Bulk Commodities Market Update

National Australia Bank

- **Trends for bulk commodity prices were mixed in April, with relative stability (at very weak levels) for both thermal and metallurgical coal, while iron ore briefly recovered from the low levels in March, before retreating again.**
- **In the first quarter of 2014, global steel production rose by 3.7% year-on-year, to total 404 million tonnes – led by China (despite concerns around pollution, profitability and access to finance).**
- **Iron ore prices have generally trended downwards since December 2013, with increasing volatility. Prices plunged in the early part of March, briefly recovered before falling again. Prices are forecast to fall further across the year, given growing seaborne supply.**
- **Metallurgical coal prices have declined since October 2013, leading to the lowest contract since the switch to quarterly pricing in 2010, and the weakest overall since the 2007 Japanese financial year. Cutbacks to production should allow some recovery in prices.**
- **Annual contracts for thermal coal were settled at their lowest level for five years. Given adequate supply and the potential for production cuts, we expect prices to remain range bound in the short term.**

Economic overview

China remains the key market for bulk commodities – the country accounts for around half of global coal consumption and produces around half of the world's steel. It dominates global markets for iron ore – with almost two-thirds of total imports of the raw material.

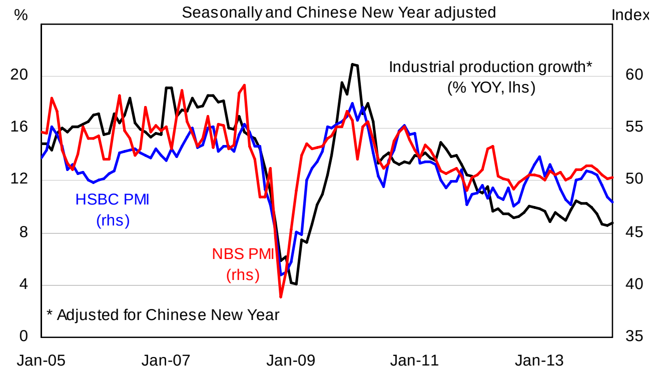
China's economic growth continues to slow in Q1 2014

* Data prior to DQ2010 are estimated by NAB.
Source: CEIC, NAB Economics

China's latest national accounts data had few surprises – the weakening trends evident since the latter part of last year continued into the first quarter of 2014, with slower economic growth, comparatively soft industrial production and investment data continuing to point downwards.

In the March quarter, China's economy grew by 7.4% year-on-year, trending down from 7.7% yoy in the December quarter. This softening was broadly in line with our expectations for China's economy and was also consistent with weaker partial indicators – such as industrial production, fixed asset investment and exports.

Industrial production trends still soft in early 2014

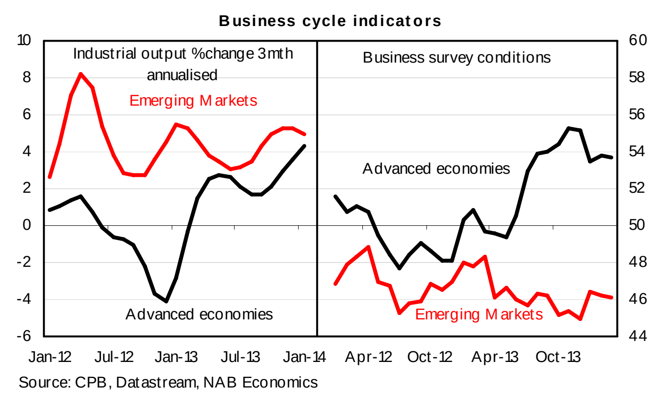


Source: CEIC, NAB Economics

China's industrial production increased by 8.8% yoy in March – slightly stronger than levels in February (8.6%) but also marginally weaker than market expectations (9.0%). Growth in industrial production remains near its lowest level since May 2009 – when China was in the midst of its post-GFC recovery.

