Minerals and Energy Update – March 2014

National Australia Bank

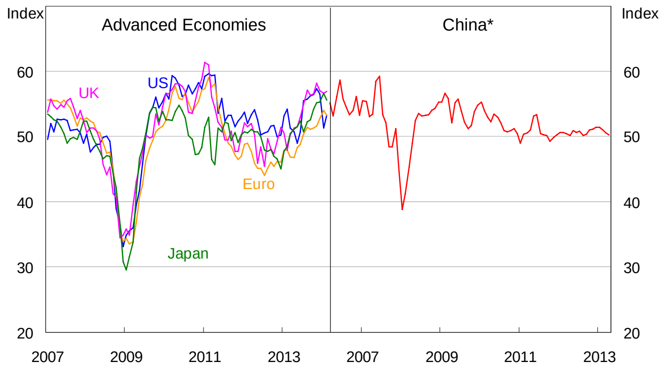
- **Economic data was mixed over the past month, but the impact from severe weather on advanced economies appears to be abating. Partial indicators suggest China's economy has continued to slow.**
- **US tapered QE again and markets remain volatile as they try to discern Fed direction. China had its first domestic bond default, fuelling financial stability concerns.**
- **Since mid-January, several idiosyncratic factors, such as the ramping up of takeaway capacity by the Keystone XL Pipeline, better US economic data and unseasonably cold weather, have propped West Texas Intermediate (WTI) prices up relative to Tapis and Brent. Meanwhile oil prices also derived some support from the escalation of geopolitical tensions in the Ukraine. However, they have since moderated on easing concerns that economic sanctions would cause significant supply disruptions.**
- **Prices for bulk commodities declined across February and March, with significant volatility in iron ore (likely related to unconventional financing arrangements). Recent weak spot prices for both thermal and metallurgical coal have resulted in weaker than expected settlements for contract prices (particularly in metallurgical coal markets).**
- **Prices for the base metals complex were mixed, but are generally softer on concerns over the Chinese economy. Indonesian export ban and geopolitical concerns impacted supply outlook for some metals.**
- **Gold prices shifted higher in the first half of the month, responding to renewed safe haven demand stemming from geopolitical risks and emerging market concerns. Prices subsequently eased on China stimulus hopes and US Fed actions.**
- **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.**

Monthly Commodity Prices

Economic data has been mixed of late, resulting from slowing economic activity in China, coupled with tightened credit conditions, better than expected economic data from the U.S and heightened geopolitical tensions in Ukraine and Russia.

Industrial commodities hit a volatile run in the month of March predominantly driven by China. The preliminary flash PMI published by Markit Economics fell for the fifth consecutive month to an eight month low of 48.1 in March (down from 48.3 in February), adding to concerns that the world's largest consumer of industrial metals could miss their 7.5% economic growth target for 2014. The manufacturing output sub-index also declined to 47.3 as activity contracted. Some of these concerns have been calmed by expectations that Chinese authorities could introduce stimulus measures – largely via small town redevelopments – to support economic growth, but uncertainty over the state of China's financial sector will continue to be a theme for markets.

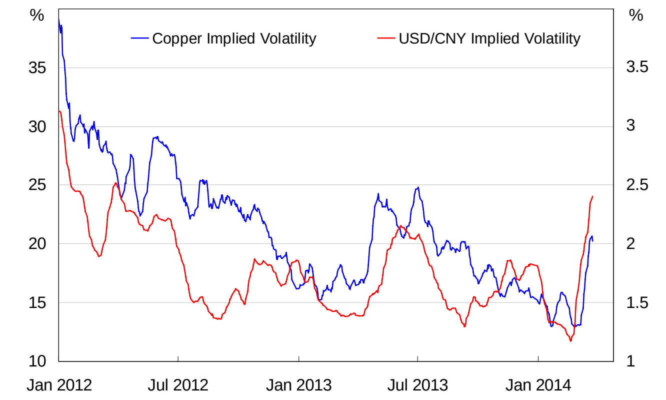
PMI Surveys



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

Despite signs of a slowing Chinese economy, stocks of some commodities (particularly iron ore and copper) have managed to surge this year in response to tighter credit conditions in China. Reports claim the banks have cut lending to industries with surplus capacity by 20% this year, resulting in companies seeking alternative lines of credit via shadow banking (including commodity financing deals). Following news of debt defaults in China – the first ever domestic bond default took place during the month – and an unexpected depreciation of the CNY (thought to have been facilitated by the central bank), copper and iron ore prices plunged as markets feared that financing deals would rapidly unravel, unleashing significant amounts of commodities into the market. Chinese authorities plans to implement measures to cut credit and impose stricter policies in their attempt to restructure the steel mill sector added to these headwinds.

Volatility in commodities and CNY may impact financing deals



Source: Bloomberg, NAB

In the U.S, the FOMC continued its third $10bn taper to the quantitative easing program, reducing the monthly bond purchase to $55bn (from $85bn) as data showed improvements in the economy. After a bad run of harsh weather conditions in the U.S, economic momentum appears to be returning as the jobless rate decreased and incomes and consumer spending increased. The preliminary U.S PMI continued to expand, albeit at a slower rate, reporting 55.5 in March (down from 57.1 in the previous month). GDP for the fourth quarter was revised up to an annual rate of 2.6% as the U.S economy grew higher than expected.

Fed Chair Janet Yellen announced that the QE program might conclude its course later this year and signalled an interest rate increase possibly within 6 months of the end of QE i.e. possibly in Q2 2015 – somewhat earlier than market expectations. More recent comments have been dovish, causing markets to re-evaluate. Expect further volatility as markets try to discern Fed direction. This had investors seeking alternative to safe haven investments. Nevertheless, geopolitical risks remain a concern post Russia's annexation of Crimea. Tensions continued to escalate as the G7 imposed sanctions. US President Obama authorized potential penalties on industries including financial services, metals, mining, energy and defence – adding to concerns this may weigh heavily on industrial commodity supplies, especially oil - Russia being the world's largest producer of this commodity. However, at this stage more meaningful economic sanctions are unlikely to be imposed.

