



Minerals & Energy Commodities Update

by NAB Group Economics

June 2014

Key Points:

- *The relative price stability that characterised oil, in particular Brent, in the first half of 2014 has been shaken of late by unexpectedly severe sectarian turmoil in Iraq. However, with Iraqi exports largely unaffected, prices have now eased somewhat.*
- *European gas prices have continued to fall despite continuing tensions in Ukraine as inventories remain buoyant after a mild European winter. US gas prices have remained largely stable as inventories rebuild after a harsh US winter.*
- *Prices for bulk commodities were far less volatile in June than recent months. Iron ore recovered some ground (from a 21 month low), while metallurgical coal tracked sideways and thermal coal eased. Bulk commodity markets remain well supplied, with little prospect for strong price recoveries.*
- *Average prices across the base metals complex were mixed in the month, with nickel and copper giving back some of their gains (although both rallied late in the month). Tight physical supplies are supporting metals prices, while some recent positive economic data, particularly on China's industrial sector, is fuelling slightly better optimism about the demand outlook. Aluminium and zinc posted the largest gains for the month.*
- *Gold prices rallied strongly over the month of June, supported by a variety of factors. Escalating political tensions in Iraq triggered demand for safe haven assets, while ECB easing and comments from the US Fed – which weighed on the USD – further contributed to investor demand for the metal. Signals for physical demand were relatively mixed, but the recent relaxation of Indian import restrictions has helped to lower domestic premiums and should lift official import volumes.*



Economic overview

- Movements in commodity markets remained relatively mixed in June, resulting from geopolitical tensions in Iraq, a stabilising Chinese economy and varied US economic data.
- Despite the easing property market, China's economy appears to be stabilising. The preliminary flash and final HSBC-Markit PMIs expanded to a seven and six month high respectively. Conversely, real estate investment indicators appear to be softening. According to the RBA, residential construction accounts for approximately 14% of China's crude steel output. Slowing construction will impact domestic steel demand, with potential flow on effects on Australian commodity demand.
- The US Fed Reserve tapered for the fifth consecutive month, despite revisions in economic data pointing to a GDP contraction larger than previously published for Q1 (-2.9% as opposed to the -1% initially estimated). The US manufacturing sector eased marginally but remains solid, with the ISM PMI easing to 55.3 in June (from 55.4). On a brighter note, the residential real-estate market looks to be rebounding. Sales of new homes reached their highest for a number of years, supported by still low interest rates and a recovering job market. Business investment is also strengthening.
- Geopolitical tensions flared in Iraq, OPEC's second largest oil producer, as a military group seized the country's largest northern city, Mosul. Supply uncertainty appears to be factored in as oil prices eased on the back of increased supplies from Saudi Arabia and Nigeria. In contrast, gold rallied as investors increased their appetite for safe haven assets.
- Financial market volatility remained relatively muted, as VIX (dubbed 'fear index') hit a seven year low, driving a global search for yield. The lower VIX is supported by loose central bank policy.
- The direction of commodity markets varied in June. Bulk commodities - iron ore and metallurgical coal – stabilised, while thermal coal edged marginally downwards. Base metals (particularly copper, aluminium and nickel) closed higher on tighter supplies and an improved US and Chinese manufacturing sector. Geopolitical tensions have had mixed flow on effects on commodities. For oil, rising political turmoil in Iraq has been offset by increased output by Saudi Arabia and Nigeria. Meanwhile, investors flocked to gold, causing the price to increase. This was also supported by quantitative easing and the Fed's comments on interest rate policy.

Figure 1: China official PMI at a six month high

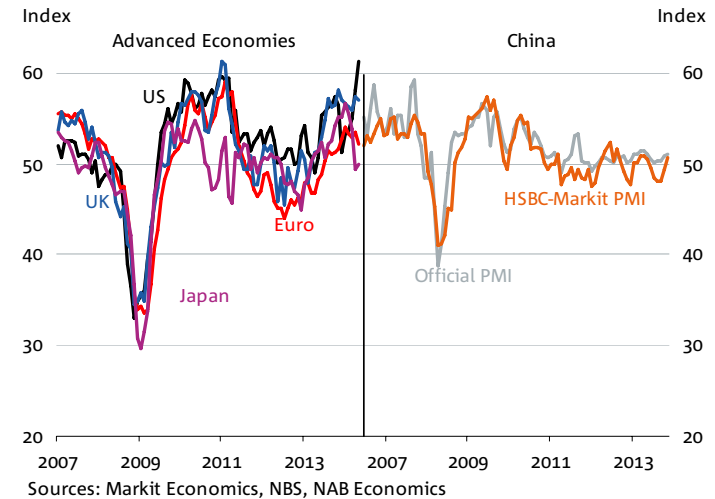
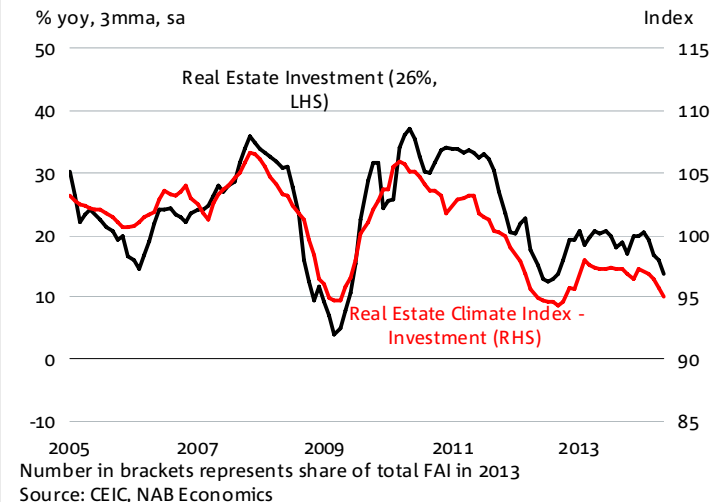


