Minerals and Energy Update – April 2014

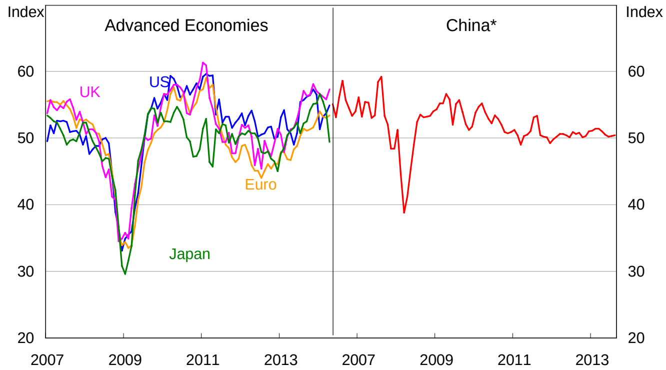
National Australia Bank

- **Economic data confirmed slower global growth in Q1, but more timely indicators are looking a little more promising. Japan is a major exception where a recent consumption tax hike is having a distortionary effect.**
- **US tapered QE again, but market implications appeared relatively muted as the move was largely expected and took a back seat to other economic and political events.**
- **After years of being decoupled from global oil markets and regarded to be a less risk hedging measure than Brent, West Texas Intermediate (WTI) is poised to resume its previous status as a world benchmark as stock inventories at Cushing eased to the lowest level in more than four years in April.**
- **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.**
- **Prices for the base metals complex generally rose in the month, but nickel generally outperformed (followed by aluminium), largely driven by supply side factors. Soft Chinese data has been a dampener, but hopes of stimulus have been offsetting.**
- **Gold price have fluctuated over the past month, but generally eased off as demand for 'safe haven' assets eased in response to (initially) easing tensions in the Ukraine and signs that the US economy was improving late in Q1.**
- **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

Global attention in April was largely focussed on the key headline Q1 GDP numbers for the US and China, both down from the previous quarter. The unambiguous strength in the US labour market suggests that the recovery in the country is on track, despite a dismal GDP growth print of 0.1% in Q1 presumed to be weather induced to a large extent. Undeterred by the headline growth figure, the US Fed proceeded with another US$10 billion cut in their monthly quantitative easing program to US$45 billion. The Chinese Q1 GDP outcome of 7.4% y-o-y was above market expectations despite slowing from 7.7% in December quarter, and more recent PMIs indicate signs of stabilisation in industrial output in April as the Chinese government announced a series of targeted policy stimulus.

PMI Surveys

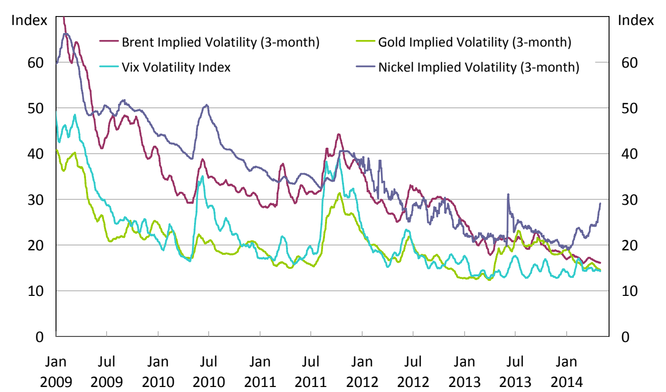


* Official PMI published by China's NBS.
Sources: Markit Economics; NAB; NBS

While Manufacturing PMI's have been holding up in many major advanced markets, Japan's PMI slid into contraction following a hike in consumption taxes from April 1. Consumers stocked up on durable goods in the months leading up to the hike, but this is now expected to leave a void in demand that is prompting firms to scale back production. While the tax hike is an important step towards addressing debt levels in Japan – as well as (attempting) to herald-in some inflation momentum – it also runs the risk of throwing Japan's economic recovery off track.

There were some large movements in financial markets over the past month, corresponding to sharp corrections in tech stocks in the US, but so far the spillover effects onto commodities have been limited. Market reactions to renewed geopolitical tensions in the Black Sea region and the subsequent fresh round of sanctions imposed on Russian business and political heavyweights were reasonably muted as well.

Market volatility largely limited to nickel



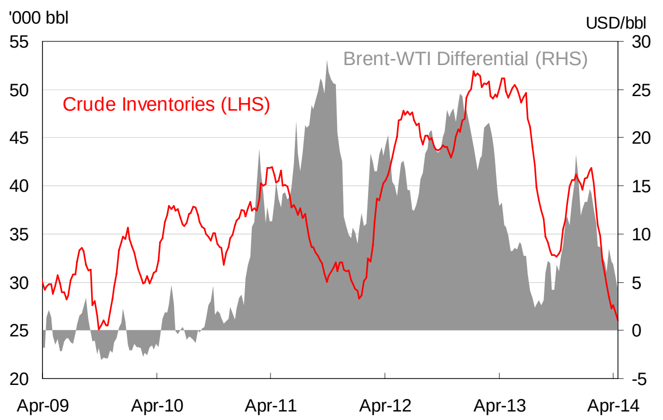
After a volatile run in March, April proved to be uneventful for most industrial commodity prices. The 3-month implied volatility for major commodities was largely range-bound, except for nickel, which moved more in line with the escalation in the Ukraine crisis. Energy prices also lifted in the month, but a comfortable supply side generally helped to contain any significant movements.

