Bulk Commodities Update

by NAB Group Economics

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National Australia Bank

Key Points:

- In 2014, China's official economic growth was 7.4%, the slowest annual rate growth since 1990. From a bulk commodity perspective, slowing levels of fixed asset investment across the year impacted demand for steel and energy.
- Based on adjusted World Steel data, global steel production rose by 3.5% in 2014, to total 1.64 billion tonnes. China remained the key contributor to this growth – increasing by 5.6% to 823 million tonnes.
- China's steel demand is likely to remain weak in 2015 – reflecting the poor conditions in the country's property sector – and steel exports (which rose sharply in the latter half of 2014) are unlikely to be as supportive, with a range of export incentives wound back.
- After a brief recovery in late December, iron ore prices drifted lower again in January – to the lowest levels since May 2009. Recovery in steel output after the Chinese New Year could provide some short term support, however further growth in low cost supply and comparatively weaker steel demand in 2015 should drive prices gradually lower once again – with prices expected to be around US$67 a tonne by year end.
- Prices for metallurgical coal have remained comparatively stable since March 2014 – trading in a range of around US$5 a tonne. Sustained production cuts are expected to support a modest (but limited) recovery in prices – trending up to US$125 a tonne by the end of the year.
- Spot prices for thermal coal have continued to drift lower. In mid January, prices at the port of Newcastle dropped below US$60 a tonne – the lowest level since June 2007 – before recovering. Negotiations for the Japanese financial year contract are likely to be protracted. These contracts typically settle at a premium to prevailing spot prices. For now, our forecast is unchanged at US$72.50 a tonne – however the risks are to the downside.

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Economic overview

- China remains the dominant market for bulk commodities – accounting for around two-thirds of iron ore trade, and around a quarter of thermal and metallurgical coal trade in 2013.

- In 2014, China's official data showed economic growth of 7.4%, the slowest annual rate since 1990. From a bulk commodity perspective, slowing levels of fixed asset investment across the year impacted demand for steel and energy. We expect China's economic growth will ease further – given China's focus on reform – to 7.1% in 2015 and further to 6.9% in 2016.

- In average terms, fixed asset investment growth slowed from around 20% in 2013 to 16% in 2014. In particular, there were noticeable slowdowns in real estate investment (given slowing conditions in the property sector) and manufacturing.

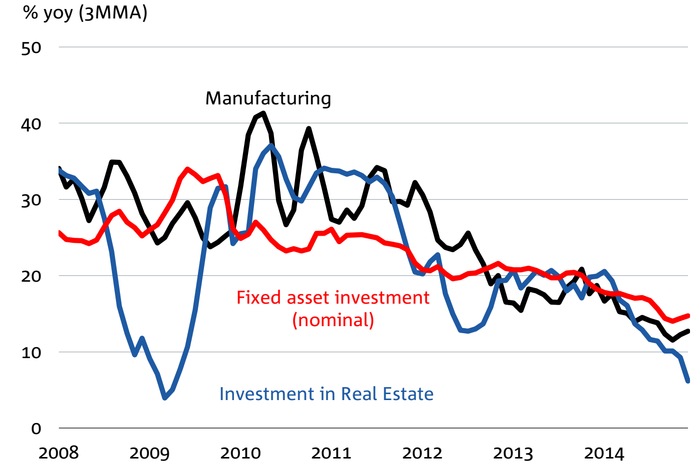
- China's economy continues on its gradual transition, away from a manufacturing hub towards a modern, consumption based economy. One signal of this trend is the increasing share of China's services sector, averaging 48% of GDP in 2014 (up from 47% in 2013). In contrast the share of secondary industries (manufacturing and construction) fell below 43%.

- Outside China, global growth remains sub-trend, with big variations between key economies. The US & UK have grown solidly, but Japan and the Eurozone are major drags on the global economy, while the rest of East Asia and Latin America are also weak. Lower oil prices should have a stimulatory effect for importing nations (but is a negative for many emerging markets).

- Global growth is expected to improve in 2015 – up to 3.4% (from around 3.0% in 2014) – before edging up to 3.6% in 2016.