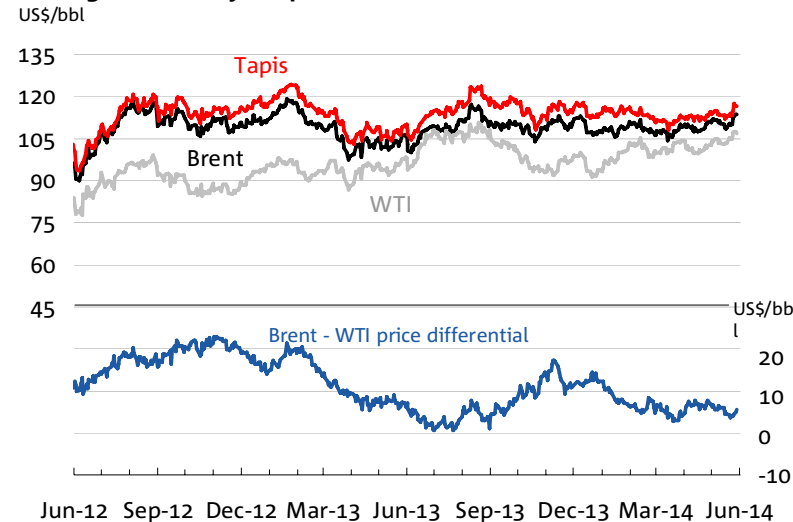
Figure 2: Chinese real estate investment indicators



Global oil prices

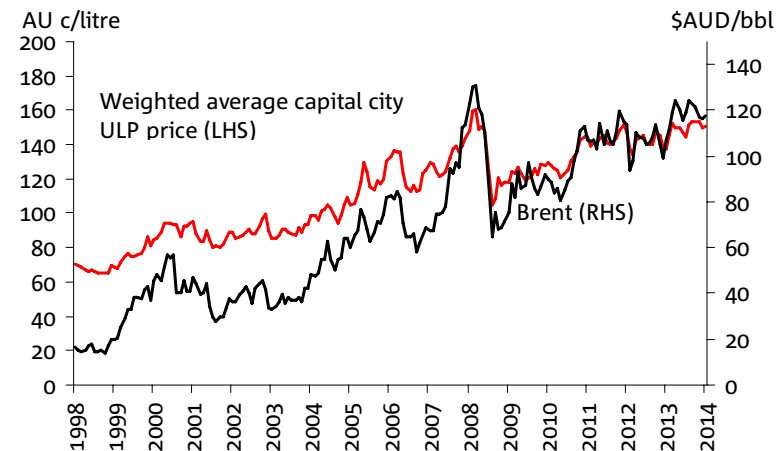
- Brent and Tapis enjoyed relative stability over May, increasing moderately on the back of lower than expected non-OPEC production and improved expectations of future economic growth. Prices remained in a relatively narrow band of US\$4.34 over the month, continuing a trend established in late 2013.
- Prices spiked on 10 June, when a rapid deterioration of the security situation in Iraq shocked investors and saw Brent increase 4% over a week and break through \$115 per barrel by 19 June. Prices have eased somewhat as most Iraqi production is located away from the fighting and does not appear to be under imminent threat.
- The opening of the southern section of the Keystone XL pipeline in January 2014 increased the takeaway capacity to refineries on the Texas coast. This saw the price differential between Brent and WTI decline 22% in the March quarter as inventories at Cushing, Oklahoma continued to fall. The price differential has stabilised somewhat in the June quarter, hovering just below \$7/bbl on average.
- Australian retail fuel prices declined over the year as the AUD appreciated against the USD. The weighted average capital city ULP price was 150.5 c/litre in May, down 2% since February. However, prices are up 10% compared to the same time last year.
- *For further details on oil, please read our in-depth note released this month.*

Figure 3: Daily oil prices



Source: Thomson Datastream

Figure 4: Retail fuel prices



Source: RACQ, US Energy Information Administration

Global gas prices

- US gas prices remained stable in May and June, as US inventories continued to rebuild after an unusually harsh winter. The benchmark Henry Hub spot price remained range-bound between US\$4.35 and US\$4.83/mmbtu and stood at US\$4.42 at the beginning of July. European prices continued their fall which began in December 2013 as inventories reached very high levels following the mildest European winter in seven years. The benchmark National Balancing Point spot price stood at US\$6.60/mmbtu at the beginning of July.
- On 16 June, Russia cut natural gas supply to Ukraine. The proximate cause of the disconnection was a dispute over an unpaid debt, claimed by Russian supplier Gazprom to amount to almost US\$4.5 billion. However, the disconnection is part of a much larger geopolitical crisis over the future direction of the country.
- Ukrainian pipelines carry around 15 per cent of the European Union's gas supplies. While Russian gas continues to flow to Europe through Ukraine, a further escalation in tensions could threaten these supplies. In late June, Gazprom threatened to cut supplies to European countries that send Russian gas back to Ukraine. The immediate risk of this threat to supplies is mitigated by high European inventories (70% as of 29 June) and the high cost to Gazprom of breaking lucrative European contracts.
- Japanese nuclear reactors remain idle for the duration of the northern summer, the first time in four decades that nuclear will be absent from Japan's summer generation mix. This will place a greater burden on gas-fired generation and is likely to keep LNG imports buoyant for the time being. The Japanese Government and nuclear industry are proceeding with plans to restart reactors, but it is not yet known if and when reactors will come back online.

Figure 5: Daily gas spot price

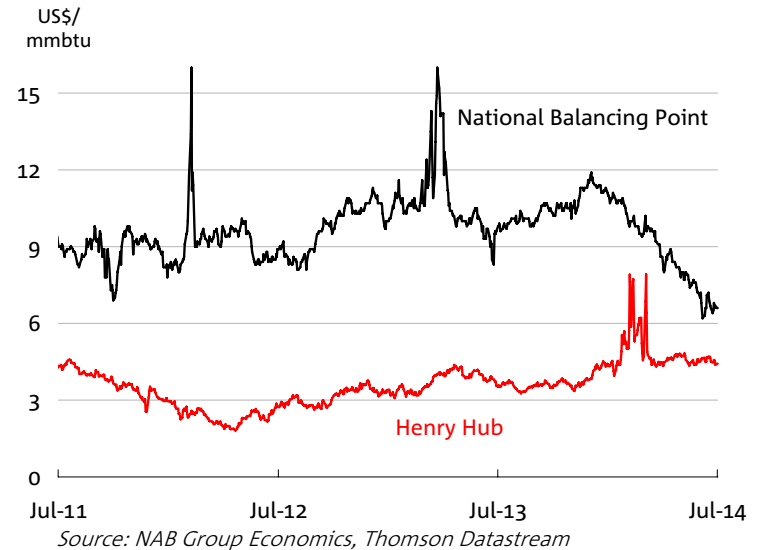
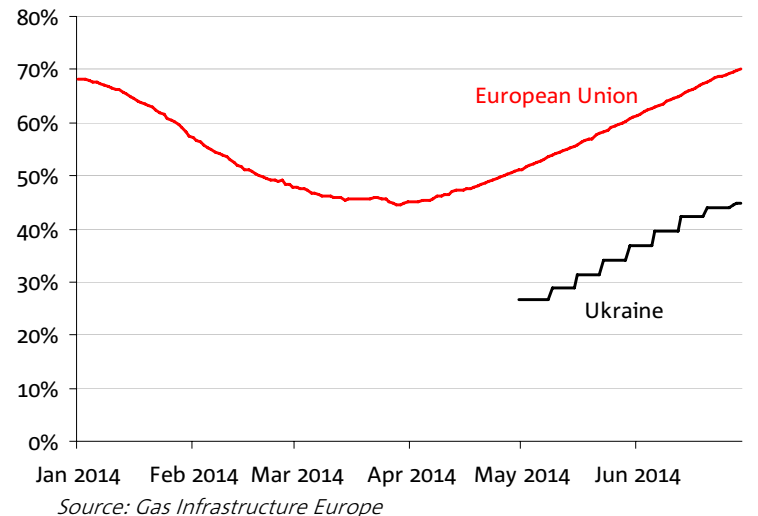