As outlined above, mixed data has resulted in differing directions of commodity markets. Prices of bulk commodities have been weighed down by signs of slowing in the Chinese economy and heightened risks associated with collateral financing deals in China. Industrial metals have faced the same headwinds, although supply side fundamentals differ across the complex. The Indonesian ore export ban has had a particularly large impact on nickel prices, which have risen significantly. Gold prices reached a 6-month high in March as investor appetite for safe haven assets rose in response to geopolitical uncertainties and the mix of economic data of late. Supply side issues and tensions in Russia continue to have an upward trend on the price of oil, however we expect prices to moderate in the near term.

Summary of Price Developments

Oil

Weekly Crude Inventories at Cushing

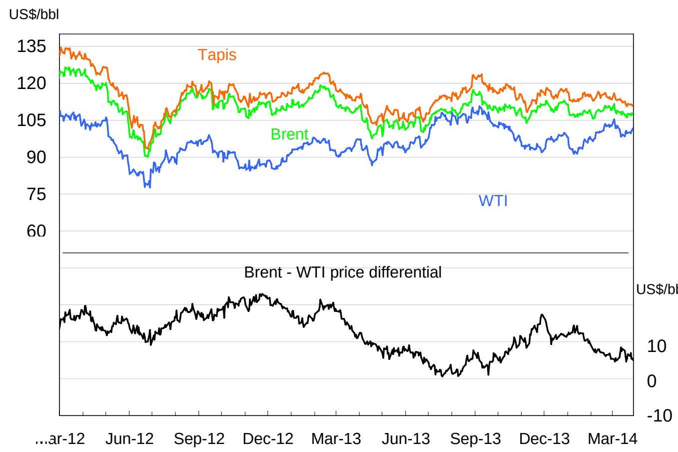
Source: US EIA

Since mid-January, several idiosyncratic factors have propped up the prices of West Texas Intermediate (WTI) relative to Tapis and Brent. WTI rose for eight consecutive weeks from mid-January to the first week of March, the longest sustained weekly rise in close to five years, to be currently just under US$100/bbl. The gains were supported by unseasonably cold winter conditions going into March which resulted in strong demand on distillates and lower stocks and the opening of the southern leg of the XL Keystone pipeline in January which improved the takeaway capacity of crude inventories from Cushing to the Texas Gulf coast. Crude oil inventories at Cushing, Oklahoma, the primary crude oil hub in the US, decreased 13 million barrels (32%) over the past two months (to 21 March) to reach their lowest levels since early 2012.

	Avg Price (US$/bbl) Mar-14	Monthly % change Mar-14	Mar-13 - Mar-14 % change
Brent	108	-0.9	-1.6
WTI	101	-0.1	8.1
Tapis	112	-1.8	-2.3

Sources: NAB Economics; Thomson Datastream

Daily Oil Prices



Source: Thomson Datastream

The escalation of geopolitical tensions in the Ukraine also supported oil prices more generally in February, especially Brent. However, the price rises in oil indices immediately after the outcome of the Crimean referendum favouring reunification with Russia and its subsequent annexation were relatively subdued, for the result was largely anticipated and involved little resistance or violence; and despite vehement disapproval from the EU and US, they have limited scope to intervene apart from imposing economic sanctions. The delicate balance between the requirements by Western Europe for Russia's energy exports, and Russia's intractable reliance on these exports for around half of its government revenue has effectively locked opposing parties in a stalemate situation. So far the sanctions imposed by the US and EU on Russia have largely focussed on freezing the personal assets and disrupting business and travel plans of 40 Russian and Ukrainian government officials and politicians, including two top advisers to Russian President Vladimir Putin and former Ukrainian President Viktor Yanukovich. Sanctions have also been imposed on a bank assumed to have close ties with these oligarchs.

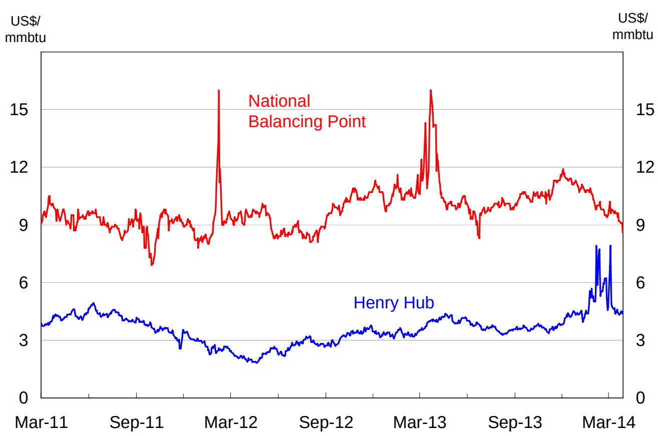
Apart from the Ukrainian crisis, continued unrest in Libya and South Sudan also lent some support to prices in February, especially Brent. The forced closure of the El Sharara oil field in Libya (with production capacity of around 340,000 bbl/d) due to ongoing protests has caused a significant cutback in Libyan oil output from around 375,000 bbl/d to below 200,000, while South Sudan's oil production fell to about a third of its capacity at 170,000 bbl/d.

However, the gains of Brent in February have been largely unwound in March as speculative activity during over the run-up to Russia's annexation of Crimea subsided, while a continuation of weak Chinese economic data reinforced concerns of a slowdown in the world's largest net energy importer. WTI has also moderated from its highs in February as total US commercial crude stocks build from rapid production growth in the US, while refineries enter their maintenance season ahead of peak summer demand.