In summary, prices of bulk commodities have been mixed, with cost pressures limiting the downside to coal, while iron ore was weighed down in the second half of the month by softer Chinese economic data and reports of an investigation into bank holdings of the mineral. Industrial metals on the other hand have generally improved on a mix of supply side issues, recent overselling, better US labour market, and expectations for Chinese economic stimulus. Gold prices have been relatively trade bound, but eased slightly on US Fed tapering and as market concerns over the Ukraine took a step back earlier in the month. Oil prices were generally higher due to the escalating crisis in Ukraine but the divergence in natural gas prices between the US, Europe and Asia was largely weather induced.

Summary of Price Developments

Oil

Weekly Crude Inventories at Cushing and Brent-WTI Differential



Source: US EIA

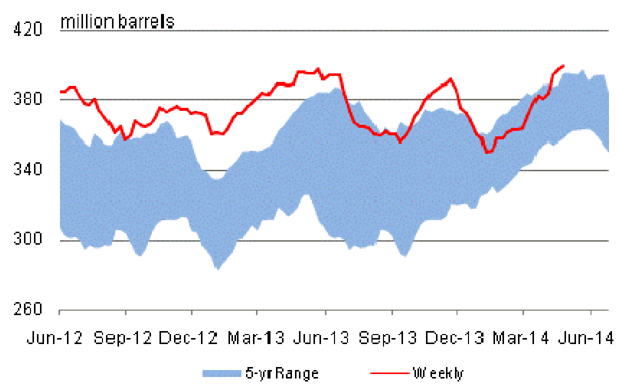
After years of being decoupled from global oil markets and regarded to be a less risk hedging measure than Brent, West Texas Intermediate (WTI) is poised to resume its previous status as a world benchmark as inventories at Cushing eased to the lowest level in more than four years in April. This is largely due to the increased takeaway capacity from the hub to the Texas Gulf Coast via the southern leg of the Keystone XL which came into operation since January. Meanwhile, Canadian-government backed proposed construction of the northern leg of the pipeline, which links oil sands in Alberta, Canada, to the refineries in US's Midwest, was dealt another blow recently. On 18 April, the US government announced that it will once again delay its ruling on the $5.4 billion project, now in its sixth year of review, for an indefinite amount of time or at least past November mid-term elections. This has caused concern to the Canadian government, the pipeline's owner Transcanada Corp and labour backers hoping for rise in construction jobs, but was well-received by environmental activists who voiced concerns over potential further carbon pollution by the project. The announcement has relatively contained effects on WTI prices but more so on Canadian crude prices.

	Avg Price (US$/bbl) Apr-14	Monthly % change Apr-14	Apr-13 - Apr-14 % change
Brent	108	0.1	4.9
WTI	102	1.4	11.0
Tapis	112	-0.7	3.2

Sources: NAB Economics; Thomson Datastream

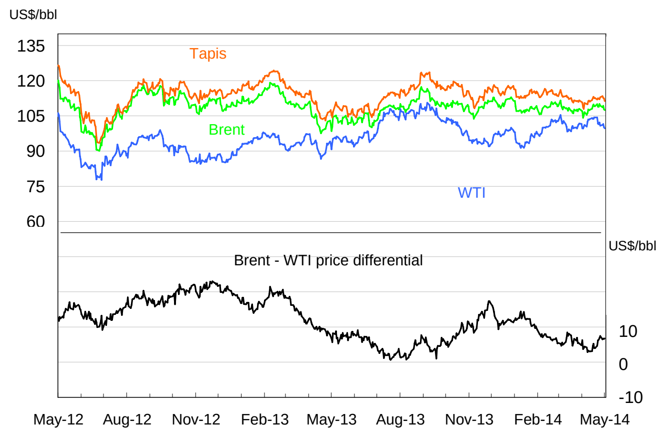
As a reflection of an improvement in underlying oversupply, WTI has risen for eight consecutive weeks to the first week of March, the longest sustained weekly rise in close to five years, and since then has hovered around a new normal of just over US$100/bbl. The index rose by a further 1.5% in April. The WTI's discount to Brent, which is highly correlated with Cushing crude stocks (see above chart), peaked in September 2011 to be just a touch under US$30/bbl to be currently below US$10. Also lending some support to WTI was the stream of positive economic data from the US which showed that recovery is on track. At the start of May, reports of a record level in total commercial crude stocks by the US Energy Information Administration (EIA) took some steam out of WTI but it remains at elevated levels of just below US$100/bbl.