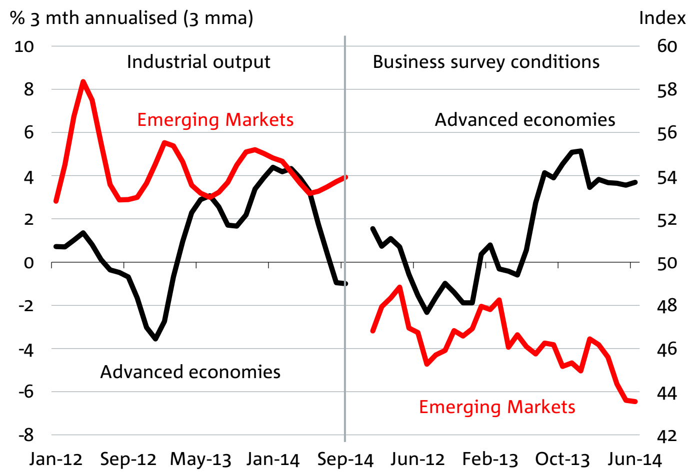
- For more details, see NAB's Global and Australian Forecasts and China Economic Briefing.

China's investment growth slowed across 2014, with key steel consumers like property particularly weak



Source: CEIC, NAB Economics

Global trends still mixed – US and UK stronger among advanced, Eurozone & Japan weak, emerging struggling



Source: CPB, Datastream, NAB Economics

Steel industry

- Based on World Steel data, adjusted for official Chinese output data, global steel production rose by 3.5% in 2014, to total 1.64 billion tonnes. China remained the key contributor to this growth – increasing by 5.6% to 823 million tonnes.

- Outside China, growth was comparatively modest – increasing by 1.4% to total 814 million tonnes. The main contributors to the growth in 2014 were South Korea, India, Russia and the United States. When combined, the top five growth countries accounted for over 96% of the total increase.

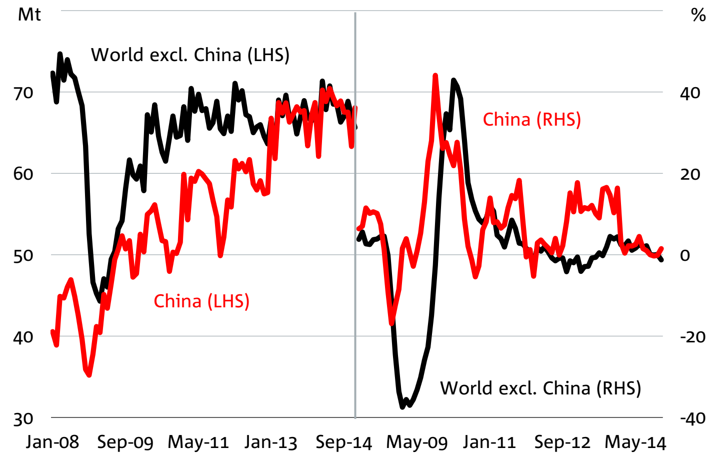
- China's steel production slowed in the latter part of 2014 – particularly ahead of November's APEC summit, held in Beijing. Steel production fell by around 6% month-on-month in November, before rebounding sharply in December.

- The profitability of China's steel sector improved considerably over the second and third quarters of 2014. While domestic steel prices drifted lower, raw material costs fell more rapidly. That said, prices in early 2015 have fallen below RMB 3000 a tonne, despite falling inventories – indicating soft demand conditions (in part related to weakness in the residential property sector).

- According to the China Iron & Steel Association, China's steel consumption fell in 2014 – down 3.4% to 738.3 million tonnes. NAB's estimation of apparent consumption (which includes movements in stockpiles) produces a different result – with growth of 1.5% – albeit this represents a very weak performance when compared with recent years.