Figure 6: European Union and Ukraine natural gas storage



Global steel market

- In the first five months of 2014, global steel production grew by 3.5% year-on-year to total 682 million tonnes (World Steel). China's production continues to grow – with output increasing by 4.9% yoy over the period, to 340 million tonnes (just under half of the global total) – highlighting that efforts to tighten regulations (financial and environmental) and cut production capacity have so far had little impact on output.
- Conditions in China's steel industry appear to be improving – albeit modestly. Year-to-date losses for China Iron and Steel Association members have fallen from RMB 2.8 billion in February to RMB 1.1 billion in April (indicative of modest profits in March and April) – while the share of firms making losses has fallen to 38% (from 48% in February).
- The improved profitability largely reflects lower costs for raw materials, with domestic steel prices remaining weak. Debt levels (and the risk of default) remain high – with the average debt ratio for large producers around 70%.

Figure 8: China's steel price still weak, but profitability is higher on weaker input prices

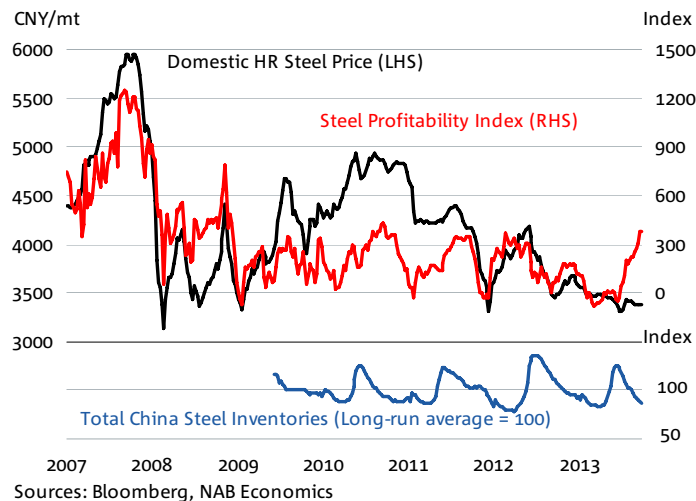


Figure 7: Growth in China's steel production still outpaces the rest of the world

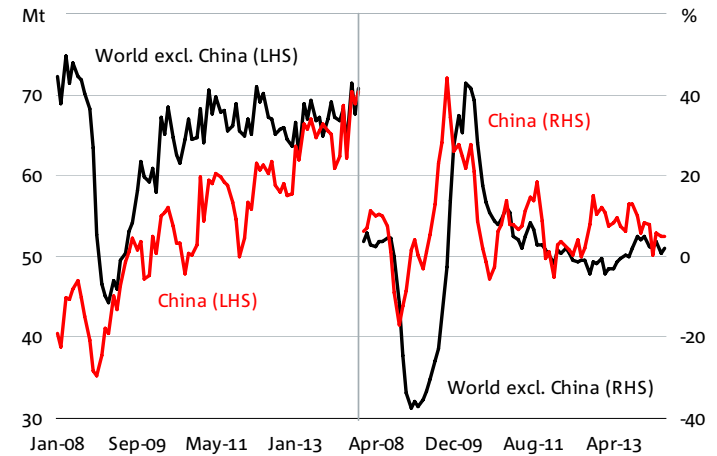
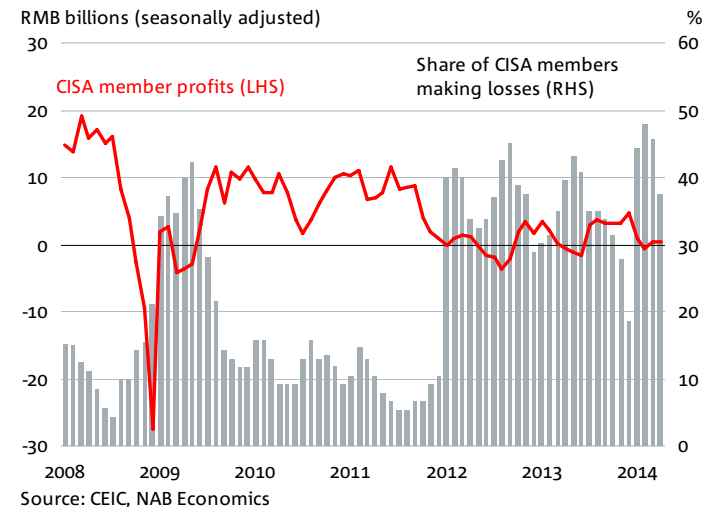


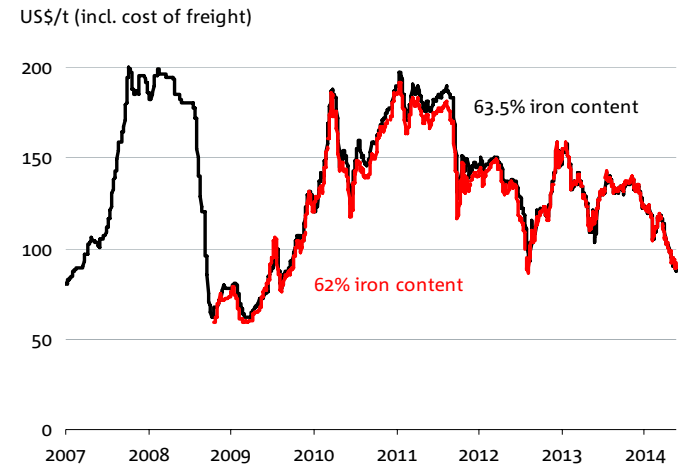
Figure 9: Share of loss making firms in China's steel sector fell in April, as profitability edged up



