Bulk Commodities Update

by NAB Group Economics

June 2015

National Australia Bank

Key Points:

- China's economic growth has continued to slow in the early months of 2015. First quarter national accounts showed China grew by 7.0% yoy, down from 7.4% in 2014. The changing composition of China's growth model – towards services rather than heavy industry – means it is less commodity intensive than in the past.
- According to World Steel data, global steel production was 535 million tonnes in the first four months of 2015, a decline of 1.6% yoy. Output in China fell more moderately, down by 1.0% to 269 million tonnes.
- China's apparent steel consumption has fallen in early 2015 – down by almost 5% over the first four months of the year – reflecting the weak demand from China's construction sector. We expect the country's steel demand to remain subdued across this year.
- Key thermal coal consumers are lowering demand – with China addressing pollution and Japan nearing a phased restart of nuclear capacity.
- Reflecting the softer thermal coal demand conditions and excess capacity for supply, we expect weak conditions to persist. The 2016 Japanese financial year contract price is forecast at US$62 a tonne (from US$67.80 this year).
- Further cuts to metallurgical coal production are likely to be necessary, given the sharp fall in prices across recent months. Quarterly contract prices are forecast to average US$105 a tonne in 2015 and US$95 a tonne in 2016, though current weakness highlights downside risk.
- Higher cost iron ore production is finally exiting the market, however this excess supply will limit any significant upward pressure on prices. We forecast spot prices to average US$60 a tonne in 2015 and ease further to US$57 a tonne in 2016.

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Economic overview

- Bulk commodity markets remain dominated by China's demand – despite its slowing economy. In 2014, China accounted for two-thirds of iron ore trade and just over 20% of total coal trade.

- China's economic growth has continued to slow in the early months of 2015. First quarter national accounts showed China grew by 7.0% yoy, down from 7.4% in 2014. The changing composition of China's growth model – towards services rather than heavy industry – means it is less commodity intensive than in the past. The sustainability of growth is also a concern – a surge in share market activity was a key driver of growth in Q1.

- China's industrial production remained weak in April – although marginally stronger than March, edging up to 5.9% yoy (from a six year low of 5.6% previously).

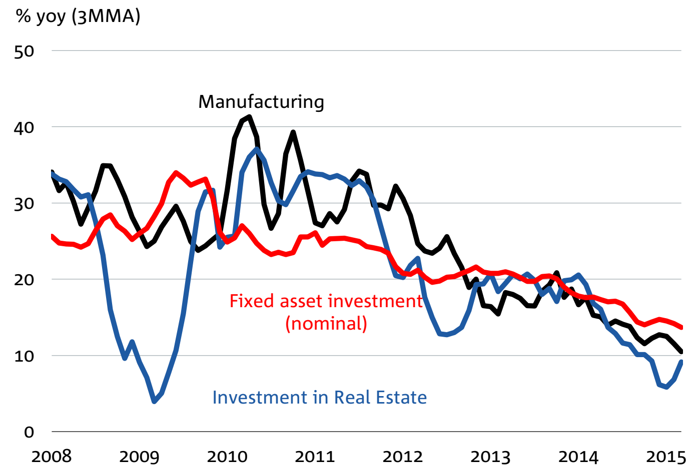
- Fixed asset investment continued its slowing trend in April – down to 9.4% yoy (from 13.2% in March) – dragged lower by manufacturing and real estate. This was the slowest rate of growth for investment since December 2001 and points to weaker demand for steel.

- The People's Bank of China (PBoC) cut interest rates for the third time in six months in May – bringing the one year lending rate to 5.1%. The PBoC is purchasing local government bonds to support the debt swap program in a measure that superficially resembles quantitative easing – which remains unnecessary due to the still high level of the Reserve Requirement Ratio.

- Elsewhere, global growth remains stuck at a sub-trend pace. After 3.3% growth in 2014 we now expect only 3.2% in 2015. While the Euro-zone and Japan are experiencing upturns, first quarter US and UK data has been disappointing. We have delayed the Fed starting rate tightening until September (or later) and reduced US GDP growth in 2015 to 2.5%.

