Economics@ANZ

ANZ Commodities Quarterly

US sneezes, but China does as it pleases

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Inside:

Authors:

Mark Pervan
Senior Commodity Strategist
+61 3 9273 3716
Mark.Pervan@anz.com

Katie Dean
Senior Economist, International
+61 3 9273 1381
Katie.Dean@anz.com

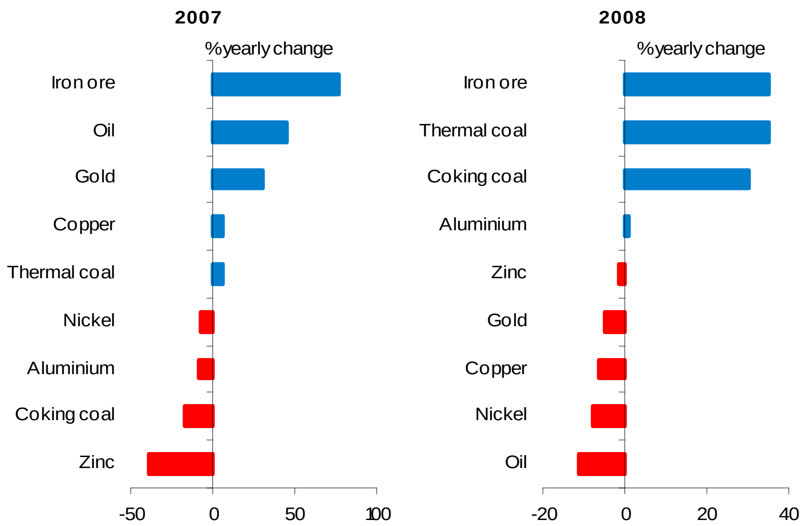
Our Vision:

For Economics@ANZ to be the most respected, sought-after and commercially valued source of economics research and information on Australia, New Zealand, the Pacific and Asia.

Overview

- **2008 will be a mixed year for commodity markets.** Rapidly rising energy demands and infrastructure construction in the developing world is likely to underpin strong price rises in coal and iron ore. In contrast, softer global economic growth and mining and refinery expansions will weigh on most base metal prices.
- **The fundamental economic backdrop remains favourable.** While the sub-prime mortgage shock has bruised confidence in G3 growth, it has prompted only a minor downgrade to our overall world outlook. We expect global growth to slow, but still remain well above trend, with China and other developing countries leading the way.
- **Base metal prices will ease** in 2008 as a larger supply response and softer demand conditions usher in profit taking. Nickel will be the most vulnerable as large new supply is commissioned, while aluminium could surprise on the upside as high energy costs prompt supply closure.
- **Bulks prices are set to rise** underpinned by strong demand and ongoing supply constraints. Contract prices for iron ore and thermal coal are expected to rise 35% and coking coal by 30%. China will increase its dominance in demand for thermal coal and iron ore and India's importance in coking coal demand will continue to grow.
- **Gold prices will remain linked to the path of the USD.** Risk aversion and concerns about the inflationary impact of a weak USD and higher oil prices should see gold prices stay above US$800 for at least the first part of next year.
- **Oil prices look set to stay above US$80 next year.** Keeping prices high will be increased primary energy use amongst the world's developing countries, rising extraction costs amongst non-OPEC producers and uncertainty over new OPEC production.

Commodity Price Outlook



Source: ANZ

Source: ANZ

Commodity price forecasts					
End-period	**Dec-07F**	**Mar-08F**	**Jun-08F**	**Dec-08F**	**Long-term**
Iron ore – Newman Fines US$/t	81.7	81.7	110.3	110.3	65
Coking coal – Premium Hard US$/t	96.0	96.0	125.0	125.0	80
Thermal coal US$/t	55.6	55.6	75.0	75.0	50
Crude oil (WTI) US$/bbl	90	85	82	80	60
Gold US$/oz	820	850	845	780	550
Copper US$/t	7,054	7,054	6,834	6,614	3,500
Aluminium US$/t	2,579	2,579	2,535	2,601	1,800
Nickel US$/t	31,965	32,406	29,761	29,540	16,500
Zinc US$/t	2,689	2,734	2,645	2,645	1,700
Commodity supply and demand forecasts					
% annual change	**2005**	**2006**	**2007F**	**2008F**	**Long-term**
ANZ non-rural commodity demand index#	8.2	3.0	6.2	6.9	n.a.
ANZ non-rural commodity supply index#	5.8	5.6	8.1	6.1	n.a.
ANZ base metal commodity demand index#	0.2	4.4	4.8	4.8	n.a.
ANZ base metal commodity supply index#	3.5	5.0	5.0	5.4	n.a.
Key economic forecasts					
Real GDP (annual % change)	**2005**	**2006**	**2007F**	**2008F**	**Long-term**
World	4.8	5.3	5.1	4.9	4.6
United States	3.1	2.9	2.2	2.9	2.9
Japan	1.9	2.2	1.6	1.2	1.8
Europe	1.5	2.6	2.3	1.9	2.0
Australia	2.8	2.7	4.3	3.9	3.4
China	10.4	10.7	11.3	10.3	9.0
East Asia ex Japan and China	5.1	5.5	5.6	5.4	5.3
India	9.0	9.4	8.7	8.5	8.7
Key financial market forecasts					
End-period	**Dec-07F**	**Mar-08F**	**Jun-08F**	**Sep-08F**	**Dec-08F**
AUD/USD	0.94	0.95	0.96	0.93	0.90
USD/JPY	114.0	113.0	112.0	110.0	108.0
EUR/USD	1.45	1.47	1.46	1.42	1.39
USD/CNY	7.397	7.309	7.220	7.132	7.043
DXY ##	76.50	75.70	76.00	77.70	79.00
Official interest rates (%pa)					
US Fed funds rate	4.50	4.25	4.25	4.25	4.50
ECB policy rate	4.00	4.00	4.25	4.25	4.25
Japan BOJ target rate	0.50	0.50	0.75	0.75	1.00
Australia RBA cash rate	6.75	7.00	7.25	7.25	7.25
China 12-month lending rate	7.47	7.65	7.65	7.65	7.65

2001=100, excludes oil and gold

USD currency index

Source: Bloomberg, DataStream, Economics@ANZ

Global economic outlook

World growth to remain above-trend at 4.7% in 2008

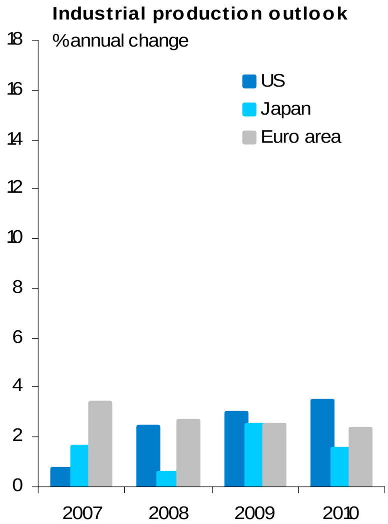
Downside risks to the global economy are greater

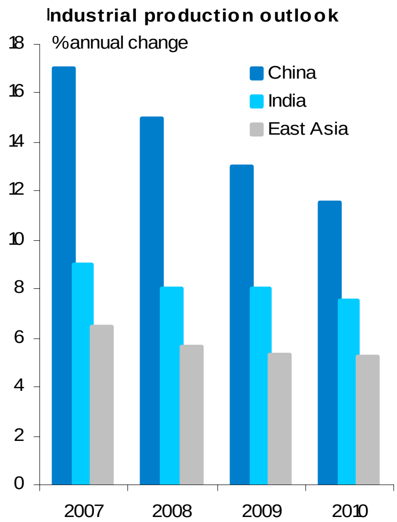
The fallout from the US sub-prime shock continues to cloud the global outlook. Equity markets are skittish, the USD has collapsed and risk premiums on the credit of major US lenders have made new highs. The biggest uncertainty is that sub-prime losses do not yet appear fully resolved. Until this occurs, financial market volatility will persist, the cost of credit will stay elevated and the risks to global economic growth will remain to the downside.

But the developing world will keep global growth is above trend

The most stunning outcome of recent events – and what is of most importance to commodity markets - is that, despite this financial market turbulence and deterioration in US prospects, the global economic backdrop remains fundamentally strong. Recent events have prompted only a modest downgrade to our global economic forecasts. We now expect global GDP to expand by 4.7% in 2008, down from 5.0% this year, but still well above trend. Moreover, our forecast for above-trend global growth extends to the end of our forecast period in 2010. This is almost entirely attributable to the developing world, with growth expected to remain significantly above historic trend rates across Asia, Latin America, the Middle East and emerging Europe. Rapid domestic-driven industrialisation and increased inter-regional trade links have seen these economies become increasingly desynchronized from the business cycle of the developed world. As such, while G7 industrial production was travelling at just a 2% yearly pace over Q3, industrial production in Asia (ex-Japan) was growing by 14%, having *accelerated* from an 11% pace earlier this year.

The Asian story remains compelling





Source: Datastream, Economics@ANZ

China has failed to respond to tighter policy

The Chinese phenomenon is the clearest case in point. Virtually untouched from recent events, Chinese economic growth maintained a strong 11.5% yearly pace in Q3. Industrial production is up 17% from last year, fixed asset investment is up 25% in the first nine months of the year and exports are rising by a 20% annual rate. Authorities continue to tighten monetary policy to try and put the brakes on this unrelenting rate of growth, so far with little success. We currently expect Chinese economic growth will slow modestly from 11.3% in 2007 to 10.3% in 2008. In the absence of a significant policy mistake, we still see little chance of Chinese economic growth slowing to below 10% before 2010. A strong China, in turn almost guarantees a strong region, and we expect only a modest slowdown in East Asian (ex Japan and China) economic growth from 5.6% in 2007 to 5.4% in 2008. Meanwhile, increased exports into the Asian region, as well as a relatively low exposure to sub-prime-related debts, should ensure the Japanese economy only slows modestly in the period ahead.

The outlook for the Indian economy is little changed with growth expected to slow slightly from 8.7% in 2007 to 8.5% in 2008. Strong investment spending, led by aggressive infrastructure development, should remain the main driver of

India is more vulnerable to recent global market events

growth. That said, India is probably more exposed to the ructions in global credit markets than most of its East Asian neighbours as India's capital account deficit leaves local investors relatively more dependent on external financing. At this stage however, we have seen little impact, and so we expect these higher costs of capital will be a headwind, but not a stop on strong local (and international) investor appetite.

Prospects for the remaining BRIC economies, Brazil and Russia, are also strong. Economic growth in both of these countries is expected to remain above trend, fuelled by large commodity-based current account surpluses, strong capital inflows, local productivity gains and, in the case of Brazil, easier monetary policy. Higher capital inflows should encourage a rebalancing in the drivers of growth in these economies from consumption to investment, especially infrastructure development.

The US should (narrowly) avoid recession

At the other end of the spectrum, US economic growth is expected to slow to well below trend in the coming year. Despite a further collapse in housing starts and now the pressure from record oil prices, we do not expect the US economy to follow its housing market into recession. Recent better than expected Q3 GDP growth, at 3.9% annualised, suggests this economy's 'starting point' was a little stronger than first thought. Moreover, the falling USD is helping exports and the Fed's aggressive actions should also now be providing support. Nevertheless, the risks of a more severe downturn are clearly heightened. We are particularly concerned that the collapse in housing construction and financial sector troubles will prompt a sharp correction in the hitherto solid labour market. This is the biggest risk to our forecast for the Fed to deliver just one further rate cut early next year.

Europe is the other key risk

Apart from a US recession, the biggest short-term risk to our global outlook is a sharper slowdown in the Euro area. European banks are unlikely to escape market ructions unscathed, and the record EUR must also be hurting the export sector. A hawkish ECB also appears to have less room to cut rates than the Fed, given that eurozone inflation is still running relatively high. With the eurozone having overtaken the US as the major export destination for Chinese producers, it is this region we will be watching as a key barometer of our global growth call.

The USD will remain out of favour

Against this backdrop, we see little that will shift the current weak sentiment around the USD. Just as the US is becoming less important to the global economy, so USD assets are losing their hegemony in the financial markets. Strong growth in the stock of financial assets in Europe and emerging markets means that USD assets now face unprecedented competition. Home bias is on the decline, and investors increasingly perceive the EUR as an alternative store of value. Yield has also turned against the USD, with US interest rates falling while rates in the rest of the world are stable or rising. In our view, it will take a strong rebound in the US economy, and/or deterioration in European prospects, to cause a shift in prevailing market sentiment. Neither of these events are our core view, and thus we expect that the USD will continue to search for a new floor in the months ahead.