Iron ore

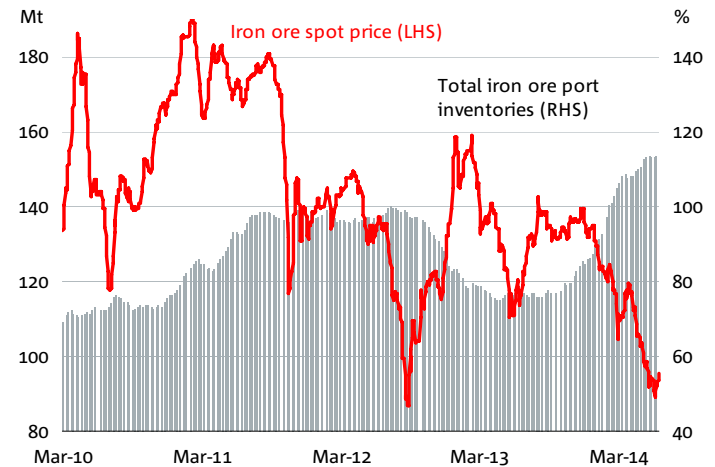
- Spot prices exhibited less volatility in June than they did in May – trading in a narrow range across the month – in contrast to a persistent downward trend since late 2013. In late June, prices for 62% fines edged back above US\$95 a tonne (having fallen as low as US\$89 a tonne)
- Unlike other bulk commodities, imports of iron ore into China have remained strong – increasing by almost 19% in the first five months of the year to 383 million tonnes.
- The strong level of exports have seen stockpiles at Chinese ports rise to record levels – at almost 114 million tonnes – albeit the level has remained fairly stable in June. MySteel Research had previously estimated that around 40% of stocks were connected to shadow banking-related financing deals, however a more recent estimate by Bank of America-Merrill Lynch suggests steel mills control 70% of current stocks.
- Reuters report that some Chinese steel mills are selling future iron ore cargoes (delivered under long term contracts) and purchasing material currently at ports – for which the prices are lower. This trend may have supported the recent (albeit modest) recovery in spot prices.
- Lower prices are likely impacting the viability of Chinese ore producers – with estimates that around 80% of Chinese iron ore mines have cash costs at between US\$80 and US\$90 a tonne (MySteel).
- Our forecasts for iron ore prices are unchanged – our hybrid price consists of a weighted combination of spot and contract prices – however the recent weakness in spot prices highlights downside risk. We expect iron ore at around US\$100 at the end of 2014 and down to US\$95 a tonne at the end of 2015.

Figure 10: Iron ore prices appear more stable in June



Source: Bloomberg, Thomson Datastream, NAB Economics

Figure 11: Chinese port stockpiles remain at record highs but growth slower in June



Source: Bloomberg, Steelhome, NAB Economics

Metallurgical coal

- Spot prices for metallurgical coal were relatively stable in early June – having trended around US\$115 a tonne from the second half of April onwards. Markets appear better balanced at the present time, with producers cutting production globally in response to weak apparent consumption.
- According to Bloomberg, producers have cut around 17 million tonnes of capacity (or 5% of total seaborne trade) since the second quarter contract settlement. Some producers are attempting to renegotiate existing take-or-pay contracts with infrastructure providers as well as contracts with mining services firms to reduce their cost profiles.
- Reducing costs is critical for producers – Wood Mackenzie estimate that around 55% of global metallurgical coal production is unprofitable at the current contract price.
- Apparent consumption in China has remained subdued – with imports totalling 25 million tonnes (down around 17% yoy) – despite strong growth in both steel production and iron ore imports over the same period.
- Given weak price trends in recent months, we expect that quarterly contracts will be settled lower for Q3, and we are revising down our price profile. Prices are forecast to edge higher by the end of 2014 to around US\$125 a tonne, and to rise solidly to US\$150 by the end of 2015.

Figure 12: Spot prices stabilised in June, but at low levels

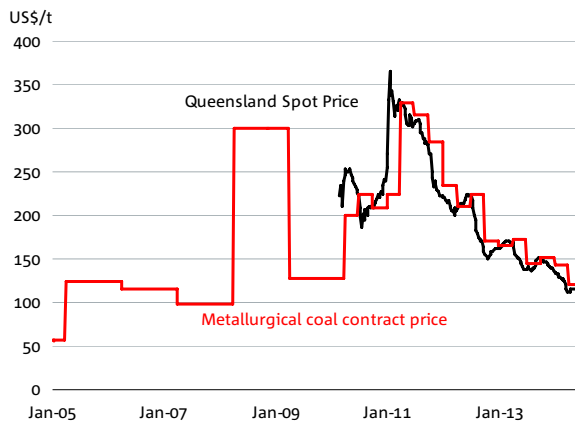


Figure 13: Chinese metallurgical coal imports pick up in April and May, but weak in yoy terms

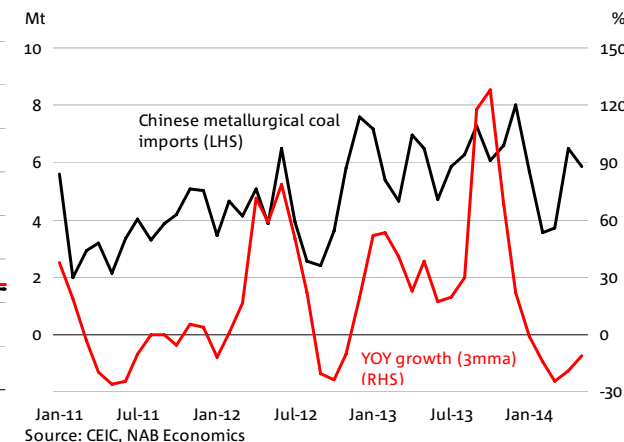
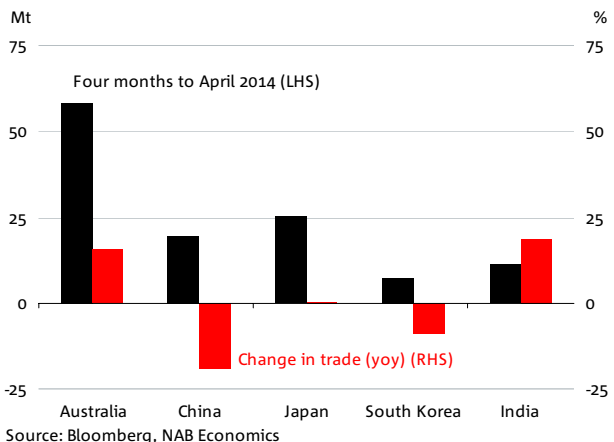


