



Non-Rural Commodity Markets Overview

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Key Points

- Mixed global macroeconomic data over the past month continue to reflect recovery, albeit at a modest pace.
- From the various PMI surveys, signs that the pace of inventory contraction is slowing and reports that Chinese export sales are increasing are positive for commodity prices.
- A continued structural depreciation in the US dollar is likely to boost demand for commodities from foreign investors and those concerned about the prospect of US inflation.
- Bulk commodity contract price negotiations are soon to begin. We are forecasting solid price increases for iron ore, metallurgical coal and thermal coal based on renewed Chinese demand and continuing signs of recovery in India.
- While, in US dollar terms, the NAB Non-Rural Commodity Price Index is forecast to rise by around 16.4 per cent through the year to December 2010, in Australian dollar terms, the index is forecast to fall by 7.5 per cent.

Global economic indicators continue to show signs of gradual recovery

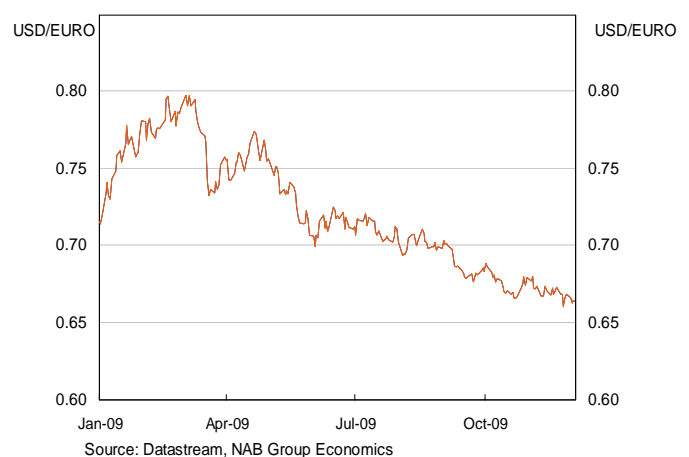
On the whole, mixed macroeconomic indicators over the last month continue to depict a global economy that is recovering, albeit at a modest pace. In the US, weaker than expected industrial production growth and retail sales (exc autos) were partially offset by indications that the deterioration in the labour market is slowing. In November, a decrease of only 11,000 jobs led to a fall in the US unemployment rate, although it remains at a high 10 per cent.

While a rise in consumption across many of the major economies has to date been largely serviced by businesses running down inventories, industrial production growth is showing signs of gradual improvement. Readings of PMI surveys, regarded as a reasonable indicator of production activity, have risen for both developed and emerging countries from their lows earlier in the year to report activity at expansionary levels. Nevertheless, PMI readings for November in the UK and US emphasise that, while production growth is recovering, the pace of rebound is tepid so far. Of importance for commodity markets are signs that the pace of inventory contraction is slowing and reports from the HSBC PMI for China that export sales are rising.

Continued USD depreciation supporting commodity prices

Concerns over the value of the US dollar continue to raise the appeal of commodities to overseas investors and those concerned about the prospect of US inflation. The US dollar has experienced substantial volatility since late 2008 (see Graph 1). Initially, heightened risk aversion associated with the financial crisis had investors flooding into US dollar denominated assets, causing the currency to appreciate. Since March 2009, however, the strength of economic indicators has tended to surprise market participants, causing some unwinding of earlier 'safe haven' purchases. Also, expectations that the Federal Reserve will leave interest rates lower than most of their major trading partners and the large US budget deficit have weighed on the value of the US dollar. There have also been some reports of a group of countries pushing for the adoption of an alternative reserve currency for pricing international products. NAB Currency Strategists are predicting a continued structural depreciation in the US dollar, likely to give further support to commodity prices going forward.

Graph 1
USD/Euro Exchange Rate



Gold prices climbing, while most metal prices have risen and oil prices remain rangebound

The strong central bank response to IMF gold sales surprised the market, causing prices to rally to around US\$1200 per ounce. Following the purchase of 200 metric tonnes of gold by the Reserve Bank of India (RBI), the price has gained with expectations of other central banks diversifying away from US dollars into gold. At present, we see gold as fairly valued given the unexpected net accumulation by central banks as well as other supporting factors such as a weaker US dollar, continued

safe-haven purchases by investors and some evidence of heightened inflation expectations. Indeed, in the short-term, there is the possibility for speculative investment flows pushing gold prices well in excess of US\$1200 per fine ounce. However, in the absence of further news, we expect that such a rally would eventually be unwound as prices settle around our quarterly average forecast levels (for details, see the *NAB Gold Market Monthly*).

