Economics@ANZ

ANZ Commodities Quarterly

Approaching the summit

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Inside:

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2007 is proving to be a year of strength and volatility in commodities markets. Prices for a range of major resource commodities have soared to record levels, underpinned by continued strong global demand and tight supply. However, there has also been increased divergence and volatility in the performance of commodities. Lead prices for example have moved by a massive 81% from peak to trough in the first half of 2006 while aluminium prices have moved by a relatively subdued 12%.

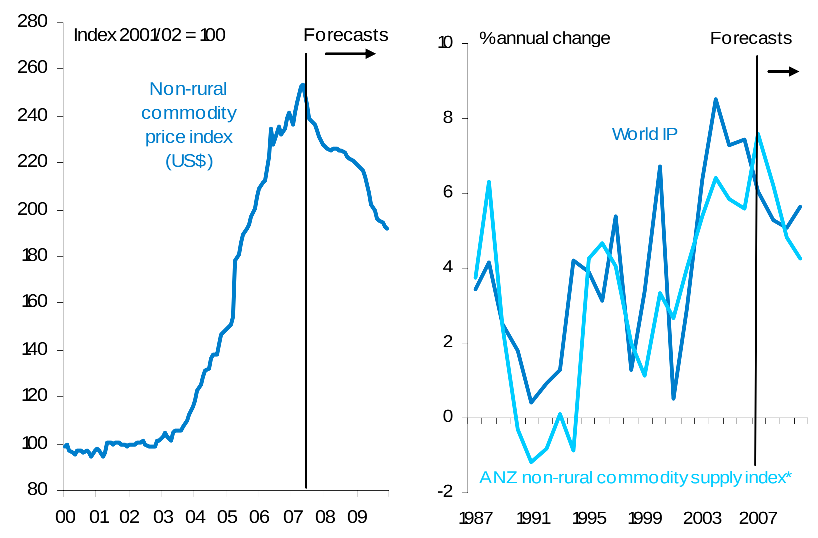
In net terms therefore, this year is proving to be no match for 2006. The RBA's index of non-rural commodity prices has increased by 1.4% in US dollar terms in the six months to June, lower than the 5.9% increase in the previous six months and well down on the 11% rise in prices that occurred in the first half of 2006.

We believe these price developments signal a turning point in the non-rural commodities price cycle. This is backed up by our analysis of 'fundamental' market conditions. While the global economy continues to boom, our estimates suggest that the long-awaited 'supply' response is finally kicking in. Global supply of non-rural commodities is expected to grow by nearly 8% in 2007. If achieved, this will be the biggest annual supply boost for more than two decades. It will also be potentially the first time in more than a decade that global supply growth has outpaced global demand growth.

These fundamental conditions suggest the commodity price boom is close to its peak. However, the performance of individual commodities will continue to diverge. While base metals are likely to lead the price correction, ongoing supply constraints and continued rapid demand point to further price rises across the energy and steel sectors.

Despite some modest price correction in the short-term, the medium-term bull market for commodities remains. This will remain a demand-led boom, underpinned by the continued development, industrialisation and income-growth in emerging economies, notably China and India.

Increases in supply are starting to weigh on prices



* Excludes gold and oil
Source: ABARE, AME, EIU, RBA, Morgan-Stanley, Economics@ANZ

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.

Commodity price forecasts					
End-period	**Jun-07**	**Dec-07**	**Dec-08**	**Dec-09**	**Long-term**
Iron ore - lump contract US$/t	60.8	60.8	65.0	58.5	42.0
Coking coal US$/t	98.0	98.0	103.0	95.0	80.0
Thermal coal US$/t	55.5	57.0	51.5	47.0	44.0
Crude oil (WTI) US$/bbl	67.5	64.0	63.0	62.0	65.0
Gold US$/oz	655	640	600	610	520
Copper US$/t	7 474	6 500	5 500	5 000	3 500
Aluminium US$/t	2 677	2 600	2 400	2 200	1 800
Nickel US$/t	41 705	40 000	35 000	21 000	18 000
Zinc US$/t	3 603	3 300	2 700	2 200	1 700
Non-rural commodities index#	**245.1**	**228.2**	**221.3**	**192.1**	**na**
% annual change		-6.9	-3.0	-13.1	na
ANZ non-rural commodity supply index##	**125.1**	**133.4**	**141.5**	**149.1**	**na**
% annual change		7.6	6.2	4.8	na

Key economic forecasts					
Real GDP (annual % change)	**2005**	**2006**	**2007**	**2008**	**2009**
World	4.7	5.1	4.7	4.6	4.6
United States	3.2	3.3	2.2	3.0	3.2
Japan	1.9	2.2	2.4	1.9	2.1
Europe	1.4	2.6	2.3	2.1	2.1
G7	2.3	2.8	2.2	2.5	2.8
Australia	2.8	2.7	4.0	3.8	3.7
New Zealand	2.1	1.7	1.2	2.5	3.7
China	10.2	10.7	10.2	9.6	9.0
East Asia ex Japan and China	5.1	5.5	5.3	5.2	5.8
India	9.0	9.4	8.7	8.5	8.5