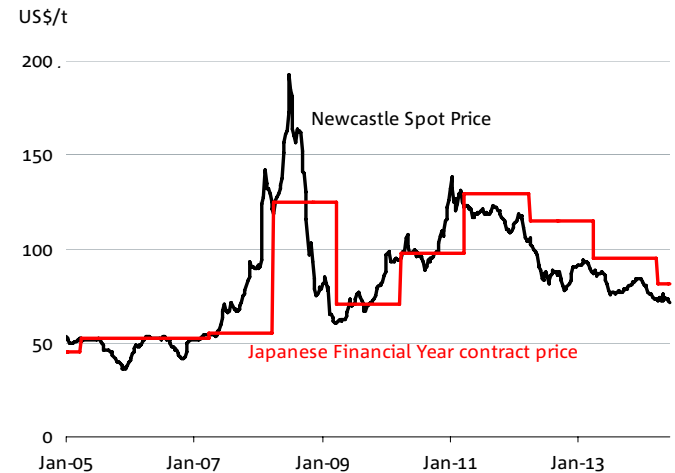
Figure 14: Balance of trade shift – Aus exports rise, but imports lower in most of Asia



Thermal coal

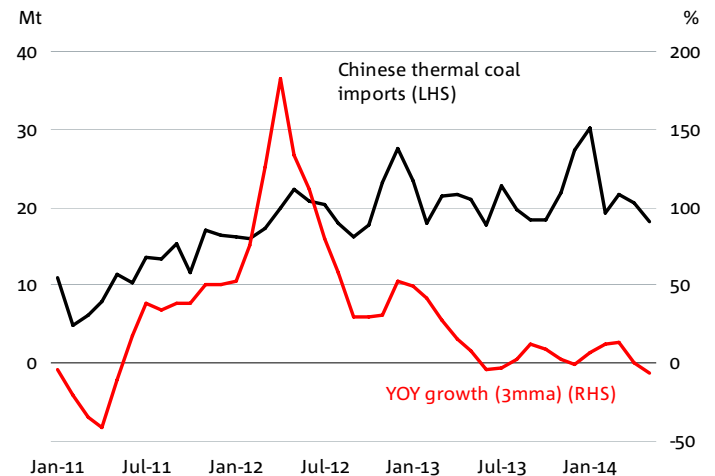
- Spot prices for thermal coal edged marginally lower in June – with prices at the port of Newcastle at around US\$71.45 a tonne mid month (from US\$72.95 at the end of May).
- Market conditions continue to signal a well supplied market. In the first four months of 2014, Australian exports rose by 10.3% yoy, to 62.3 million tonnes – despite reports of production cuts at higher cost mines. In contrast, imports over the same period grew more modestly in key importers such as China (up by 4.1%) and Japan (7.2%).
- Profitability for global producers has become more challenging – Morgan Stanley estimate around a quarter of producers are unprofitable at current spot prices. Reports suggest that some miners are attempting to renegotiate the take-or-pay contracts with infrastructure providers, that so far have reduced the supply response.
- Reflecting adequate supplies and comparatively soft demand, we expect prices to remain range bound in the short term.

Figure 15: Thermal coal prices marginally lower in June



Source: McCloskey's, BREE, NAB Economics

Figure 16: China's thermal coal imports trending lower in recent months

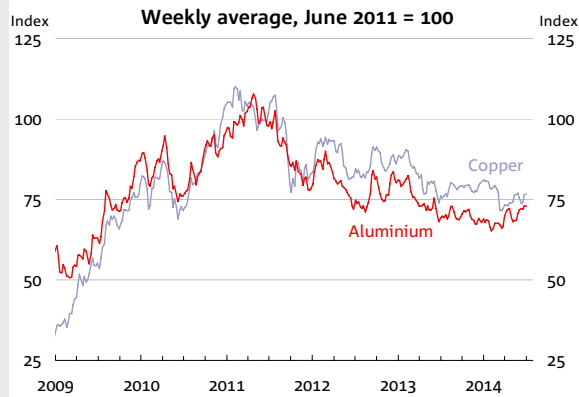


Source: CEIC, NAB Economics

Base Metals: Copper

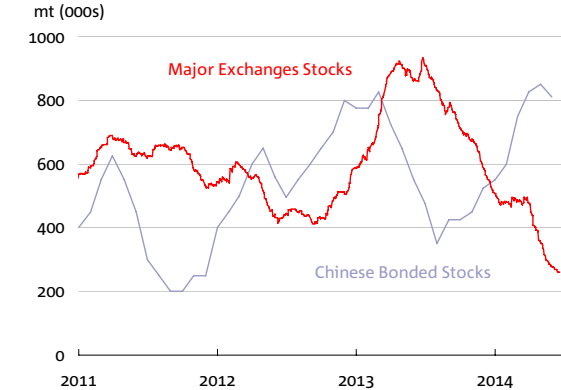
- Average copper prices eased 1.2% in June, to be around 3% lower over the year. However, spot prices rallied in the second half of the month on improved housing data in the US, signs of stabilisation in the Chinese economy and a softening USD; the spot price is up nearly 1% from end-May.
- Global copper exchange stocks are low, suggesting a tighter spot market, but slower refined production may be contributing more than demand (although new production is anticipated in H2). Estimates also show significant volumes continue to be held off exchange and tied up in financing deals, although bonded stocks declined for the first time in May (Figure 18). Market concerns over how these stock will re-enter the market are a source of volatility. Movements following the recent probe into metal financing highlight this, with Chinese copper imports falling heavily in May. However, we maintain the view that the shift in volumes will be gradual.
- Premiums remain elevated in some markets, but have eased significantly in Shanghai – even with reports of longer customs processing times at Chinese ports.
- New production capacity is expected to come on line during H2 that will exert some downward pressure on copper prices. However a stabilising Chinese economy, continued recovery in the US and tied-up bonded stocks will keep spot supplies tight and prices close to current levels. A disruptive unwinding of financing deals is a risk, but remains unlikely.