In the central case of our forecasts, without a major flare-up in the Russian-Ukraine crisis as major Western economies threaten Russia with more severe economic sanctions, Brent and WTI are likely to succumb to lower seasonal demand while the pace of production picks up in major producing regions of North America and the Middle East. Therefore, we expect crude prices to moderate in the near-term, with the correction in WTI likely to be more pronounced from its recent sustained rallies, and further supply pressures as total US commercial crude stocks continue to build, partly offset by the ramp-up in the takeaway capacity of the Keystone XL Pipeline. Brent price prospects are weighed on by rapidly expanding Iraq and Iranian output, in addition to mounting competitive pressures from booming North American supplies. In the medium term, we expect WTI and Brent to continue to converge, as the transportation infrastructure for moving crude supplies in the US continues to improve, along with an expansion in refining capacity at the Gulf of Mexico from upgrades of existing refineries or construction of new refineries. This month, the forecast profile is kept largely unchanged for we view it as having captured all the foreseeable risk factors for now. Meanwhile, the latest March quarter outcomes were almost identical to our forecasts published last month, and were within a whisker of those made a quarter ago.

Natural Gas

Henry Hub and National Balancing Point Prices

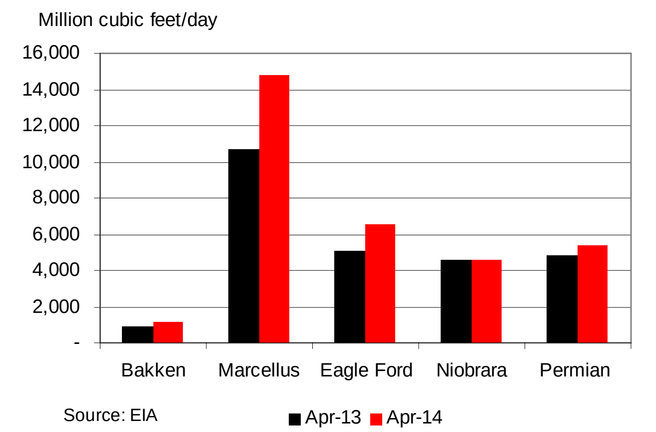


Sources: NAB; Thomson Reuters

The exceptionally wintry conditions that had resulted in some gravity defying movements in US natural gas prices over January and February persisted through to the first week of March, when the Henry Hub index spiked to its highest level since late 2008 to be just under US$8/MmBtu. However, prices have since eased substantially on the return of more moderate conditions, with the pace of weekly working gas storage withdrawals slowing from the record pace in January and February. Gas inventory withdrawals exceeded 200 billion cubic feet (Bcf) for 3 of the 4 weeks in January, and the first two weeks of February to culminate in an unprecedented four consecutive weeks of 200-Bcf plus draws.

As a result of net withdrawals for an uninterrupted nineteen weeks since mid-November, US natural gas inventories fell to below 1000 billion cubic feet (Bcf) in the first two weeks of March, a feat that has not been achieved since 2001. This is in spite of the solid pace of shale gas production driven by the increasing precision and efficiency of horizontal drilling and hydraulic fracturing in oil and natural gas extraction in the US, with the most prolific shale play of Marcellus driving about 75% of the gas production growth.

US Natural Gas Production at Major Shale Plays

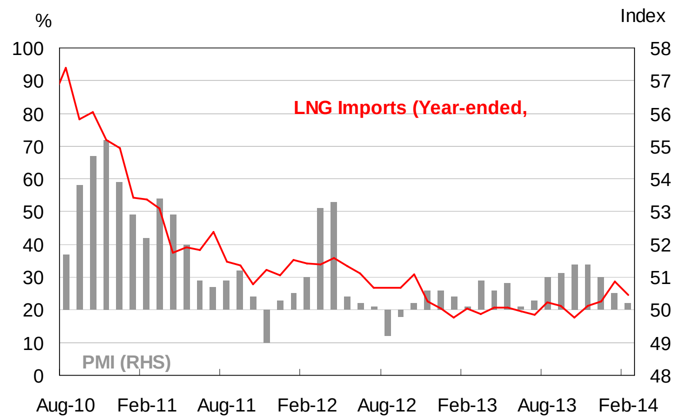


Source: EIA

In the UK and Europe more generally, the supposedly mildest winter since 2008 has exerted little pressure on existing inventories, hence curbing any upward momentum in prices. Despite some short-term volatility induced by the Crimean crisis, UK gas prices indicated by the National Balancing Point Index has shown a definite downward trend since peaking in December to reach its lowest levels in nine months towards the end of March, as forecasts of warmer weather and the impending arrival of some LNG cargoes weighed on sentiment, despite a generally undersupplied system. Meanwhile, the implications of the still-evolving Ukraine-Russian crisis on future European gas prices remain murky, even though Russia is unlikely to cut supplies to the region as an act of retaliation towards the sanctions imposed on it by the European Union alongside the US. The region's current reliance on Russia for around 30% of its gas needs with no immediate alternatives requires it to tread carefully in its political dealings with Russia. Despite talks of the ability of the US or Canada to take the place of Russia in supplying gas to the region, the higher costs associated with freight transportation and the lack of infrastructure from both the exporting and importing ends render it an unfeasible option in the near-term. Meanwhile, the Ukrainian interim government has agreed to the condition specified by the International Monetary Fund (IMF) to reform its natural gas subsidy program by raising gas prices for domestic consumers by 50% starting May this year in return for aid package worth US$ $15-20 billion.

In Asia, LNG prices in March have ebbed gradually from their historic highs in February. Weaker spot cargo demand from major Asian and South American buyers as they concluded their procurement programs, accompanied by lower seasonal demand, more reloaded cargoes from Iberia on offer and supply tenders from projects in the Atlantic and Asia-Pacific basins, caused excessive supply-side pressures that weighed on prices. That said, prices remain above historical seasonal averages to be currently around US$18/MmBtu.