Fixed asset investment also softened in March, with the seasonally adjusted rate easing to 17.4% yoy (down from 17.9% in February). This rate of growth has been steadily trending downwards over the past few years, as authorities have attempted to rebalance the economy towards consumption.

Conditions improved in advanced economies, but levelling out



Source: CPB, Datastream, NAB Economics

We expect economic conditions in China to remain comparatively weak across 2014 – with the Government more focussed on its reform agenda than headline growth. That said, a sharp slowdown could trigger a stimulus response if social stability is threatened. Our forecast remains unchanged at 7.3% this year – with this flowing through to weaker growth in demand for steel and bulk commodities.

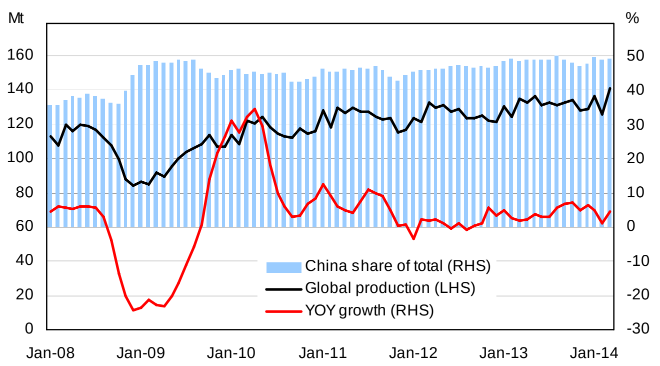
More generally, the global economy is growing at around trend levels – having accelerated across 2013 – however rates of growth are starting to level out. Business surveys have dipped slightly across the United Kingdom, Japan and the Eurozone, and fallen more sharply in the US (albeit this may have reflected weather related disruptions to supply chains).

We expect advanced economies to be the main contributor to global growth in 2014 (up from around 1.3% in 2013 to 2.2% this year), while growth in emerging economies is expected to remain relatively stable – at 5.4%. That said, most of this acceleration has already occurred. The stronger growth in advanced economies will have a muted impact on demand for bulk commodities – reflecting the less commodity intensive nature of these markets.

Global Steel Industry

In the first quarter of 2014, global steel production rose by 3.7% year-on-year, to total 404 million tonnes (World Steel). China has been the main driver of steel production growth in recent years – global production excluding China increased by only 2.5% yoy to 203 million tonnes.

China continues to dominate global steel output



Source: World Steel, NAB Economics

Steel production in China increased by 4.9% yoy in the first quarter, to reach 201 million tonnes. Steel maker profitability and air pollution are increasing concerns in China, and may contribute to a slowing trend for growth. During the National People's Congress in March, delegates representing major steel makers suggested the country's production was near its peak. The China Iron and Steel Association (CISA) forecast steel production to rise to 810 million tonnes in 2014 (from around 779 million tonnes last year) – and peak between 860 and 880 million tonnes in the next three to five years.

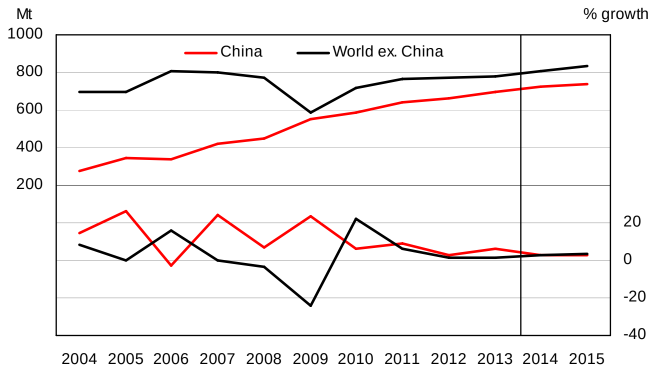
According to CISA, more than 45% of steel makers recorded losses in the first quarter of 2014 – totalling RMB 2.33 billion. Financing for the steel industry has become increasingly challenging over the past few years, with tightening credit requirements from the banking sector, and more recent attempts to crack down on shadow banking. Reuters has reported that banks have cut lending to industries with surplus capacity (such as steel) by 20% this year, while the steel sector is subject to closer financial monitoring by the China Banking and Regulatory Commission (CBRC).