Exchange rate forecasts					
End-period	**Jun-07**	**Sep-07**	**Dec-07**	**Jun-08**	**Dec-08**
AUD/USD	0.8493	0.8200	0.8300	0.8300	0.8000
NZD/USD	0.7726	0.7300	0.6900	0.6500	0.6200
USD/JPY	123.18	124.00	126.00	126.00	122.00
EUR/USD	1.35	1.38	1.36	1.30	1.25
GBP/USD	2.00	1.97	1.95	1.91	1.86
USD/CNY	7.613	7.524	7.450	7.400	7.350
DXY ###	81.92	81.50	82.60	85.40	87.90

US$ 2001/02=100, excludes oil

2001=100, excludes oil and gold, Jun-07 is estimate for Dec-06

USD currency index

Source: Bloomberg, DataStream, RBA, Economics@ANZ

Global economic outlook

The global economy has renewed momentum

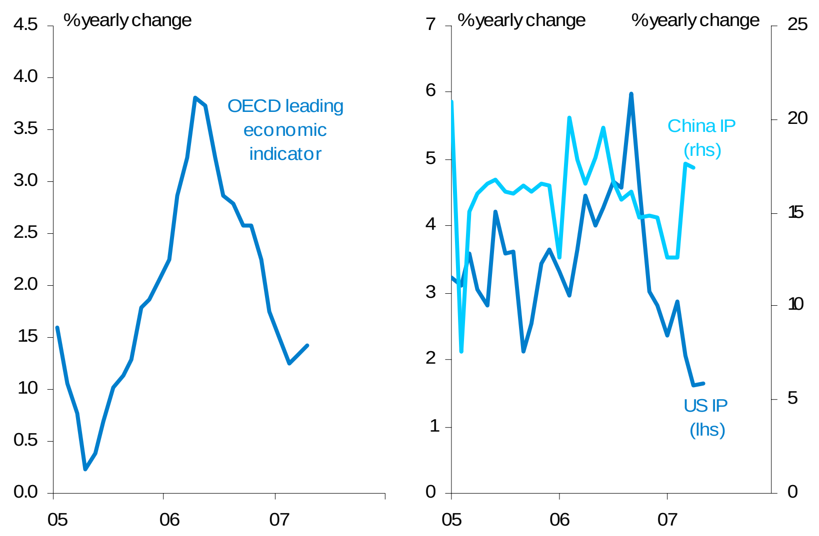
After slightly easing in the first quarter of 2007, the global economy appears to have staged a modest come back in recent months. The rebound has been led by the US, where GDP growth is expected to improve from a meagre 0.7% saar rate in Q1 to 3.5% saar in Q2. Other G7 economies, notably the United Kingdom and Canada, are also strong, more than offsetting a slight slowdown in Europe and Japan. Significantly, the increasingly important Asian region continues to boom, led by the indefatigable Chinese economy.

With the global economy now in the midst of its fifth consecutive year of above-trend growth, there are increasing concerns about inflation risks. Input prices continue to rise, led by record commodity prices, tight labour markets and ongoing infrastructure constraints. Central banks remain alert to these inflation risks with further interest rate rises across Europe, the United Kingdom, Japan and China all likely before the end of this year. The Federal Reserve also continues to emphasise the upside risks to the domestic inflation outlook, although we do not anticipate a rise in US interest rates this year.

Strong emerging economies will keep global growth above trend

Tighter monetary policy should see G7 growth resume its moderation in the second half of this year and by 2008 we expect growth in this region will return to trend. Tighter policy in contrast is likely to have more limited success across the emerging world with growth in these economies, and in particular the Asian region, expected to slow only modestly in the period ahead. The continued strong performance across this rapidly industrialising region should keep global growth and demand for commodities above-trend until at least 2009.

Global growth showing signs of an upturn



Source: Datastream, Economics@ANZ

The outlook for the United States is uncertain

The outlook for the US remains the biggest uncertainty to the global outlook. Recent data suggests that activity is stabilising, with business confidence and retail sales improving. However, several indicators cast doubt over the sustainability of this upturn. Sharply higher gasoline prices and slower employment growth should soon start to weigh on the US consumer. Meanwhile the housing market is continuing to weaken and there is a risk of a deeper downturn if the fall out in the sub-prime mortgage market prompts a significant tightening of lending standards. We expect these developments will keep US growth below trend in the second half of this year, but, as with most possible turning points, it remains a matter of closely 'watching the data'.

But China continues to boom

There is little need for uncertainty in the outlook for the world's second biggest economy, China. Chinese activity re-accelerated in Q2, with an upturn in all indicators of economic activity including fixed asset investment, industrial production and domestic consumption. While authorities have introduced further measures to try and cool exports, they are likely to have little luck in slowing investment spending ahead of the 17th Chinese Communist Party congress in late 2007. We therefore expect Chinese economic growth will stay close to 10%pa in both 2007 and 2008.

