

OUTLOOK FOR METALS AND MINERALS

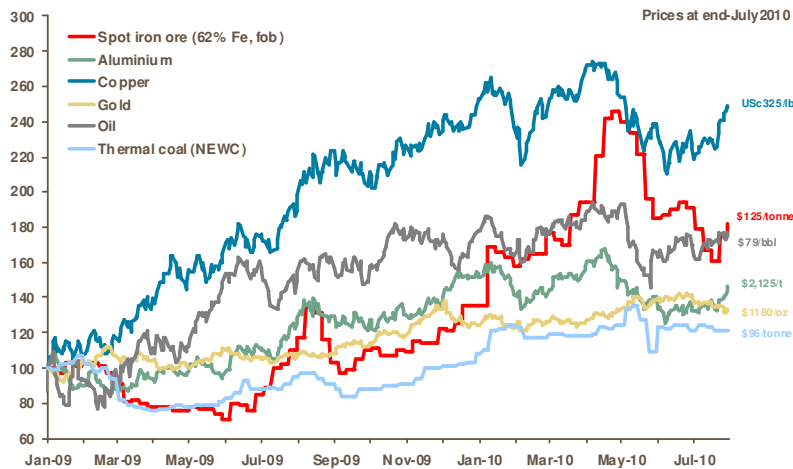
Mid Year Results 2010  
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Vivek Tulpulé  
Chief Economist

Economic conditions and the markets for most commodities have improved considerably since a year ago. Following the global recession in 2009, world GDP has returned to 2008 levels on the back of enormous economic stimulus. Most prices peaked around April/May before falling on concerns about Sovereign debt risks in Europe and slowing macroeconomic indicators in China and the United States.

Commodity market prices

Daily spot price index (1 January 2009 = 100)



Source: LME, SBB, Metal Bulletin, Reuters Ecowin, globalCOAL

Looking forward, the IMF predicts global growth of around four per cent this year and in 2011 with Chinese GDP expected to grow at around nine per cent. Such outcomes would have positive implications for metals and minerals markets. Nevertheless, it is clear that economic conditions on a global scale remain volatile and we continue to be cautious about the near term outlook.

Our assessment of market conditions for the remainder of 2010 and into 2011 is broadly unchanged from the view we expressed at the start of this year. In particular there are some key risks relating to economic activity for the period ahead:

- An inevitable reduction in the level of fiscal stimulus, much of which has been commodity intensive;
- The possibility of a tightening of monetary and/or lending policies in Asian economies in response to concerns about consumer and/or asset price inflation;
- The possibility that consumer spending – especially in OECD economies - will remain constrained for an extended period on concerns about high unemployment; the need to rebuild wealth following recent asset price deflation and an expectation of higher future taxes;

- Sovereign debt crises in some countries, the potential impact of these on financial stability and the negative implications for investor confidence;
- Any deceleration in commodity demand once inventory rebuilding slows;
- The likelihood that commodity supply will be encouraged by the price and credit market improvements since 2009.

Looking further to the future, two key themes are expected to dominate the global economic environment.

First, increasing prosperity in developing countries including China and India, with associated industrialisation and urbanisation will continue to drive underlying growth in demand for commodities. On this basis, we expect that real long run prices and margins for almost all minerals and metals will average significantly higher going forward than in the decade preceding the most recent five year boom.

But while average prices and returns may be higher over the long run, volatility is also expected to be elevated. For example, in some instances the speed of expected demand growth relative to capacity combined with input supply problems would increase the frequency of intermittent supply shortages and associated price spikes. However, it can also be expected that there will be occasional periods of excess investment followed by slower growth and lower prices. Additionally, given the rapidity of change expected going forward, frequent negative and positive swings in sentiment about broader macroeconomic and financial market conditions will affect prices through speculation.

Second, it is clear that substantial economic imbalances persist in both developed and developing countries. These will need to be resolved and that process will take time. In particular, developed countries will be under increased pressure to reduce public and private debt, while China is expected to begin a move toward reduced dependence on exports and investment to fuel economic growth. The recent sovereign debt crisis in Europe and its sweeping contagion into financial markets around the world illustrate the potential for persistent economic imbalances and hidden risks to cause ongoing disruption to global economic activity.

This combination of factors suggests a high average growth setting for our markets but also one that will be characterized by elevated volatility and scope for discontinuities - a pattern we have dubbed as the 'sawtooth economy'.

The remainder of this paper addresses key near term drivers of the broad outlook. We also discuss some specific issues affecting aluminium, copper, iron ore and thermal coal markets.