This tighter funding environment encouraged steel mills to seek alternative financing – most recently using iron ore as collateral for loans. In March, Mysteel Research estimated that 40% of iron ore stocks at Chinese ports were part of financing deals. This type of collateral financing has previously been evident in copper markets – however its use in iron ore is 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 tonne and tendency to oxidise).

Various reports suggest that the CBRC has warned banks to tighten controls on letters of credit for iron ore imports (the mechanism for collateral financing) from May 1. Tougher access to finance is likely to impact on growth within the steel industry and demand for bulk commodities longer term.

Finished steel consumption is forecast to increase to 1.53 billion tonnes in 2014 (an increase of 3.1%) (World Steel). Consumption growth in China is expected to slow to 3.0% this year and 2.7% in 2015 – while there is a strong recovery in consumption in North America (supported by improved economic conditions in the United States).

Advanced economies expected to drive steel consumption



Source: World Steel, NAB Economics

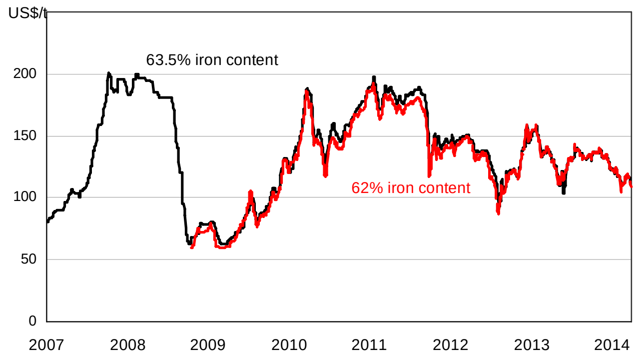
Iron Ore

Iron ore prices have generally trended downwards since December 2013, and volatility has risen. Prices plunged in the early part of March (down to US$104.70 a tonne CFR for 62% iron content fines – the lowest level since September 2012), briefly recovered back near US$120 a tonne in early April, before falling again. In late April, spot prices were at around US$109 a tonne.

Uncertainty around steel mill and iron trader financing (which may have driven some liquidation of iron ore stockpiles at ports) may have contributed to this volatility. Fundamental demand conditions should be improving (relative to early 2014) – with steel production recovering from Chinese New Year lows.

China remains the key market for global iron ore trade – accounting for around two-thirds of total imports in 2013 (compared with a quarter of trade in 2003). In the first quarter of 2014, Chinese iron ore imports rose by 19% to 222 million tonnes.

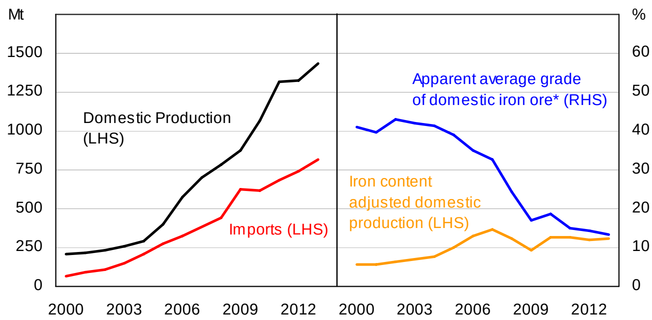
Iron ore prices have trended down since December 2013



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

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 smaller 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