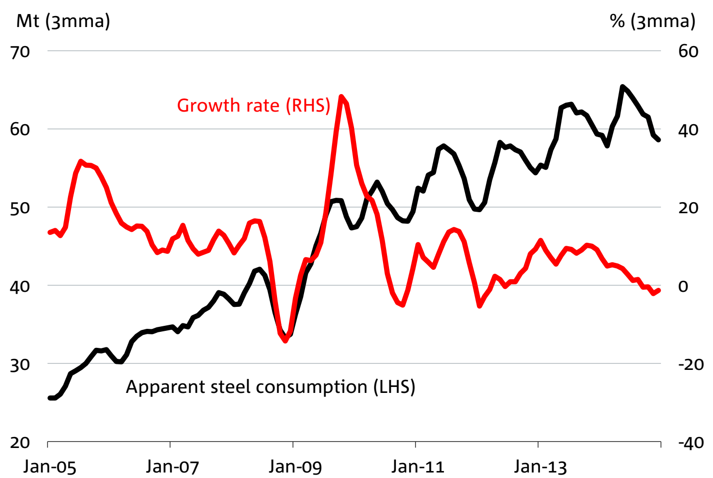
- China's steel demand is likely to remain weak in 2015 – reflecting the poor conditions in the country's property sector – and steel exports (which rose sharply in the latter half of 2014) are unlikely to be as supportive, with a range of export incentives wound back.

China was the key driver of global growth in 2014, accounting for around half of the total output



Source: World Steel, NAB Economics

China's apparent steel consumption slowed in the latter part of 2014, turning negative at the end of the year

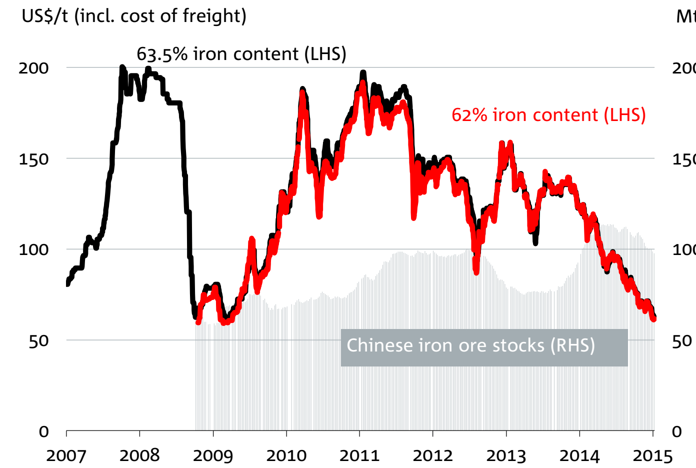


Sources: CEIC, Bloomberg, NAB Economics

Iron ore

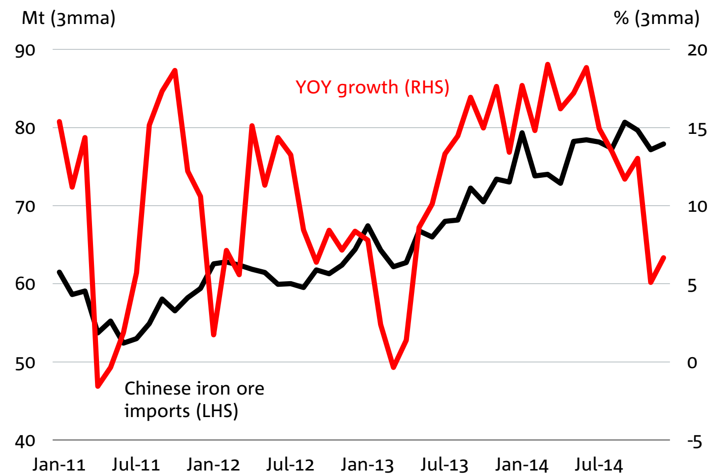
- After a brief recovery in late December, when iron ore prices rose back above US$70 a tonne (for 62% ore at the port of Tianjin), prices drifted lower again in January – down to the low US$60s in early February – the lowest levels since May 2009. Reflecting the declines across 2014, prices in January were around half the level of twelve months ago.
- Falling iron ore prices across 2014 were driven by the rapid increase in global supply – with Australian producers providing the majority of the increase, as higher cost producers were forced out of the market. In the first ten months of the year, global trade expanded by around 102 million tonnes, while Australian exports rose by 119 million tonnes and Brazilian exports by 14 million tonnes. Other producers contracted exports.
- China has remained the key market for iron ore trade – although growth in imports slowed in the latter part of 2014. For the full year, imports totalled 933 million tonnes – an increase of almost 14% – however growth was considerably stronger over the first half of the year. That said, this was exacerbated by a sharp slowdown in November – related to the APEC steel sector shutdowns – with imports rising to an all time high in December.
- The stocks at China's ports have drifted lower across late 2014 – down to around 100 million tonnes at the end of the year, compared with an all time high of 114 million tonnes in early July. That said, compared with recent years, stock levels remain high.
- The viability of ongoing domestic ore production in China remains uncertain. Estimated cash costs, produced by Bloomberg Intelligence in late 2014, suggest that around three-quarters of the country's mines are unprofitable at current spot prices. Producers in China may finally be responding to the price signals – with output in December down 4.2% yoy (and over 9% below the peak level recorded in June 2014).