Weekly US Commercial Crude Stocks



Source: EIA

Daily Oil Prices



Source: Thomson Datastream

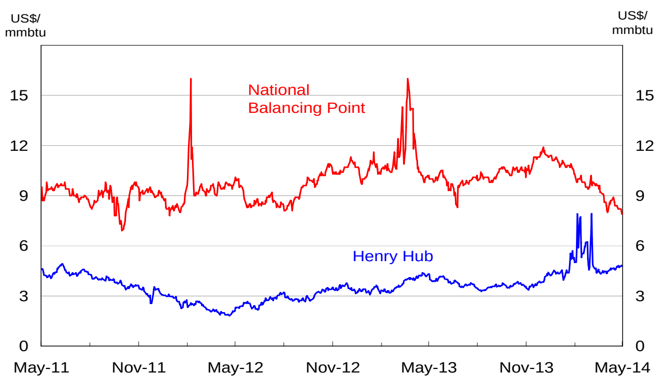
Meanwhile, ongoing tensions between Ukraine and Russia even after the annexation of Crimea, followed by the imposition of a fresh round of sanctions by the US and EU on the Russian government and some of its oligarchs, continued to offer some support to oil indices in the month, especially Brent. However, the new measures by the EU continued to be largely similar in nature as the earlier round, targeting mainly asset freezes and travel bans on a greater number of those in Putin's "circle", while the US suggested that it would now ban high-tech exports to Russia. So far, the delicate balance in the energy landscape in Europe, one that is still highly reliant on Russian exports, has prevented the EU and US from taking more stringent curbs on the Russian financial and energy sectors – those which would do the most serious damage to Russia's economy. It is expected that the political tug-of-war will continue in a moderate fashion but downside risks of an extreme event, such as a major disruption in gas and supplies to parts of Western Europe from Russia via pipelines through Ukraine, cannot be ruled out.

Apart from geopolitical factors, the other dynamics underlying the fundamentals of Brent were not as supportive. Sustained sluggish demand conditions in Europe and softer prospects of Chinese GDP growth, combined with the gradual resumption in Libyan exports, acted as dampening factors on Brent prices. The Libyan government managed to successfully broker a deal with eastern rebel leaders in early April to re-open export terminals—including its largest, Sidra—following an eight-month blockade which had crippled the country's oil export activity. Over this period, Libyan exports fell from 1.4 million barrels per day to be around just 220,000 barrels currently. Iraq's oil production was also reasonably resilient, but exports in March (2.4 mb/d) retreated significantly from their record-high of 2.8 mb/d in February after insurgents sabotaged a northern pipeline running from the Kirkuk oilfields to a port in Turkey.

In our note last month, we expected seasonal factors and mounting US commercial crude stocks to detract from WTI this month after a succession of impressive rallies, even after considering the effects of the Keystone XL pipeline. Its sustained strength so far is slightly surprising, barring minor corrections recently as the effects of high crude stocks finally kicked in. A possible explanation could be a recovery in confidence by global investors in the index after the glut problem in Cushing is perceived to have been resolved in a sustainable manner. This suggests that a level above US$100/bbl would be more of a norm than an aberration going forward, underpinned further by the persistent volatility in the Black Sea region. We have revised our near-term forecasts of WTI upwards, while keeping those of Brent largely unchanged. The broad-tenor of our medium-term outlook of gradual convergence between the two indices remains intact.

Natural Gas

Henry Hub and National Balancing Point Prices



Sources: NAB: Thomson Reuters

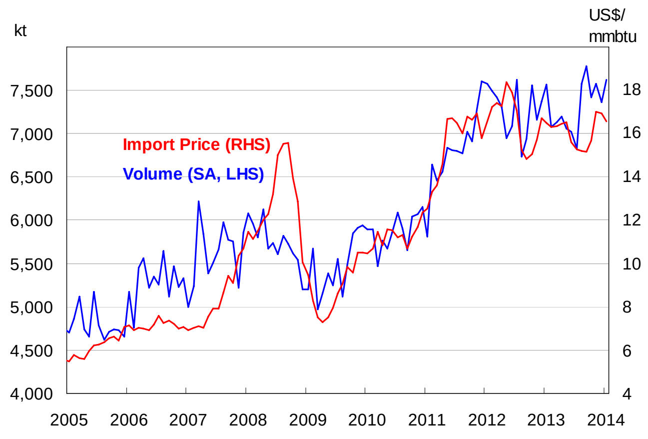
After extreme weather-related volatility in the first quarter of this year, US natural gas prices indicated by the Henry Hub index have eased substantially on the back of more moderate conditions. However, lingering cold from a punishing winter season has kept heating demand up for the spring season to date, and buoyed natural gas prices in April to be 11% higher than the same time last year to be around a monthly average of US$4.60/mmBtu. In April, the first net injections into underground gas storage were recorded after 20 consecutive weekly withdrawals from November to the end of March, with the ones in January and February occurring at record rates. This period of unprecedented rate in withdrawals resulted in the US working gas in storage to be reduced to their lowest levels in 11 years. So far the injections in April were too small to have any significant impact.

In contrast, six months of warmer-than-usual weather in Europe continued to exert downward pressures on European natural gas prices in the longest losing streak in five years. At the start of May, UK gas prices represented by the National Balancing Point (NBP) NBP fell to below US$8/MmBtu, its lowest levels since late 2011, from low heating demand and plentiful stored supplies. UK gas demand fell 21% from a year earlier to 6.2 billion cubic meters in April as temperatures were 1 degree Celsius above the seasonal norm, according to National Grid Plc and WSI data compiled by Bloomberg.