Figure 17: Copper & Aluminium Price (LME)



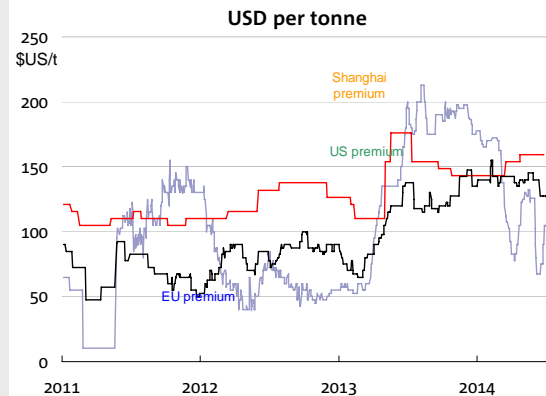
Sources: NAB; Thomson Reuters

Figure 18: Chinese Copper Bonded Stocks



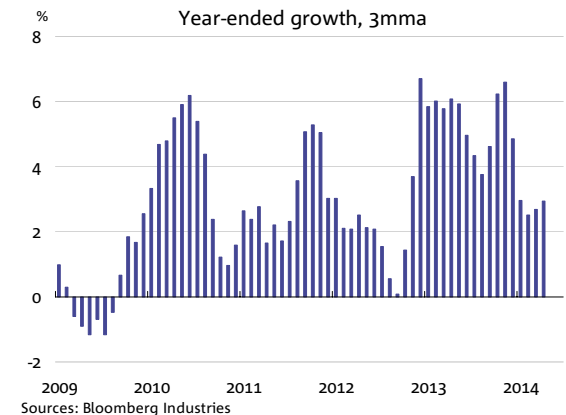
Source: Bloomberg, NAB

Figure 19: Copper Premiums



Sources: Bloomberg Industries

Figure 20: Refined copper production

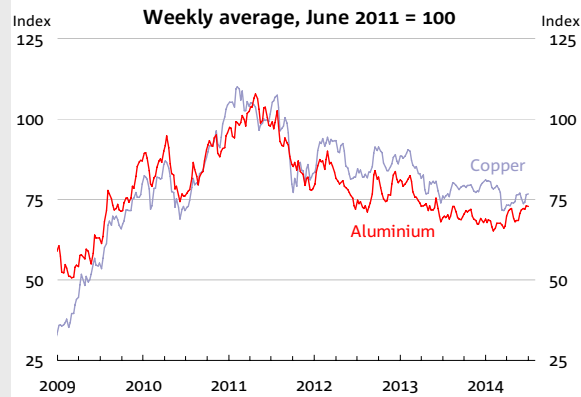


Sources: Bloomberg Industries

Base Metals: Aluminium

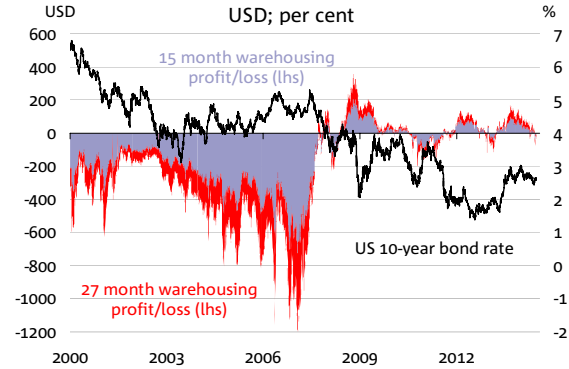
- Average aluminium prices rose 5% in June, to be around 1% higher over the year. Spot prices started to ease in late June, but remain nearly 2½% above end-May levels. Nevertheless, elevated inventories may limit any price rally in the near-term, although large volumes are still inaccessible.
- Exchange inventories of aluminium remain elevated due to overcapacity, volumes locked into financing deals and backlogs at warehouses. However, with US interest rates up from their previous lows and contango easing slightly, aluminium warehousing incentives are slowly being eroded, which could help to alleviate tightness in spot markets. However, the US Fed continues to emphasise its intentions to keep interest rates lower for longer, suggesting financing deals will remain.
- Consequently, tight physical supplies have seen premiums rise, again reaching record highs in some markets. Tightness in physical markets, higher bauxite prices and some improvement in demand is expected to see aluminium prices lift in the medium-term, although the recent hike in Japan's consumption tax could hinder demand from domestic auto producers.
- Chinese production capacity curtailments to address overcapacity are expected, but reports of restarts and new capacity have been more than offsetting. Around 3Mtpa of curtailments to global capacity is estimated by end-September, but around 5Mtpa of new capacity is expected this year; global primary production growth has remained steady.

Figure 21: Copper & Aluminium Price (LME)