## **Macroeconomic overview**

While the consensus of economic forecasters had progressively upgraded growth forecasts over the course of 2010, recent data suggest that the recovery in activity may be slower than had been expected. The recovery in overall global economic conditions continues to depend very much on government stimulus and short-term gains from economy-wide restocking. As the positive effects of these factors have waned, economies around the world have started to show signs of slowing.

China's GDP growth slowed to 10.3 per cent in Q2 2010, as the slowdown in stimulus-related investment led to a deceleration in heavy industry production. We expect this trend to continue through 2010 with growth to exceed 9 per cent for the year as a whole with similar growth in 2011.

While there are some risks to the Chinese growth outlook, in the event that the economy slows down much more sharply than expected, we would expect the government to quickly loosen policies; for example by reducing the strength of tightening measures that have been imposed on the housing market and introducing some new fiscal stimulus measures focussed on increasing domestic consumption rates.

### World Economic Activity and Consumer Price Inflation

	Real GDP Growth		Consumer Prices	
	2010	2011	2010	2011
China	10.1	9.1	3.2	3.1
India	8.3	8.3	8.3	6.2
Russia*	4.0	4.3	6.4	6.5
Indonesia	5.9	6.1	4.6	5.9
Australia	3.0	3.3	3.2	3.1
Brazil	7.1	4.3	5.4	4.9
South Korea	5.8	4.3	2.9	3.1
Taiwan	6.7	4.3	1.4	1.7
Saudi Arabia	3.5	4.6	5.3	5.6
Germany	2.0	1.7	1.1	1.4
France	1.4	1.5	1.6	1.5
UK	1.3	2.1	3.0	2.3
US	3.1	3.0	1.7	1.5
Canada	3.5	2.8	1.9	2.2
Japan	3.2	1.6	-1.0	-0.2

Source: Consensus forecasts (July 2010), \*Global Insight (July 2010)

Indian growth for 2010 has exceeded most expectations. The Reserve Bank of India (RBI) has forecast growth of 8.5 for the year to March 2011. The key risk is high inflation – now in double digits – and the potentially negative effects on economic growth from any over-tightening in monetary policy.

The normal pattern of recovery from recession is that the process of inventory rebuilding and economic stimulus would generate jobs growth, increase business confidence, and create the basis for increased consumption. Such a process would allow the recovery in OECD economies to be sustained beyond the initial temporary burst.

At this stage, however, there are risks that the pace of OECD recovery may not be sustained. This is because consumer confidence has been so heavily weighed upon by high unemployment rates, the loss in wealth and the prospect of increased taxes to fund the current stimulus and reduce budget deficits. Additionally, investor confidence has been negatively affected by concerns about the potential for financial crises arising from Sovereign debt problems in Europe notwithstanding the results of the recent banking stress tests.

### Currencies

The US dollar weakened substantially over 2009 owing to concerns about the strength of economic activity. Since January, though, the trade weighted average exchange rate has strengthened somewhat to a level comparable with August 2009. Commodity currencies have remained broadly in line against the dollar with the Canadian dollar and the Brazilian Real trading currently at roughly their average for January. Meanwhile the Australian dollar weakened against other commodity currencies following the initial announcement of the proposed Resource Super Profit Tax in May, but has since recovered lost ground.

The decision by the Chinese authorities in June to allow more flexibility with the RMB exchange rate up to a limit of 0.5% movement per day will enable the RMB to appreciate gently. The slowing economy will most likely mean only gradual RMB appreciation in the months ahead.

Since marginal production of many commodities such as iron ore, coal and aluminium is predominantly Chinese, any appreciation of the RMB would increase Chinese costs in US dollar terms and therefore industry marginal costs. Such an outcome would tend to support commodity prices.

## **Commodity markets**

### Costs

Stronger commodity prices and continued demand growth in emerging markets have led to a gradual restart of production capacity as well as large capital projects across the mining sector. As a result, pressures on input costs are slowly building up again, although the industry is not yet experiencing the kind of widespread cost inflation seen before the financial crisis.

EPCM skills are developing as the most likely medium term constraints to project development, especially for projects with small owner's teams. These shortages tend to be more acute in regions already severely affected before the financial crisis such as Australia.

However, in some sectors supply remains ample to accommodate higher activity levels. For example the availability of mining and processing equipment remains good with no signs yet of bottlenecks. During the first half of 2010 lead times for most equipment used in mining projects had remained near 2009 levels driven by the excess in supply resulting from committed capacity increases in 2007/2008.