The current low level of spot gas prices, set against the potential for future supply disruption from the ongoing Ukrainian crisis, has resulted in the widening of the future premium for gas. For contracts for delivery six months from October, the premium to spot is above 10 pence a therm ($16.84/mmBtu), making the storage of heating fuel an attractive option. As a result, there had been heavier than normal injections to European countries' inventories, with EU storage reported to be currently more than 50% filled, a seasonal high since at least 2007. Meanwhile UK inventories lifted strongly over the month to be more than 60% of storage capacity. So far Russian gas flow transiting through Ukraine, which accounts for around 16% of total EU demand, remains uninterrupted. However, in the event of a disruption, the current storage levels are reported to be able to withstand a cut of more than one and half months, thereby allaying fears of extreme supply and price shocks.

In Asia, spot LNG prices continued to cool off from the historical levels reached in February before summer demand picks up, according to the latest Platts Japan/Korea Marker (JKM) for month-ahead delivery. Most major Asian and South American buyers appeared to have fulfilled their requirements through term contracts, leaving residual demand for spot cargoes thin. Spot prices for May cargoes traded around US$15.60 compared to US$18/MmBtu for April, according to the Platts JKM series. In a bid to improve the transparency around LNG imports, Japan's Ministry of Economy, Trade and Industry released its inaugural survey of the average of all contract-based (or arrival-based) prices of spot-LNG in Japan, revealing the March average to be USD 18.3/Mmbtu. the implicit per unit price based on Japan's aggregate LNG imports for the same month was around USD 16.50/Mmbtu. Japan currently accounts for around one-third of spot LNG demand in the world, which in turn represents 27% of global LNG trade.

Japan's LNG Imports and Prices



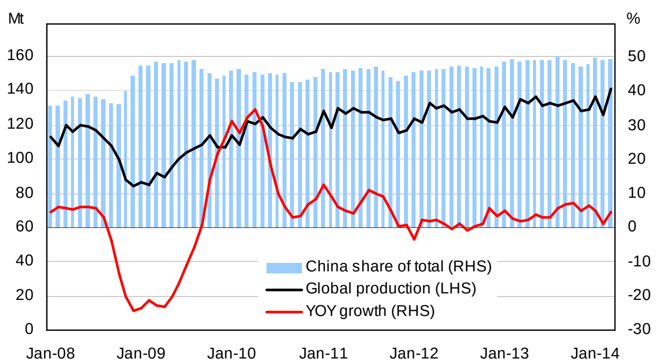
Source: CEIC, NAB Economics

Historically, LNG contracts were almost traded exclusively under oil-linked long-term contracts, but there had been a significant rise in the share of LNG traded spot or on contracts of less than four years in the last few years. Asian buyers, responsible for about three-quarters of global LNG demand, are increasingly demanding more flexible contracts and lower prices. Progressively, utility companies from major consumer countries are looking to consolidate their bargaining power by forming a buyers group. For example, Indian state-run gas supplier GAIL (India) Ltd recently signed an initial pact with Japan's Chubu Electric Power Co. to explore the possibility of jointly procuring LNG. While in the short-term this is unlikely to yield much benefit due to the few major producers in the market, supply competition is only going to increase overtime when exports from Australia and the US pick up substantially in the medium term. The Bureau of Resources and Energy Economics forecast Australian LNG export volumes to increase at an average annual rate of 22 per cent to reach 79 million tonnes 2018–19 up from 24 million tonnes in 2012–13.

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.

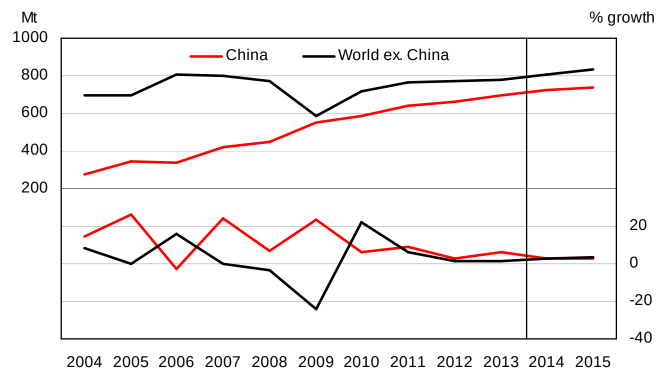
According to CISA, more than 45% of steel makers recorded losses in the first quarter of 2014 – totalling RMB 2.33 billion. Financing for the steel industry has become increasingly challenging over the past few years, with tightening credit requirements from the banking sector, and more recent attempts 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

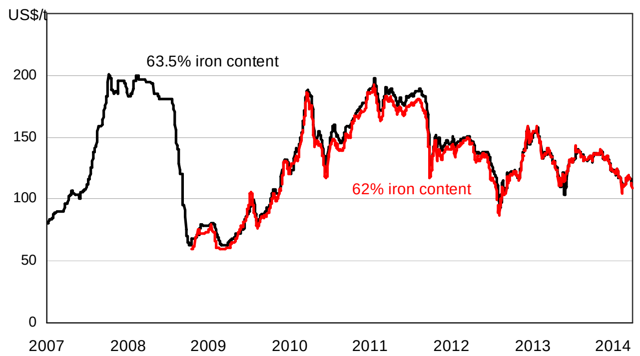
Iron Ore

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.