World economic growth forecasts (%)

	2005	2006	2007F	2008F	2009F	2010F
World#	4.7	5.2	5.1	4.9	4.7	4.6
US	3.2	2.9	2.2	2.9	3.2	3.4
Eurozone	1.5	2.6	2.3	1.9	1.9	2.0
Japan	0.8	2.5	2.6	2.2	2.3	2.1
China	10.4	10.7	11.3	10.3	9.0	8.8
India	9.0	9.4	8.7	8.5	8.5	8.0
East Asia (ex China & Japan)	5.1	5.5	5.6	5.4	5.0	5.1
Brazil	2.9	3.7	4.7	4.5	4.1	3.9
Russia	6.4	6.7	7.2	6.4	5.5	4.7

Source: IMF, ANZ
World GDP calculated at purchasing parity rates

Copper

Prices to fall 6.2% in 2008

Weak US housing market and falling Chinese imports has cooled our view

We have made minor downgrades to our copper price forecasts following a larger than expected rise in LME supply. Weaker US housing data and a sharp drop in Chinese copper imports over the September quarter has also cooled our view. However, we don't expect prices to fall too far in the short term. In fact, they look a little oversold, and we would expect some buying on weakness towards the end of the quarter. Further weakness in the USD in the months ahead should also support higher prices. However, a firmer USD and rising supply response in the second half of 2008 should trigger lower prices. Accordingly, we are forecasting copper prices to fall 6.2% to US$6,614/t by the end of 2008.

Rising LME and Shanghai supply is currently weighing on sentiment. LME copper stocks are now at a six month high, up 83% in the past four months, while Shanghai stocks have risen 24% in the past two months. Strike affected South American supply now appears to be returning to the market. Falling Chinese copper imports is also implying lower metal usage, heavy de-stocking or a ramp-up in domestic supply. It appears to be the later, with Chinese refined copper production rising a strong 16.3% to 2.5mt for the first nine months of 2007.

Weak September production reports and low TC/RC's may tighten 2008 supply

Nonetheless, it's not dire for prices. The September production reporting period has been particularly disappointing. Key South American and Indonesian supply have been hit by lower grades and equipment shortages. The current annual treatment charge negotiations are also pointing to record low prices, implying tight copper concentrate supply in the near term. It's too early to assess the production impacts from the recent earthquake in Chile, but we would expect some operating problems. These issues, along with a pick-up in US and Japanese demand towards the end of 2008, should keep a high floor on prices. A flattening in backwardation of the copper futures curve recently appears to be implying a similar price outcome.

Supply

We expect copper supply be to be tight in 2007 and 2008 before easing in 2009. The latest International Copper Study Group (ICSG) report shows that the global refined copper market was in supply deficit of 258kt for the first eight months of 2007. We forecast that deficit to narrow to 225kt by the end of the year before moving into a small 48kt surplus by the end of 2008. Refined copper supply will grow by a mild 3.8% in 2007, again impacted (like in 2006) by a series of mine strikes, lower mine grades and equipment/labour shortages. Supply will rebound by 6.7% in 2008, from a catch-up on 2007's issues, and from a ramp-up in new mine capacity. However, our 2008 refined supply forecast of 19.2mt could be trimmed back if a tight copper concentrate market forces high cost smelting capacity to close.

Reports suggest the annual 2008 treatment and refining charges (TC/RCs) could fall to a record low of US$35/t and 3.5¢/lb, from US$60/t and 6.0¢/lb in 2007. With the high likelihood that price participation will be eliminated (in line with half year TC/RC contracts), high cost refined capacity will come under increased pressure to close. The Chinese smelters look vulnerable, with an increasing reliance on imported copper concentrates in 2007 being used to fuel its impressive refined supply growth.

Demand

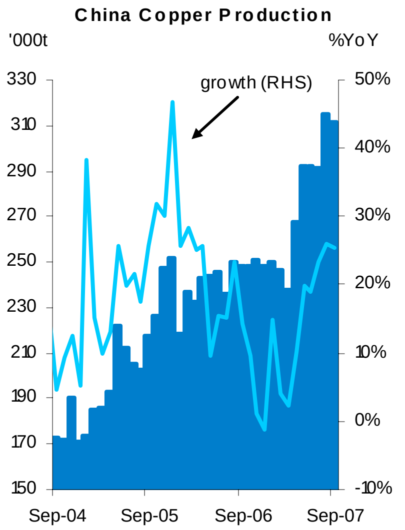
Absence of Chinese restocking will reduce 2008 demand growth

We expect copper demand to recover strongly in 2007, after a strong Chinese re-stocking phase in the first of the year. Global refined copper demand will increase 6.8% or 1.16mt to 18.2mt in 2007, of which China will contribute 760kt or 67% of the growth. Demand growth in 2008 will ease in the absence of Chinese restocking to 5.2%, but still remain well above historical trend. China is again the positive story, although we expect demand to pick up in the US off a low 2007 base.

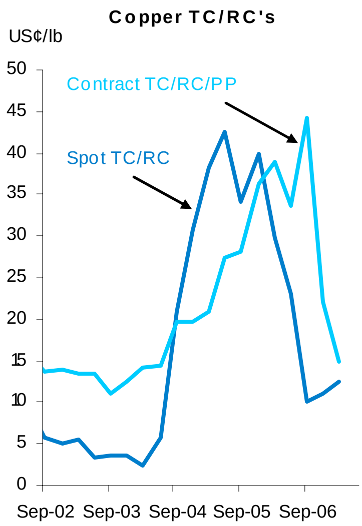
China's power industry, not the US housing market is now the main bell weather

We remain less worried about a sharply falling US housing market, which in the 1990's represented about 8% of global copper demand, but today accounts for only about 4%. The main focus today is the booming Chinese power market, which will represent about 12% of global copper demand this year compared to about 3% in the 1990s. A key growth plank in China's current eleventh five year plan (2005-2010) is the establishment of a comprehensive power industry. And with almost three quarters of China's electric power consumed by industry, which show no signs of slowing, strong demand for copper should continue.

Chinese refined copper supply rising but global concentrates set to tighten



Source: China Customs



Source: AME

Copper supply/demand balance

Supply catch-up emerging in 2008

	2005	2006	2007F	2008F	2009F	2010F
Total Supply Kt	16,610	17,328	17,980	19,193	20,164	21,137
% change	4.8%	4.3%	3.8%	6.7%	5.1%	4.8%
Total Demand Kt	16,655	17,043	18,204	19,145	19,992	20,840
% change	-0.1%	2.3%	6.8%	5.2%	4.4%	4.2%
Surplus / (Deficit) Kt	**(45)**	**285**	**(225)**	**48**	**172**	**297**
Total stocks Kt	547	703	479	527	698	995
Weeks of supply	1.7	2.1	1.4	1.4	1.8	2.5
Prices US¢/lb end-period	**206**	**286**	**320**	**300**	**260**	**230**
Prices US$/t end-period	4,542	6,308	7,054	6,614	5,732	5,070
% change	39.2%	38.9%	11.8%	-6.2%	-13.3%	-11.5%
China Supply Kt	2,574	2,959	3,719	4,343	4,607	4,864
% change	18.4%	15.0%	25.7%	16.8%	6.1%	5.6%
China Demand Kt	3,656	3,610	4,440	4,950	5,396	5,827
% change	8.7%	-1.3%	23.0%	11.5%	9.0%	8.0%
China Surplus / (Deficit)	(1,082)	(650)	(721)	(607)	(789)	(964)
% of Global Supply	15.5%	17.1%	20.7%	22.6%	22.8%	23.0%
% of Global Demand	**22.0%**	**21.2%**	**24.4%**	**25.9%**	**27.0%**	**28.0%**

Source: WBMS, ANZ

Aluminium

Prices to rise 0.9% in 2008

A fall in Chinese exports has improved our outlook

We made upgraded our short term aluminium price forecasts to a mild increase in 2008. In fact, aluminium will be the best performing base metal in 2008 and 2009 driven by a tightening net supply position. Its underperformance to other metals in the past three years should also create lower downside risk if conditions cool. Key to our more positive view has been the steady drop in Chinese aluminium exports over the past three months and the levelling out in rising LME stock moves. Aluminium is also the most sensitive metal to rising power prices, which could mean lower than forecast output in the coming year. The market is pricing in higher future prices, with aluminium the only metal in contango. We forecast prices to rise 0.9% to US$2,601/t in 2008 and sustain that price level by the end of 2009.

The 37% drop in Chinese aluminium exports in the past three months has been a welcome relief for the global aluminium market heavily weighed down by excess Chinese supply over the past three years. China's aluminium exports grew by a stellar 61% from 2004 to 2007, more than offsetting an equally impressive 47% increase in domestic aluminium demand. The July imposition of a 15% export tax on Chinese aluminium products, after a similar tax was imposed on primary (unwrought) aluminium in December 2006, appears to have had the desired affect of reining in exports. We believe further tax increases are possible in the near term, with high energy-intensive products like aluminium a main target of Chinese government cooling initiatives.

High sensitivity to rising energy prices could curb supply growth

Aluminium is the most energy intensive base metal, with electricity contributing between 30%-40% to the total cost of production. With oil and coal prices at record levels, it's plausible we will see an increase in closure of high cost aluminium capacity, particularly in North America and Europe. The huge Chinese smelting industry up until recently has been more sensitive to alumina prices, with power prices subsidised (or controlled) by the government. However, these controls are being lifted, and although alumina prices remain well off the highs of 18-months ago, a mild recovery in the past three months (together with booming energy prices) could put pressure on the growth of Chinese smelter capacity.

Supply

We forecast aluminium supply to jump 11.8% to 37.9mt for 2007, up from an impressive 6.2% rise for 2006. China alone will account for three quarters of the 2007 global demand growth, with domestic smelter output set to increase 31.6% to 12.3mt. In fact, our China supply forecast could turn out conservative, with the latest Customs data showing Chinese aluminium production rose a stunning 38.4% YOY to 9.230mt for the first nine months of 2007.

We forecast supply growth to slow in 2008 and 2009 to 6.4% and 4.2%, driven by high energy costs and rising environmental issues. A rise in alumina prices off a low base could be the biggest risk for lower Chinese output, where ample alumina supply in 2007 (and low alumina prices) has been driven by, to a large extent, unsustainably high levels of bauxite imports from Indonesia. From 2010 onwards, the migration of new smelter capacity to lower energy based locations like Russia, the Middle East and Iceland should see the supply response increase more quickly.

Demand

China demand set to rise a whopping 34% in 2007

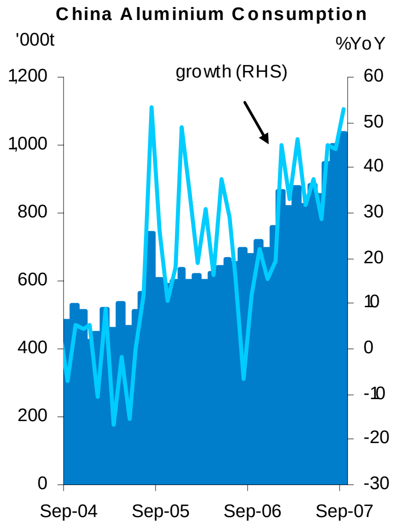
We forecast aluminium demand to rise by 9.9% to 37.7mt for 2007, up from a 7.1% growth rate for 2006. China will again be main factor for the impressive growth rates. We forecast Chinese demand to rise 34.0% to 11.6mt – accounting for a whopping 86.5% of global consumption growth in 2007. Demand will be mainly softer elsewhere, reflecting slower economic growth conditions. As a result, the global aluminium market will move from a 373kt deficit in 2006 to a 241kt surplus in 2007

The longer-term outlook for demand looks very positive, and again is influenced heavily by China. China's current per capita consumption of aluminium stands at

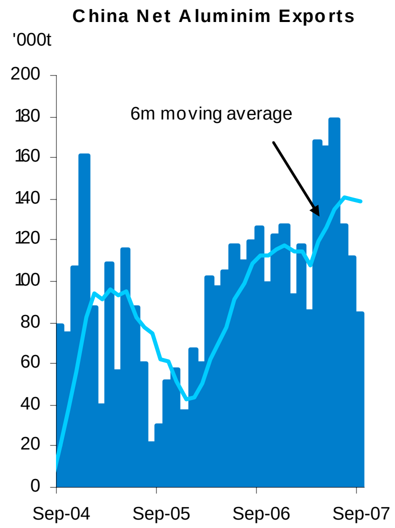
China's aluminium consumption per capita still very low on a global scale

a low 6.6kg per person, well below the Western world average of 20kg per person and that of industrial-based economies like South Korea at 25kg per person. The catch up for China will come from strong growth in still immature aluminium packaging and automobile industries. According to the National Development and Reform Commission, motor-vehicle production in China is forecast to increase from 8m vehicles in 2006 to 10m vehicles in 2008 and 20m vehicles in 2010 – and importantly, we expect the vehicle growth to make more intensive use of lightweight materials like aluminium to enhance fuel efficiency.