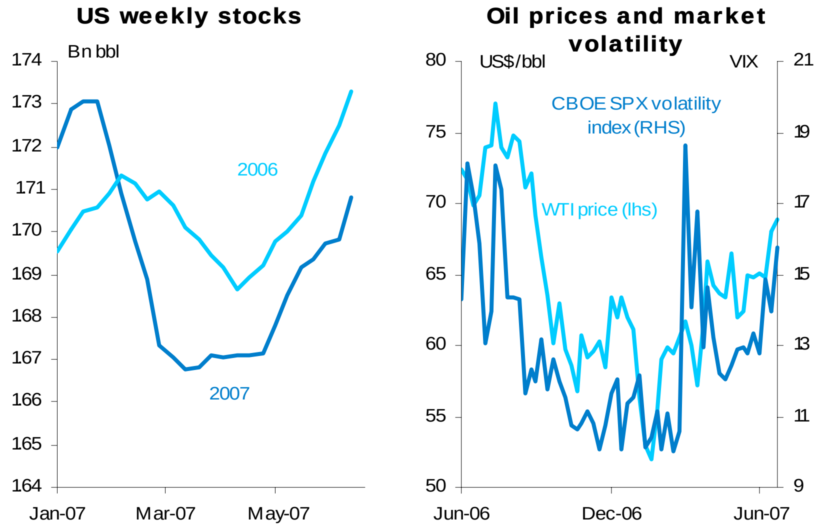
Energy

Oil

Oil prices are back above US$70

Oil prices have once again had a volatile start to the year. A warmer than usual northern hemisphere winter as well as concerns about US economic prospects saw the West Texas Intermediate (WTI) oil price average just US$58.6/bbl in the first quarter of 2007, the lowest quarterly average since the second quarter of 2005. In the last three months, however, oil prices have moved sharply off their lows. The WTI oil price averaged US$65/bbl last quarter and is now above US$70/bbl, the highest level since August last year. This rebound in oil prices has largely been driven by increased confidence over the US economy, a corresponding fall in US petroleum stocks to well below 2006 levels and a rise in the risk profile around oil supply, mainly reflecting supply disruptions in Nigeria.

Oil prices spike on lower US stocks and higher risk



Source: EIA, Datastream

A tight market will keep prices high and volatile

The outlook is for oil prices to remain both high and volatile. The unsustainable pace of global oil consumption is illustrated by the latest BP World Energy Review[1] which shows that proven global oil reserves declined slightly in 2006, from 1.210tn barrels to 1.208tn barrels. This entirely reflected a fall in non-OPEC reserves which, at 174.5bn barrels, are now at the lowest level since 2002. OPEC reserves meanwhile have increased slightly to 914.6bn barrels, mostly due to an increase in Saudi Arabia.

Global oil production is expected to rise by around 1¾%pa over the next five years[2]. This is unchanged from the average production growth of the last five years and is well short of our forecasts for global economic growth of around 5%pa. It is thus clear that this market remains highly vulnerable to any sudden changes in demand and especially supply.

In the short-term, uncertainty over oil supply in Nigeria and the Middle East and demand out of the US should keep oil prices around current highs. Spikes toward US$75/bbl cannot be ruled out. However, we do expect that this current stream of upward pressure will prove relatively temporary. Again, the outlook hinges on the US economy. We expect a further slowdown in US economic growth will see oil prices retreat to around US$66/bbl by September and to US$63/bbl by the end of 2007.

Apart from the performance of US economic growth, we consider the key short-term risks to the oil price outlook to be unexpected weather or political-related

[1] BP Statistical Review of World Energy June 2007

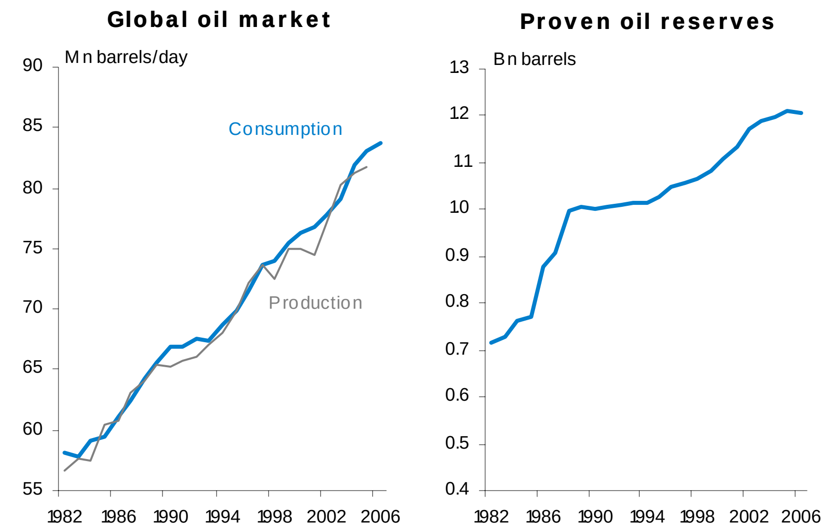
[2] ABARE estimates (June 2007)

supply disruptions. Potentially higher than usual storm activity in the Atlantic ocean remains a concern while it is difficult to pick when or indeed if current high levels of violence and strikes in Nigeria will ease. The chance of an escalation in geopolitical tensions in the Middle East and North Korea also clouds the outlook for oil prices.

Alternative energy sources won't give oil prices relief

The unsustainable rate of global oil consumption, as well as elevated oil prices, is continuing to prompt increased interest in alternative energy sources, including alternative fuels, nuclear and hydroelectric power. Any meaningful take up of these alternative sources is a long-term proposition, given the extensive technological requirements and consumer preference changes required. It is doubtful as to whether, in the short-term at least, the take up of these alternative fuels will dent rates of oil consumption growth any more than changes in the economic cycle. As such we don't expect that an increased uptake of these oil substitutes to provide much relief to oil prices over the medium-term.