Spot prices weaker again in January, following on from a minor recovery in late December



Source: Bloomberg, Thomson Datastream, NAB Economics

China's iron ore import growth slowed across the second half of 2014 (following rising stockpiles)

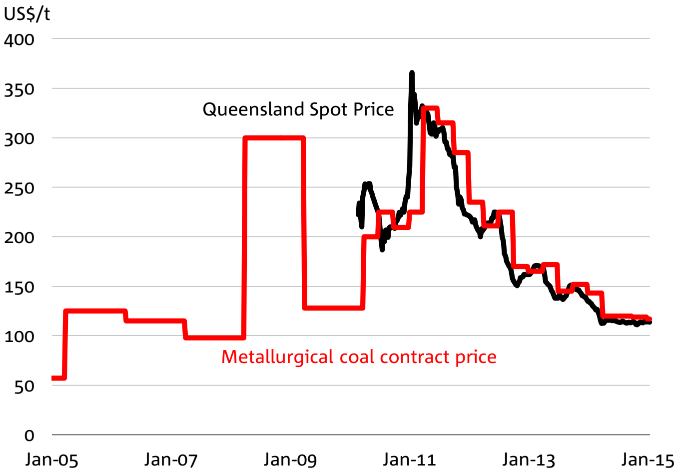


Source: CEIC, NAB Economics

Metallurgical coal

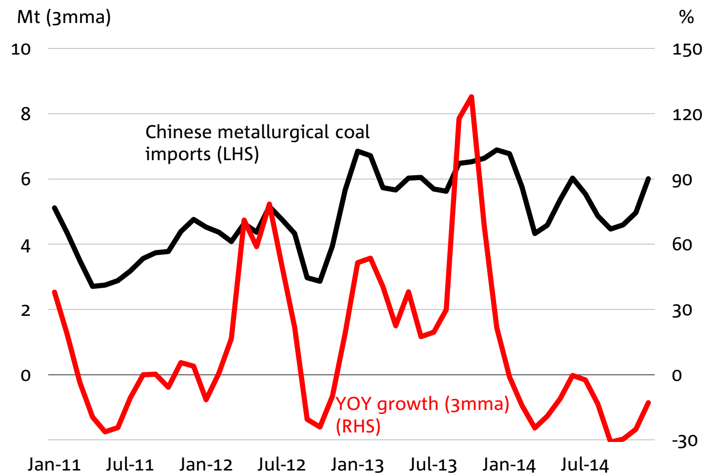
- Prices for metallurgical coal have remained comparatively stable since March 2014 – trading in a range of around US$5 a tonne. In early February, the spot price was around US$113 a tonne (for Queensland hard coking coal).
- Contract prices for the first quarter of 2014 edged marginally lower – down to US$117 a tonne (compared with US$119 a tonne for Q4 2014). Across the second half of the year, contract prices have held up at comparatively high levels – compared with the indicative level suggested by the lower spot price, with consumers likely paying a slight premium to ensure supply.
- The ongoing stability in metallurgical coal prices is evidence of a well balanced market. In response to falling prices across the first half of the year, higher cost producers – the bulk in North America – implemented production cuts. Bloomberg Intelligence estimate that around 20 million tonnes of annual capacity was removed from the market from the start of the second quarter.
- The cutbacks have impacted the balance of global trade. While Australian exports grew strongly in 2014 – contributing to the downward pressure on prices – exports from the United States fell by 5.8% yoy and Canada by 9.7% yoy in the first nine months of the year.
- A key contributor to the softening in prices has been the weak import conditions in China. In 2014 China imported a total of 62 million tonnes, a year-on-year decline of 17%. While the availability of domestic metallurgical coal has improved – due to large scale rail infrastructure projects – domestic producers have struggled for profitability as well.

