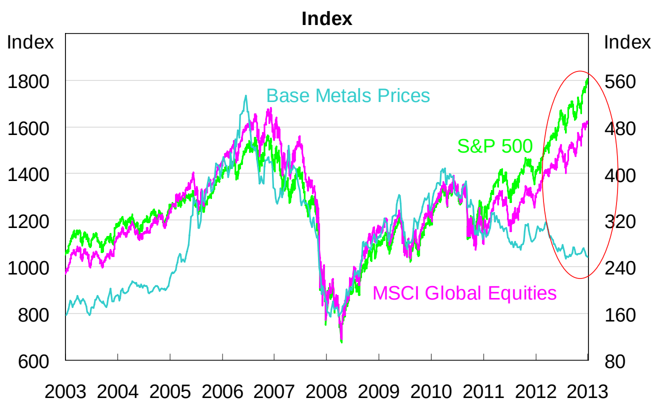
* Prices on an LME cash basis.

Sources: LME; NAB

Price declines were recorded for all of the base metals in November, although the magnitude of the increases has varied slightly across the complex. Nickel and aluminium prices recorded the largest declines (around 3-4%) following the announced changes to LME warehousing rules, which could see an increase in metal supply in physical markets – although the true impact is still unclear with some market participants expecting falling premiums to be offset by higher prices. Average copper, lead and zinc prices also fell in the month by around 1 to 2%, although fundamentals for lead and zinc in particular remain positive. In annual terms, zinc and lead have been the best performers, falling by 2% and 4% over the year respectively, with prices buoyed by robust demand for lead-acid batteries and steel, while additions to supply capacity will be limited. Nickel and aluminium prices recorded the largest declines (down 16% and 10% respectively), while copper prices are 8% lower.

Base metals have significantly underperformed relative to equity markets, which is unusual given historical behaviour. Both metal and equity markets historically improve along with economic conditions, but the undershooting of base metals could signal a change in the supply/demand dynamics in metals markets, or could imply some considerable potential upside to prices if economic conditions continue to improve.

Base metals prices diverging from equity markets

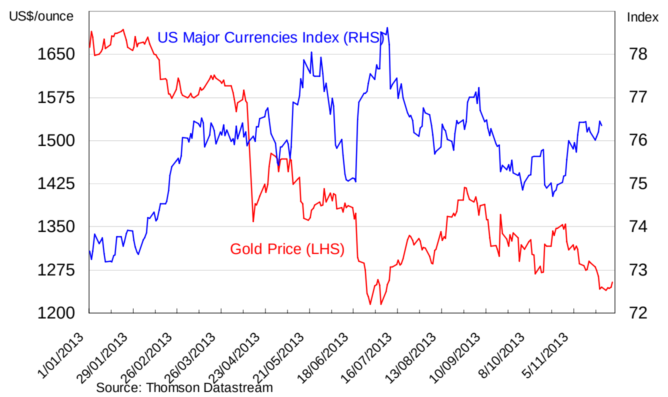


Supply and demand fundamentals vary across the base metals, but gradual improvements in demand will be largely matched by rising supplies, suggesting limited upside to prices in the near term. However, lower prices could see a consolidation of expansion plans, particularly in commodities where the Indonesian export ban will be another factor that may constrain supply and tighten the market balance. Finally, changes to warehouse rules from April will generate more uncertainty and may contribute to a temporary surge in physical premiums, but the changes are expected to reduce market distortions in the longer-term. Nevertheless, incentives for financing deals could remain in place for some time.

Gold

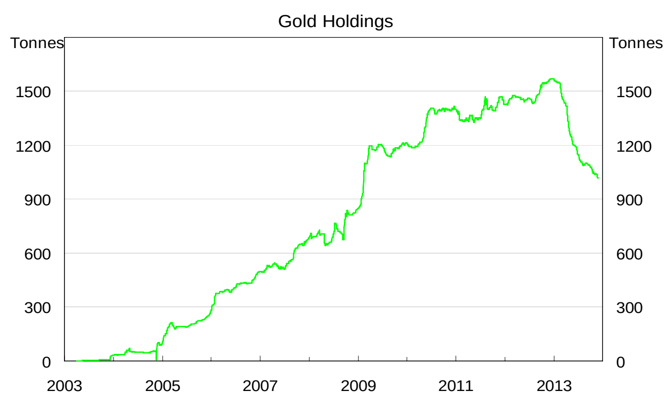
Gold bears have remained in the drivers seat to steer gold prices lower, even as physical demand holds up, particularly in Asia. Investor appetite for gold has been pared back in the wake of generally positive economic data out of the US, suggesting less of a need for investors to hold safe haven assets such as gold. Consequently, gold prices have been moving steadily lower to record their lowest levels in over four months and are not far from their 2010 lows. The average price fell by around 3% in November, and is currently trading at around US$1,250 per ounce. This follows broadly no growth in October and a slight decline in September. In year ended terms, the price of gold in October was around 25% below levels recorded in the same month of the previous year.