Strong Chinese consumption starting to soak up excess supply



Source: China Customs



Source: China Customs

Slowing supply and rising demand to create deficit in 2009

Aluminium supply/demand balance

	2005	2006	2007F	2008F	2009F	2010F
Total Supply Kt	31,941	33,937	37,948	40,357	42,053	44,757
% change	6.9%	6.2%	11.8%	6.4%	4.2%	6.4%
Total Demand Kt	32,026	34,309	37,707	40,068	42,235	44,578
% change	4.9%	7.1%	9.9%	6.3%	5.4%	5.5%
Surplus / (Deficit) Kt	**(85)**	**(372)**	**241**	**289**	**(182)**	**179**
Total stocks Kt	3,010	2,764	3,005	3,294	3,112	3,291
Weeks of supply	4.9	4.2	4.1	4.3	3.8	3.8
Prices US¢/lb end-period	**103**	**128**	**117**	**118**	**118**	**108**
Prices US$/t end-period	2,280	2,831	2,579	2,601	2,601	2,381
% change	16.2%	24.2%	-8.9%	0.9%	0.0%	-8.5%
China Supply Kt	7,806	9,349	12,306	13,544	14,424	15,322
% change	16.7%	19.8%	31.6%	10.1%	6.5%	6.2%
China Demand Kt	7,119	8,648	11,588	13,037	14,341	15,775
% change	17.8%	21.5%	34.0%	12.5%	10.0%	10.0%
China Surplus / (Deficit)	687	701	718	507	84	(453)
% of Global Supply	24.4%	27.5%	32.4%	33.6%	34.3%	34.2%
% of Global Demand	**22.2%**	**25.2%**	**30.7%**	**32.5%**	**34.0%**	**35.4%**

Source: WBMS, ANZ

Nickel

Prices to fall 6.1% in 2008

Stainless steel de-stocking has triggered jump in LME supply

We have made further downgrades to our short term nickel price forecasts following the sharp rise in LME supply over the past three months. A concerted de-stocking phase by global stainless steel producers and a greater up-take of low grade nickel pig iron by many Chinese steel mills appears to have cooled a previously overheated nickel market. However, we are now seeing signs of a rebound in prices and a slowing in LME stock builds suggesting stainless producers may be returning to the market to replenish low inventory levels. We now forecast nickel prices to fall 6.1% in 2007 to US$31,965/t and drop a further 7.6% in 2008 to US$29,540/t.

LME supply has risen 530% since the start of the year (albeit from a low base) and now stands at it highest level since January 2000. The introduction of new LME trading rules (freeing up more nickel supply) in May released some material back onto the market, but the bulk of the rise appears stainless steel de-stocking. This tends to have a big influence, with stainless steel being nickel's biggest end user, contributing 65% of global consumption. Encouragingly, stainless steel mills in Europe (Outokumpu and ThyssenKrupp) and China (Baosteel, Taiyuan and Zhangjiagang Posco) are reporting improving fourth quarter order books and/or predicting higher domestic steel prices. The recent slowing in LME stockpile increases could be a precursor to this, although a choppy price performance suggests the market is still playing a waiting game for more concrete signs of a pickup in market conditions.

Emergence of nickel pig iron now likely to stay

Reports that Chinese stainless producers are taking equity or aligning closely with low grade nickel laterite deposits, suggests that nickel pig iron supply is a longer term story. Encouragingly, for traditional nickel metal producers, the growth in nickel pig iron may be curbed by Chinese government initiatives to force the re-closure of small inefficient blast furnaces (under 300m^3), which had been re-commissioned to produce nickel pig iron over the past 12-18 months. It remains to be seen how successful this is, with a large majority of Chinese stainless producers now reliant on nickel pig iron as a feedstock.

Supply

We forecast nickel supply growth to accelerate in 2007, with refined output set to rise 7.8% to 1.47mt from a 4.8% growth rate in 2006. The bulk of the 106kt rise will come from the rapid rise in nickel pig iron production in China, which will add about 50kt of nickel metal in 2007. Supply increases elsewhere will mainly be small to medium-sized brownfield expansions in Australia, Canada, the Philippines and Russia. A lower level of mine strike activity will also reduce lost production from industrial disputes in 2007.

Big new greenfield supply expected in 2008

The supply response in 2008 will also be strong, with refined output forecast to rise 119kt or 8.1% to 1.59kt. The supply growth will switch more towards new greenfield output outside of China– most notably, BHP's 50ktpa Ravensthorpe nickel project in Western Australia and CVRD's 58ktpa Onca Puma nickel project in Brazil. Chinese nickel pig iron production is expected to remain strong – but as noted above - growth could slow, with the Chinese Government likely to crack down on smaller, inefficient producers. The next big supply growth response is likely from 2010 onwards when the next round of 50ktpa plus projects (Goro, Vermelho and Koniambo) are scheduled to be commissioned.

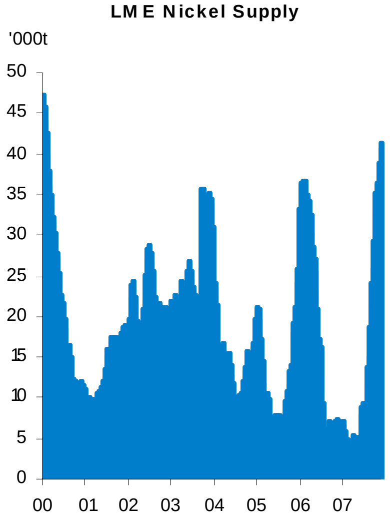
Demand

We forecast nickel demand to grow 7.9% to 1.51mt in 2007 following a stellar 12.8% growth rate in 2006. Demand this year has benefited from the tail end of a strong re-stocking phase in 2006, but ironically will be held back in the second half by the re-emergence of de-stocking. Nonetheless, the nickel market will fall further into a supply deficit position of 38kt from a 34kt deficit in 2006. Slower Chinese demand off a very high base will reduce the global demand growth rate to 4.6% in 2008, putting the nickel market into a supply surplus position of 12kt.

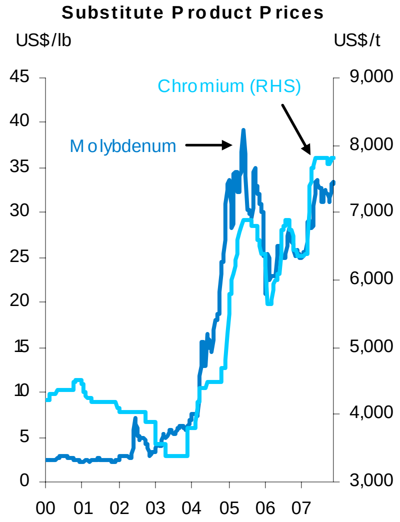
High molybdenum and chromium prices has eased substitution risk

Substitution will continue to be a feature of nickel demand, but will depend on relative prices. China's sharp rise in nickel pig iron production and the strong rebound in chromium and molybdenum prices in the past nine months highlight the industry's flexibility in stainless steel feedstock. However, these products are now highly priced and in most cases are not amenable for high quality Series-300 stainless steel required in important growth areas of power generation and petro-chemical industries in China. New demand uses are also emerging in China, with an increasing number of building projects being clad in stainless steel to combat high levels of corrosive air pollution.

Rising LME supply may be offset by high priced substitute products



Source: Bloomberg



Source: Bloomberg

Supply tightness fading

Nickel supply/demand balance

	2005	2006	2007F	2008F	2009F	2010F
Total Supply Kt	1,298	1,362	1,468	1,587	1,675	1,758
% change	2.9%	4.9%	7.8%	8.1%	5.5%	5.0%
Total Demand Kt	1,237	1,396	1,506	1,575	1,636	1,699
% change	-1.3%	12.8%	7.9%	4.6%	3.9%	3.8%
Surplus / (Deficit) Kt	**61**	**(34)**	**(38)**	**12**	**39**	**59**
Total stocks Kt	112	87	49	61	100	159
Weeks of supply	4.7	3.2	1.7	2.0	3.2	4.9
Prices US¢/lb end period	**607**	**1,543**	**1,450**	**1,340**	**1,150**	**950**
Prices US$/t end period	13,372	34,025	31,965	29,540	25,352	20,943
% change	-10.1%	154.4%	-6.1%	-7.6%	-14.2%	-17.4%
China Supply Kt	97	138	198	200	182	183
% change	28.5%	41.4%	43.5%	1.3%	-9.2%	1.0%
China Demand Kt	197	240	324	363	399	435
% change	37.0%	21.8%	35.0%	12.0%	10.0%	9.0%
China Surplus / (Deficit)	(100)	(102)	(127)	(163)	(218)	(252)
% of Global Supply	7.5%	10.1%	13.5%	12.7%	11.0%	10.5%
% of Global Demand	**15.9%**	**17.2%**	**21.5%**	**23.1%**	**24.4%**	**25.6%**

Source: WBMS, ANZ

Zinc

Prices to fall 1.6% in 2008

A sharp supply response in Chinese zinc production has cooled sentiment

Zinc prices have corrected heavily in the past 12-months driven by a sharp supply response in Chinese refined zinc output. What really spooked the market was China's ability to swing into a net exporting zinc position in the first quarter of 2007 after being forced into a large net importing position through 2005 and 2006. A corresponding rise in LME supply in the third quarter of 2007 and a build in Shanghai stocks in the past month suggests supply conditions are now ample enough to meet demand. Our 4kt net surplus forecast of refined zinc for 2007 highlights a similar outcome. We now expect prices to end the 2007 at US$2,689/t, down 37.3% on the price at the end of 2006 – and prices in 2008 to ease 3.3% to US$2,601/t.

In defence of the sharp price fall, zinc looked heavily overbought from the price rally through 2005 and 2006. The supply response, particularly from China, has been quicker and larger than expected. However, the relatively unconsolidated nature of the zinc market (compared to other base metals) means that the supply response is always going to be quite rapid. Put in context, the top-5 zinc producers control 28% of global supply compared to 40% for aluminium and 42% for copper. Part of the fast Chinese supply response has been the rapid increase in zinc concentrate imports, which have risen 260% for the first eight months of 2007. With sky high freight rates, it remains to be seen if this level of concentrate import growth can be maintained, which would have implications for Chinese refined growth.

Rising LME price premium could trigger increased China zinc exports

Chinese arbitrage trading between Shanghai and LME markets has the ability to sway sentiment quickly, particularly if Chinese refined zinc trade moves into a net exporting position. The latest preliminary Customs Data showed a slowing in zinc imports, and last month's final numbers had China in a small 16.8kt net importing position. The Shanghai/LME ratio has been choppy over the past 12 months, but has generally traded at a LME premium. The recent rise in Shanghai stocks, and a widening LME premium, suggests a move towards higher exports is likely in months ahead (which would be negative for prices).

Supply

Higher TC/RC's should prompt further smelter expansions

We are forecasting refined zinc supply to rise 5.5% to 11.3mt in 2007 and 5.8% to 11.9mt in 2008. The sharp supply response in China has been particularly impressive and highlights how price sensitive and possibly short-term focused, domestic production is. A rebound in treatment and refining charges (TC/RC' s) has also made it more amendable for smelter restarts and expansions. China's refined zinc production is up 20.8% to 2.3mt for the first nine months of 2007, and will surpass our annual 2007 target of 3.5mt by 200kt if the current September output level is maintained. Supply increases elsewhere mainly reflect restarts or brownfield expansions in Australia and Canada.

The recent start-up of Apex Silver's 200ktpa San Cristobal project in Bolivia (1.7% of global supply) is the first major zinc mine to be commissioned since BHP Billiton's 220ktpa Antamina mine in October 2001. The pipeline of other large projects is rather small and highlights a still fragmented and fairly uncertain outlook for longer term supply. That uncertainty is reflected in our forecasts, with supply growth easing to 4.4% in 2010, reducing the net surplus position to 58kt.

Demand

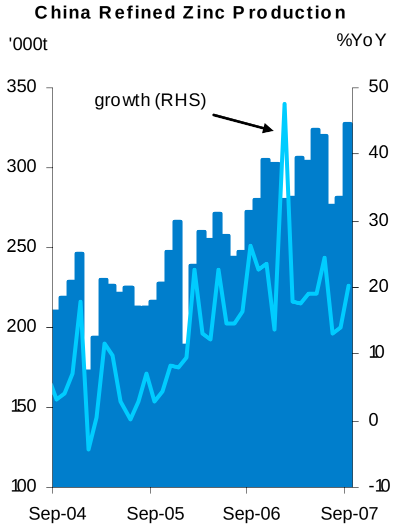
Chinese galvanised steel consumption is booming

We expect demand to rise by 3.8% in 2007 and 5.3% in 2008 after a softer 2.6% growth rate in 2006. China will lead the way, with strong growth in galvanized-steel production forecast for its booming manufacturing, construction and auto industries. The latest China Customs data shows Chinese galvanised steel production was up a booming 120% to 20.5mt for the first nine months of 2007. Galvanised demand has also picked up in Japan, where high oil prices is driving strong demand for fuel efficient Japanese cars in the US (a car body is predominately galvanised steel).