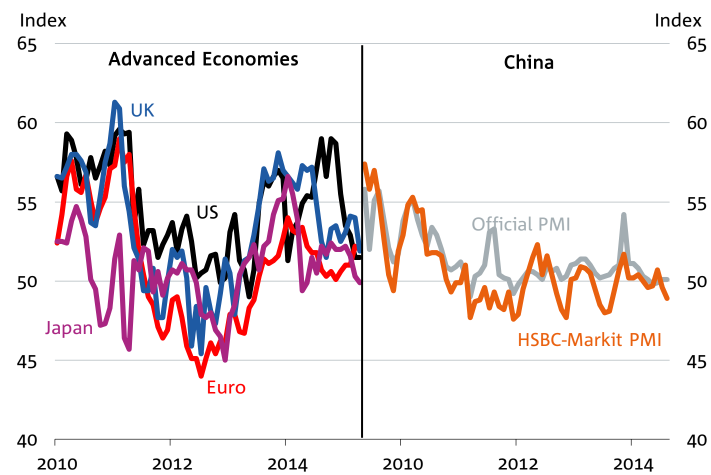
- For more details, see NAB's Global and Australian Forecasts (Budget Special) and China Economic Briefing.

China's growth in real estate investment continues to slow – impacting steel demand



Source: CEIC, NAB Economics

Weak conditions in Q1 for US and UK evident in pullback in PMI measures



Sources: Markit Economics, NBS, NAB Economics

Steel industry

- According to World Steel data, global steel production was 535 million tonnes in the first four months of 2015, a decline of 1.6% yoy. Output in China fell more moderately, down by 1.0% to 269 million tonnes – resulting in China accounting for over 50% of global output over this period.

- Steel production outside of China fell by 2.1% yoy to 266 million tonnes in the first four months. Production trends were highly mixed over this period – with output rising in India, Russia and Taiwan, but falling in Ukraine, the United States, Japan and South Korea.

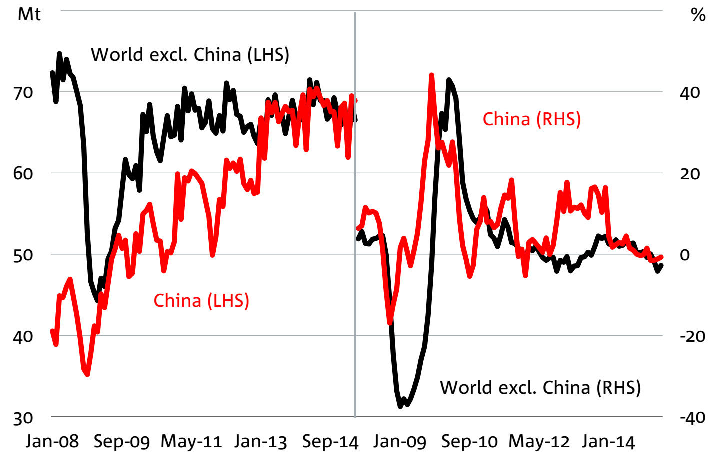
- Weaker output likely reflects the deterioration in profitability in recent months – as steel prices have fallen more rapidly than raw materials. China's domestic steel prices have dropped below RMB 2500 a tonne, at a time that iron ore prices have edged higher. China's steel prices have fallen despite domestic steel inventories declining – with levels well below the ranges of the past four years – indicating the weakness in demand.

- According to China Iron & Steel Association (CISA) data, around half of the country's major steel mills were loss-making in March. Across the country, excess capacity is estimated at around 300 million tonnes – around a quarter of the total.

- China's apparent steel consumption has fallen in early 2015 – down by almost 5% over the first four months of the year – reflecting the weak demand from China's construction sector. We expect the country's steel demand to remain subdued across this year, while steel exports are unlikely to be as supportive as last year, due to lower incentives for producers to export.