Oil reserves are becoming more limited



Source: BP World Energy Review

Thermal (steaming) coal

Thermal coal prices are up again

As coal-fired electricity generation capacity in Asia and the US continues to grow rapidly a series of major supply disruptions has underpinned a further rise in thermal coal prices. Asian and Australian spot prices have both increased in recent months. Australian suppliers meanwhile settled thermal coal contract prices with Japanese coal importers at US$55.50/t for Japanese financial year 2007-08, a rise of around US$3/t from last year.

A significant change in the Chinese thermal coal market is perhaps having the biggest impact on prices. China produces 2.2 billion tonnes of thermal coal, more than eight times Australia's output, and has traditionally been a coal exporter, supplying the Asian region. No more. In the first quarter of 2007, Chinese demand for thermal coal overwhelmed domestic supply, with the country becoming a net importer of coal for the first time. This is a major change in the global thermal coal market and if it continues it will have a major positive impact on prices. At the very least we expect increased demand for thermal coal imports from China will drive a further small rise in Australian thermal coal contract prices in 2008.

A fundamental market shift with China becoming a net importer

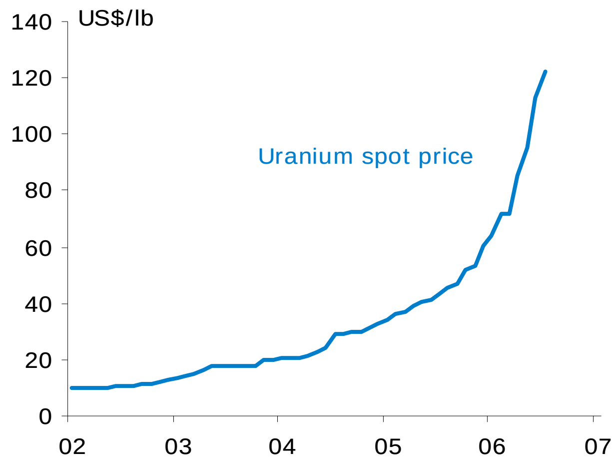
As well as the emerging shortfall in Chinese production, a series of natural disasters and export infrastructure capacity constraints have hampered Australian thermal coal exports. Severe storms prevented coal transport in New South Wales for a week in June while current upgrades to coal transport infrastructure across Australia's east coast is not expected to become fully functional until 2008. These disruptions should continue to keep spot thermal coal prices elevated in the short-term.

Uranium

Uranium prices are soaring

Uranium prices continue to soar, reaching a new record of US$122/lb in June. These prices have now increased by 180% in the last year and by 320% in the last two years. Uranium futures prices point to further price rises with the December 2007 contract currently priced at US$154. These futures contracts were only launched in early May and should improve price transparency in this market.

Uranium prices are soaring



Source: Datastream

Speculation is building of higher future demand for nuclear energy

The rapid rise in uranium prices is being driven not necessarily by current conditions but instead appears to be largely speculative as investors and power utilities alike buy heavily in anticipation of further price increases. The rapid build up in speculative positions in the uranium market does raise concerns about both the sustainability of current prices and the potential for a sharp (downwards) correction in the event of any unexpected market development or rise in general risk aversion. Nevertheless, it can easily be argued that the bullish outlook for uranium should keep current high prices fairly well supported.

Demand for nuclear energy is rising solidly. The World Nuclear Association estimates that there are currently 437 nuclear reactors in operation with a further 30 currently being built (an increase of 7%) and another 74 on order of planned (a further increase of 16%). The increased threat of global warming could see demand for uranium rise more rapidly with many governments, including Australia, recently flagging increased interest in using higher rates of nuclear power.

High regulation constrains supply

Supply of uranium meanwhile continues to increase only slowly, largely reflecting the heavy regulation of this industry. There have been some significant policy changes in Australia's uranium industry, with the federal government raising the possibility of selling uranium into India, a non-signatory to the Nuclear Non-Proliferation Treaty, and the Labor Party reversing its "no new uranium mines" policy. However, given the Australian market is still highly regulated it appears unlikely that these changes could prompt any significant increase in or new Australian uranium production inside of at least the next five years. General equipment and labour shortages, which plague most mining sectors, are also a constraint across the global uranium industry.

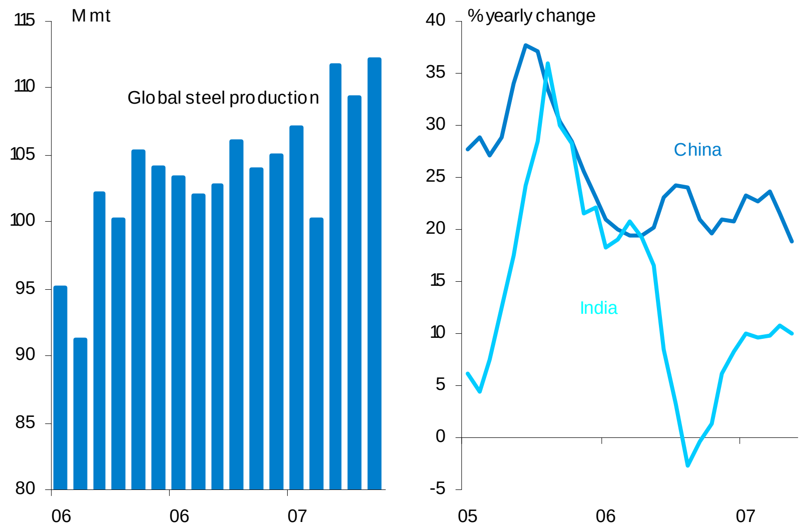
Steel, iron ore and coal

Steel

Steel production keeps breaking records

Global steel production continues to surge. After easing slightly in April, global steel production rose to a record 112mt in May.