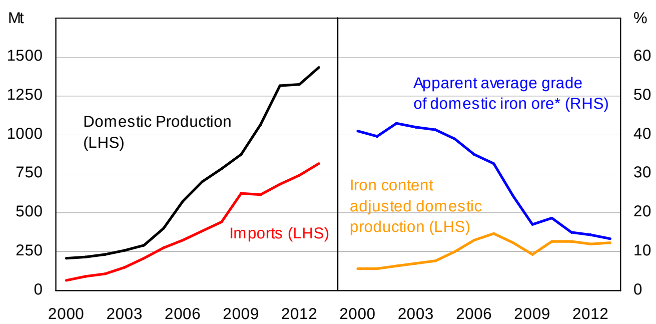
Iron ore prices have trended down since December 2013



* 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

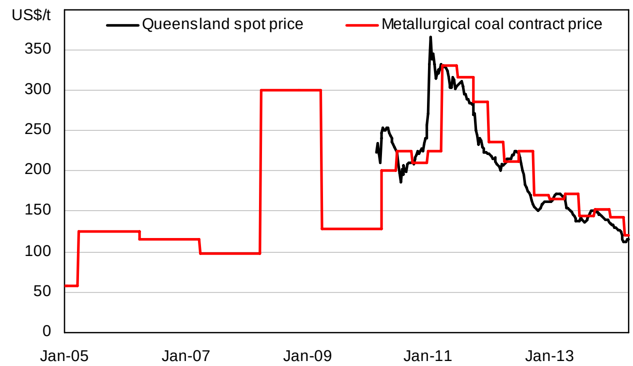
Global seaborne iron ore supply is expected to increase significantly in 2014 and 2015 – with the bulk of new capacity in Western Australia. Bloomberg estimate an increase of around 104 million tonnes (or around 8% of trade in 2013) – as projects from BHP Billiton, Rio Tinto and Fortescue come online. 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.

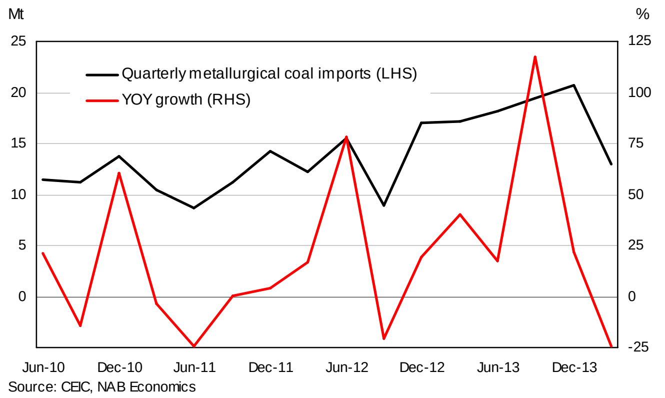
Lower prices are likely to have a significant impact on producers. Wood Mackenzie estimate that around 55% of global production is unprofitable at the newly settled contract price – compared with around 12% at first quarter contract prices.

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 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.

Chinese metallurgical coal imports weak in Q1



Source: CEIC, NAB Economics

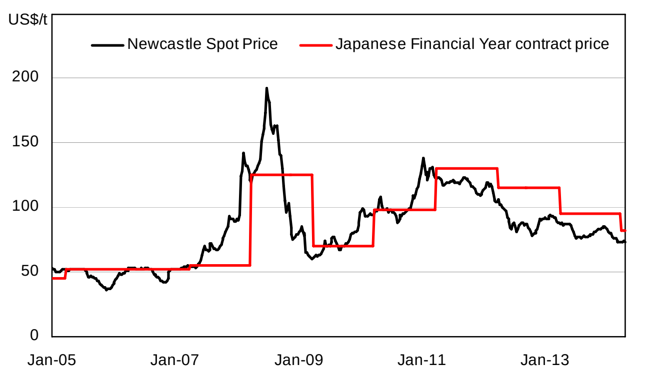
This may indicate a rundown in metallurgical coal stocks at steel mills and ports, and potential for stronger demand in coming months. A recovery in demand from China should allow prices to increase from current unprofitable lows, however the scale of idle production capacity will limit upside price 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.

Base Metals

Base Metals Prices*

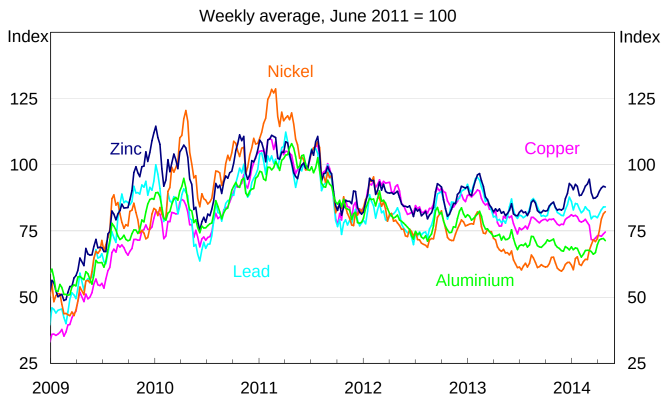
	Avg Price (US$/tonne) Apr-14	Monthly % change Apr-14	Apr-13 - Apr-14 % change
Aluminium	1812	6.3	-3
Copper	6673	0.3	-8
Lead	2090	1.8	3
Nickel	17419	11.1	11
Zinc	2029	1.1	9
Base Metals Index		4.1	0

* Prices on an LME cash basis.