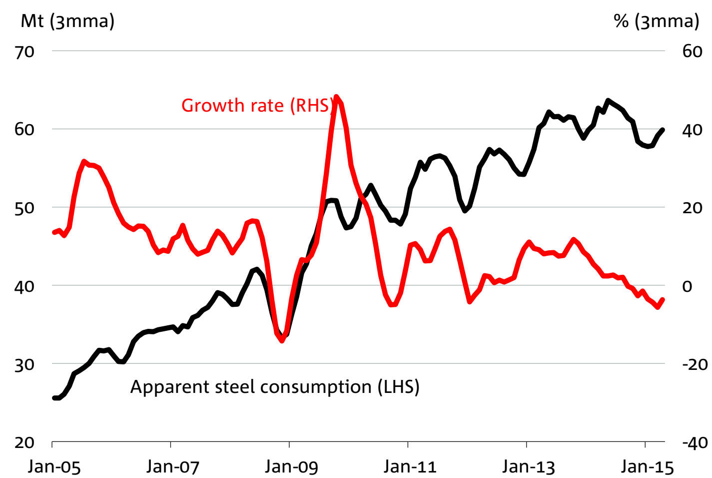
- The CISA expect steel consumption to fall by around 6% in 2015, following on from their estimate of a 3.4% fall in consumption in 2014.

China's steel output has fallen in early 2015, though less rapidly than the rest of the world



Source: World Steel, NAB Economics

China's apparent steel consumption has continued to fall as conditions in construction have slowed demand

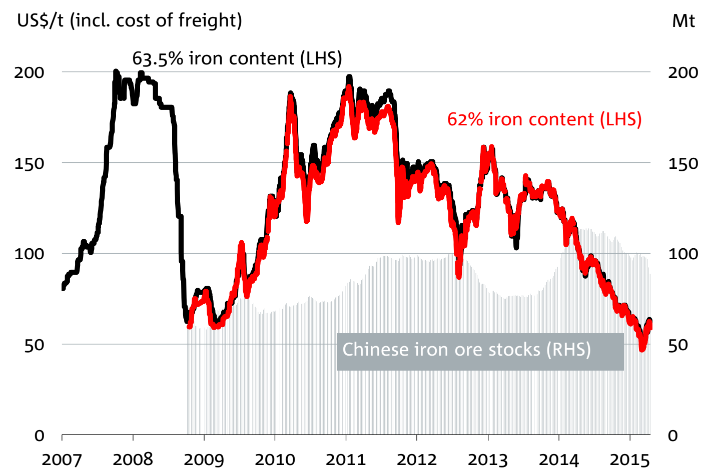


Sources: CEIC, Bloomberg, NAB Economics

Iron ore

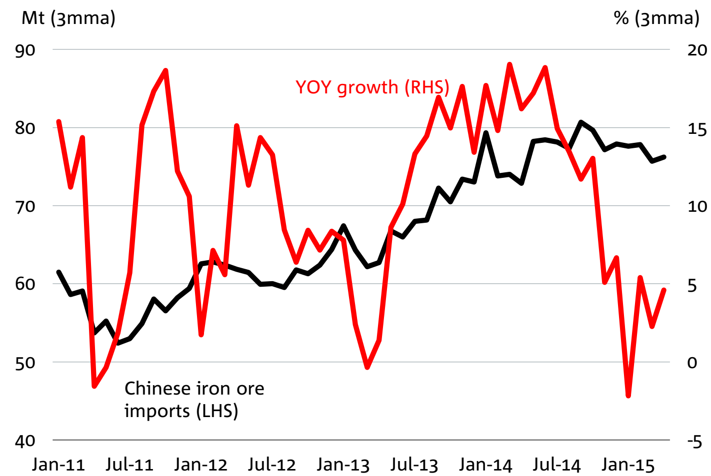
- Iron ore spot prices trended slightly higher across April and early May – pulling away from levels that were effectively all time lows (since spot markets became more active less than a decade ago) near US$45 a tonne in early April to just above US$60 a tonne in mid May. Despite the upturn, prices were still around 40% lower than a year earlier.
- The downward pressure on iron ore prices over the past eighteen months has been driven in part by the rapid increase in global supply. Australian producers have accounted for the majority of the increase – up around 13% yoy in the first three months of the year – with similar growth from Brazil, at around 11% yoy over the same period. In contrast, output from other higher cost producers has contracted.
- China's domestic production of iron ore finally appears to be responding to weaker market prices. Chinese ore typically has a lower iron content than internationally traded ores and suffers significant cost disadvantages when compared with exporters such as Australia and Brazil. Until the end of 2014, Chinese ore production had remained strong (despite these factors), but it has fallen by almost 10% yoy in the first four months of the year.
- Iron ore stocks at Chinese ports appear to be falling – reflecting weaker imports and slowing domestic production. In mid May, stocks totalled 88 million tonnes – the lowest level since January 2014. This appears to indicate that supply has slowed more rapidly than iron ore demand (from weaker domestic steel output) – supporting the slight uptick in prices.
- China remains the key market for global iron ore imports, however the rate of growth has slowed considerably (particularly compared with the first half of 2014). In the first four months of the year, China's iron ore imports totalled 307 million tonnes, an increase of just 0.6% yoy.