Global steel production is rising sharply, despite a slowdown in China



Source: International Iron and Steel Institute, China National Statistics Office

China continues to be the main driver of this market, accounting for more than one third of the world's steel production. Recent trends in Chinese steel production have been choppy, reflecting recent domestic policy changes. The overall trend in production, however, remains indisputably strong, underpinned by China's rapid rates of industrialisation and urbanisation.

China remains the global driver

Chinese steel production picked up in the first part of 2007 to grow in excess of 20% in yearly terms while exports of steel re-accelerated to a record high in April. Part of this strong increase reflected a bring-forward of production ahead of the end of some steel export VAT rebates in April. Indeed, the yearly pace of both steel production and exports both then slumped in May.

Further domestic policy changes may weigh on the rates of growth in Chinese steel production and exports in the coming months. In an attempt to address the continued rises in China's massive trade surplus and to reduce China's use of natural resources, the Chinese government announced an export tariff from June 1 of between 5% and 10% on 85 types of steel products. The products that will be subject to the new export tax are the same for which the VAT rebate was abolished in April, implying a significant rise in the costs of production. This should erode some of the competitive price advantage Chinese steel exporters have enjoyed in world markets. At the very least, these tax changes should see Chinese steel exports come off recent record highs. This, in turn, should keep global steel prices firm.

It remains to be seen, however, whether these policy changes will have the desired longer-term dampening impact. We suspect the longer-term impact on Chinese exports will be modest, if any. With the industry still seemingly buoyed by domestic overcapacity, exporters are likely to simply redirect exports away from marginal markets and towards markets where margins are higher. Chinese steel exports to Europe for example currently trade at around a US$100 premium to exports to US[3]. With the European economy booming, there is clearly considerable scope for export-reorientation amongst Chinese producers.

[3] SBB Analytics China 28 May 2007

Moreover, we see little chance of significant interruption to China's strong domestic demand for steel in the coming few years. To be sure, authorities have tightened policy to try and reduce 'overinvestment' in local economy. However, with elections due this year, reigning in investment spending, and in particular construction will be difficult. Indeed, the need for China's infrastructure build is put in context by recent United Nations estimates that a further 60mn people will move from rural China to urban China by 2010.

Production is strong across most parts of the world

Other parts of the rapidly industrialising developing world are also keeping steel demand strong. Recent developments in India in particular stand out with steel production in this country picking up notably in the last year. With the government announcing plans to significantly expand rail, road and port infrastructure, India is set to become an increasingly important driver of the global steel market in the coming years.

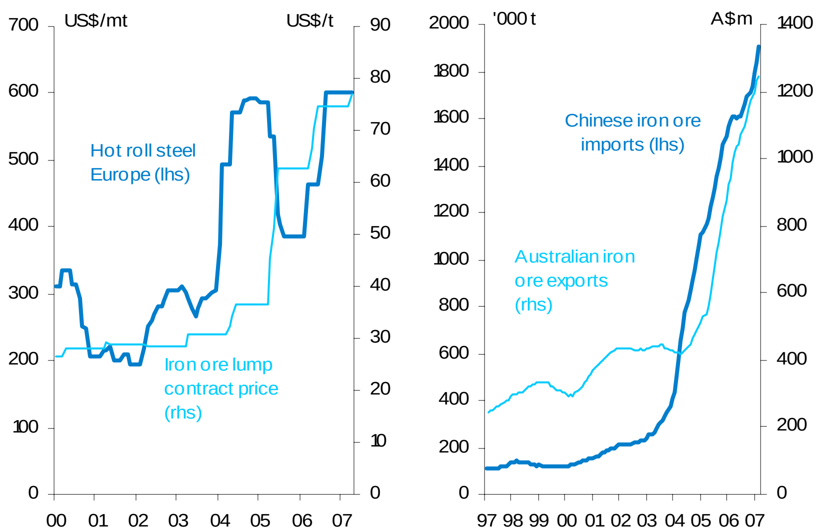
Steel consumption is also strong in the traditional 'global' drivers. After slumping late last year, steel production in the US has picked up sharply in recent months. Production also remains robust in Europe and is showing signs of accelerating in Japan.

Overall, the outlook for the steel market is positive. The International Iron and Steel Institute predicts global steel use will increase by a strong 5.9% in 2007, accelerating slightly to 6.1% growth in 2008 as US consumption returns to a positive trend.

Iron ore

Australian producers successfully negotiated a 9.5% rise in both fine and lump iron ore contract prices for Japanese fiscal year (beginning 1 April) 2007-08. This is the fifth consecutive yearly price rise with nominal contract prices now more than 200% higher than in 1999-00.