Another area of costs under the influence of pre-crisis expansion plans is freight. A record 364 vessels joined the global fleet in 1H 2010 (90 Capesize, 71 Panamax, 133 Handymax and 70 Handysize) growing capacity by 7% to 492 million dwt, despite delays in new vessel deliveries. This combined with diminished cargo requirements and an uncertain near term demand outlook weighed heavily on the market in recent months with the Baltic Dry Index (BDI) reaching a low of 2,406 points. Subdued, yet volatile spot freight rates are likely to persist over the rest of the year as swings in commodity demand and levels of port congestion also continue to influence freight pricing direction.

### Aluminium

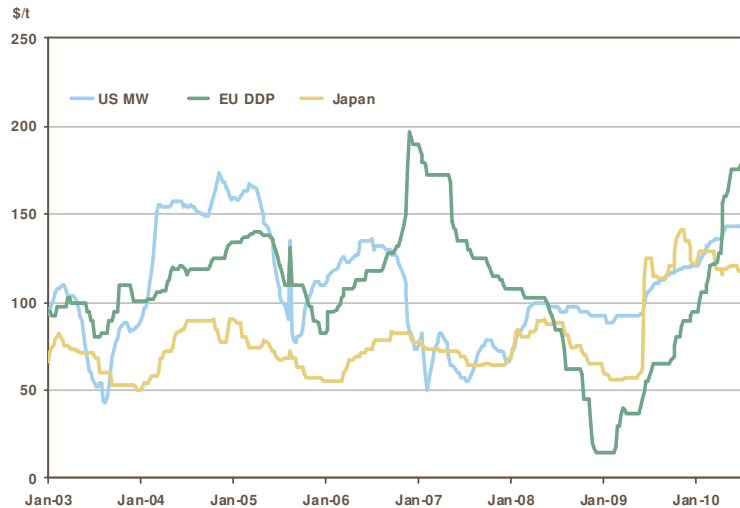
Surging physical premiums have been the main feature of the aluminium market over the first half of 2010. This reflects the combination of two forces: a robust recovery in end-use demand in developed economies and the continued roll-over of stocks financing positions amidst a prolonged period of low interest rates.

Triggered by an initial phase of restocking, the demand recovery in the US and Europe gradually broadened out and gained momentum over the past two quarters. Business confidence grew stronger throughout that period with end-users regaining some sense of near term visibility in their markets. This encouraged increasingly forward-looking ordering activity in contrast to the hand-to-mouth demand seen during 2009. Laggard sectors such as construction remained a drag on demand although on the other hand a tighter availability of scrap supported higher primary aluminium consumption.

The demand turnaround led smelters' casthouses once again to focus on the production of value added products, therefore limiting the supply of ingots into the market. Consumers

hoping to draw on the large existing stock positions to make up for this shortfall found themselves competing with stock financing deals. Whilst returns on these deals have diminished, stock holders have continued to roll-over their positions or move stocks into new deals with more attractive warehousing costs. This competition has pushed premiums for duty paid ingots in Europe to \$180-190/t, stronger than in early 2007 (when the import duty was also higher). Premiums also rose strongly in the US to about 6.5c/lb in the Midwest.

### Physical aluminium regional premia



Source: Metal Bulletin, Platts

Looking forward the growth momentum in demand is expected to ease during the second half of the year. Meanwhile with the recent narrowing of nearby spreads some financing deals could start to look increasingly fragile, potentially releasing material back to the market. Whilst current product premiums could be sustained into the second half, downward pressures are likely to build on ingot premiums.

LME prices have themselves already been under pressure for some time declining from around \$2,400/t in mid-April to below \$2,000/t by the start of June. Prices at these levels are once again testing the profitability of smelters in the higher part of the cost curve in a context of rising input prices. Higher raw material costs and the removal of preferential power rates in China are putting local smelters under renewed pressure. China's annualised production rate reached in excess of 17 million tonnes of primary aluminium in June, about 7 million tonnes above the levels seen at the start of 2009 and 3 million tonnes higher than the pre-crisis peak. However with curtailments already announced in key production bases such as Henan we would expect output levels to stabilise or even fall slightly over the remainder of 2010.