Spot prices recorded a modest recovery across April and early May but still around 40% lower year-on-year



Source: Bloomberg, Thomson Datastream, NAB Economics

China's import demand slowed considerably across the second half of 2014 and remains comparatively weak



Source: CEIC, NAB Economics

Metallurgical coal

- Prices for hard coking coal remained largely unchanged in the twelve months to March 2015 (trading in a range of around US$5 a tonne over the period). However since this time, spot prices have fallen – down from around US$114 a tonne at the start of the year to US$85 a tonne in mid-May (for the Asia Clear Australian active contract) – a level it stabilised at for the remainder of the month.

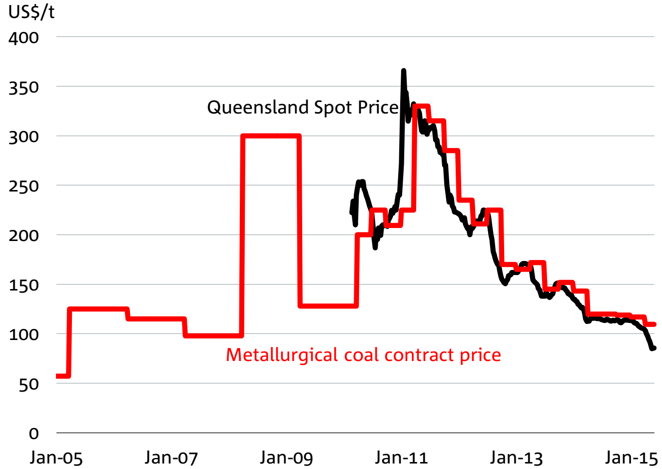
- These prices are well below current contract levels – which were set at US$109.50 a tonne for Q2 – indicating that the third quarter contract will be settled at a considerably lower level.

- Global metallurgical coal markets remain influenced by the weakness in China's seaborne demand. In the first four months of the year, China's imports of metallurgical coal totalled 14.7 million tonnes, a year-on-year decline of almost 25%. We don't anticipate a major recovery in China's imports – reflecting the ongoing weakness in the country's steel sector.

- Recent price trends appear to indicate that the market has been oversupplied in early 2015 – following on from a balanced market for much of 2014 (as production cuts in North America offset weaker Chinese demand). Further strength in Australian exports and lower Chinese import volumes have softened the market once again – and further supply cuts may be required.

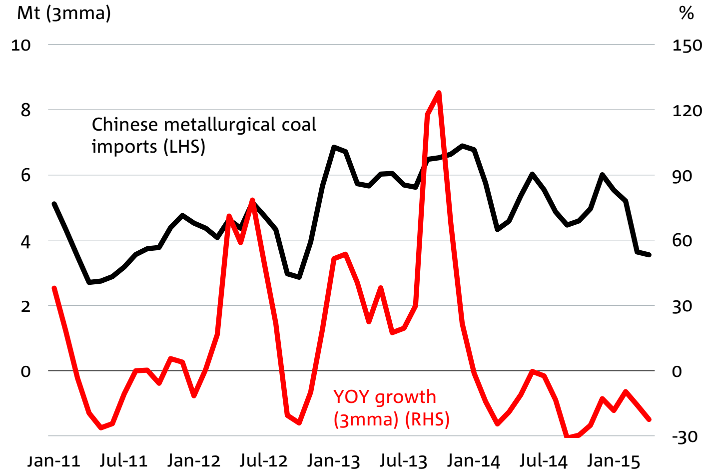
- The supply picture remains mixed. Australian exports are continuing to increase in early 2015, while Canadian exports have fallen by around 5% yoy in the first three months of the year. US export data for the first quarter has not yet been released, however total exports in 2014 fell by 4%.