In **base metal** markets over November, prices for aluminium, copper, lead and zinc all recorded solid rises, while nickel prices fell amid reports of an oversupply of stainless steel in China and a marked slowing in Chinese nickel imports. Looking forward, one theme to remain prominent across metal markets is the increased utilisation of Asian production facilities, leading to weaker Chinese demand for commodities from world markets (for details, see the *NAB Base Metals Market Monthly*).

Oil prices were broadly flat over November after gradually rising through the middle part of October. The price of West Texas Intermediate (WTI) has traded within a narrow range of US\$75-\$80 since mid October, reflecting mixed macroeconomic data releases and relatively little change in fundamental conditions in the market. In the short-term, oil prices are likely to remain range-bound. With a reasonably upbeat demand outlook already priced into oil markets, weak fundamental conditions in the form of abundant global oil supplies are the factor weighing on the oil price. Indeed, a sustained upward trend in oil prices is unlikely until a series of draw-downs in OECD oil product stocks is observed and markets are more confident that the global demand recovery is on firm footing (for details, see the *NAB Oil Market Monthly*).

Bulk commodity contract negotiations soon underway, with strong demand from China and India boosting prices

Bulk commodity contract price negotiations for the 2010 Japanese Fiscal Year (JFY) are soon to begin. The recovery in Chinese steel production has been much more rapid than expected, with signs that a rebound in India is also well underway. September Quarter GDP growth in both China and India surpassed most analysts forecasts, a positive signal for the recovery in demand for bulk commodities.

After the 2009 benchmark price for iron ore fines was cut by 33 per cent from the previous year, we are forecasting a 20 per cent rise in 2010. This reflects further strong growth in Chinese demand for high quality iron ore imports as the recovery continues to progress and rising costs (and lower quality ore) limit the extent of domestic production. Also, the expectation of declining exports from India will support iron ore prices. While the Chinese Iron and Steel Association (CISA) did not manage to come to terms with the large iron ore miners in Australia and Brazil in JFY 2009, iron ore has been sold at provisional prices to Chinese mills in line with the benchmark. At present, iron ore spot prices are around one third higher than the benchmark level. While BHP continue to push for more flexible 'index pricing', a mechanism that adjusts prices more regularly based on movements in the spot price, we still expect the settlement of contracts for next financial year, though anticipate a higher proportion of iron ore to be sold at more flexible prices.

Focusing on the other bulk commodities, we are expecting negotiated thermal coal prices to rise by 17 per cent, as strong demand from India and China is partially offset by weaker activity in Japan and the European Union. The recovery in India is also likely to result in a pick up in imports of metallurgical coal. We are also forecasting metallurgical coal contract prices to rise by 17 per cent over JFY2010.

The depreciation of the US dollar against the Australian dollar has consequences for the income of Australian miners. While bulk prices are denominated in US dollars miners costs are predominantly priced in the local currency, meaning the appreciation of the AUD has adversely affected miner profits. With the Brazilian Real experiencing a similar appreciation, it is possible that miners will use the exchange rate movements to push for higher contract prices in this round of negotiations.

In US dollar terms, non-rural commodity prices expected to trend higher over 2010

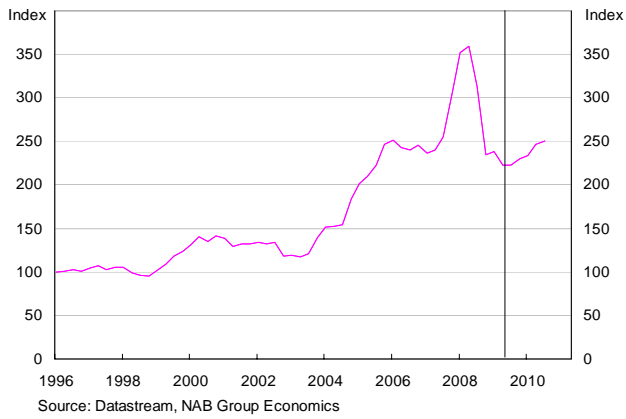
Looking forward, commodity markets are likely to continue taking guidance from macroeconomic indicators. NAB Group Economics expect global growth to pick up throughout 2010, increasing by 3 per cent over the year. While, in US dollar terms, the NAB Non-Rural Commodity Price Index is forecast to rise by around 16.4 per cent through the year to December 2010, in Australian dollar terms, the index is forecast to fall by 7.5 per cent over the same period (see Graph 2, over the page). Our non-rural commodity price forecasts heavily reflect the impact of China, with the price of those commodities associated with strong Chinese buying on world markets expected to experience relatively strong price growth.

For a discussion of conditions in rural commodity markets, visit: www.nab.com.au/agrireports

Graph 2

NAB Non-Rural Commodity Price Index

Australian dollars, September 1996 = 100



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