Strong steel market keeping iron ore prices high



Source: Abare, Datastream, Economics@ANZ

Record steel production underpinning high iron ore prices

Global conditions are expected to support continued high iron ore prices in the short-term and, while it is not our base forecast, we would not be surprised to see a further small rise in contract prices in 2008-09. Demand is exceptionally strong, spurred by record steel production in China. Meanwhile capacity constraints in this industry remain acute. New mining output in the short-term continues to be incremental and in the first half of 2007 global production was adversely affected by cyclone activity in Western Australia and labour strikes in Canada. Global shortages also persist in transport facilities, machinery and equipment and skilled labour in this industry and this is pushing up input prices across the board.

That said, the world's biggest producers have major medium-term mine expansions in the pipeline, many of which should reach full capacity by the end of 2008-09. This supply response could trigger sharp price falls in iron ore in 2009-10.

Metallurgical (coking) coal

Supply response prompts lower metallurgical coal prices

In contrast to iron ore producers, metallurgical (coking) coal producers had to settle for a 16% decline in contract prices for 2007-08. This is the second consecutive decline in contract prices, although they are still well above 2005 levels. The fall in coking coal contract prices occurred despite continued strong global demand for this commodity, as reflected by record rates of global steel production, and instead reflected strong actual and/or planned production increases. ABARE estimates that Australia alone has 19 new mines and 21 brownfield expansions either under construction, recently opened or planned before 2010. Production has also been rising strongly in other parts of the world, including Indonesia.

Some fillip to coking coal producers will be provided by higher prices for semi-soft coals. Acute infrastructure constraints – as currently evidenced by long ship queues off the Australian coal port of Newcastle and strained coal supply chains in Queensland – is supporting these prices and indeed points to some supply fragility for this commodity in the short-term. Failure to adequately alleviate these infrastructure constraints could see Australian metallurgical coal contract prices rebound in 2007-08.

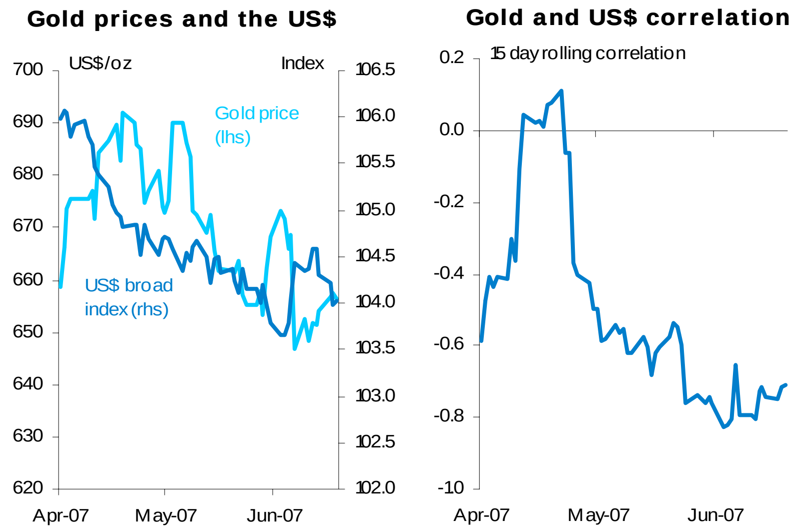
Gold

Having made a run towards US$700/oz in early-May, gold prices failed to breach this psychologically important level and have since retreated to now be trading around US$655. Two significant factors that are now dampening gold prices are the rebound in the US dollar and an increase in central bank gold sales.

Gold fails to break US$700/oz

In the last month there has been a break in the US$ downtrend as stronger than expected economic data has underpinned some return to confidence in the world's major reserve currency. This in turn has weighed on the price of the world's other major reserve, gold. The charts below show that the rebound in the US$ was accompanied by a sharp increase in the (negative) correlation between this currency and the gold price, perhaps as investors switched their favoured reserve holding. The correlation between daily movements in these 'stores of value' now stands at around 70%, signalling the strongest relationship in over a year. We expect the US$ will make further, albeit small, gains over the rest of 2007. This is thus a potential headwind for the gold price going forward.

The gold and US$ correlation has reasserted



Now the bears are out

Source: Datastream, Economics@ANZ

Also dampening the gold price in recent months has been a rise in central bank gold sales. The latest data suggests that central banks took advantage of recent strong prices to offload 100t of gold in the March quarter, almost double the 59t sold in the December quarter 2006 and the largest sales since the December quarter 2005. These sales partly reflect further destocking as agreed under the Central Bank Gold Agreement (CBGA) with both France (30.9t) and Spain (39.8t) notable sellers in the last quarter. Non-signatories to the CBGA have also stepped up sales again, notably Indonesia (23.3t).