Gold Price and the US Dollar (Daily)



Improving labour market data have been particularly pertinent to the shift in market expectations. This is because the Fed has emphasised the importance of a stronger labour market to their current stance on quantitative easing. Comments in the Fed's October meeting minutes as well as better labour market data – along with other improvements in the partials – are fuelling expectations that stimulus is likely to be withdrawn sooner than previously thought, removing a major source of support for the market for the past few years. If recent trends continue and tapering of quantitative easing commences, gold will continue to lose its appeal to investors as a hedge against inflation.

US Exchange ETF Gold Holdings



* A sample of funds from the US

Sources: ishares.com; exchangetradedgold.com; NAB

In this environment, investors have been seeking out higher returns in alternative assets. Global equities have been performing well on an improved outlook for the economy and earnings; the MSCI All Country World Index of equities has gained more than 20% since the start of the year. Similarly, gold's inverse relationship with the US dollar has continued through November, with the recent strengthening in the US dollar against major currencies coinciding with gold's decline. The US currency has been buoyed by expectations for QE tapering, although the USD remains well below mid-year values; the US major currencies index has appreciated 2.2% since late October. In light of these headwinds, gold stocks held by exchange traded funds (ETF's) have depleted further over the past month, continuing the trend seen since the start of the year. Holdings are now at their lowest levels since early 2009, while investor net long positions have again pared back the increases seen since July.

With investors offloading large volumes, price declines have kept physical demand for gold strong in Asia, particularly China. In October China's net imports of gold from Hong Kong reportedly reached their second highest levels on record, which has put them well on track to overtake India as the world's largest consumer of gold. India's demand for gold has been constrained in recent months by government curbs on gold imports – imposed to help address concerns over a growing current account deficit (which has driven down the Rupee, further weighing on gold demand). India recently celebrated Diwali and Dhanteras – big gold buying festivals – but limited supplies kept buyers cautious; according to reports, India imported 23.5 tonnes of gold in October, less than half the average monthly consumption of last year, down from 162 tonnes in May.

While gold is traditionally a 'safe haven' asset, where prices tend to rise on negative economic news, the recent market reactions to speculation over QE has made gold prices just as sensitive to positive economic news (causing prices to drop) as it is to negative economic sentiment. This type of market behaviour looks likely to continue into the early months of next year, contributing to gold price volatility given the uncertainty over the timing of Fed tapering. The recent run of generally positive economic data out of the US, combined with signals out of the Fed, suggest some risk that it could occur even sooner than our current expectation for March. In contrast, more bullish gold investors expected that the appointment of Janet Yellen as Fed Chairman will likely delay tapering given what they view her as more dovish on policy (for more details, see note). This combined with our benign outlook for inflation suggests weaker prices for gold over the medium term.

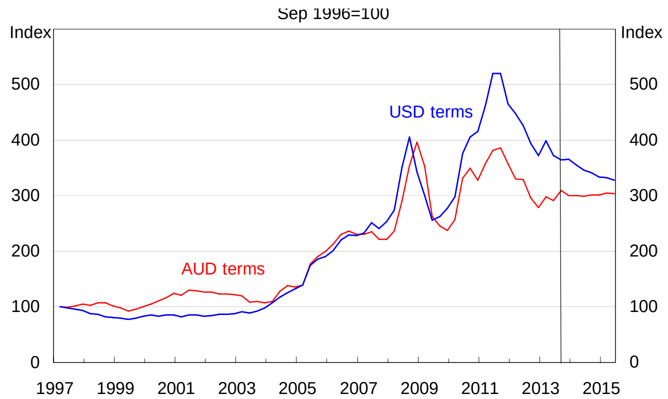
Outlook

In aggregate, business surveys across the main advanced economies show positive net balances of firms expecting growth to continue through the next year, which should bode well for industrial commodities as manufacturing and construction gather pace and offset the eventual headwinds as accommodative monetary policies in these countries are pared back.