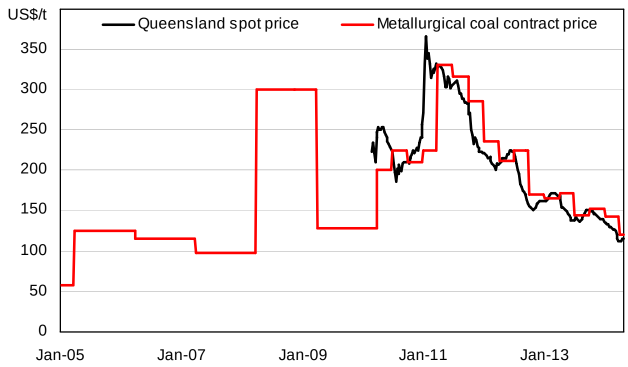
Global seaborne iron ore supply is expected to increase significantly in 2014 and 2015 – with the bulk of new capacity in Western Australia. Bloomberg estimate an increase of around 104 million tonnes (or around 8% of trade in 2013) – as projects from BHP Billiton, Rio Tinto and Fortescue come online. This new supply will add downward pressure to prices across the second half of the year – with the estimated cash costs of these projects well below current prices.

Our price outlook for iron ore is unchanged, with downward pressure on spot markets to continue across 2014 (particularly in the second half) to see prices trending towards US$100 a tonne by the end of the year.

Metallurgical Coal

Spot prices for metallurgical coal fell sharply in March – down to US$112.50 a tonne, the lowest level since active spot trading commenced. Growing seaborne supply and a period of weak import demand has contributed to the downward trend since October 2013. Prices were stable across the first half of April, before edging higher – to US$116.10 late in the month.

Metallurgical coal prices continue to slide



Source: Energy Publishing, Bloomberg, NAB Economics

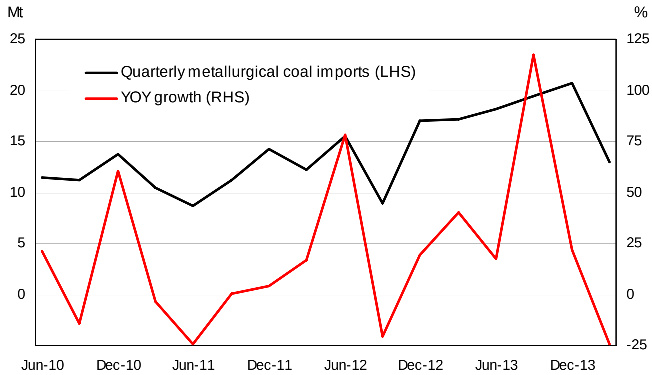
Weaker spot prices have pushed quarterly contract prices lower – with second quarter contracts recently settled at US$120 a tonne (broadly in line with the average spot price across the quarter). This price is the weakest level since the switch to quarterly pricing in 2010, and the weakest overall since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

Lower prices are likely to have a significant impact on producers. Wood Mackenzie estimate that around 55% of global production is unprofitable at the newly settled contract price – compared with around 12% at first quarter contract prices.

Producers have started to respond to the weaker prices, with around 7 million tonnes of annual capacity cut in April. This includes Glencore-Xstrata's Ravensworth mine in New South Wales (around 2.1 million tonnes a year) and Walter Energy's Wolverine and Brule operations in Canada (combined around 3.6 million tonnes). Given poor profitability, further cuts are likely, however take-or-pay contracts with infrastructure providers could limit the scale of potential cuts – at least until losses from supplying global markets exceed penalty costs under the terms of these contracts.

Despite recent trends, capacity to supply markets will be boosted by a range of projects this year, largely developed in Queensland – such as Rio Tinto's Kestrel project and BHP Billiton Mitsubishi Alliance's Daunia and Caval Ridge mines.

Chinese metallurgical coal imports weak in Q1



Source: CEIC, NAB Economics

Chinese imports of metallurgical coal have been particularly weak in the early part of 2014. For the first three months, Imports have totalled almost 13 million tonnes – down around 25% from the same period last year. This fall came despite an increase in steel production of 4.9% yoy over the first quarter.