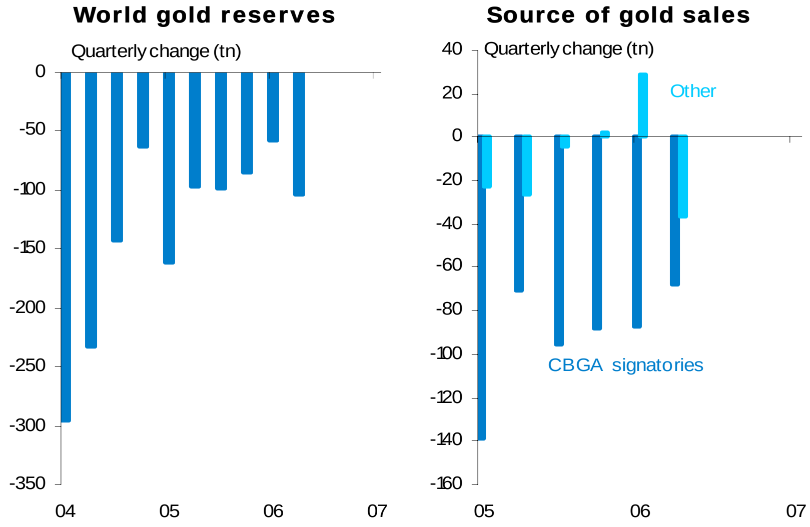
We expect global central banks will continue to take advantage of price spikes to reduce holdings of gold reserves in the period ahead, but do not think the sales limit of 500t agreed under the CBGA will be met. Gold holdings by non-CBGA members also look set to fall or, at least, not rise significantly. The establishment and growth of central bank investment vehicles (ie. sovereign wealth funds) in many emerging economies, including China, indicates these countries are likely to diversify their reserve holdings away from traditional assets such as gold and towards higher-yielding (and most likely US dollar) assets.

Central banks will keep selling on spikes

While demand for gold is waning amongst central banks, it is showing little sign of a slowdown amongst average consumers. Buoyant global economic conditions suggest that consumption of fabricated gold, which is mainly jewellery, will remain robust this year. The economies of the world's big jewellery buyers – India and the Middle East – continue to boom. Gold prices above US$650/oz are unlikely to have deterred too many buyers in these economies, given strong rates of domestic income growth. With global oil prices on the rise again and the latest Indian economic data continuing to print strongly, we expect demand for gold to stay strong at current price levels.

Strong income growth in India and the Middle East will keep fabricated gold demand strong

Central bank gold sales have picked up again



Source: World gold council, Economics@ANZ

New production of gold meanwhile is likely to remain relatively flat. While recent strong prices have encouraged a small 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.

Fundamental conditions, that is, strong demand and limited supply, therefore suggest upside risk to gold prices from here. The recent rise in oil prices is also a source of upside risk, should investors return to gold as an inflation hedge. We suspect however, that continued central bank gold sales as well as a rise in the US dollar, will offset this upward pressure. Overall, we suspect gold prices will fall a little further from current levels to be US$640/oz by the end of this year.

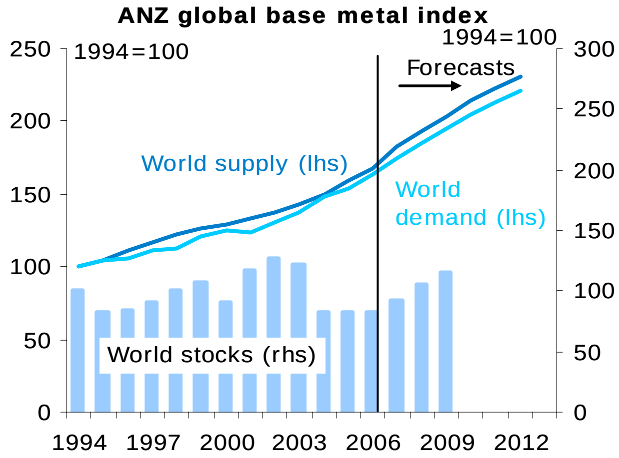
Base metals

Growing signs that base metal prices have peaked

There are growing signs that the bull-run in base metal markets has peaked. ANZ's base metal price index (in US$ terms) declined by 4% in June, the second consecutive monthly fall after May's 1.9% decline. That said, this index remains a strong 8% higher than at the start of this year.

The fall in base metal prices in the past month has been almost universal across the commodities, with falls in nickel, zinc, copper and aluminium all more than offsetting a sharp rise in lead. Broad market trends suggest that base metal prices, in aggregate, should continue to ease from here. While growth in the demand for these metals remains strong, and is expected to actually accelerate to 7.0% this year, the long-awaited supply response is finally showing signs of life. ANZ's base metal supply index predicts that global production will rise by nearly 9% in 2007 and by a cumulative 20% in the next three years. This should be more than enough to improve market balance with base metal stocks expected to rise by nearly 40% in the three years to 2009, reversing the 32% run down in base metal stocks that occurred over the three years to 2006.

Market fundamentals prompting a price response



Source: Datastream, Bloomberg, ABARE, LME, Economics@ANZ

The supply response is finally kicking in

Such a surge in supply would usually suggest that base metal prices are in for a sharp, and protracted, fall. However, we suspect that continued strong demand, led by the rapidly industrialising Asian region will ensure that the impending price correction will be relatively mild. As such, we predict ANZ's base metal price index will fall by around 11% by year-end and by a further 16% in 2008. Despite such falls, this price index would remain at mid-2006 levels by the end of next year.