Metallurgical coal prices have fallen significantly in recent months (following twelve months of stability)



Source: Bloomberg, NAB Economics

China's metallurgical coal imports have trended down from a late 2013 peak – driving prices lower

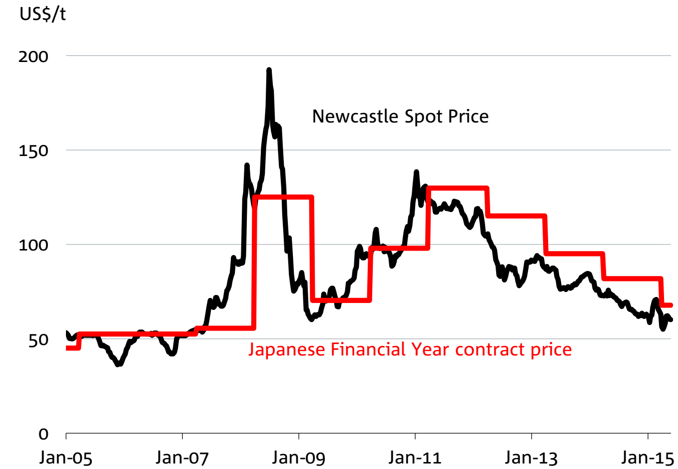


Source: CEIC, NAB Economics

Thermal coal

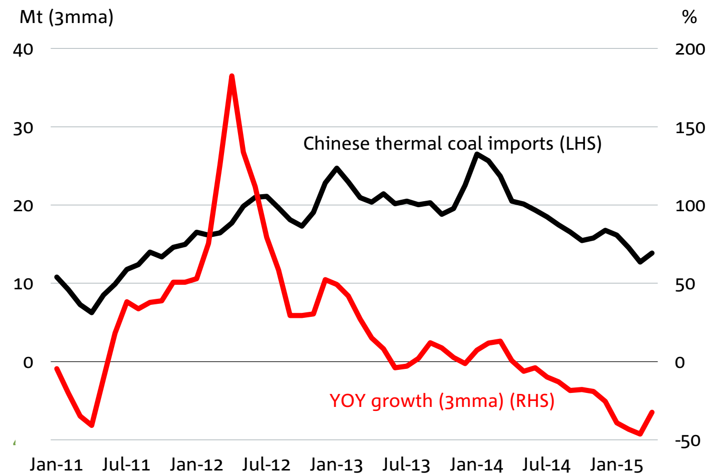
- Spot prices for thermal coal were relatively stable in May – having recovered from sub-US$60 a tonne prices in April. The active Newcastle contract on the Intercontinental Exchange traded in a $2.50 range across the month, trending back towards US$60 at the end of the month – almost 18% lower than a year earlier.
- Minimal volatility in prices followed on from the settlement of Japanese financial year contracts in April – which set the annual contract price at US$67.80 a tonne (a fall of 17% from the previous contract).
- Falling prices since early 2014 in part reflect the declining demand from China for internationally traded coal. In the first four months of the year, China's imports of thermal coal fell by almost 41% yoy to total 54.4 million tonnes.
- Although coal remains the dominant fuel in China's energy mix, coal consumption is falling, as authorities attempt to address the country's air pollution crisis. Total coal production (thermal and metallurgical) was around 1.15 billion tonnes in the first four months of the year – a decline of 6.1% yoy. Falling domestic production and imports point to much weaker demand than in previous years.
- The China National Coal Association forecast production to fall by 5% in 2015. The trend of falling domestic consumption is set to continue, with official targets to cut coal consumption by 13 million tonnes in the five years to 2017.
- Outside China, thermal coal demand in Japan is likely to be impacted by the phased restart of the country's nuclear generation capacity. In late May, the third and final approval was granted to the Kyushu Electric Power Company to restart two units at the Sendai nuclear plant – likely in mid-July. The company expects the plant to return to normal operation by mid-August.