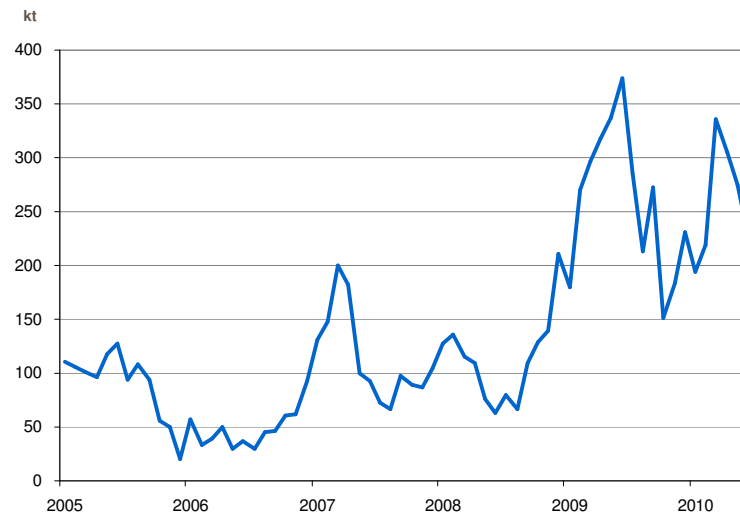
#### Copper

Following the strong rally throughout 2009, copper prices have traded within a \$2.85/lb to \$3.60/lb band so far in 2010 with prices currently towards the middle of that range. The lows are being tested every time confidence in the global recovery is shaken and price appears more responsive to macro-economic events than copper market fundamentals.

OECD demand continues to recover from last year's depressed levels with CRU estimating an 11 per cent increase in global consumption in the first half of this year. Market uncertainty in Europe and the low level of homebuilding activity in the US has made for a somewhat

disappointing demand recovery in these regions. But this has been offset by stronger Japanese consumption, where a surge in exports has bolstered copper demand.

### Chinese net imports of copper cathodes



Source: Customs Statistics

Meanwhile demand in China is consolidating following last year's more than 20 per cent surge in consumption. Chinese copper imports during the first half of 2010 have held better than many expected given the record levels reached in 2009. The sharp decline in global manufacturing activity and the associated reduction in scrap availability was a key driver behind the 120% surge in cathode imports last year. Whilst the tightness in the scrap market has eased somewhat since, imports still reached just over 1.5 million tonnes during the first six months of the year compared to 3.2 million tonnes for the whole of 2009.

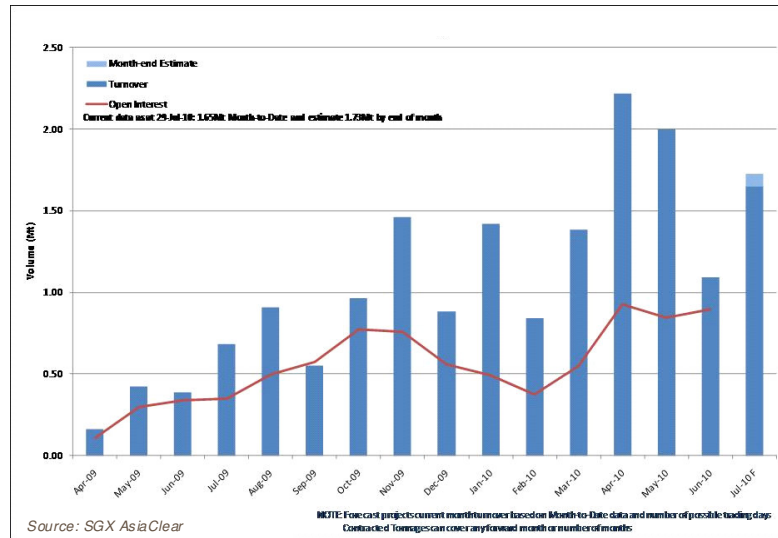
Turning to supply, the commissioning of new mine capacity is expected to be limited this year. But at the same time, no major disruptions were reported in the first half of the year in contrast with the experience over the past few years. At this rate the market should end the year in very modest surplus. Based on public announcements mined production is forecast to grow by 5.4% next year. This will barely be sufficient to balance the market as the recovery in demand, particularly in Europe and the US, is expected to continue well into next year. If there are any unanticipated disruptions the market would move into deficit.

#### Iron ore

Spot iron ore prices rose rapidly for the first four months of the year as steel intensive stimulus spending and investment-led growth continued. Concerns with asset bubbles and speculation resulted in the Chinese government introducing a range of tightening policies at the end of April designed to cool the property market which accounts for a third of apparent steel consumption. Sharply declining iron ore prices followed in May and June. Recently spot prices have rebounded reflecting cost support at about \$120/t CFR China.