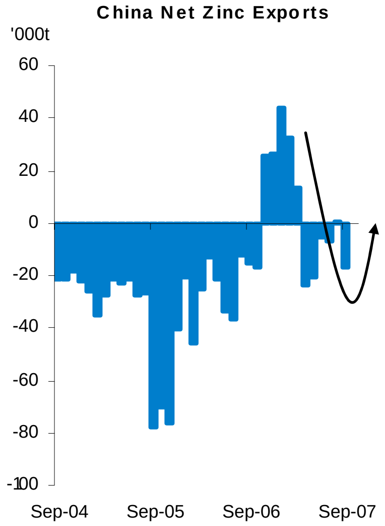
Lower substitution risk than nickel

Lower zinc prices has reduced substitution risk, although the substituting of zinc in galvanized steel is normally a lot lower than for nickel in stainless steel. About 35kg of zinc is required for every tonne on galvanized steel, compared with about 100kg of nickel for every tonne of stainless steel, making zinc a less price-sensitive cost input for end users.

Rising China refined output could allow for net exporting of zinc



Source: China Customs



Source: China Customs

Supply surplus to ease towards end on decade

Zinc supply / demand balance

	2005	2006	2007F	2008F	2009F	2010F
Total Supply Kt	10,180	10,667	11,257	11,904	12,518	13,066
% change	0.5%	4.8%	5.5%	5.8%	5.2%	4.4%
Total Demand Kt	10,561	10,838	11,253	11,853	12,415	13,009
% change	3.8%	2.6%	3.8%	5.3%	4.7%	4.8%
Surplus / (Deficit) Kt	**(381)**	**(171)**	**4**	**52**	**103**	**58**
Total stocks Kt	783	492	496	547	651	708
Weeks of supply	3.9	2.4	2.3	2.4	2.7	2.8
Prices US¢/lb end-period	**86**	**195**	**122**	**118**	**112**	**100**
Prices US$/t end-period	1,901	4,290	2,689	2,601	2,469	2,205
% change	51.6%	125.7%	-37.3%	-3.3%	-5.1%	-10.7%
China Supply Kt	2,776	3,153	3,543	3,895	4,216	4,471
% change	10.2%	13.6%	12.4%	9.9%	8.2%	6.0%
China Demand Kt	2,989	3,115	3,442	3,752	4,052	4,377
% change	17.2%	4.2%	10.5%	9.0%	8.0%	8.0%
China Surplus / (Deficit)	(213)	38	101	143	164	94
% of Global Supply	27.3%	29.6%	31.5%	32.7%	33.7%	34.2%
% of Global Demand	**28.3%**	**28.7%**	**30.6%**	**31.7%**	**32.6%**	**33.6%**

Source: WBMS, ANZ

Gold

Prices to fall 5% in 2008

In an elevated risk climate, gold has become a currency call

We have revised up our outlook for gold prices and are now targeting US$820/oz by end-2007 with a very modest pull-back to US$780/oz by end-2008. In the period ahead we expect gold price movements will remain dominated by the global investor risk climate and, more specifically, the fate of the USD and the EUR. The loss of USD hegemony, continued investor uncertainty in the aftermath of sub-prime and the inflationary impact of high oil prices will all combine to keep gold prices elevated. Global mine supply and consumer dynamics, although likely to have only a marginal impact, should nevertheless also work to keep a firm floor under the gold price.

The global credit crunch and unprecedented collapse in the USD has seen gold storm back as investor's preferred 'store of value'. While the credit freeze in August initially pushed gold prices down, as investors sold all types of financial assets to access much-needed cash, prices of the precious metal have since soared. By mid-November gold prices had hit as high as US$820/oz as investors look for a safe haven and a hedge against the inflationary impact of the falling USD and rising oil prices. A strong correlation between the price of gold and the EUR currency has also been reasserted. Prices of both have been the primary beneficiaries of the weak USD, with the EUR increasingly challenging the dominance of the USD as the world's alternative 'reserve' currency. The correlation between daily movements in these two 'stores of value' has increased to 70% with the correlation between gold and the USD a similar (although negative) 60%.

We expect a slower US economy and continued instability in financial markets will see the USD continue to weaken and the gold price thus make further gains over the rest of 2007 and the first part of 2008. At this stage we expect the Fed will make one further cut in interest rates in February 2008. The end of US monetary policy easing should allow the USD to form a base, and gold to thus form a peak of US$850/oz in March 2008.

Further USD weakness should push gold back up to US$850/oz

In the short-term, we see significant risks to our gold price outlook in both directions. Strong upward momentum in this market could clearly see gold move above our forecast peak, particularly if the USD falls further than we expect (with our current call for EUR/USD to top out at 1.47). On the other hand, the gold price is also looking vulnerable to profit-taking, with net longs on the CFTC at record levels. Another freeze in credit markets would also hit the gold price as investors would likely repeat mid-August behaviour and liquidate gold to buy the ultimate safe haven, cash. A healthy correction in the oil price, while not our core forecast, could also see gold prices drop sharply from here. The biggest downside risk to the gold price however would come from a sharp turnaround in the USD, prompted perhaps by the Fed coming good on its inflation warnings and not further cutting US interest rates as expected.

Supply

After a relatively modest rise of 1.7% this year, the global supply of gold is likely to rise at a slightly faster 3.5% pace in 2008. Most of this rise in supply is expected to come from new mine production. In Australia, there should be notable production expansions out of Crescent Gold's Laverton mine, View Resources' Bronzewing mine and Avoca Resources' Trident mine while in China Sino Gold's Jinfeng mine should ramp up to full capacity. Higher prices should also spark some recovery in gold mine production out of South Africa and the US, with smaller mines across other parts of Africa also likely to boost supply.

Gold supply to rise by a faster pace next year

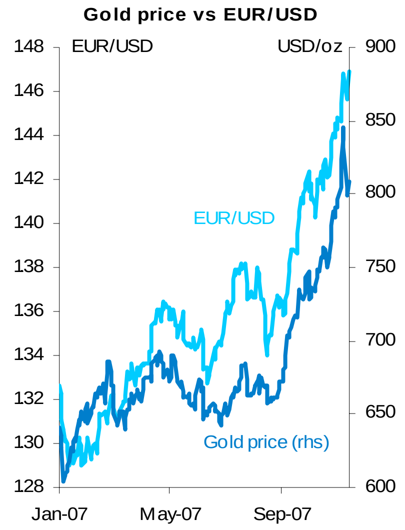
Over 2009 and 2010 new gold supply is likely to grow by a more modest 2.5%pa on average. While central bank sales are likely to accelerate slightly, new mine production will be subdued. Despite a rise in exploration, new mining projects remain small. The long gestation period of gold mines – it takes approximately 10 years to move from exploration to production - will also cap growth in new gold supply.

Demand

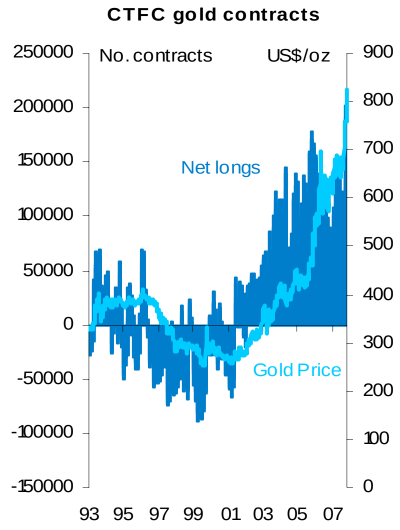
Demand for gold is becoming dominated by investors and central banks

We expect demand for gold be increasingly dominated by investors, central banks and SWFs in the coming years. Gold stores are likely to rise as governments around the world increasingly demand diversification (and yield) for the US$3.5tn held in foreign exchange reserves (with an additional US$2bn at least held in SWFs). This investor demand should offset a dent in demand for fabricated gold, which will likely be weighed down by higher gold prices and slightly slower global economic growth. We expect continued strong income growth within the world's big jewellery buyers, India, the Middle East, and China, will be offset by slower demand out of North America and Europe and thus have a fairly flat outlook for fabricated gold out to 2010.

Gold has become a currency play



Source: Bloomberg, ANZ



Source: Bloomberg

Prices will stay above long-term averages

Gold supply/demand balance

	2005	2006	2007F	2008F	2009F	2010F
Supply	2,550	2,477	2,520	2,608	2,660	2,719
Mine Production	2.3%	-2.9%	1.7%	3.5%	2.0%	2.2%
% change	674	352	450	500	500	500
Central Bank Sales	886	1,105	1,000	1,000	1,050	1,100
Disinvestment	4,110	3,934	3,970	4,108	4,210	4,319
Total Gold Supply	6.9%	-4.3%	0.9%	3.5%	2.5%	2.6%
% change	2,550	2,477	2,520	2,608	2,660	2,719
Demand						
Jewellery	2,707	2,279	2,740	2,780	2,780	2,780
% change	3.6%	-15.8%	20.2%	1.5%	0.0%	0.0%
Other Demand	575	640	650	670	690	712
Total Fabrication	3,282	2,919	3,390	3,450	3,470	3,492
Bar Hoarding	348	592	420	498	579	665
Investment	480	423	160	160	161	162
Total Gold Demand	4,110	3,934	3,970	4,108	4,210	4,319
% change	6.9%	-4.3%	0.9%	3.5%	2.5%	2.6%
Surplus / (Deficit)	0	0	0	0	0	0
Prices US$/oz end-period	513	635	820	780	685	640
% change	17.2%	23.8%	29.1%	-4.9%	-12.2%	-6.6%

Source: ANZ

Oil

Oil price to stay above US$80 nex year

A weaker US economy hasn't stopped oil prices rising 90% this year

We have raised our oil price outlook and now expect West Texas Intermediate to end 2007 at US$90/bbl and remain above US$80/bbl over the course of 2008. In 2009 and 2010 we are looking for a further easing, but still expect prices to remain above our long-term forecast of US$60/bbl.

The upgrade to our oil price outlook comes in spite of our downgrade to global economic growth. It is pertinent to note that despite a sharp slowdown in the world's largest single oil consumer, the US economy, so far this year the price of oil has risen 90% above its January low. This divergence in oil prices from the US business cycle reflects not only the sharply increasing energy demands of the rest of the world but also the absence of new OPEC supply.

In the coming year we see little to disrupt either of these trends. The rising energy demands out of non-OECD countries is likely to underpin even stronger growth in oil demand. While OPEC does have significant investment plans for upstream oil production, the extent to which this will convert into actual new oil supply depends critically on government policies and so is far from assured. The willingness to turn on the tap also now faces a significant wind from the declining USD with producers keen to ensure that exchange rate movments do not erode oil-derived incomes. Also contributing to prices is higher extraction costs with non-OPEC producers having to rely more and more on remote and deeper-water fields.

US$100/bbl looks inevitable, but unsustainable

So why not US$100/bbl? We would be foolish to rule out a break of this key level, and indeed it is almost looking inevitable. Heightened geopolitical tension or adverse weather conditions are the most likely triggers. On our projections, fundamental supply and demand conditions do *not* support an oil price above US$100/bbl with slated new production expected to be enough to ensure the market balance does not deteriorate. We believe that a sharp shock to world oil supply would be required for the magic US$100 mark to be sustained.

In the short-term we think the oil price, currently trading at US$94/bbl, looks vulnerable to some further, albeit limited, falls. There is still room for part of the seasonal hurricane premium to be unwound while a recent climb in US crude oil stocks finally points to some downside risk to consumption out of this slowing economy. The impact of the weak USD on recent oil price rises may also have been overexaggerated. Contrary to some perceptions, stronger non-USD currencies have not been nearly enough to offset the recent oil spike, with oil prices in EUR still up 38% and prices in JPY up 42% since the start of this year. These significant price rises are a headwind to demand growth in these already slowing regions which in turn may limit further oil price gains.

Supply

Oil supply has been sluggish this year, posting an expected rise of just 0.2%, the slowest rate of growth since 2002. A reduction in OPEC supply lies behind this soft growth with the decision in September to raise production not enough to counter the impact of production cuts in late 2006 and early 2007. OPEC oil supply is therefore still expected to fall by at least 1.5% this year.

New oil supply critically depends on OPEC

In 2008, we expect a strong pick up in the rate of growth of world oil supply to 2.2%. Indeed, we expect oil supply growth will average 2.1%pa between 2008-10, a sharp rise from the 0.7%pa growth achieved over 2005-07. This bullish supply view is entirely reliant on higher OPEC production coming on board. Government policies in the member-countries, partiuclarly in the face of a weakening USD, remains critical to this outlook. With some 90 upstream investment projects currently listed amongst the OPEC region, our base case conservatively calls for at least half of these expansions to meet fruitiation. . Meanwhile growth in non-OPEC supply will continue to slow. Maturing fields will see oil supply fall out of the US, Mexico, the UK and Norway with only Africa, Latin America, Canada and CIS expected to boost production.