Chinese LNG Imports and PMI



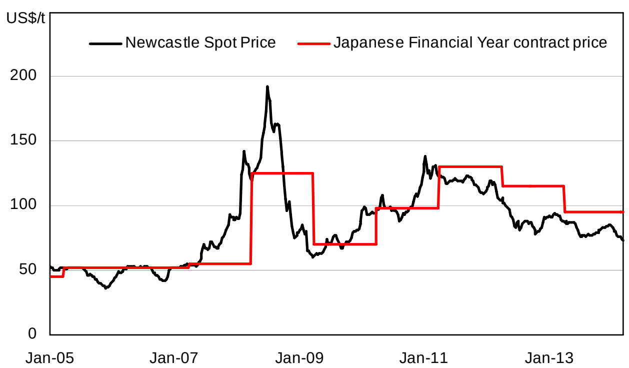
Source: CEIC, Datastream, NAB Economics

In the absence of further escalation of the Ukraine-Russia crisis, natural gas prices in the northern hemisphere are likely to succumb to fundamental movements in slower seasonal demand in the coming months and moderate from their current levels. Rapid production in the US will potentially culminate in a record stock rebuilding period over next half of the year from their currently dismal levels, while the reasonable amount of inventories in European hubs at the moment limits any substantial upward price potential. In Asia, gas prices are expected to remain at elevated levels in the coming months, with the possibility of some resumption of nuclear capacity in Japan constituting risks on the downside.

Thermal Coal

Spot prices for thermal coal continued to soften in the first half of March – a trend that has been evident since the start of the year. The market has been relatively subdued over this period, given few supply side constraints and substantial stockpiles at major ports and generators.

Spot prices have continued to ease since the start of 2014



Source: McCloskey's, BREE, NAB Economics

In the week ending 21 March, spot prices at the port of Newcastle were US$72.90 a tonne, down from around US$76 a tonne a month earlier and the six month high of US$84.60 a tonne in late December.

Domestic prices in China have also trended down in the past few months. Prices at Qinhuangdao (China's largest thermal coal port) fell to around RMB 553 a tonne (excluding VAT) in mid March, from around RMB 566 a tonne in mid February.

Negotiations for Japanese financial year contracts have reportedly been completed between Tohoku Electric and Glencore-Xstrata. Reflecting the recent weakness in spot prices (which traded at a significant discount to the JFY 2013 contract of US$95 a tonne), the new contract has been settled at US$81.80 a tonne (below our previous forecast of US$86.50 a tonne).

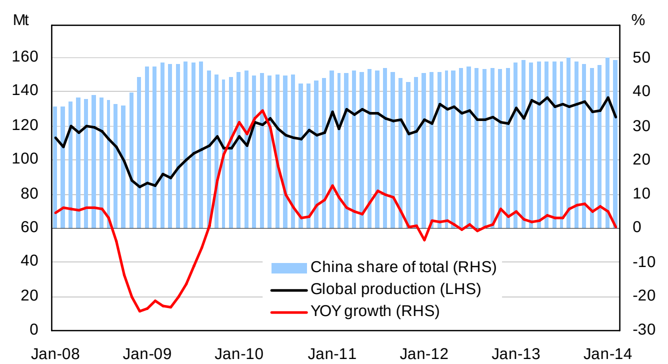
Japanese thermal coal demand may weaken in coming months, with a renewed urgency to restart the country's idle nuclear generation capacity. The Japanese government's draft energy policy – released in late February – put nuclear at the heart of long term energy requirements (in stark contrast to policies of the previous government).

In contrast, China's demand for coal is likely to be the key driver – despite efforts to address pollution concerns. According to China Development Bank, around 36 gigawatts of new thermal coal fired generation was added in 2013, with a similar amount likely this year (although none will be constructed near Shanghai, Tianjin, in Hebei province or the Yangtze and Pearl River deltas). Efforts to reduce the country's consumption of lignite and low energy value coal could be beneficial for Australian exporters in coming months.

Thermal coal markets remain well supplied – with this trend likely to be the key influence on prices in the short term. Producers in the United States, Canada and Australia have reduced output at higher cost mines – although for many Australian producers, take-or-pay contracts with infrastructure providers limit their capacity to cut production. According to Bloomberg, around 31 million tonnes of new capacity will be added to global supply this year.

Steel Production

Steel production growth slows in February



Source: World Steel, NAB Economics

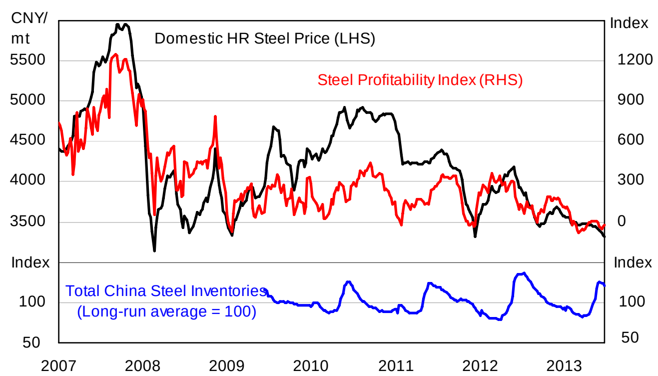
Global steel production pulled back in February to 125.0 million tonnes (compared with 136.7 million tonnes in January). The bulk of the decline was recorded in Asia, with Chinese production sharply lower (down by around 6 million tonnes, due in part to the Chinese New Year holidays) along with weaker output in India, Japan and South Korea. In terms of growth, global production was marginally higher, at +0.6%

yoy – however this was the slowest rate of growth since August 2012.

Overcapacity in China's steel sector remains a key theme – with Bloomberg estimating excess capacity at around 271 million tonnes in 2013. At the recent National People's Congress, delegates representing major steel makers suggested the country's production was near its peak. The China Iron and Steel Association forecast steel production to rise to 810 million tonnes in 2014 (from around 775 million tonnes last year) – and peak between 860 and 880 million tonnes in the next three to five years.