The transition from an annual benchmark pricing system to quarterly contracts and increased significance of index and spot pricing has encouraged the development and use of iron ore derivatives, however liquidity and depth remain key issues. Iron ore derivatives can enable steel mills to hedge their main raw material risk and investors to gain iron ore exposure. As the spot market matures, derivatives volume has the potential to increase exponentially and exert a greater influence on spot price formation, although supply and demand fundamentals will remain the key drivers of price over the medium term.

## SGX Iron Ore Swaps



The volatility in iron ore pricing has been a function of tight fundamentals and a cost curve with a steep gradient. At this gradient, minor demand fluctuations and supply disruptions have resulted in significant price changes. These price movements have been amplified by the stocking cycle. Recently, the Indian Monsoon has had a significant impact on Indian iron ore supplies with exports falling by nearly 50% to 5.6 million tonnes in June. To some extent this has been offset by stronger recent Brazilian exports.

Looking forward the balance of risks for seaborne iron ore remains concentrated on China. We expect Chinese demand growth to continue to moderate throughout the year as the effects of stimulus slow. Over the longer term the underlying trends of urbanisation and development will continue to sustain China's strong steel intensity per capita trajectory.

### Thermal coal

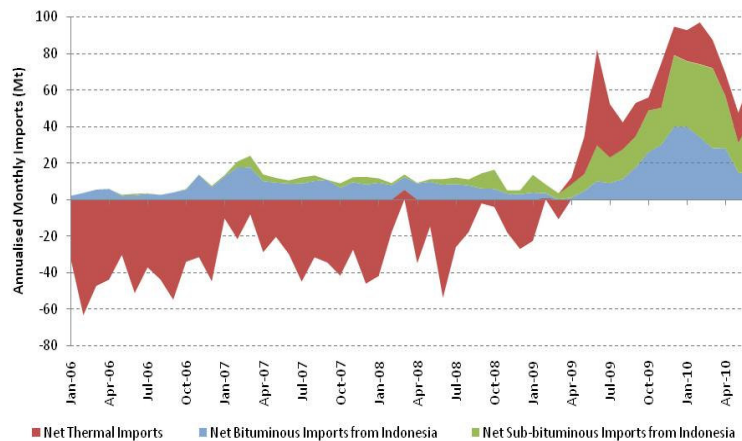
The April price settlement, at just below \$98/t, has been the anchor around which the market has tended to fluctuate throughout the first half of the year. At the end of April bullish sentiment pushed the price to around \$110/t FOB Newcastle but since then the price has declined.

The differentials between the key benchmark coal prices have reverted to historical levels. For example, coal delivered to Europe was \$13/t less expensive than the coal free-on-board at Richards Bay. Since June this has reversed and Richards Bay has returned to being priced below the European benchmark. The large Atlantic-Pacific differential has also significantly reduced from \$13/t to less than \$5/t.

Part of the reason for the lower differentials is the decline in freight rates. The impact of this has been to bring the Atlantic and Pacific markets closer together as longer distance trades become viable and regional arbitrage opportunities increase. In particular Colombian coal delivered to China has become profitable in the low freight environment and in June 2010 China imported nearly 700kt of Colombian coal, compared with the previous June when no Colombian coal was shipped to China.

China continues to set the scene for the seaborne thermal coal market and net imports started the year at the high rate at which they ended. During the first quarter, Chinese net thermal imports were running at an annualised rate of 92 Mt compared to thermal imports of 39Mt in 2009. But a decline has already started, with a sharp drop-off in May, as imported coal has become less competitive relative to domestic supplies. The recent fall in freight rates has allowed a partial pick-up in imports.

### Annualised Chinese net thermal imports



Source: GTIS

### Conclusion

The IMF predicts global growth of nearly four per cent this year and in 2011 with Chinese GDP expected to grow at around nine per cent. Such outcomes would have positive implications for metals and minerals markets.

Nevertheless, it is clear that economic conditions on a global scale remain volatile and uncertain and we continue to be cautious about the near term outlook.

Asian countries are having to contend with inflationary risks arising from the massive economic stimulus packages that were put in place last year. In particular, Chinese efforts to prevent overheating in asset markets will have negative effects on our markets.

Additionally, the recent sovereign debt crisis in Europe and its sweeping contagion into financial markets around the world illustrate the potential for persistent economic imbalances and hidden risks to cause ongoing disruption to global economic activity.

Looking to the longer term, increasing prosperity in developing countries including China and India, with associated industrialisation and urbanisation will continue to drive underlying growth in demand for commodities. At the same time, it is apparent that global imbalances will take many years to resolve. The implications is a high average growth setting for our markets but also one that will be characterized by elevated volatility and scope for discontinuities - a pattern we have dubbed as the 'sawtooth economy'.