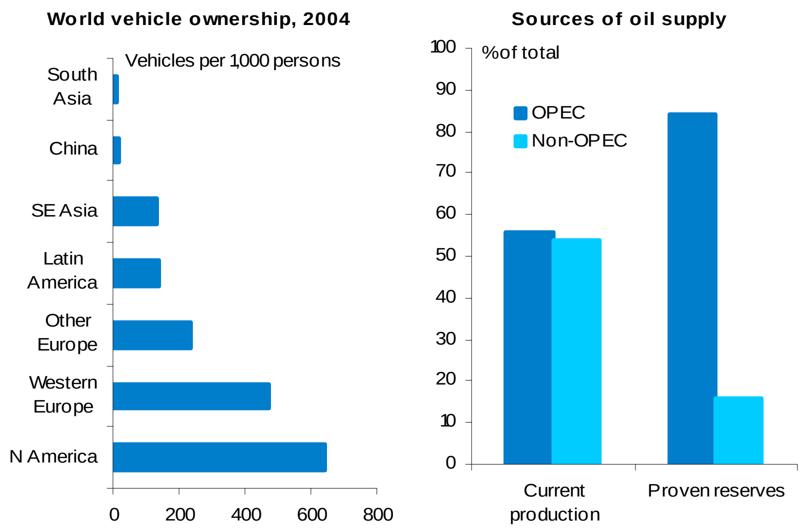
As OPEC holds the bulk of proven and recoverable oil reserves, the world will rely increasingly on this grouping to meet future rises in oil supply over the medium-term. Non-conventional supplies, such as mineral sands, should also make a growing contribution to output over the medium-term, albeit incurring higher production costs than crude oil extraction.

Demand

G3 business cycles are having less impact on oil demand

We see little to disrupt the expected strong 2007 growth rate of 1.6% in global oil demand over 2008-10. We are actually forecasting a slight increase in global oil demand growth, to 1.7%pa over this period. The majority of this increase in demand is expected to come from the developing world, especially China and India. The rapidly expanding transport sector, espeically personal automobile use, is set to underpin a strong rise in oil consumed per person in these developing economies. This demand will be driven by rising per capita incomes in these regions. Against this backdrop the influence on global oil demand of global business cycles, particularly in the G3, will continue to wane.

Easy to be bullish on demand, counting on OPEC for supply



Source: OPEC

Source: BP World Energy Review

Oil supply/demand balance

The oil market will remain in deficit

	2005	2006	2007F	2008F	2009F	2010F
OPEC supply Mb/d	35.3	35.6	35.1	36.0	37.0	38.0
% change	3.4%	0.9%	-1.5%	2.7%	2.7%	2.7%
Non-OPEC supply Mb/d	45.9	46.1	46.7	47.6	48.3	49.0
% change	-0.3%	0.2%	1.5%	1.8%	1.5%	1.5%
World supply Mbbl/day	81.3	81.7	81.8	83.6	85.3	87.0
% change	1.3%	0.5%	0.2%	2.2%	2.0%	2.0%
World demand Mb/d	83.1	83.7	85.1	86.5	88.0	89.5
% change	1.4%	0.8%	1.6%	1.7%	1.7%	1.7%
Surplus / (Deficit)	**-2**	**-2**	**-3**	**-3**	**-3**	**-2**
Prices US$/bbl end-period	**59.39**	**62.02**	**90.00**	**80.00**	**70.00**	**65.00**
% change	37.3%	4.4%	45.1%	-11.1%	-12.5%	-7.1%
China Demand Mb/d	**7.0**	**7.4**	**7.9**	**8.3**	**8.7**	**9.1**
% change	3.1%	6.6%	6.0%	5.5%	5.0%	4.6%
% of World Demand	8.4%	8.9%	9.3%	9.6%	9.9%	10.2%
US demand Mb/d	**20.8**	**20.6**	**20.9**	**21.1**	**21.3**	**21.5**
% change	0.3%	-1.0%	1.5%	0.8%	1.0%	1.0%
% of World Demand	25%	25%	25%	24%	24%	24%

Source: BP World Energy Review, OPEC, IEA, ANZ

Thermal coal

Contract prices to rise 35% in 2008

We have significantly revised up our thermal coal contract price forecasts and are now expecting a steep 35% rise to US$75/mt for the 2008 Japanese fiscal year. These strong conditions look set to be largely maintained over the short-term, with the 2009 negotiations now forecast to produce a relatively modest 7% fall to US$70/mt.

Our bullish outlook for thermal coal may prove conservative

The upgrade to forecast contract prices puts us towards the top of market expectations, but given current strong market conditions even our bullish outlook may prove conservative. Xstrata has reportedly made a 2008 term offer price of US$78/mt with Japanese utilities and spot prices in the thermal coal market are continuing to hit record highs. Coal for delivery from Australia's Newcastle port climbed to US$83.51/mt in the first week of November, the fifth new record in six weeks.

The sharp upgrade to the thermal coal price outlook reflects an expected strong rise in Chinese coal imports and continued disruptions in thermal coal supply. The emergence of China as a net coal importer over 2007 – as local consumption outpaces local production - has had a marked impact on the global coal market. We now expect Chinese export demand to grow from 9% to nearly 11% of global exports by 2010. This strong demand outlook should dominate thermal coal trade dynamics in the coming years and underpins our bullish medium-term outlook for prices.

Spot prices look set to test further highs

In the short-term, spot prices are set to test further record highs. The vessel queue off Newcastle port has increased again to 44 vessels and recent allocation cuts will further constrain shipments. The approach of Indonesia's wet season also poses a risk to global supply. The short-term demand outlook is also strong. The northern hemisphere is entering its winter heating demand period and the Chinese Ministry of Commerce has reported this country will also enter its peak season for coal storage and consumption in the last two months of the year.

Supply

New thermal coal export supply continues to face headwinds

Exported thermal coal supply is expected to have risen by just 3.2% in 2007, hampered by infrastructure constraints, heavy rainfall in both Australia and Indonesia and lower Chinese exports. In the coming year infrastructure improvements should begin to boost supply out of Australia and South Africa as well as Columbia, which is now the world's fourth-biggest thermal coal exporter. That said, these slated capacity expansions continue to run the risk of underperformance. Expected 2008 capacity at the Newcastle port for example has already been reduced from 97mtpa to 95mtpa with some industry analysts suggesting a rise to 90 mtpa (from 84mtpa in 2007) is more realistic. One definite negative for supply is the likelihood of a further fall in Chinese thermal coal exports as well as slower growth in Indonesian exports. Rapid growth in local electricity generation is set to underpin strong domestic demand for thermal coal in both of these countries, thus limiting stocks available for export. As such, growth in global exported thermal coal, while improving, is still expected to remain relatively modest at around 4.1% in 2008.

Longer-term, we expect global thermal coal supply will tighten again over 2009 and 2010. While the completion of infrastructure expansions should allow a jump in exports from Australia and South Africa in 2009, this is likely to be offset by continued slower production growth in China and Indonesia. By 2010, we expect Chinese annual thermal coal supply will drop to 48 mt, some 30mt below the peak in export supply achieved in 2003.

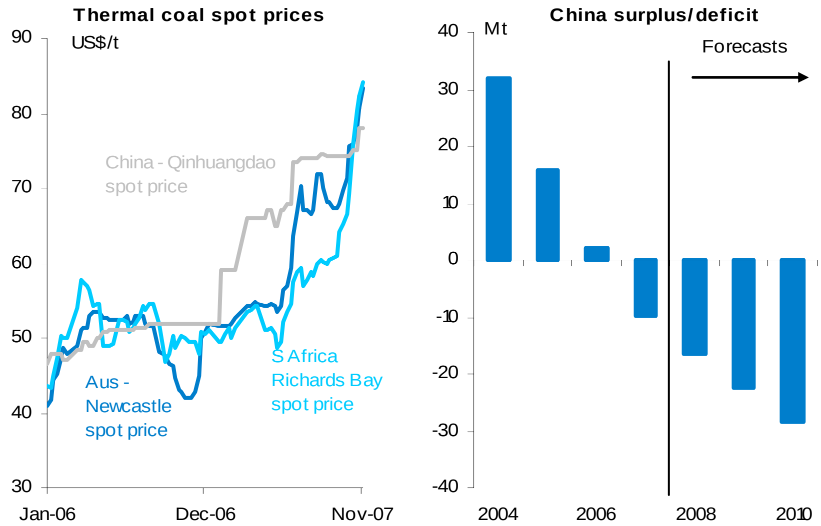
Demand

Having risen an estimated 3.3% in 2007, global demand for thermal coal is forecast to rise by 4.1% in 2008. Our forecast acceleration in demand growth next year comes despite an expected slowdown in global economic growth and is instead driven primarily by our expectation for further strong growth in coal-fired electricity generation capacity across industrialising Asia.

Coal-fired electricity generation will grow rapidly across Asia

China will continue to increase its role in international coal demand. In contrast to other commodity markets, large domestic production has previously limited Chinese demand for coal imports, and thus China's influence on global prices. This is now quickly changing and after becoming a net coal importer for the first time earlier this year, China's reliance on external coal supply is set to grow significantly. We are forecasting Chinese demand for thermal coal imports to rise by 8-9% pa out to 2010. This will see China's thermal coal balance deteriorate from a surplus of 2mt in 2006 to a deficit of 28mt by 2010. As well as a rapid build in electricity generation, other factors spurring Chinese coal imports will be an expected further appreciation of the CNY, which will improve the relative price of imported US$-priced coal, and local infrastructure constraints, which currently make it cheaper for southern Chinese companies to import coal from Indonesia rather than source it domestically from northern China. Japan and India are also expected to be key sources of new thermal coal import demand in the coming years while growing electricity demand in Korea, Taiwan and Malaysia is also expected to be met by thermal coal. This will more than offset a likely moderation in demand growth out of Europe.

Spot price surge as China increases its impact on the market



Source: Bloomberg and ANZ

Source: AME and ANZ

Thermal coal supply/demand balance

China will become increasingly dependent on thermal coal imports

	2005	2006	2007F	2008F	2009F	2010F
Export Supply Mt	576	625	645	671	695	716
% change	4.3%	8.4%	3.2%	4.1%	3.5%	3.0%
Export Demand Mt	576	625	645	671	695	718
% change	4.3%	8.4%	3.3%	4.1%	3.5%	3.3%
Surplus / (Deficit) Mt	**0**	**0**	**0**	**0**	**0**	**-2**
Prices						
Japanese Contract US$/t	53.00	52.50	55.60	75.00	70.00	70.00
% change	17.8%	-0.9%	5.9%	35.0%	-6.7%	0.0%
China Supply Mt	63	56	50	48	48	48
% change	-12.8%	-11.5%	-11.6%	-3.0%	0.0%	-1.0%
China Demand Mt	47	54	59	65	70	76
% change	16.5%	13.5%	10.0%	9.0%	9.0%	8.0%
China Surplus / (Deficit) Mt	16	2	-10	-17	-22	-28
% of Export Demand	**8.2%**	**8.6%**	**9.2%**	**9.6%**	**10.1%**	**10.6%**

Source: AME, ANZ

Coking coal

Contract prices to rise 30% in 2008

Our forecast for the 2008 premium hard coking coal contract price has been upgraded significantly to US$125/t FOB, a rise of 30% from the 2007 contract price. A robust outlook for global steel production set against continued constraints on coking coal exports is expected to deliver this sharp rise. These factors look set to keep the coking coal market tight into the medium-term. We thus expect only a partial unwinding of the strong 2008 gains and are forecasting modest falls in contract prices of around 4% pa in 2009 and 2010.

The steel market is decoupling from the US economy

Never has the de-coupling of commodity markets from the US economy been clearer than in the current steel market dynamics. Despite a sharp slowdown in the steel-intensive US housing sector, world steel production was still 7.3% higher in first nine months of 2007 compared with this period last year. A strong 12% rise in Asian production – led by a phenomenal 21% rise in India and a slower but still impressive 14% rise in China - more than offset a 4% decline in US steel production. The tightening of global credit markets is unlikely to dent steel production across Asia with investment largely financed locally, out of current account surpluses and record high reserves.

A repeat of 2005?

No surprise that in this environment spot prices for coking coal have gone through the roof. The spot price for coking coal exports into China has soared by almost 100% since the start of the year and Australian low volatile PCI coal is now reportedly selling into Brazil at nearly 50% above the 2007 Japanese contract price. Against this backdrop, our forecast 30% contract price rise looks conservative. However we note that the current traded deficit in coking coal, predicted to be around 1mt this year, is just one third that of the 3mt deficit of 2004 which delivered the 120% contract price increase of 2005. Global macroeconomic dynamics are also different this time around with 2004-05 the start of a synchronised upturn across all of the major global economies.

Supply

Australia should lead a 6% rise in world export supply next year

While not as acute as in the thermal coal market, infrastructure constraints, particularly in Queensland ports, continues to limit coking coal exports. While global export supply has recovered from a 2.4% fall in 2006 to post an expected 3% rise this year, this is still not enough growth to meet demand. In 2008, we are predicting a stronger 5.6% rise in global export supply, with, as always, delays in infrastructure upgrades the biggest downside risk to this outlook. If all goes to plan however, Australia should drive the majority of this increase in exports, with the long-awaited increased rail transport facilities and power upgrades expected to boost coal supply chains in the Gladstone and Dalrymple ports. Coking coal exports out of Canada should also rise solidly as production out of the Elk Valley site ramps up. Weak domestic demand meanwhile should see US coking coal producers rotate sales towards the export market with these producers also likely to boost output to take advantage of strong global prices.