Spot prices stabilised in May, following on from the 17% fall in contract prices settled in April



Source: Bloomberg, BREE, NAB Economics

The plunge in China's imports has been a key driver of the softening conditions in the thermal coal market



Source: CEIC, NAB Economics

Australian exports

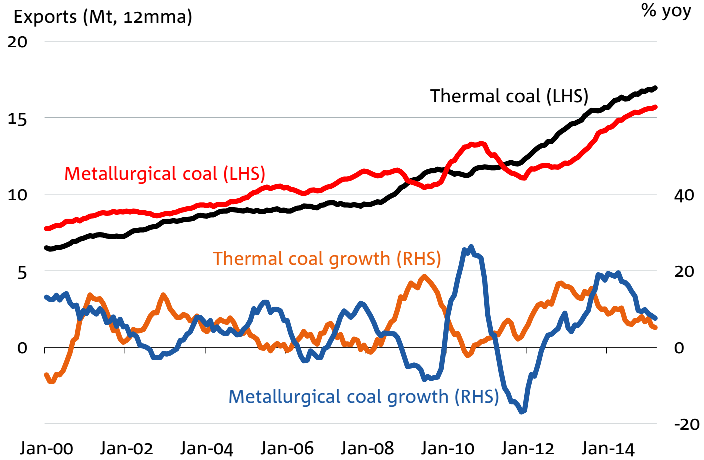
- Australian exports of bulk commodities have continued to grow in 2015, albeit at a slower rate than was the case for much of 2014. Major producers are benefiting from new mining projects being brought on line as well as the long term investment in infrastructure to support larger volumes.

- Despite the falling import volumes in China, Australia's exports of metallurgical coal have continued to grow. In the first three months of 2015, exports totalled 45 million tonnes, an increase of 4.7% yoy.

- Australian thermal coal exports have grown more slowly over the past eighteen months, but have continued to expand. In the first three months, thermal coal exports grew by 5.9% yoy to almost 50 million tonnes.

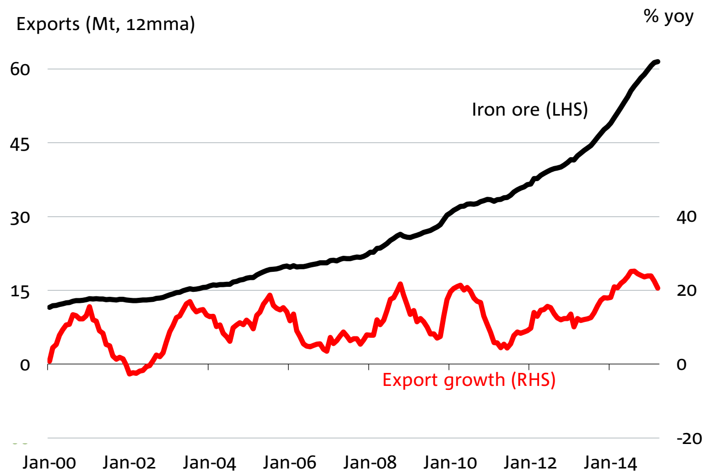
- There has been less of slowdown in iron ore exports than that evident in coal. In the first three months of 2015, iron ore exports reached 180 million tonnes, an increase of 13% yoy.

Rate of growth is slowing, but coal exports are continuing to grow in early 2015



Sources: Bloomberg, NAB Economics

Australia's iron ore exports have continued to grow, despite the slowing trends in China's imports