However, the ramping up in sentiment on both current and future conditions ran out of steam in October, which just highlights the bumpy road ahead, particularly as hurdles regarding the US debt limit and Japanese consumption tax approach. Similarly, sentiment is not very positive in some of the big emerging economies with especially weak numbers in the Indian business surveys that do not seem to foreshadow a return to the rapid pre-2012 growth rates seen in the third largest global economy. In contrast, China's economy has stabilised and is expected to continue growing in excess of 7% pa, which will provide an ongoing source of significant demand growth. Finally, the impact on emerging economies of the eventual tapering in quantitative easing in the US (and the rest of the world) will be a major source of uncertainty. Experience from earlier this year suggests that this is something that warrants close monitoring.

On the supply side, production of bulk commodities and some metals is expected to outpace the improvement in demand as the global economy recovers, precluding a tightening in market balances and limiting upside potential to prices. Given all these factors, the improvement in overall global economic growth remains consistent with our expectation for commodity prices to ease, but remain at historically elevated levels.

NAB Non-Rural Commodities Price Index



Sources: BREE; ABS; Bloomberg; NAB; Thomson Reuters

In US dollar terms, the NAB non-rural commodity price index fell by around 20% over 2012. We are expecting another decline of around 1½% in 2013, before easing by a further 9% over 2014 (see Graph). Given our forecast for the AUD/USD to depreciate further over the remainder of the forecast horizon, AUD prices are expected to rise by 7¾% over the year to December 2013, before a modest increase of ½% over 2014. In aggregating the index, iron ore, thermal coal and metallurgical coal have a combined weight of around 55%.

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Commodity update release dates*

December 2013: Overview – 23/12/2013

* Reports to be released by these dates.

Quarterly Price Profile

Oil Price Forecasts – Quarterly Average

	Actual	Forecasts							
	Sep-13	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*
Brent US$/bbl	110	108	104	103	103	100	100	100	100
WTI US$/bbl	106	96	98	97	95	95	95	95	95
Tapis US$/bbl	116	114	110	109	109	105	105	105	105
Petrol AUc/L	142	140	138	140	141	142	142	143	143

Sources: NAB Economics; RACQ; Thomson Datastream

Natural Gas Price Forecasts – Quarterly Average

	Actual	Forecasts							
US$/mmbtu	Sep-13	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*
Henry Hub	3.55	3.70	3.90	3.70	3.90	3.60	3.80	3.60	3.90
Japan LNG	15.73	16.50	16.00	15.50	15.50	15.30	15.00	14.50	14.35
Brent Oil	110	108	104	103	103	100	100	100	100

Source: Datastream, CEIC, NAB Economics

Bulk Commodities and Coal Quarterly Contract Price Profile ($US/T)

	Actual	Forecasts							
	Sep-13	*Dec-13*	*Mar-14*	*Jun-14*	*Sep-14*	*Dec-14*	*Mar-15*	*Jun-15*	*Sep-15*
Iron Ore*	121	122	114	108	105	100	100	95	95
Hard Coking Coal	145	152	155	160	160	160	160	160	160
Semi-soft Coking Coal	105	110	110	115	115	115	115	115	115
Thermal Coal	95	95	95	87	87	87	87	87	87

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.

Base Metals Price Forecasts – Quarterly Average

	Actual	Forecasts							
US$/MT	Sep-13	*Dec-13*	*Mar-14*	*Jun-14*	*Sep-14*	*Dec-14*	*Mar-15*	*Jun-15*	*Sep-15*
Aluminium	1783	1796	1836	1863	1891	1920	1958	1997	2037
Copper	7086	7157	7121	7157	7193	7229	7229	7229	7229
Lead	2102	2123	2153	2169	2185	2202	2218	2235	2252
Nickel	13956	13711	13848	14091	14337	14588	14844	15103	15368
Zinc	1861	1889	1908	1922	1941	1961	1980	2000	2020
Base Metals Index	267	268	270	272	275	278	280	283	285

Sources: Thomson Reuters; NAB Economics

Gold Price Forecasts – Quarterly Average

	Actual	Forecasts							
	Sep 13	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*
Gold - US$	1328	1280	1230	1180	1130	1090	1050	1060	1060
Gold - AU$	1450	1360	1320	1300	1280	1250	1230	1260	1280

Sources: Thomson Datastream; NAB

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