Profitability in the Chinese steel sector has remained challenging – with prices for benchmark hot rolled steel continuing to trend lower across the past few months. That said, weaker raw material prices have reduced some of the cost pressures on producers, and steel inventories appear to have reached the seasonal peak, and will decline as consumers return to the market.

Conditions remain challenging for China's steel mills

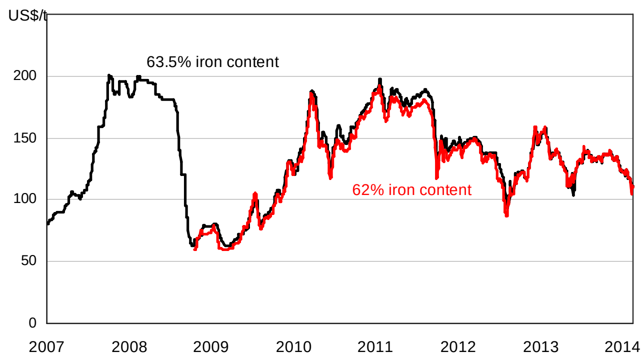


Sources: Bloomberg, NAB Economics

Iron Ore

Spot prices for iron ore were unusually volatile in the first half of March. Tighter credit controls on the steel sector and uncertainties around commodity collateral financing and the US dollar exchange rate appeared to weigh on markets. The price for 62% fines at the port of Tianjin plunged 8.3% on March 10 – down to US$104.70 a tonne, before recovering most of the losses a week later.

Chinese spot prices highly volatile in March



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

Steel mill financing in China has become an increasing concern – with Reuters reporting that banks have cut lending to industries with surplus capacity by 20% this year while the China Banking and Regulatory Commission has requested regular reports on outstanding loans to similar sectors (specifically steel, cement, aluminium smelting, flat-glass and shipbuilding).

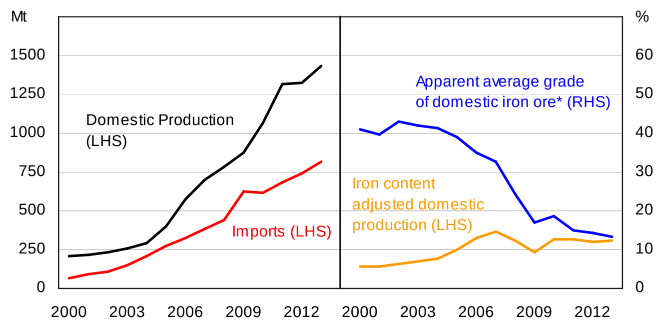
Tighter funding had encouraged steel mills to seek alternative financing via shadow banking – including using iron ore as collateral for loans (from both domestic and international sources) – with Mysteel Research estimating that 40% of iron ore stocks at China's ports are part of finance deals. This type of collateral financing has been evident in copper markets – however its use in iron ore seems considerably more risky. Compared with copper, markets for iron ore are far less liquid, paper trading is less established and the commodity is more difficult to store (due to the low value per unit of mass).

Various reports have suggested that iron ore collateral inventories are largely unhedged, and that the depreciation in the US dollar exchange rate may have triggered a sell off in order to meet margin calls – contributing to the short term plunge in spot prices.

From a demand perspective, China remains the key market for global iron ore trade – with China's share of imports growing strongly across the past decade, rising to an estimated 67% in 2013. In contrast, both European and Japanese consumers have declined in importance. Over the first two months of 2014, China's imports of iron ore increased by 21% to 148 million tonnes.

China's domestic iron ore production has increased strongly over the past decade – however this has also coincided with steep declines in the average iron content of domestic ore – which increases processing costs for steel producers. While imports are considerably lower than domestic production (around 57% in 2013), imports account for almost 73% of pig iron production

Falling grades mean China is dependent on imported ore



* Based on pig iron production, excludes changes in ore inventories, assumes constant average grade for imports at 62.5%
Source: CEIC, NAB Economics

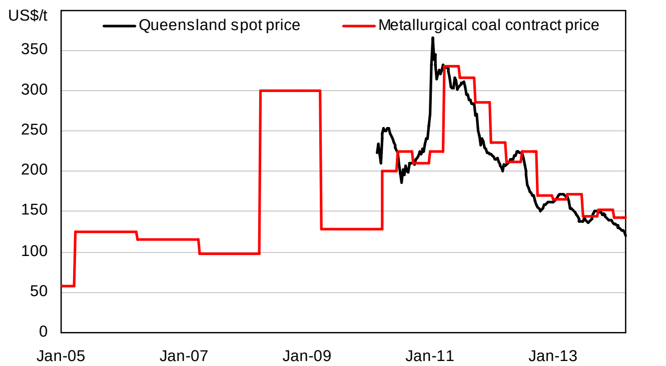
Expanding supply will add downward pressure to iron ore prices in 2014 (particularly in the second half of the year). The bulk of this new supply will come from Western Australia's Pilbara region, where major investment in mine, rail and port capacity will provide a boost to seaborne supply.

In the short term, volatility in Chinese financial markets creates some uncertainty for iron ore spot prices – however we expect prices to remain near current levels, before trending down to around US$100 a tonne by the end of the year.

Metallurgical Coal

Spot prices for metallurgical coal softened further in March, with prices for Queensland coal edging down to around US$119 a tonne in mid March (compared with US$127 a tonne in mid February).