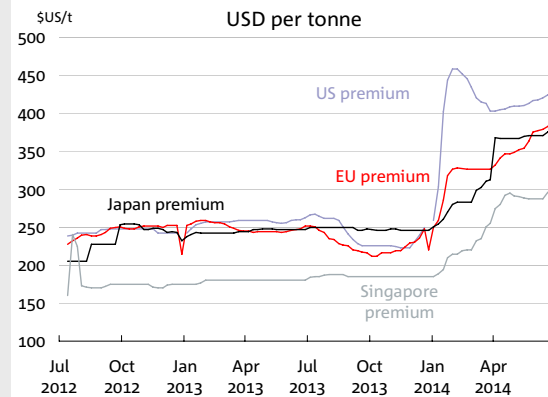
Sources: NAB; Thomson Reuters

Figure 22: Aluminium Warehouse Incentives



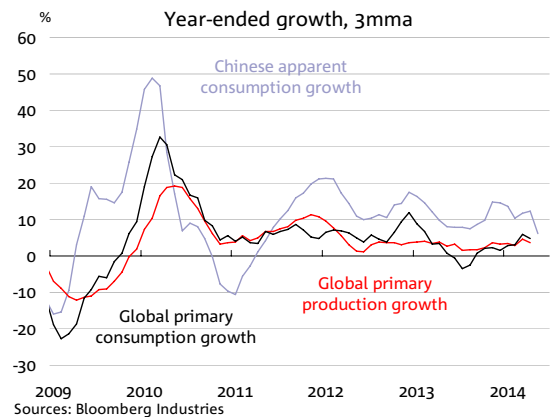
Sources: Bloomberg Industries; NAB

Figure 23: Aluminium Premiums



Sources: Bloomberg Industries

Figure 24: Aluminium Production & Consumption



Sources: Bloomberg Industries

Base Metals: Nickel, Lead, Zinc

- Nickel market fundamentals have been overshadowed this year by the ore export ban in Indonesia, which has seen spot prices surge by more than a third since the start of the year. Higher nickel pig iron prices have made refined metal more attractive to stainless steel producers. However, softer fundamentals – particularly the elevated levels of refined nickel stocks in China – are capping further price rises and could potentially see prices ease further ; spot prices have already eased 10% from May’s peak. Chinese producers are now also starting to source more nickel ore and concentrate from producers other than Indonesia (such as the Philippines). Average nickel prices recorded their first monthly decline in June, dropping almost 4%, but still up almost a third over the year.
- The outlook for the nickel market remains quite uncertain, and the upcoming Indonesian elections (scheduled for July 9) are yet another factor that could potentially impact the current mining law. Nevertheless, the recent correction to prices – in light of elevated global nickel stocks – suggests further potential for lower prices in the near-to-medium term. This is particularly true if Indonesia review their export policy in the near future.
- Lead and prices have remained range bound over the past month, with average prices up just 0.4% in June. Zinc prices on the other hand are up more than 3% on average for the month, reflecting expectations of a supply deficit and declining inventories. The closure of old mines and better demand – along with improving conditions for steel producers – is helping to drive these trends.

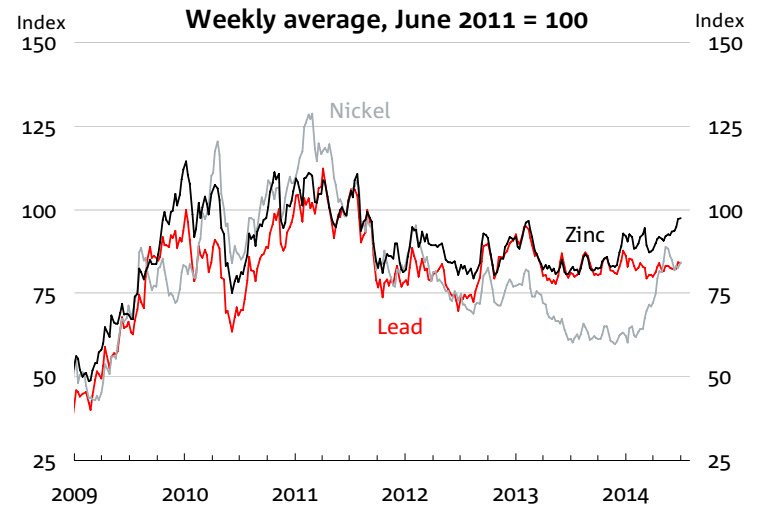
Table 1: Base Metal Prices*

	Avg Price (US\$/tonne)	Monthly % change	Jun-13 - Jun-14
	Jun-14	Jun-14	% change
Aluminium	1838	4.9	1
Copper	6810	-1.2	-3
Lead	2105	0.4	0
Nickel	18612	-3.9	30
Zinc	2124	3.1	15
Base Metals Index		-0.6	8

* Prices on an LME cash basis.

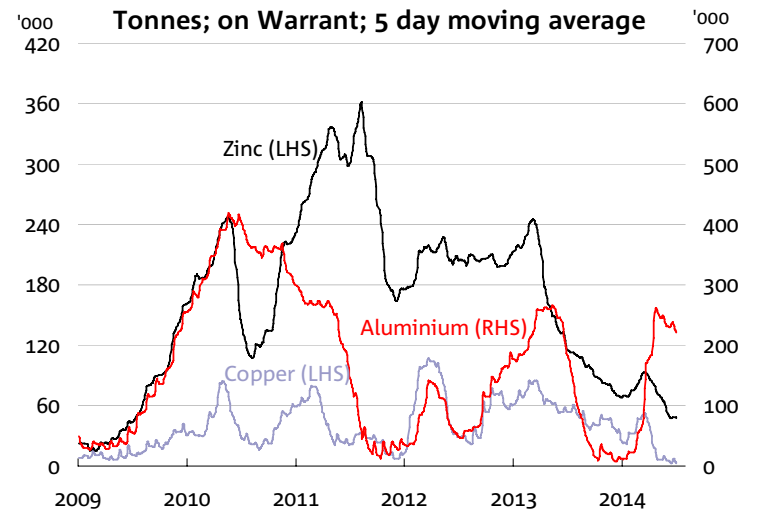
Sources: LME; NAB

Figure 25: Nickel, Lead, Zinc Prices (LME)



Sources: NAB; Thomson Reuters

Figure 26: SHFE Stocks on Warrant



Sources: Bloomberg; NAB

Gold Market

- Political tensions, ECB easing and a softer USD contributed to gold price rally this month. The US Fed's comments to keep interest rates low for a 'considerable time' also increased gold's appeal to investors, despite further rallies in global equities. In contrast, low inflation expectations is limiting demand for an inflation hedge. Spot gold prices lifted to just below US\$1,330 per ounce, up more than 6% from end-May.
- Softer than expected Q1 GDP in the US fuelled some concerns over the economic recovery, which along with comments from the US Fed saw the USD weaken against major currencies – raising gold's appeal to investors.
- Accordingly, investor/safe-haven demand has improved. Exchange traded fund (ETF) holdings of gold have now stabilised relative to the sharp fall since last year, while net long positions of gold rose.
- However, a probe into commodity financing in China, which has recently uncovered a number of fraudulent gold transactions, could weigh on China's demand (at least through official channels). Chinese net imports of gold from Hong Kong easing further in May.
- Aside from the risks related to geopolitical tensions, a potential unwinding of India's gold import restrictions poses a significant upside risk. Indian premiums remain high, but have eased since a partial relaxation of import restrictions.
- In the medium term, we continue to expect gold prices to ease to below US\$1,100 per ounce as global interest rates normalise.