Sources: LME; NAB

Once again, nickel has been the star performer over the past month, with prices continuing to rise on the back of supply concerns. The Indonesian export ban has remained steadfast and ongoing geopolitical tensions cloud the outlook for Russian mineral supplies. The remainder of the metals complex has been somewhat mixed, although all have rallied to some extent over the past month. Talk of a pending interest rate hike in the US has been watered down over the past month, helping to partly offset some of the market volatility stemming from other factors, including geopolitical tensions. Targeted stimulus measures announced in China have also helped buoy the market, although details of the size and timing of any spending measures are limited. The US Fed stepped up their QE tapering again at the latest meeting, but this was widely expected and had a limited impact on markets. Most metals prices eased in the lead up to the meeting and softened a little more following the decision – although a softer than expected China PMI contributed. However, most metal prices lifted following the strong US labour data, partly offset by negative news on the Ukraine that rekindled some interest in safe haven assets.

Base Metals Prices



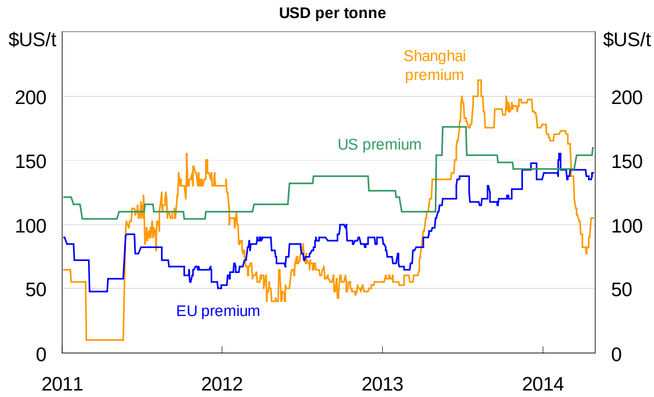
Sources: NAB; Thomson Reuters

In aggregate, base metals prices on the London Metal Exchange (LME) have risen by nearly 4% in April, following a modest decline in March, to be broadly flat over the year. Prices have been restrained over the past year due to tepid physical demand conditions. Demand look set to improve in advanced economies this year, but there is still significant uncertainty surrounding emerging markets – a major user of industrial metals.

Price rises were recorded across all of the base metals in April, but the strength of price gains varied significantly. After nickel (up over 10% in April), aluminium prices recorded the next biggest gain for the month, rising almost 7%, also largely driven by supply factors. Aluminium premiums remain elevated with (hefty) warehouse stocks remaining largely tied up in financing deals – a situation that may persist for longer given the overturning of new LME offloading requirements. Average copper prices underperformed, but still posted a modest gain in the month (but down 8% over the year), while zinc and lead showed slightly more moderate gains.

On the demand side, the Chinese economy is showing further signs of shifting down a gear, with GDP growth slowing along with a raft of partial indicators in recent months. Timely PMI indicators of manufacturing activity remain quite soft (although stable), and construction growth has also slowed. As mentioned above, there have been reports of potential stimulus measures in China, but information is mixed and there is little evidence of a stimulus getting underway in the near-term. Nevertheless, Chinese imports of copper and aluminium remain at reasonably elevated levels, although falling from recent peaks. Strong imports and production of refined copper in China suggest that apparent demand may be holding up. Certainly, it appears as though seasonal demand (and official stockpiling) contributed to the recent rally in copper prices; reports suggest that China's Sovereign Reserve Bureau may have purchased up to 500Kt of refined copper so far in 2014. In the US, Q1 GDP numbers were below market expectations and confirmed the weather affected slowdown, but more recent economic indicators are suggesting some improvement towards the end of the quarter, while the local auto market has been a relative bright spot for the metals outlook this year.

Copper premiums turn up again in Shanghai



Sources: Bloomberg Industries

There continues to be a significant volume of copper stocks tied up in financing deals at Chinese bonded warehouses, keeping physical markets tight and helping to lift Shanghai premiums from their recent trough. There is still a risk that CNY depreciation might trigger renewed pressures on copper from an unwinding of marginal financing deals (as seen during March), but we still consider a dramatic unravelling to be unlikely. Premiums outside of China remain very elevated and may eventually prompt higher copper exports from China. Subdued end-user demand is expected to persist for the time being, limiting any significant price gains for copper and aluminium in particular, although the later may see ongoing support from supply uncertainties and optimism on demand stemming from the auto manufacturing sector.