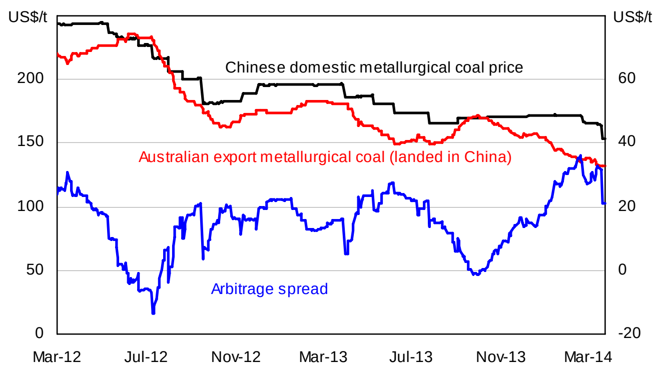
Metallurgical coal prices continuing to decline in March



Source: Energy Publishing, Bloomberg, NAB Economics

The gap between Chinese domestic prices for metallurgical coal and imports has narrowed somewhat in recent weeks – but remains relatively high. Domestic prices remained unchanged as spot import prices began to decline in the latter part of 2013, leading to the arbitrage spread peaking at almost US$35 a tonne in late February. Two cuts in price have brought this gap back closer to US$20 a tonne recently (a level that is still high in recent history).

Notable gap between domestic and imported coal prices



Source: Bloomberg, NAB Economics

Weaker spot prices have pushed quarterly contract prices lower – with second quarter contracts recently settled at US$120 a tonne (broadly in line with the average spot price across the quarter). This price is the weakest level since the switch to quarterly pricing in 2010, and the weakest overall since the 2007 Japanese financial year.

In part the downward trend in spot prices may reflect changes in Chinese inventories, rather than underlying demand. Official import data shows metallurgical coal imports declined by 26% year-on-year over the January and February period – despite a 4.3% increase in steel production (according to World Steel). This may indicate a rundown in metallurgical coal stocks at steel mills, and potential for stronger demand in coming months.

There will be some growth in seaborne metallurgical coal supply in 2014, but it will be less significant than last year. Comparatively low prices should push higher cost producers out of the market – although take-or-pay contracts with infrastructure providers in Queensland may limit potential cuts in Australia.

That said, current negotiated prices will put a significant strain on producers – with cash cost estimates by Wood Mackenzie suggesting that around 55% of global production is unprofitable at the newly settled contract (compared with around 12% at the March quarter contract).

Slower growth in supply and a recovery in demand from China should allow prices to increase from current lows. That said, the impact of current spot prices on quarterly contracts has led us to revise down our short term outlook, before prices trend upwards to US$160 a tonne by the end of 2014.

Base Metals

This year has been a rollercoaster ride for base metal markets with prices fluctuating in response to mixed (albeit generally weak) economic data, and a series of market distortions that are creating uncertainty over the supply outlook for some metals. Additional QE tapering and comments from the Fed suggesting that interest rates could be hiked sooner than most had expected, possibly contributed to the headwinds facing metals markets in the month. But, this was generally overshadowed by heightened concerns over signs of a sharper than expected deceleration in the Chinese economy – made worse by fears that China is facing its own financial crisis (or ‘Minsky moment’). On a more positive note, comments from Chinese authorities pledging to introduce stimulus measures – particularly in town redevelopment projects – have been well received by markets, while in the US, partial indicators are suggesting that the impact of severe weather is passing and the economic recovery remains intact.

The weaker economic data out of China and concerns that commodity financing deals may be unwound (exacerbated by recent CNY depreciation, Chinese debt defaults and growing anticipation of US interest rate rises) and unleash significant metal supplies into the market, have seen prices fall across most of the base metals complex in March. More recently, declines were stemmed by comments about stimulus measures in China and suggestions that authorities in China will ease restriction on banks and property developers to spur growth. On the supply side, the Indonesian ore export ban and potential sanctions on Russia in response to its involvement in the Ukraine, have fed supply concerns that are supporting nickel prices in particular – Indonesia and Russia are the sources of almost 20% and 10% per cent of global nickel mine supply respectively.

Base Metals Prices*

Base Metal Prices

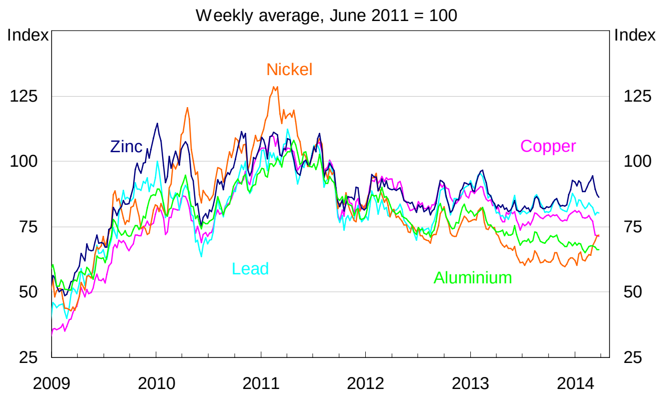
	Avg Price (US$/tonne) Mar-14	Monthly % change Mar-14	Mar-13 - Mar-14 % change
Aluminium	1704	0.5	-11
Copper	6664	-6.8	-13
Lead	2055	-2.5	-5
Nickel	15626	10.0	-7
Zinc	2021	-0.7	5
Base Metals Index		-0.8	-9

* Prices on an LME cash basis.

Sources: LME; NAB

In aggregate, base metals prices on the London Metal Exchange (LME) have fallen by nearly 1% in March to date, following a similar sized decline in October, to be almost 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 in advanced economies, there is still significant uncertainty over emerging markets and how the eventual unwinding of monetary stimulus by the major central banks is likely to unfold. We can expect to see ongoing policy distortions to market pricing, contributing to market volatility, although some factors are likely to be offsetting.