Figure 27: Other Gold Demand Factors

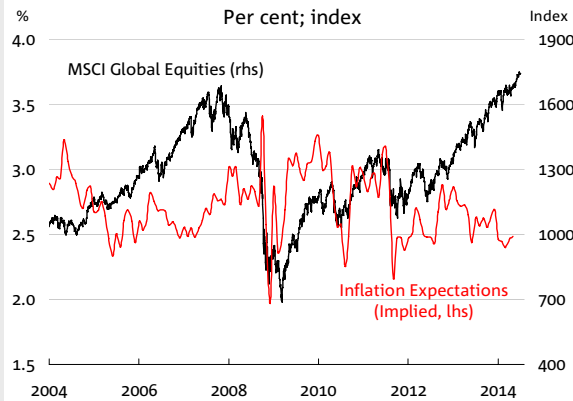


Figure 28: Gold & USD Index

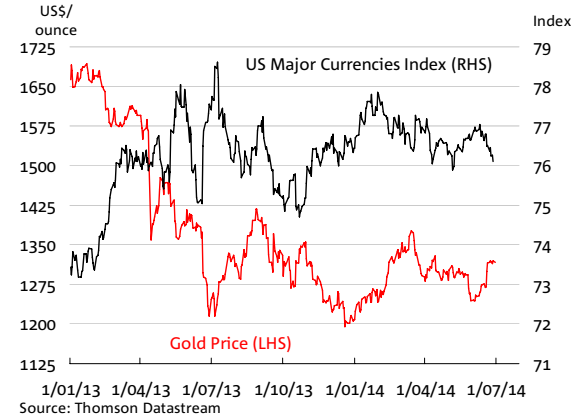


Figure 29: Exchange Traded Fund Holdings

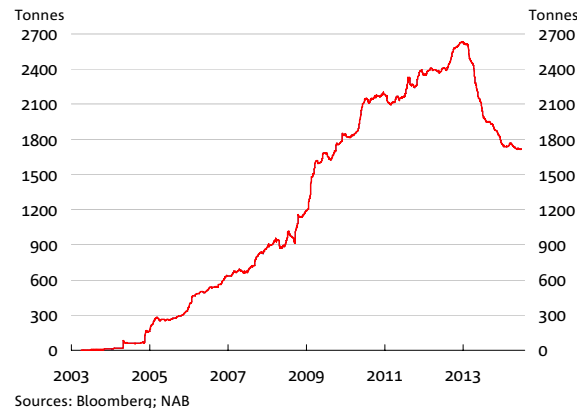
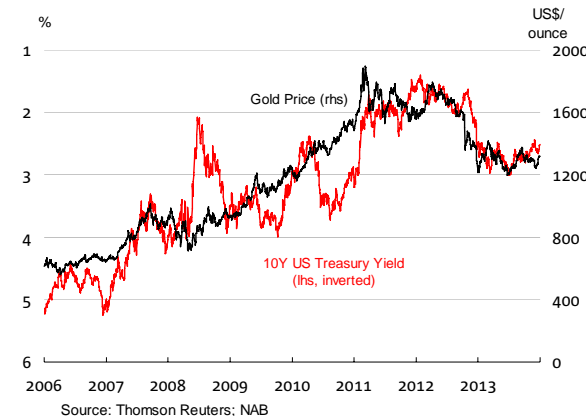


Figure 30: Gold Price & US Treasury Yield

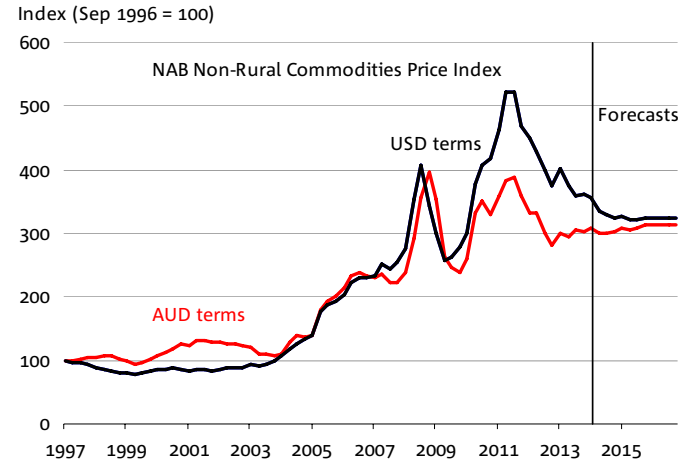


Outlook

- NAB's non-rural commodity price index is expected to fall by around 1.9% quarter-on-quarter in September (in US dollar terms) – following on from a 5.8% decline in June. Weaker prices for iron ore and metallurgical coal – Australia's largest commodity exports – are the main drivers (with the forecast for metallurgical coal lowered this month to reflect the impact of recent weak trends on Q3 contract levels).
- In Australian dollar terms, commodity prices are forecast to track sideways across the remainder of 2014, before edging higher in 2015 (up by around 2%) – largely reflecting the continued softening in the Australian dollar.

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Figure 31: Lower bulk commodity prices lead US index down, before stabilising in 2015



Sources: ABARES, ABS, Bloomberg, Thomson Datastream, NAB Economics

	Unit	Spot	Actual		Forecasts						
		Current	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
WTI oil	US\$/bbl	103	103	103	101	100	100	100	101	102	102
Brent oil	US\$/bbl	110.2	110	111	107	105	105	105	105	105	105
Singapore gasoil	AUc/litre	0.81	0.82	0.79	0.76	0.75	0.76	0.76	0.76	0.76	0.76
Tapis oil	US\$/bbl	113	113	114	111	109	109	109	109	109	109
Gold	US\$/ounce	1245	1290	1310	1300	1220	1120	1060	1060	1060	1060
Iron ore*	US\$/tonne	93	108	105	100	100	95	95	95	95	95
Hard coking coal*	US\$/tonne	n.a.	120	117	125	135	140	145	150	150	150
Semi-soft coal*	US\$/tonne	n.a.	85	83	89	96	100	103	107	107	107
Thermal coal*	US\$/tonne	74	82	82	82	82	80	80	80	80	80
Aluminium	US\$/tonne	1824	1801	1840	1860	1880	1910	1920	1920	1920	1920
Copper	US\$/tonne	6933	6795	6940	7000	7000	7000	6930	6860	6860	6860
Lead	US\$/tonne	2114	2098	2100	2120	2140	2150	2170	2190	2190	2190
Nickel	US\$/tonne	19016	18469	18840	18080	17720	18030	18350	18670	18670	18670
Zinc	US\$/tonne	2096	2072	2200	2200	2200	2200	2200	2240	2240	2240
Henry Hub	US\$/mmbtu	4.59	4.66	4.50	4.20	4.20	3.90	4.10	3.90	3.90	3.90
Japan LNG**	US\$/mmbtu	n.a.	15.50	15.50	15.50	15.50	15.30	15.00	14.50	14.35	14.35

* Data reflect NAB estimates of US\$/ tonne FOB quarterly contract prices (thermal coal is JFY contract). Actual data represent most recent final quarterly contract price.

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