In contrast, Chinese coking coal exports are expected to decline in the coming few years. While local coking coal production continues apace, local consumption of this commodity is growing faster. This has seen China move from a net exporter to a net importer of coking coal this year, with the country's net export deficit set to grow from an estimated 1mt to 3mt by 2010.

Demand

The IISI has upgraded its outlook for world steel use

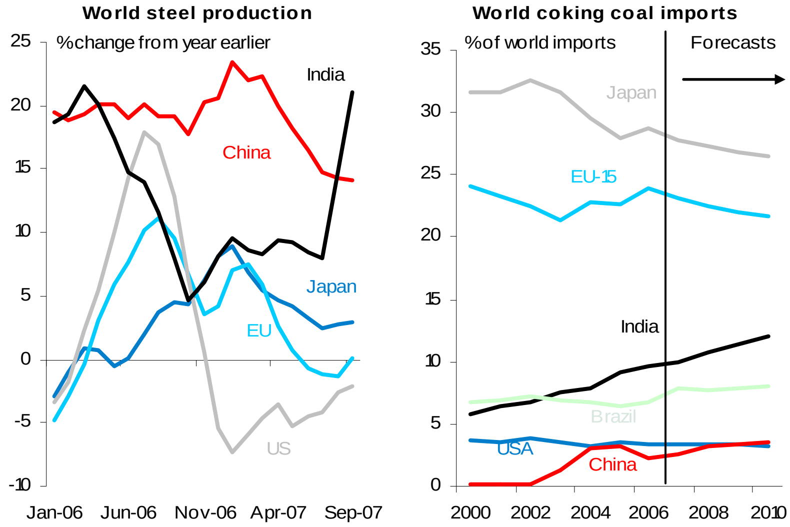
Slower growth in the G7, including a sharply weaker US economy, appears to be having little disruptive effect on the global steel market. The International Iron and Steel Institute (IISI) is now forecasting global apparent steel use to rise a solid 6.8% in both 2007 and 2008, an *upgrade* from it's last review published in March. The BRIC (Brazil, Russia, India and China) countries, which currently make up 41% of global steel demand, are again expected to lead the way and account for 71% of the growth in expected steel use next year.

While China's transformation to a net coking coal importer is important for markets, of most significance in our view is the strong prospects for import demand out of India. While only accounting for 4% of world steel production,

India will become a key driver of world coking coal demand

almost half of India's coking coal needs are met by imports. Following expected 14% growth this year, Indian steel production is forecast to rise a further 12% in 2008. Growth is likely to remain in double-digits out to 2010, fuelled by aggressive infrastructure spending with the government calling for an additional US$475bn (equivalent to 50% of current GDP) of new investment over the next five years. Indian coking coal supply meanwhile, despite the government's best efforts, remains underdeveloped and of relatively low grade. As such, India's reliance on coking coal imports is expected to grow further. We are now predicting India will account for 15% of total world coking coal imports by 2010, double the 7% share is had just last year in 2006.

Look out for India!



Source: IISI

Source: IISI, AME, ANZ

Coking coal prices will remain elevated medium-term

Coking supply/demand balance

	2005	2006	2007F	2008F	2009F	2010F
Export Supply	225	220	226	239	250	261
% change	3.5%	-2.4%	3.1%	5.6%	4.4%	4.4%
Export Demand	225	218	227	239	249	261
% change	1.9%	-3.0%	4.2%	5.1%	4.4%	4.6%
Surplus / (Deficit)	**0**	**1**	**-1**	**0**	**0**	**0**
Prices						
Premium Hard US$/t	126.90	114.00	96.00	125.00	120.00	115.00
% change	118.8%	-10.2%	-15.8%	30.2%	-4.0%	-4.2%
Standard Hard US$/t	125.00	105.00	85.00	110.00	100.00	95.00
% change	127.3%	-16.0%	-19.0%	29.4%	-9.1%	-5.0%
Semi-Soft Coking US$/t	79.50	58.00	65.00	85.00	85.00	80.00
% change	84.9%	-27.0%	12.1%	30.8%	0.0%	-5.9%
Low Volatile PCI US$/t	102.00	66.00	67.50	88.00	88.00	82.00
% change	119.4%	-35.3%	2.3%	30.4%	0.0%	-6.8%
China Supply Mt	9	7	7	6	6	5
% change	-24.8%	-14.1%	-11.0%	-7.7%	0.0%	-11.7%
China Demand Mt	7	5	7	8	8	9
% change	5.9%	-30.6%	40.0%	14.3%	3.8%	2.4%
China Surplus / (Deficit) Mt	1	2	-1	-2	-2	-3
% of Export Demand	**3.2%**	**2.3%**	**3.1%**	**3.4%**	**3.3%**	**3.3%**

Source: AME, ANZ

Iron ore

Contract prices to rise 35% in 2008

We have significantly revised up our outlook for iron ore prices and now expect that 2008 benchmark contracts will rise by a strong 35% in 2008. We don't expect current tight market conditions to persist however with a significant increase in global supply capacity, mainly out of Brazil and Australia, on track for the coming year. This rise in global supply should allow steel mills to push for a significant reduction in prices and so we are currently factoring in a 20% fall in contract prices for 2009.

China is *the* driver of world iron ore demand

Rampant demand out of China is the main factor driving iron ore prices higher in the year ahead. Local steel production remains strong, rising by 14% in the year to September. With local production of higher-grade iron ore becoming more limited, Chinese steel producers are increasingly relying on imports to meet their needs. Longer-term, the 'China factor' makes it difficult to be anything but bullish for the iron ore market. The China Iron and Steel Association is now predicting that China's rate of urbanisation (ie. the proportion of the population living in urban areas) will rise from its current level of 39% to 47% by 2010 and to as high as 60% by 2020. This will see more than 200 million people move to cities over the next decade, creating enormous demand for steel-intensive infrastructure.

Spiralling spot and freight costs put producers in the box seat for price negotiations

The spot market also points to sharply higher prices for 2008. The current Indian ore spot price into China is now trading at a record US$194/t, 140% higher than the spot price of a year ago and 105% higher than the current Australian contract price. These large differentials, together with spiralling freight costs, will be powerful bargaining tools for the iron ore producers as they commence contract price negotiations with the Japanese and Chinese steel mills this month.

Supply

BHP Billiton's attempt to takeover Rio Tinto highlights the heavy consolidation in the global iron ore industry. Currently 75% of the world's iron ore production is controlled by just three companies, CVRD, BHP Billiton and Rio Tinto. The spoils of this giant market share will shrink to just two producers if BHP's bid for Rio is successful. There are concerns that such industry consolidation will encourage further restrictions on iron ore production. However, we are more inclined to think this possible merger would be a positive for supply, as it would lead to less duplication of infrastructure and should potentially allow a more dynamic and efficient production response to changes in demand. BHP's CEO Marius Kloppers has moved to assure the market on this, suggesting a successful takeover would boost supply through the merging of BHP's and Rio's Pilbara assets. Nevertheless, global steel mills will remain concerned that greater industry consolidation will shift pricing power further towards the suppliers.

The proposed BHP-Rio merger should create synergies in supply

Following an expected 6.7% rise in global iron ore exports this year, we are forecasting another strong 8.6% rise in supply in 2008. Brazil is set to just pip Australia as the biggest contributor to this global increase as CVRD's Carajas mine marches towards its new annual capacity (100mt). In Australia supply will be ramped up by the commencement of production at Fortescue Metal's Chichester Range site (45mt) and Rio Tinto's Hope Downs site (22mt capacity). Longer-term the outlook for global iron ore production remains relatively strong, with increases of 7.7% and 7.1% expected in 2009 and 2010. Capacity expansions across Brazil and Australia are again expected to lead the way.

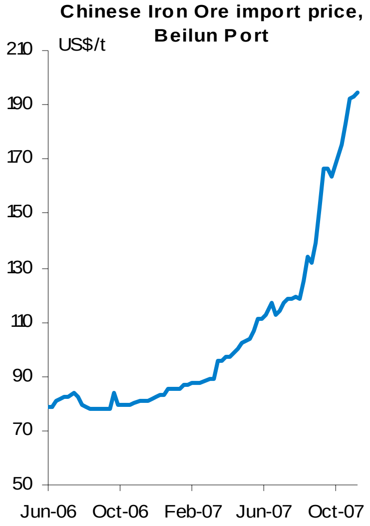
Demand

China remains the key driver of our bullish outlook for iron ore. To be sure, Chinese economic growth, and thus local steel production, is expected to ease in the period ahead. However, this is unlikely to make much dent on Chinese import demand for iron ore, which will grow as local Chinese iron ore production continues to slow. As such, we expect Chinese demand for iron ore imports will ease only slightly from 11% growth this year to around 10% by 2010. Already buying 46% of the world's iron ore exports, we now expect Chinese demand will swallow more than half of total global iron ore exports by 2010. This changing market dynamic alone makes it difficult to allow our forecast for global iron ore demand growth to fall much below 5%pa. As it stands, we are currently forecasting total demand to pick up from an estimated 7.5% in 2007 to 7.9% in 2008, slowing slightly to 7.1% in 2009 before rebounding to 7.9% in 2010.

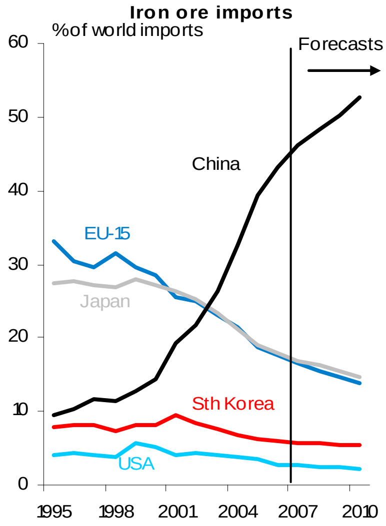
Strong domestic demand may drag on Indian iron ore exports

India is the other critical watch factor for the iron ore export market in the period ahead. Indian exports have traditionally played an important role in 'filling the gap' in world iron ore markets, ramping up in peak demand periods. However, ambitious domestic infrastructure plans are now causing an increasing share of Indian production to be diverted from exports to local use. Government policies are also encouraging higher domestic use of iron ore, with the imposition of an export tax on iron ore in March and more recently the directive that a steel mill must be constructed alongside all new iron ore mines. With any rise in Indian iron ore production likely to be incremental in the period ahead, the continued withdrawal of exports from this market further underpins our fundamentally bullish iron ore view.

China is driving the strong iron ore market



Source: Bloomberg



Source: AME and ANZ

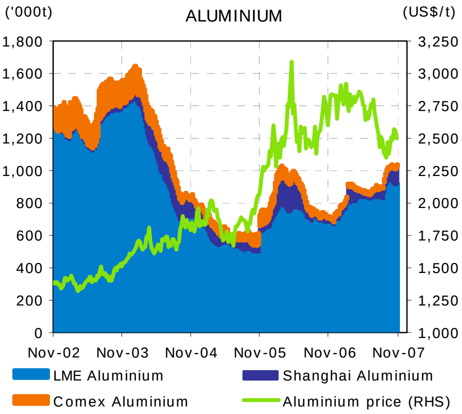
China will account for more than half of world iron ore imports by 2010

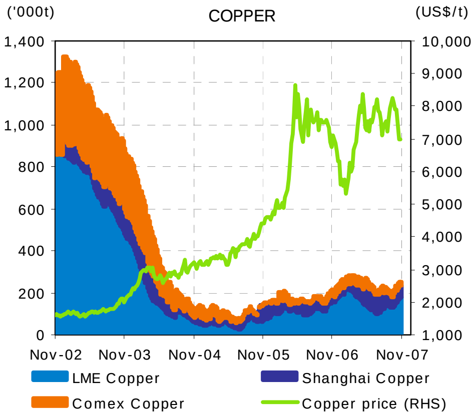
Iron ore supply/demand balance

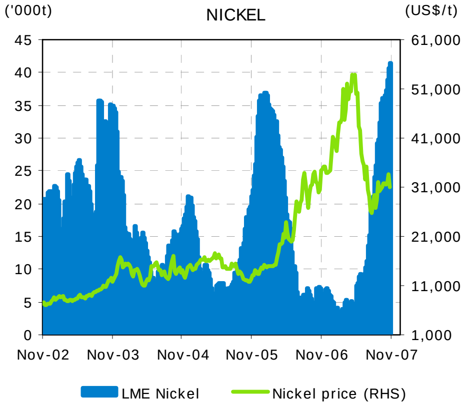
	2005	2006	2007F	2008F	2009F	2010F
Export Supply Mt	702	755	805	875	942	1,010
% change	9.9%	7.5%	6.7%	8.6%	7.7%	7.1%
Export Demand Mt	700	753	809	874	935	1,009
% change	9.4%	7.6%	7.5%	7.9%	7.1%	7.9%
Surplus / (Deficit)	**2**	**2**	**-4**	**1**	**7**	**1**
Prices						
Newman Fines $/dltu	62.71	74.63	81.72	110.32	88.26	88.26
% change	71.5%	19.0%	9.5%	35.0%	-20.0%	0.0%
Newman Lump $/dltu	80.04	95.24	104.29	140.80	112.64	112.64
% change	71.5%	19.0%	9.5%	35.0%	-20.0%	0.0%
China Supply Mt	421	588	645	700	746	807
% change	25.3%	39.8%	9.6%	8.6%	6.6%	8.2%
China Demand Mt	696	914	1,018	1,123	1,216	1,337
% change	27.9%	31.3%	11.4%	10.3%	8.3%	10.0%
China Surplus / (Deficit) Mt	-276	-326	-373	-423	-470	-531
% of Export Demand	**39.2%**	**43.2%**	**46.3%**	**48.3%**	**49.9%**	**52.5%**