Base Metals Prices



Sources: NAB; Thomson Reuters

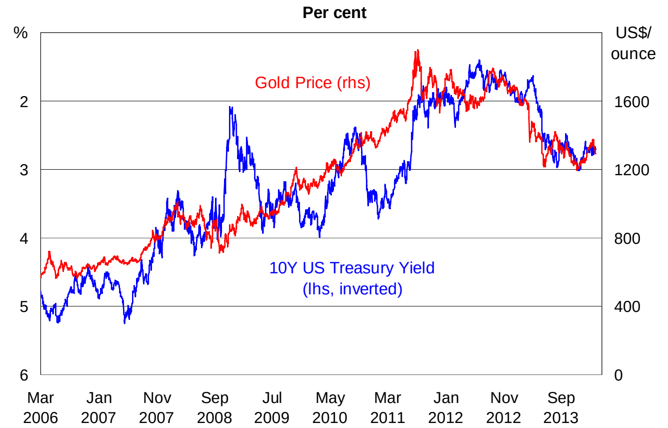
Price declines were recorded across most of the base metals in March to date, although the magnitude of decline has varied significantly. Nickel has continued to be a stand out performer, following poor results in previous years, recording solid price rises since the start of the year driven by recent supply concerns. Similarly, aluminium recorded a modest rise in the month, supported by tighter physical markets which have been further fuelled by Russia concerns and Indonesia's ban on bauxite exports, while already low prices are putting pressure on small marginal producers. Nickel prices rose by a strong 10% in March to date, while aluminium prices are up a much more modest ½%. Average copper prices are down the most in the month, falling by 6.8%, while declines in other metals varied with zinc prices down 0.7% and lead prices 2.5% lower. Nevertheless, underlying fundamentals in lead and zinc markets remain somewhat positive relative to the rest of the complex due to limited additions to supply capacity to come. In annual terms, lead and particularly zinc have been the best performers, the former falling by 5% over the year while the latter has risen by a comparable amount. Copper prices recorded the largest decline (down 13%), suggesting that the metal may have become further decoupled from advanced economies – calling into question its status as 'Dr Copper' – as they are still expected to improve over the course of 2014 despite recent signs of softening.

Gold

Over the past month, gold prices have rallied on the back of increasing 'safe haven' demand following the escalation of geopolitical risks in Europe and growing uncertainties over emerging economies. Consequently, prices have held up much higher than we had anticipated a month or so ago. Nevertheless, prices have begun to lose ground again more recently in response to comments from Fed Chairman Janet Yellen suggested that the Fed could commence hiking interest rates earlier than most had expected; the Fed also decided to taper their monthly asset purchases by a further US$10 billion from April. Additionally, there have been indications that China may introduce additional stimulus measures, helping to alleviate some of the concerns over emerging economies.

Gold prices have begun to fall in line with easing safe haven demand, but with uncertainties over the Ukraine and emerging markets looming in the background, the downward momentum in gold prices may prove to be short lived. Another uncertainty this year is how long the Indian gold import ban is likely to remain in place. Improvements in their current account deficit and large volumes of unofficial imports suggest that the ban may be eased sooner than previously thought. Over the longer term, however, rising interest rates in the US and a higher USD should see sustained pressure on gold prices.

US 10-Year Treasury Yield

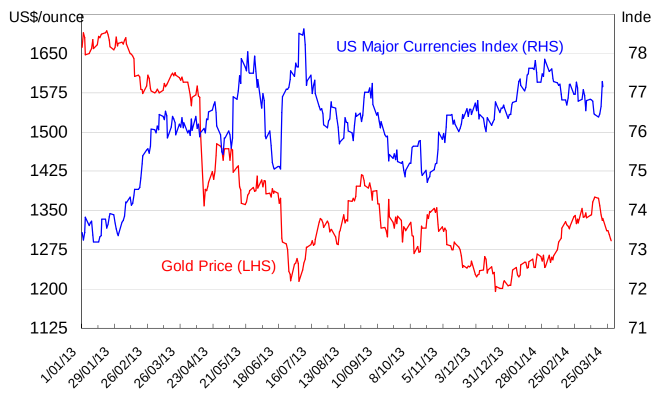


Source: Thomson Reuters; NAB

Since the end of February, the price of gold rose by around 4% to peak at just below US$1,380 per ounce mid-month, which capped a rally of almost 14% since the start of the year. The price eased back in the second half of the month, falling around 6% to settle around US$1,290 per ounce. In year ended terms, the price of gold in March was more than 15% below levels recorded in the same month of the previous year.

Gold's inverse relationship with the US dollar appeared to break-down at the start of the year, with the US dollar appreciating against major currencies as the gold price turned up. However, this could have reflected a temporary boost to physical demand from Asia in the lead up to the Lunar New Year, negating the impact from a higher USD. More recently, the traditional inverse relationship has strengthened somewhat and anticipation for further USD depreciation should provide a significant headwind to prices.

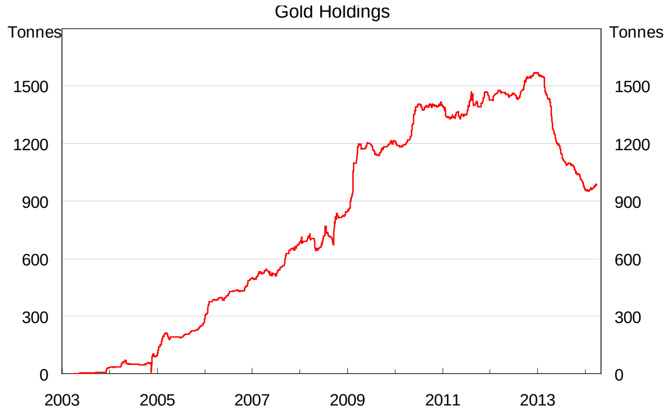
Gold Price and the US Dollar (Daily)



Source: Thomson Datastream

Data from a selection of US exchange traded gold funds (ETFs) have highlighted the sharp decline in gold holdings since the beginning of 2013, with investors losing faith in gold as a store of value. However, investors have stemmed their sales of gold more recently in response to risk-off attitudes in markets. This has similarly been reflected in an increase of net long open positions in futures and derivatives, which had previously dipped to their lowest post-GFC levels last year.