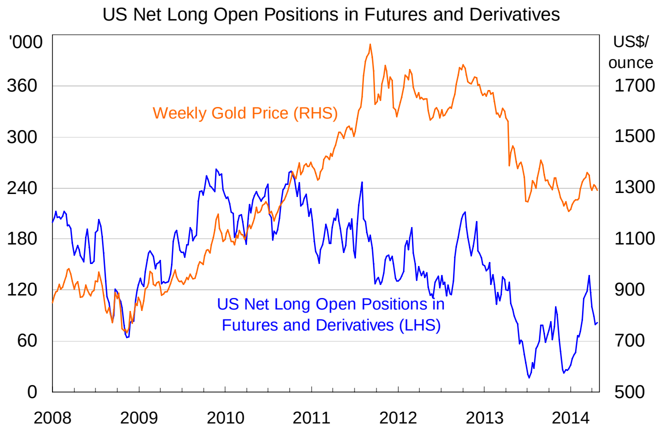
Underlying fundamentals in lead and zinc markets remain somewhat positive relative to the rest of the complex due to limited additions to supply capacity to come. The International Lead & Zinc Study Group (ILZSG) recently projected that rising demand for zinc will outstrip supply by 117,000t this year, larger than the 2013 deficit – suggesting a more positive price outlook. The outlook for nickel prices remains very murky due to Indonesia's export ban, but all indications point to it remaining in place for some time – causing the market to shift into deficit. More significant price rises may be prevented by adequate ore stockpiles, but the risk rises as these become exhausted. By that stage, more producers should have obtained exemption from the export ban.

Gold

Gold prices have fluctuated over the past month, but have generally eased off as demand for 'safe haven' assets pared back in response to (initially) easing tensions in the Ukraine and signs that the US economy was improving late in Q1 (although prices jumped again – over 1½% – on Friday due to renewed tensions). We suspected that the rally in gold prices earlier this year was likely to be temporary – maintaining our medium-term expectation for prices to dip below US$1,100 per ounce in 2015 – but the drop over the past month was a little larger and sooner than we anticipated. Nevertheless, spot prices appear to be gaining support above US$1,280 per ounce and are back around US$1,300 per ounce currently. After stabilising early this years, some ETF's are again starting to record net outflows.

Since the end of March, the price of gold has lifted by a modest 0.4% having bottomed at around US$1,281 per ounce in early April – unravelling around half of the rally since the start of the year. Prices have generally fluctuated between US$1,280 and US$1,320 per ounce during the month, failing to exhibit any clear trend, settling around US$1,295 per ounce by months end – prior to some large swings in recent days. In year ended terms, the price of gold in April was more than 12½% below levels recorded in the same month of the previous year.

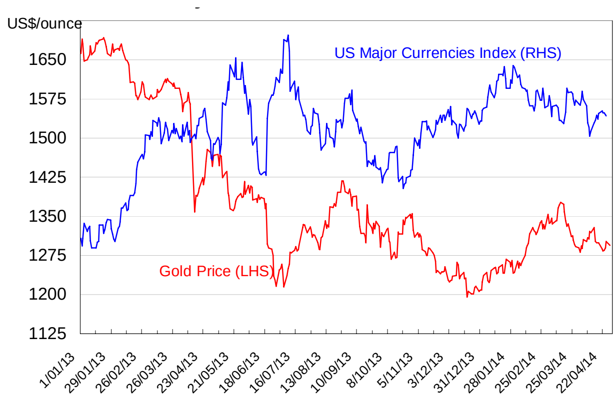
Gold investor positions fluctuating to keep prices range-bound



Sources: Bloomberg; NAB

Gold price declines were minimal following last weeks Fed announcement to taper QE asset purchases by an additional US$10 billion per month, as the statement was largely in line with market expectations – including Fed Chairman Janet Yellen's continued pledge to keep rates very low. The run up in non-commercial net long positions was partly unwound after late March as Ukraine/Russia tensions were put on the back burner. As the US economic recovery gains traction this year, the gold market is likely to submit to more positive growth news as rising US real yields, USD and equity prices weigh on investor demand for gold. With that said, lingering uncertainties over emerging markets and the Ukraine are injecting a high degree of uncertainty over the outlook that could see demand for 'safe haven' assets hold up for longer. Additionally, there is plenty of scope for stronger than expected support from Asian buyers – particularly once India winds back import bans – which could have significant implications for prices.

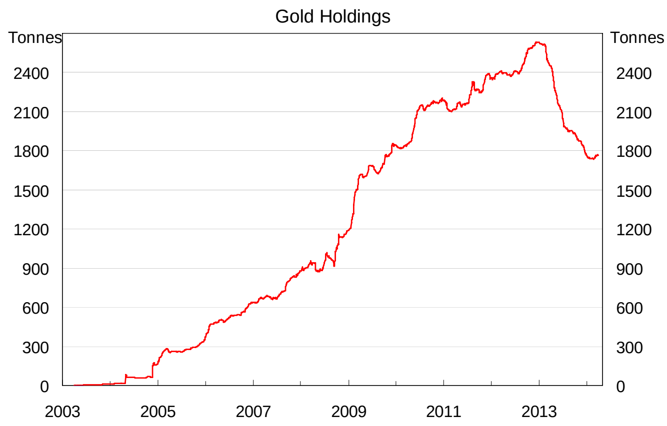
Gold Price and the US Dollar (Daily)



Source: Thomson Datastream

Data on exchange traded gold funds (ETFs) asset holdings 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 in recent months in response to risk-off attitudes in markets – a trend that is likely to be sensitive to positive growth shocks. Similarly, non-commercial net long open positions in futures and derivatives rose sharply early in the year, but have started to come off again more recently.