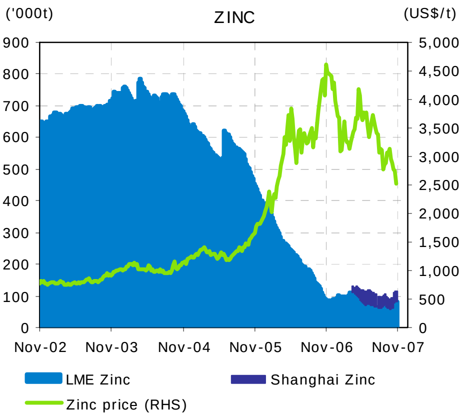
Source: AME, ANZ

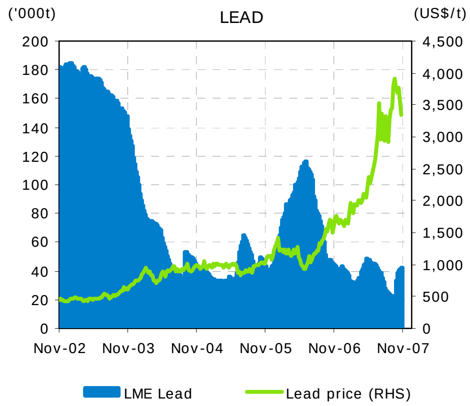
Inventory / Price Charts

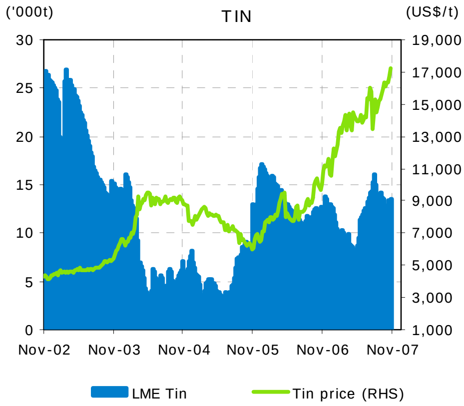


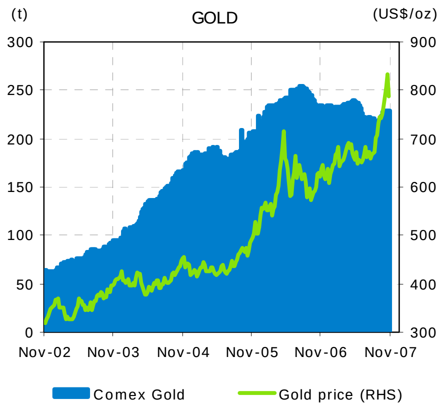


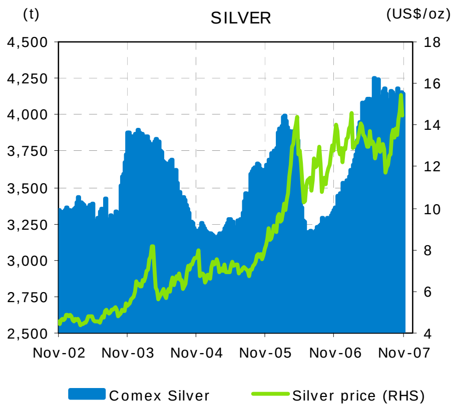


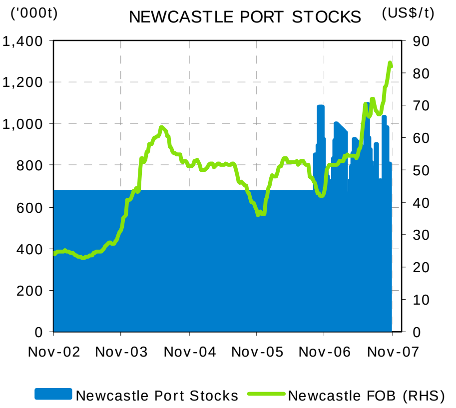


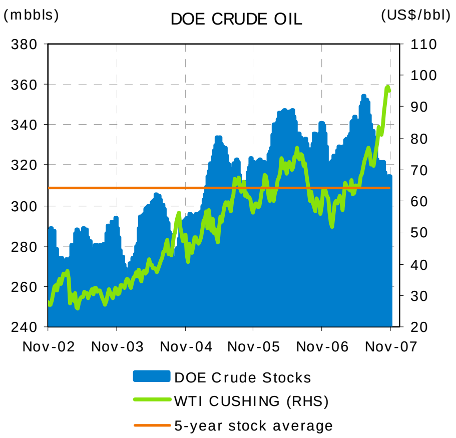


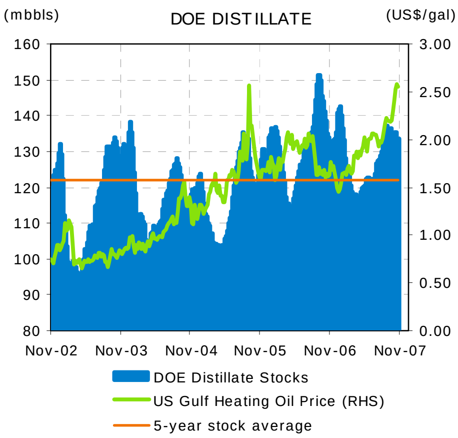


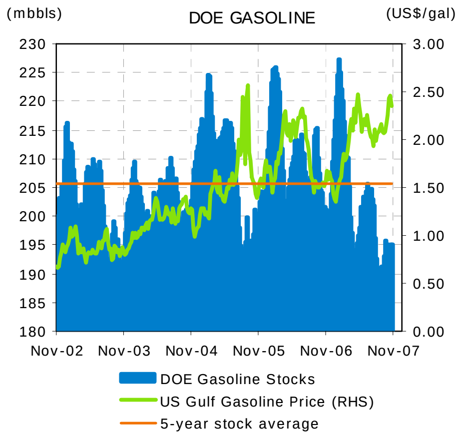






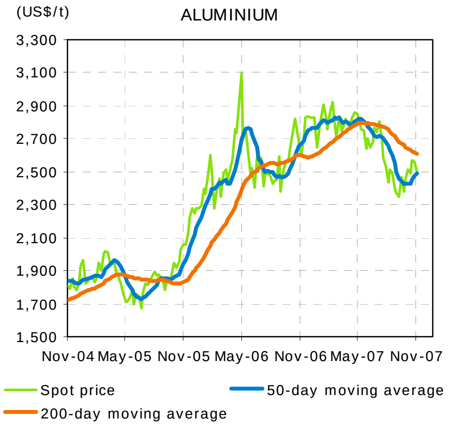


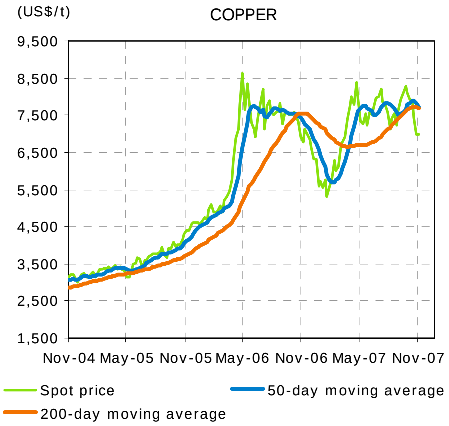


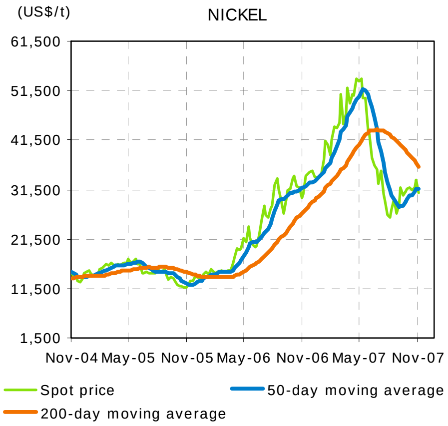


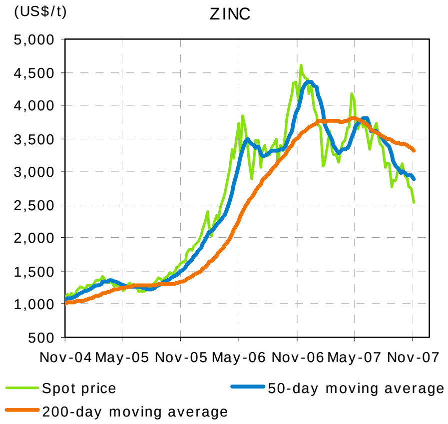
Source: Bloomberg, Hunter Valley Coal Report