The metallurgical coal spot price has tracked sideways since March 2014



Source: Energy Publishing, Bloomberg, NAB Economics

Weak Chinese imports have contributed to the soft market conditions



Source: CEIC, NAB Economics

Thermal coal

- Spot prices for thermal coal have continued to drift lower. In mid January, prices at Newcastle dropped below US$60 a tonne – the lowest level since June 2007 – before recovering slightly in February. Chinese domestic prices have remained stronger – meaning that the arbitrage between domestic and imported prices has widened to its largest level since mid-2012.

- Uncertainty around spot prices has impacted negotiations for calendar year contracts between Australian miners and Japanese power companies, which have not been concluded. This suggests that negotiations for the much more important financial year contracts may be drawn out.

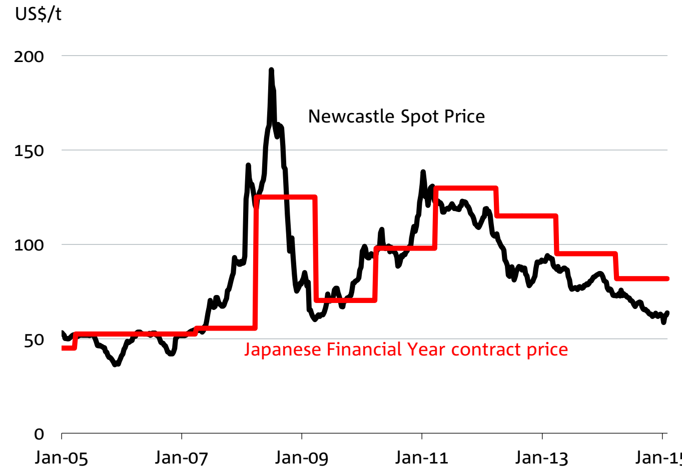
- China's imports of thermal coal slowed considerably in 2014. For the full year, imports totalled 229 million tonnes, around 9% lower than 2013. Lower imports appear to be in line with weaker demand – rather than stronger domestic supply. Data from the China National Coal Association suggests that domestic output was down around 2.1% yoy over the first eleven months of the year – indicating weaker apparent consumption.

- This trend was evident in China's electricity sector. Overall electricity generation rose by 3.2% in 2014 (the slowest rate of growth since 1998), however generation from thermal sources (primarily coal and natural gas, representing around 77% of total generation) fell by 0.4%. In contrast, there was strong growth in hydroelectric (18%) and nuclear generation (19%).

- Outside China, Japanese imports of coal were also weaker in 2014. Total coal imports (comprising both thermal and metallurgical coal) fell by 1.7% last year, to total 188 million tonnes. Japanese demand for thermal coal could fall further in 2015, with plans to restart nuclear generation.

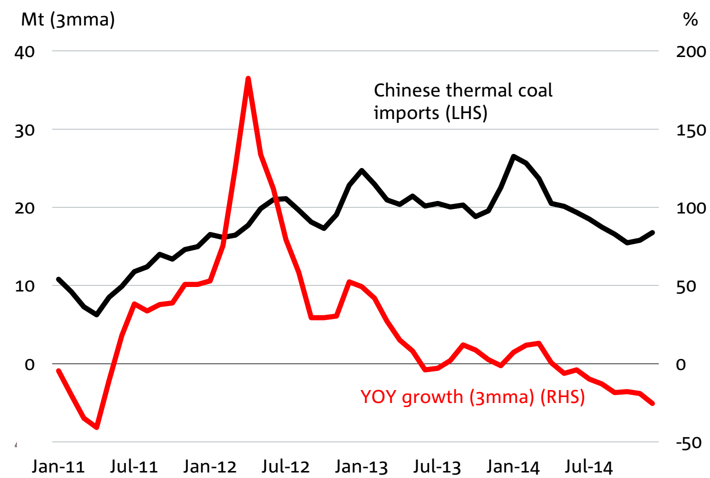
- Profitability has become a growing issue for producers over the past two years – as prices have fallen. According to data from China's National Bureau of Statistics, the country's coal mining industry saw profits fall by 46% in 2014 (having already fallen 38% in 2013).