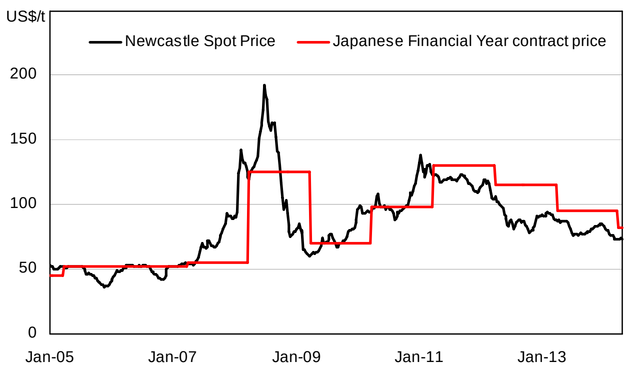
This may indicate a rundown in metallurgical coal stocks at steel mills and ports, and potential for stronger demand in coming months. A recovery in demand from China should allow prices to increase from current unprofitable lows, however the scale of idle production capacity will limit upside price pressure. Last month, we revised down the short term profile of metallurgical coal prices, but we forecast prices to trend upwards – away from unsustainably low levels – to around US$148 a tonne by the end of 2014, and around US$160 by the end of 2015.

Thermal Coal

The 2014 Japanese financial year started on 1 April, with annual contracts for thermal coal at their lowest level for five years. The contract between Tohoku Electric and Glencore-Xstrata was settled at US$81.80 a tonne (well below the previous level of US$95 a tonne).

Spot prices for thermal coal have drifted lower since the start of the year – providing impetus for the steep cut in the annual contract price. In late April, spot prices at the port of Newcastle were US$72.75 a tonne – largely unchanged since early March, but down from US$84.25 a tonne at the start of the year (McCloskey's globalCOAL).

Thermal coal prices drift to a new plateau



Source: McCloskey's, BREE, NAB Economics

Weaker prices have impacted on the profitability of producers. Morgan Stanley estimate that at the new contract price, around 13% of global production is unprofitable, while this level rises to around 25% at current spot prices. This weakness is likely to delay future mining projects and may limit short term growth in supply.

On the demand side, changes to Japanese energy policy could have an impact on thermal coal consumption. The country's draft energy policy, released in late February, put nuclear at the heart of long term energy requirements – which could reduce the level of coal burn that was boosted by the post-Fukushima nuclear shutdown.

China's coal consumption also provides some uncertainty. Efforts to address pollution include a plan to close older & less efficient power plants, bans on constructing new plants near Shanghai, Tianjin, in Hebei province or the Yangtze and Pearl River deltas and proposals to cut use of lignite and low energy value coal. The latter could provide support for Australian exporters.

Thermal coal markets generally remain well supplied – with idle production capacity in a range of key producers (in part reflecting the weakening profitability conditions). Producers in the United States, Canada and Australia have reduced output at higher cost mines – although as is the case with metallurgical coal producers, take-or-pay contracts with infrastructure providers limit the capacity of some miners to cut production. Newly developed projects could add as much as 31 million tonnes of new capacity to seaborne markets this year, according to Bloomberg.

Idle production capacity may also increase in Indonesia – if domestic policies to restrict illegal mining and Chinese policies to reduce imports of lower energy content coal (which would impact on demand for Indonesian brown coal exports) are successful.

Reflecting the level of spare production capacity to limit any upside pressure, along with potential cutbacks if prices fall further, we expect prices to remain range bound in the short term.

Outlook

Last month we revised our forecast for metallurgical coal, and our forecasts are unchanged this month. Supply side pressures will add downward pressure to iron ore prices, while we see little further downside to either thermal or metallurgical coal (reflecting profitability issues for producers).

Longer term prospects in China's steel industry add some uncertainty around the future potential for bulk commodity markets and for Australia's key exports.

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Quarterly Contract Price Profile ($US/t)

	Actual**	Forecasts							
	Jun-14	*Jun-14*	*Sep-14*	*Dec-14*	*Mar-15*	*Jun-15*	*Sep-15*	*Dec-15*	*Mar-16*
Iron Ore*	115	108	105	100	100	95	95	95	95
Hard Coking Coal	114	120	143	148	150	153	157	160	160
Semi-soft Coking Coal	81	85	102	105	107	109	112	114	114
Thermal Coal	73	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

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