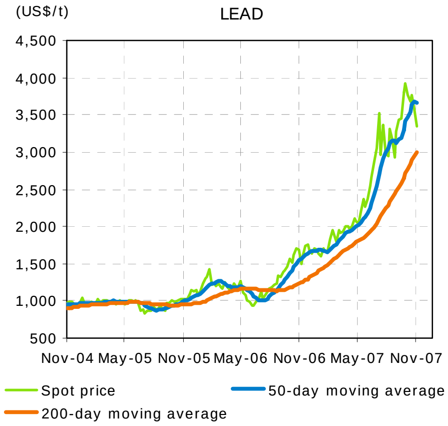
Moving Averages

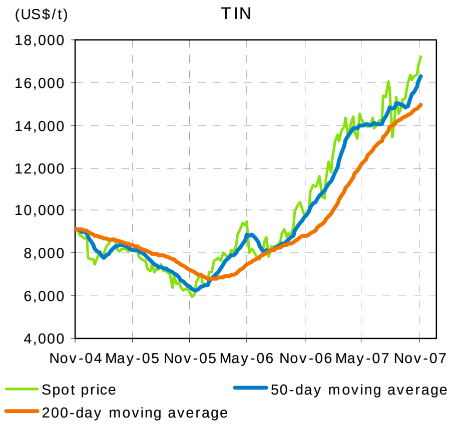


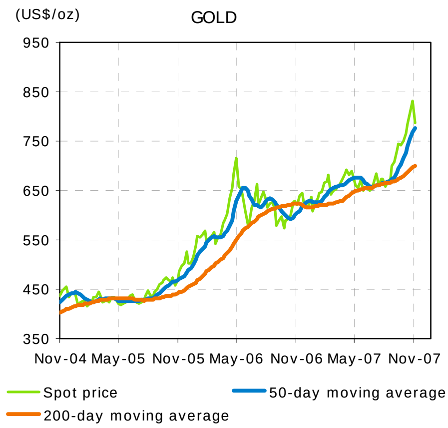


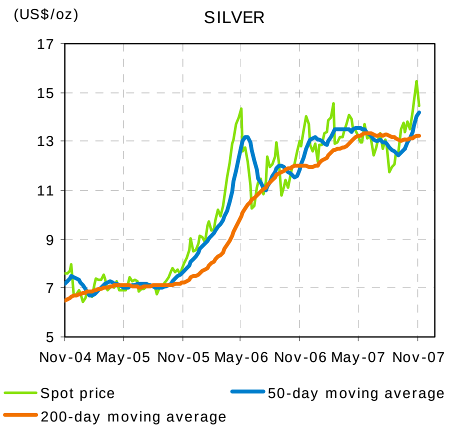


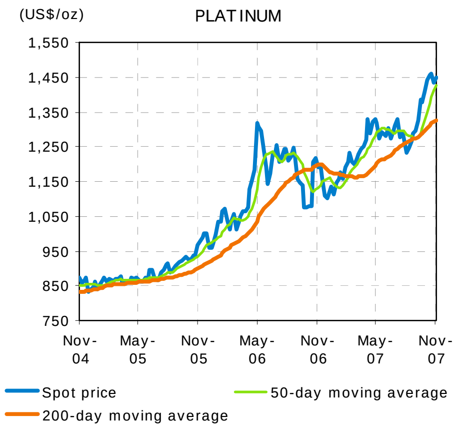


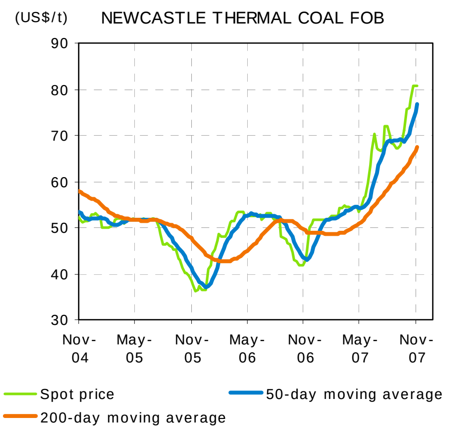


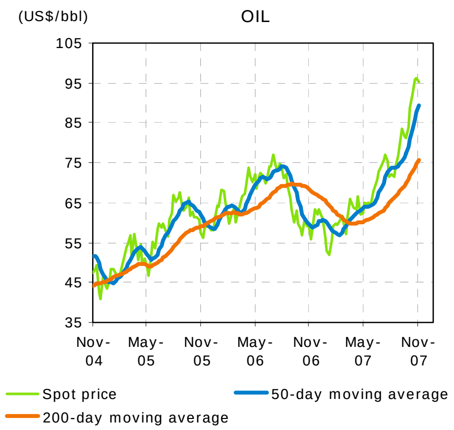


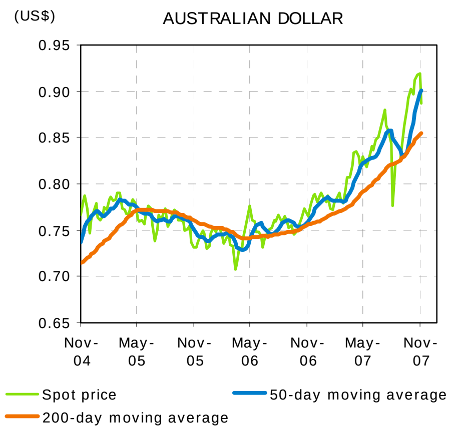






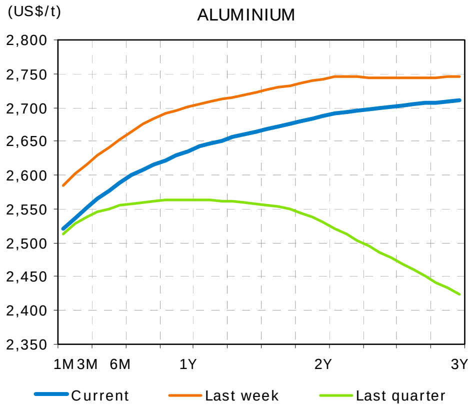


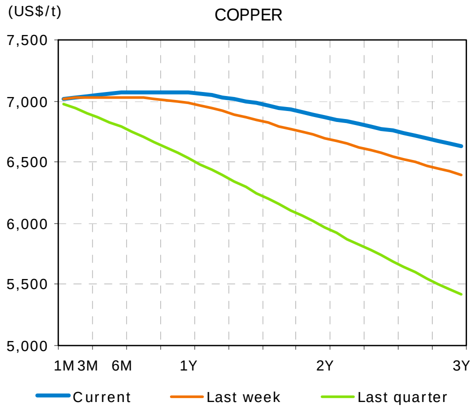


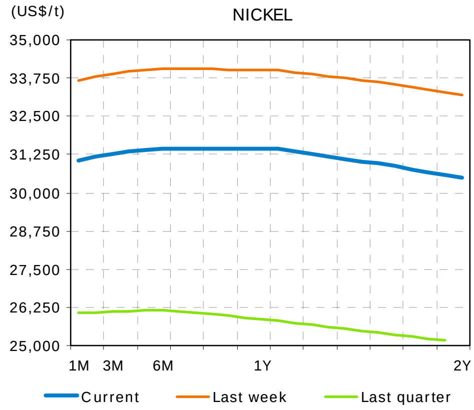


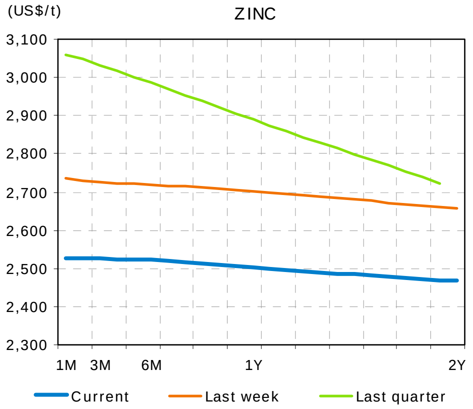
Source: Bloomberg

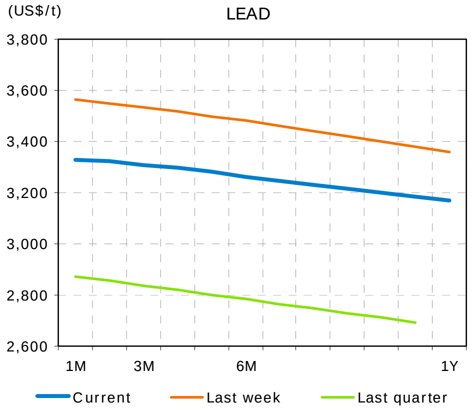
Forward Curves

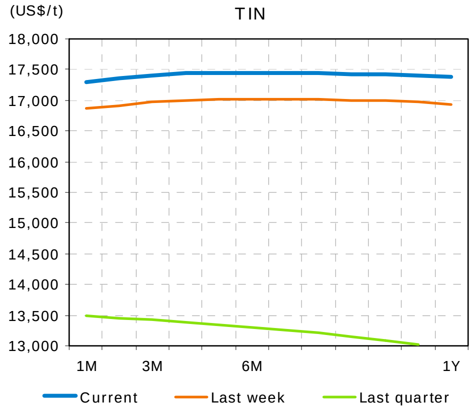


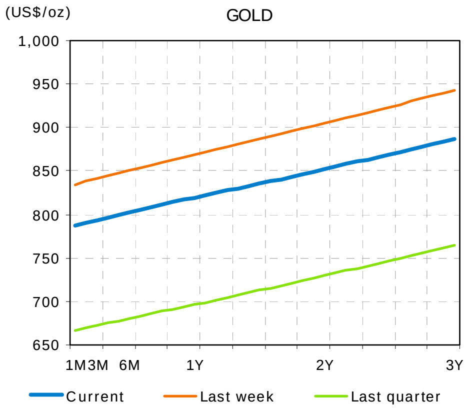


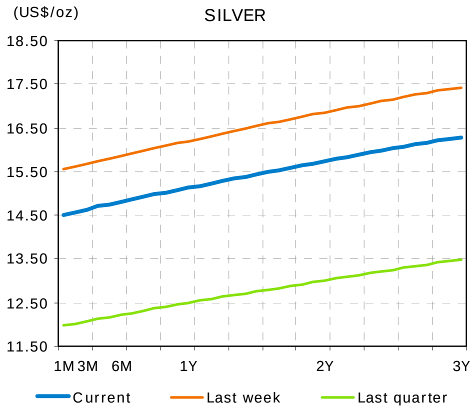


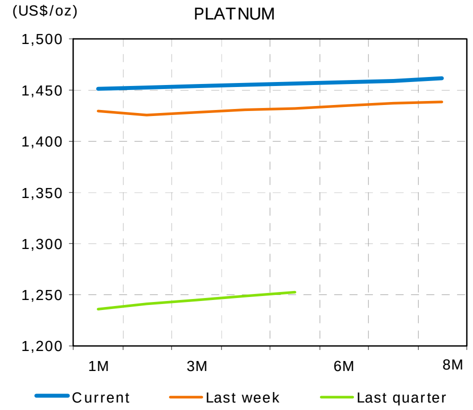


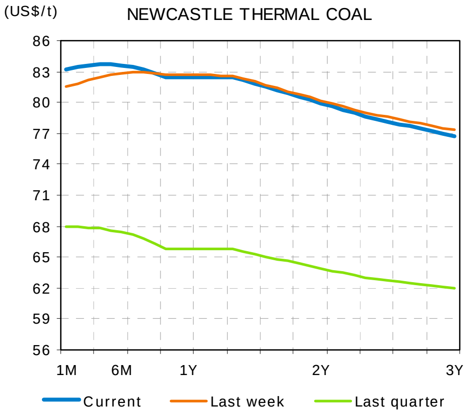


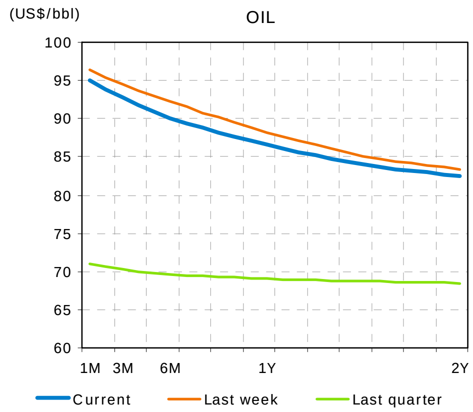


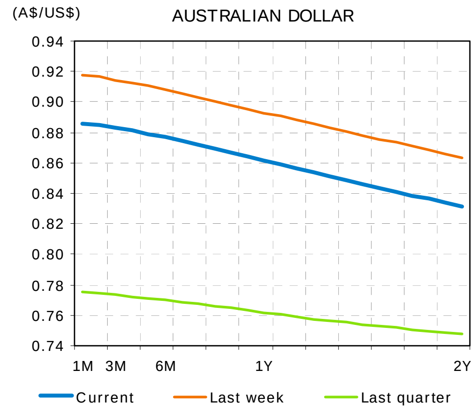












Source: Bloomberg

ANZ Research

Economics@ANZ

Saul Eslake Chief Economist +61 3 9273 6251 Saul.Eslake@anz.com	**Fiona Allen** Business Manager +61 3 9273 6224 Fiona.Allen@anz.com		
Tony Pearson Head of Australian Economics +61 3 9273 5083 Tony.Pearson@anz.com	**Mark Rodrigues** Senior Economist, Australia +61 3 9273 6286 Mark.Rodrigues@anz.com	**Riki Polygenis** Economist, Australia +61 3 9273 4060 Riki.Polygenis@anz.com	**Dr. Alex Joiner** Economist, Australia +61 3 9273 6123 Alex.Joiner@anz.com
Julie Toth Senior Economist, Industry +61 3 9273 6252 Julie.Toth@anz.com	**Wain Yuen** Economist, Industry +61 3 9273 6295 Wain.Yuen@anz.com		
Amy Auster Head of International Economics +61 3 9273 5417 Amy.Auster@anz.com	**Katie Dean** Senior Economist, International +61 3 9273 1381 Katie.Dean@anz.com	**Jasmine Robinson** Senior Economist, International +61 3 9273 6289 Jasmine.Robinson@anz.com	**Amber Rabinov** Economist, International +61 3 9273 4853 Amber.Rabinov@anz.com
Paul Braddick Head of Financial System Analysis +61 3 9273 5987 Paul.Braddick@anz.com	**Ange Montalti** Senior Economist, Financial System Analysis +61 3 9273 6288 Ange.Montalti@anz.com	**Dr. Alex Joiner** Economist, Financial System Analysis +61 3 9273 6123 Alex.Joiner@anz.com	**Stephanie Wayne** Research Analyst, Financial System Analysis +61 3 9273 4075 Stephanie.Wayne@anz.com
Warren Hogan Head of Markets Research +61 2 9227 1562 Warren.Hogan@anz.com	**Cherelle Murphy** Senior Economist, Markets +61 3 9273 1995 Cherelle.Murphy@anz.com		

ANZ Markets

Warren Hogan Head of Markets Research +61 2 9227 1562 Warren.Hogan@anz.com	**Sally Auld** Senior Interest Rate Strategist +61 2 9227 1809 Sally.Auld@anz.com	**Tony Morriss** Senior Currency Strategist +61 2 9226 6757 Anthony.Morriss@anz.com	**Cherelle Murphy** Senior Economist, Markets +61 3 9273 1995 Cherelle.Murphy@anz.com	**Mark Pervan** Senior Commodity Strategist +61 3 9273 3716 Mark.Pervan@anz.com
David Croy Strategist +44 20 7378 2070 croyd@anz.com	**Patricia Gacis** Market Strategist +61 2 9227 1272 Patricia.Gacis@anz.com			
Sarah Percy-Dove Head of Credit Research +61 2 9227 1142 Sarah.Percy-Dove@anz.com				

Research & Information Services

Mary Yaxley Head of Research & Information Services +61 3 9273 6265 Mary.Yaxley@anz.com	**Marilla Rough** Senior Information Officer +61 3 9273 6263 Marilla.Rough@anz.com	**Manesha Jayasuriya** Information Officer +61 3 9273 4121 Manesha.Jayasuriya@anz.com

ANZ New Zealand

Cameron Bagrie Chief Economist +64 4 802 2212 bagriec@anz.com	**Khoon Goh** Senior Economist +64 4 802 2357 gohk@anz.com	**Philip Borkin** Economist +64 4 802 2199 borkinp@anz.com
Sean Comber Economist +64 4 802 2286 combers@anz.com	**Steve Edwards** Economist +64 4 802 2217 edwards1@anz.com	**Kevin Wilson** Rural Economist +64 4 802 2361 Kevin.Wilson@nbnz.co.nz

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

10th Floor 100 Queen Street, Melbourne 3000, Australia

Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000