Spot prices for thermal coal have continued to slide, with the market still oversupplied



Source: McCloskey's, Bloomberg, BREE, NAB Economics

China's thermal coal imports fell away across 2014, on weaker consumption trends



Source: CEIC, NAB Economics

Australian exports

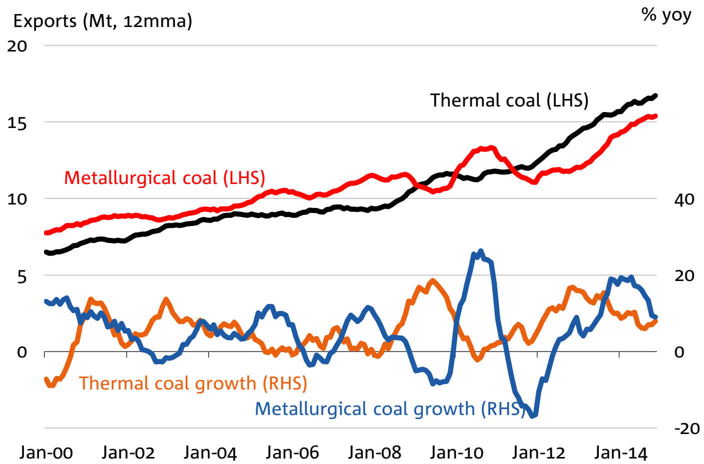
- Long term investment in export infrastructure – at mines, railways and ports – has expanded Australia's capacity to export iron ore and coal. As a result, there has been a significant increase in bulk commodity export volumes over the past two years.

- While producers in North America have cut production, Australian exports of metallurgical coal expanded strongly over 2014. For the full year, exports totalled 186 million tonnes, an increase of 9.5%.

- Compared with the strong growth of 2013, the increase in thermal coal exports in 2014 was relatively modest. That said, exports still grew by 6.5% to 201 million tonnes.

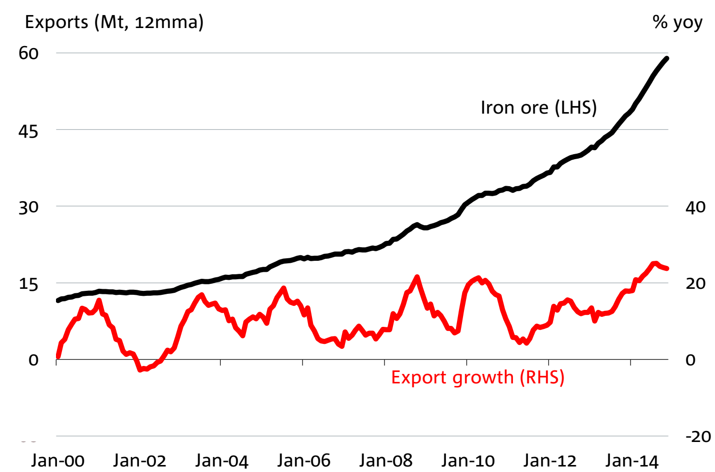
- In contrast, iron ore exports surged across 2014, rising by almost 24% to 717 million tonnes. China was the destination for almost 80% of these exports.

Coal exports grew in 2014, although the rate of growth slowed as price pressures increased