Sources: Bloomberg, NAB Economics

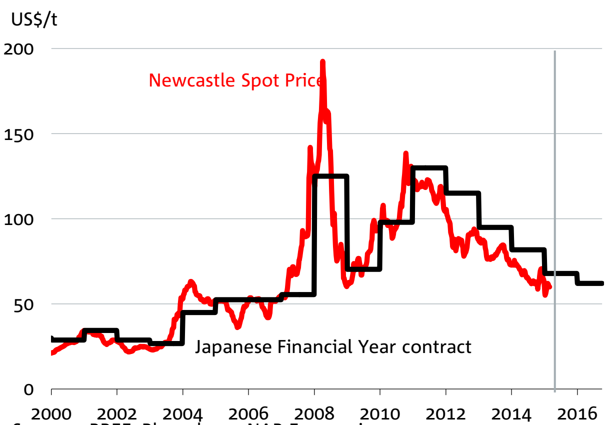
Price outlook

- In last month's Minerals & Energy Commodities Update, we revised down our forecasts for bulk commodity prices – reflecting the weakening trends in the market since our previous review.
- Reflecting the softer thermal coal demand conditions and excess capacity for supply, we expect weak conditions to persist. The 2016 Japanese financial year contract price is forecast at US$62 a tonne (from US$67.80 this year).
- Further cuts to metallurgical coal production are likely to be necessary, given the sharp fall in prices across recent months. Quarterly contract prices are forecast to average US$105 a tonne in 2015 and US$95 a tonne in 2016, though current weakness highlights downside risk.
- Higher cost iron ore production is finally exiting the market, however this excess supply will limit any significant upward pressure on prices. We forecast spot prices to average US$60 a tonne in 2015 and ease further to US$57 a tonne in 2016.

		Spot	Actual	*Forecasts*							
	Unit	Current	Mar-15	*Jun-15*	*Sep-15*	*Dec-15*	*Mar-16*	*Jun-16*	*Sep-16*	*Dec-16*	*Mar-17*
Iron ore (spot)	US$/t	61	62	58	60	61	60	58	56	54	52
Hard coking coal*	US$/t	n.a.	117	110	98	95	94	93	96	97	99
Semi-soft coal*	US$/t	n.a.	83	78	70	68	67	66	68	69	71
Thermal coal*	US$/t	64	82	68	68	68	68	62	62	62	62

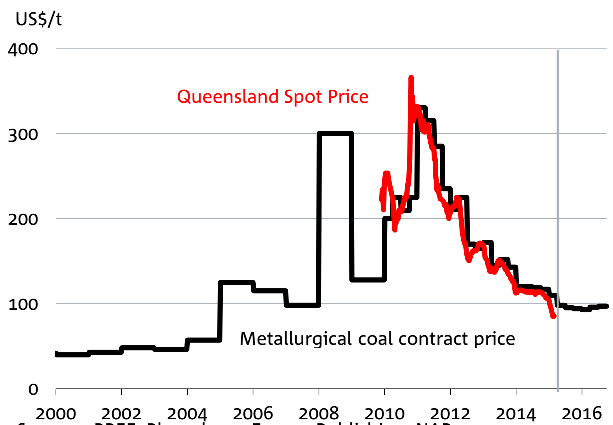
* Data reflect NAB estimates of US$/ tonne FOB quarterly contract prices (thermal coal is JFY contract). Actual data represent most recent final quarterly contract price.

Further downward pressure on thermal coal prices, as demand softens in the short term



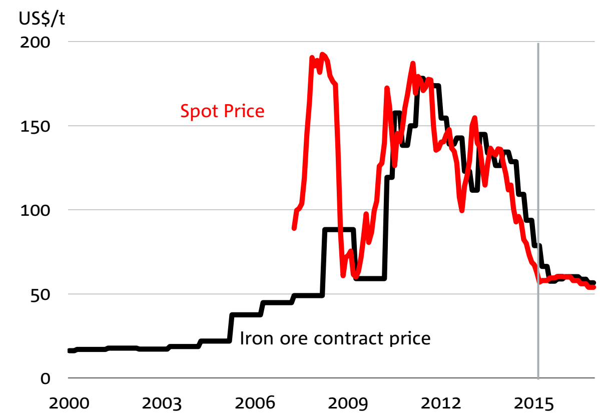
Sources: BREE, Bloomberg, NAB Economics

Metallurgical coal Spot prices have fallen further, which may trigger further supply cuts



Sources: BREE, Bloomberg, Energy Publishing, NAB

Iron ore stabilising as high cost producers exit, but this will limit upside potential



Source: BREE, Bloomberg, NAB Economics

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