Exchange Traded Funds*



* A sample of funds from the US
Sources: ishares.com; exchangetradedgold.com; NAB

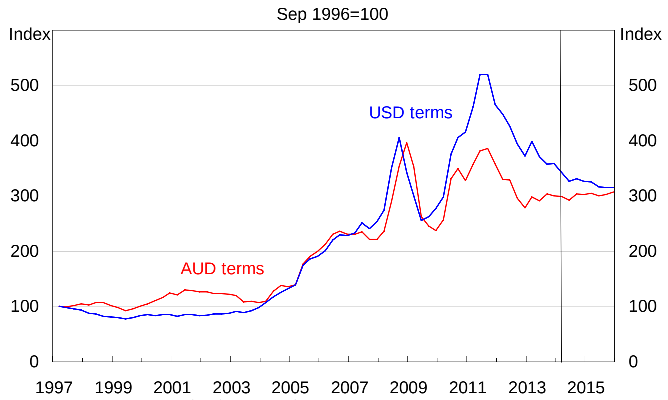
Although we suspect that the improvement in attitudes towards gold since the start of the year was likely to be temporary, the recent fall in the gold price is unlikely to gain significant momentum while geopolitical uncertainties, and economic growth concerns, loom in the background. Additionally, Asian demand is expected to remain robust, and will most likely step up a level once Indian import bans are removed – previously expected at the end of the year, but possibly sooner. Nevertheless, the outlook for equity markets remains good, at least outside of emerging markets, while demand for gold as an inflation hedge is likely to be limited as inflation expectations have remained anchored. Most importantly, our current forecasts for the US continue to have US interest rates rising from current levels over the coming quarters. Consequently, our expectation is that gold prices will be relatively range bound in the near-term (an upward revision from our previous expectation), but the medium term trend is still expected to be a gradual move lower from current levels.

Outlook

Despite some setbacks at the start of the year, growth in the advanced economies is still expected to improve over 2014, which should prove to be a support for industrial commodities (but a headwind to safe haven assets such as gold). However, the Chinese economy is still of most concern for these commodities and signs of further weakening of the economy is a concern. A GDP growth target of 7.5% for 2014 and suggestions that authorities are still willing to implement measures to spur growth can provide some comfort, although how the stimulus is achieved could have ramifications for the longer term health of the Chinese economy. Uncertainty over financing deals and how they will unravel will probably shape many commodity markets (particularly base metals and iron ore) over coming months (and possibly years) introducing even greater volatility to markets.

Supply and demand fundamentals vary across the commodities. Production of bulk commodities and some metals is expected to outpace the improvement in demand even as the global economy recovers, given that there are signs of plateauing in Chinese demand which has been predominantly responsible for a series of commodity supercycles in the past two decades. Record pace in crude and natural gas production in North America will also ensure a comfortable supply side which will cap upward potential in energy 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 3¾% over 2013. We are expecting a larger decline of around 8¾% in 2014, before easing by a further 3½% over 2015 (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 ¾% over the year to December 2014, before a larger increase of 1½% over 2015. 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*

April 2014: Overview & Bulks– 5/5/2014

* Reports to be released by these dates.

Quarterly Price Profile

Oil Price Forecasts – Quarterly Average

	Spot	Actual	Forecasts							
	28/3/2014	Mar-14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
Brent US$/bbl	107.7	108	106	105	103	103	103	103	103	103
WTI US$/bbl	101.7	98	96	98	100	100	100	100	100	100
Tapis US$/bbl	110.9	114	112	111	109	109	109	109	109	109
Petrol AUc/L*	NA	**150	150	151	151	152	153	154	155	155

Sources: NAB Economics; RACQ; Thomson Datastream

* Denotes 5-capital average **Estimate

Natural Gas Price Forecasts – Quarterly Average

	Spot	Actual	Forecasts							
US$/mmbtu	28/03/14	Mar-14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
Henry Hub	4.48	5.10	4.20	3.70	3.90	3.60	3.80	3.60	3.90	3.90
Japan LNG	NA	*16.5	16.00	15.50	15.50	15.30	15.00	14.50	14.35	14.35
Brent Oil	107.7	109	107	106	104	104	104	104	104	104

Source: Datastream, CEIC, NAB Economics

*Estimate only; full quarter data not yet available

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

	Actual**	Forecasts							
	Mar-14	*Jun-14*	*Sep-14*	*Dec-14*	*Mar-15*	*Jun-15*	*Sep-15*	*Dec-15*	*Mar-16*
Iron Ore*	120	108	105	100	100	95	95	95	95
Hard Coking Coal	127	120	143	148	150	153	157	160	160
Semi-soft Coking Coal	91	85	102	105	107	109	112	114	114
Thermal Coal	78	82	82	82	82	80	80	80	80

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. ** Spot price to date

Base Metals Price Forecasts – Quarterly Average

Base Metal Forecasts - Quarterly Average Terms

	Spot	Actual	Forecasts							
US$/MT	Current	Mar-14	*Jun-14*	*Sep-14*	*Dec-14*	*Mar-15*	*Jun-15*	*Sep-15*	*Dec-15*	*Mar-16*
Aluminium	1716	1710	1761	1811	1858	1886	1904	1914	1914	1914
Copper	6686	7044	6654	6570	6504	6553	6602	6652	6702	6702
Lead	2045	2104	2073	2088	2104	2120	2136	2152	2168	2168
Nickel	15669	14627	16097	15936	15617	15305	15573	15845	16123	16123
Zinc	1963	2028	1967	1987	2007	2027	2047	2067	2088	2088
Base Metals Index	n.a.	270	270	270	269	270	272	275	278	278

Sources: Thomson Reuters; NAB Economics

Gold Price Forecasts – Quarterly Average

Gold Price Forecast - Quarterly Average

	Spot	Actual	Forecasts							
	Current	Mar 14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
Gold - US$	1292	1295	1330	1320	1300	1230	1120	1060	1060	1060
Gold - AU$	1394	1453	1520	1540	1550	1470	1370	1300	1320	1330

Sources: Thomson Datastream; NAB

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