Sources: Bloomberg, NAB Economics

Iron ore majors rapidly expanded Australia's iron exports in 2014



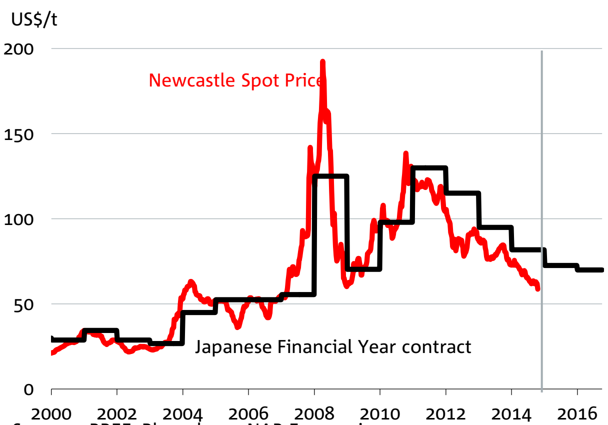
Sources: Bloomberg, NAB Economics

Price outlook

- After plunging to seven year lows, there has been a minor rally in spot thermal coal prices in early February. Negotiations for the Japanese financial year contract are likely to be protracted. These contracts typically settle at a premium to prevailing spot prices, meaning that for now our forecast is unchanged at US$72.50 a tonne – however the risks are weighted to the downside.
- Sustained production cuts (reflecting the poor profitability conditions for producers that could drive out higher cost mines) are expected to support a modest (but limited) recovery in metallurgical coal prices. Prices are expected to trend marginally higher across 2015, to US$125 a tonne by the end of the year.
- Short term conditions for iron ore are likely to remain subdued – with weaker demand from China's steel producers ahead of Chinese New Year. Reflecting the recent weakness in spot prices (and continued Chinese domestic production), we've revised down our price forecast. A recovery in steel output after the Chinese New Year could provide some short term support, however further growth in low cost supply and comparatively weaker steel demand in 2015 should drive prices gradually lower once again – with prices expected to be around US$67 a tonne by year end.

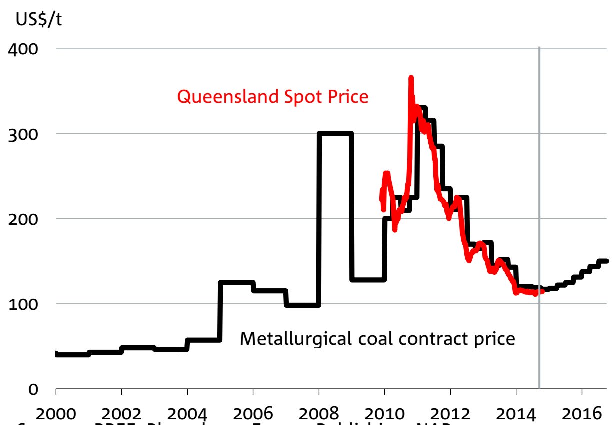
		Spot	Actual	*Forecasts*							
	Unit	Current	Dec-14	*Mar-15*	*Jun-15*	*Sep-15*	*Dec-15*	*Mar-16*	*Jun-16*	*Sep-16*	*Dec-16*
Iron ore (spot)	US$/t	61	74	66	71	69	67	65	69	67	65
Hard coking coal*	US$/t	n.a.	119	117	118	122	125	131	138	144	150
Semi-soft coal*	US$/t	n.a.	85	83	84	87	89	94	98	103	107
Thermal coal*	US$/t	63	82	82	73	73	73	73	70	70	70

Thermal coal contract price set to fall – with current spot prices indicating some downside



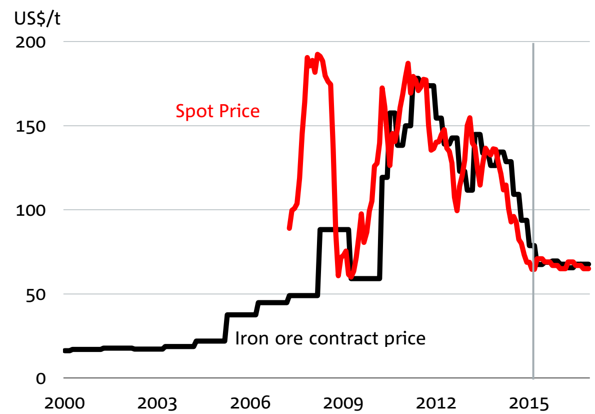
Sources: BREE, Bloomberg, NAB Economics

Metallurgical coal to trend higher on higher cost production cuts



Sources: BREE, Bloomberg, Energy Publishing, NAB

High cost iron production (including in China) to come out of market, but prices to drift lower



Source: BREE, Bloomberg, NAB Economics

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