Exchange Traded Funds*



Sources: Bloomberg; NAB

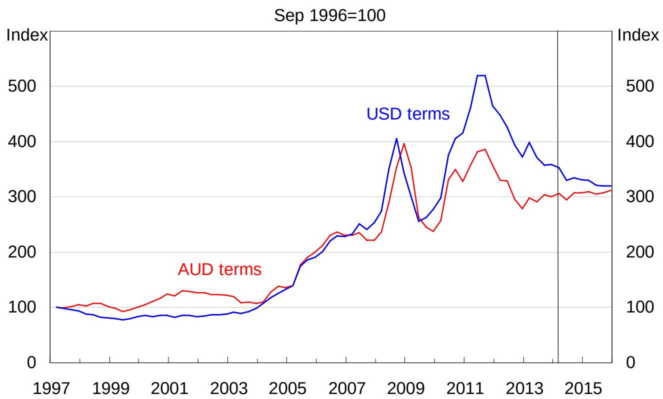
Although we suspected that the improvement in attitudes towards gold since the start of the year was likely to be temporary, the fall in prices since mid-March comes a little sooner and was a little larger than expected. While we remain comfortable with our medium term view of further declines, a correction in prices 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. Gold demand from emerging markets is likely to remain robust, but investor demand for gold as an inflation hedge should be limited so long as inflation expectations remain anchored. Most importantly, our current forecasts for the US continue to have US yields rising from current levels over the coming quarters. But considering other factors, our expectation is for gold prices to be relatively range bound in the near-term, before resuming their downward adjustment.

Outlook

Future developments in the Ukraine crisis will continue to affect market sentiment, despite a limited impact on volatility to date. Even so, signs of improvement in some of the advanced economies more recently have been positive for industrial commodities. Growth in these economies is expected to continue gaining traction over the coming quarters, although the Japan outlook is clouded by the recent consumption tax hike which has seen manufacturing activity plummet following a strong run-up in demand prior to the hike. In the US, this means that the Fed will continue to taper its QE purchases this year and is likely to commence raising interest rates in H2 of 2015 – with potential ramifications for commodity financing arrangements. China's economy on the other hand is throwing up mixed signals, but timely indicators suggest that the economy may have stabilised. Hopes of Chinese stimulus are also helping to buoy the market, although our own assessment is that authorities are likely to withhold significant stimulus spending unless growth threatens to drop below 7%.

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, particularly given signs that Chinese demand growth has reached a plateau. US oil prices have surprised on the upside recently but the growth impetus associated with an alleviated glut situation in Cushing appeared to have been exhausted, while record pace in crude and natural gas production in North America will 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 (trade weighted) commodity prices to ease, but to stay at historically elevated levels.

NAB Non-Rural Commodities Price Index



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 7¾% in 2014, before easing by a further 3¼% 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 2% over the year to December 2014, before another 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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Quarterly Price Profile

Oil Price Forecasts – Quarterly Average

	Spot	Actual	Forecasts							
	2/05/2014	Mar-14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
Brent US$/bbl	107.5	109	107	106	104	104	104	104	104	104
WTI US$/bbl	100.1	95	99	98	97	97	97	97	97	97
Tapis US$/bbl	111.3	114	112	111	109	109	109	109	109	109
Petrol AUc/L*	NA	**150	150	151	151	152	153	154	155	156

Sources: NAB Economics; RACQ; Thomson Datastream

* Denotes 5-capital average **Estimate

Natural Gas Price Forecasts – Quarterly Average

	Spot	Actual	Forecasts							
US$/mmbtu	2/05/2014	Mar-14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
Henry Hub	4.71	5.10	4.50	4.20	4.20	3.90	4.10	3.90	3.90	3.90
Japan LNG	NA	16.75	16.00	15.50	15.50	15.30	15.00	14.50	14.35	14.35
Brent Oil	107.5	109	107	106	104	104	104	104	104	104

Source: Datastream, CEIC, NAB Economics

Bulk Commodities and Coal 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

Base Metals Price Forecasts – Quarterly Average

	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	1743	1710	1800	1810	1860	1900	1920	1930	1930	1930
Copper	6756	7031	6640	6690	6740	6800	6800	6750	6700	6700
Lead	2071	2102	2080	2090	2100	2120	2130	2150	2170	2170
Nickel	18246	14657	17000	16660	16330	16610	16910	17200	17500	17500
Zinc	2042	2027	2010	2030	2050	2090	2130	2170	2220	2220
Base Metals Index	n.a.	270	280	280	280	280	280	280	290	290

Sources: Thomson Reuters; NAB Economics

Gold Price Forecasts – 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$	1294	1292	1300	1300	1300	1230	1120	1060	1060	1060
Gold - AU$	1393	1443	1480	1520	1540	1470	1370	1300	1320	1330

Sources: Thomson Datastream; NAB

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