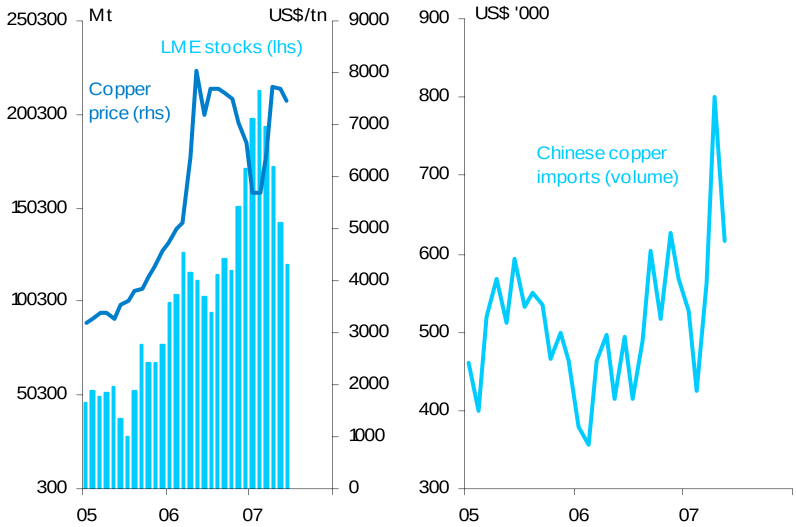
There has been some concern that increased speculative positions in commodity markets could see base metal prices fall more sharply than 'market fundamentals' suggest. We highlight this as a significant risk to our price forecasts going forward and indeed expect the increased role of speculators will lead to higher volatility in base metal prices going forward. We note however that the strong global economic outlook as well as high rates of global liquidity should prevent any sharp 'speculator-led' downturn in base metal prices from being prolonged.

Copper

Copper prices have bounced back strongly, rising by around 43% from their mid-February lows to peak above US$8,100/t in early May. Having come under pressure from the downturn in the US housing market which was compounded by a speculative sell off early this year, this rebound in copper prices was driven by a surge in Chinese imports. China's imports of copper rose by 49% yoy in volume terms and by 158% yoy in value terms in April on strong restocking of this metal by private and public firms. This restocking follows a sustained period of destocking late last year, perhaps as China took advantage of, at the time, historically high prices. In the last month a hint of slower Chinese imports has seen copper prices again retreat to now be trading at around US$7,550/t.

Copper prices have rebounded

A surge in Chinese demand sends copper higher



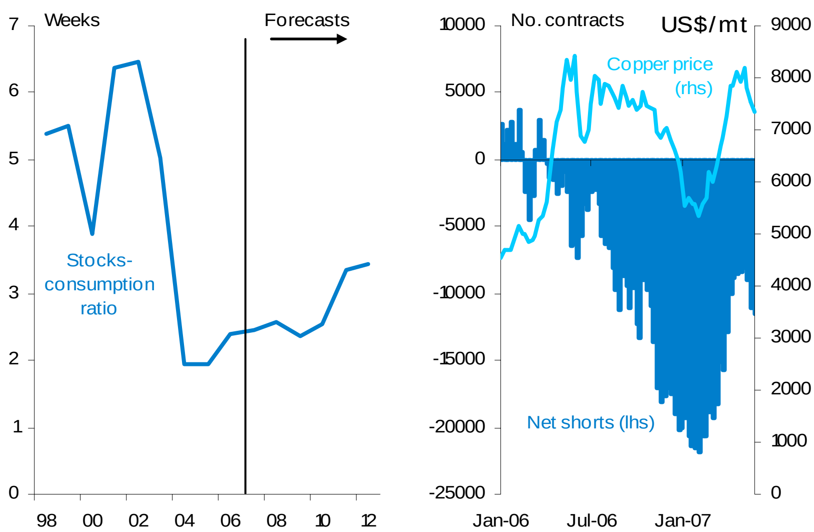
Source: Bloomberg, Datastream, Economics@ANZ

Copper stocks will stay low

The surge in Chinese copper imports will not be sustained, as reflected by a recent easing in Shanghai copper prices. That said, ongoing demand for copper will remain strong as it continues to track continued rapid rates of investment growth in this economy. Moreover, demand from the world's largest consumer of copper – Europe – is also robust. This will offset continued easing copper consumption from the downturn in the housing market in the US. While demand growth will soften slightly in the year ahead, growth in the production of copper is set to rise only slightly in the short-term. This is expected to keep stocks ratios near historically low levels of between 2-3 weeks of consumption. While this suggests that downward pressure on prices should be relatively small, the events of late last year show that copper is now more vulnerable to speculative positioning in the market. Current market positioning shows that net shorts are starting to rebuild in the market, a trend that if it continues could put further upward pressure on the price short-term but will also leave prices increasingly vulnerable to a sharp correction. Hence, while our 'base case' is for copper prices to fall by 12% to around US$6,500 by the end-2007, volatility around this point forecast is practically assured.

But prices are on the way back down

The copper market is tight, but prices are vulnerable to speculative forces



Source: Bloomberg, AME, ABARE, Morgan Stanley, Economics@ANZ

Aluminium

Aluminium faces competing forces

Aluminium prices are facing competing forces at the moment. On the one hand, prices are being depressed by rising stocks and a downturn in the US' housing sector. On the other, prices are being driven higher by the strong demand from the booming economies of Europe and China. The upshot has been that aluminium prices have remained strong and comparatively steady. In the first half of 2007 the price of this metal has traded within a 12% range around an average of US$2780/mt.

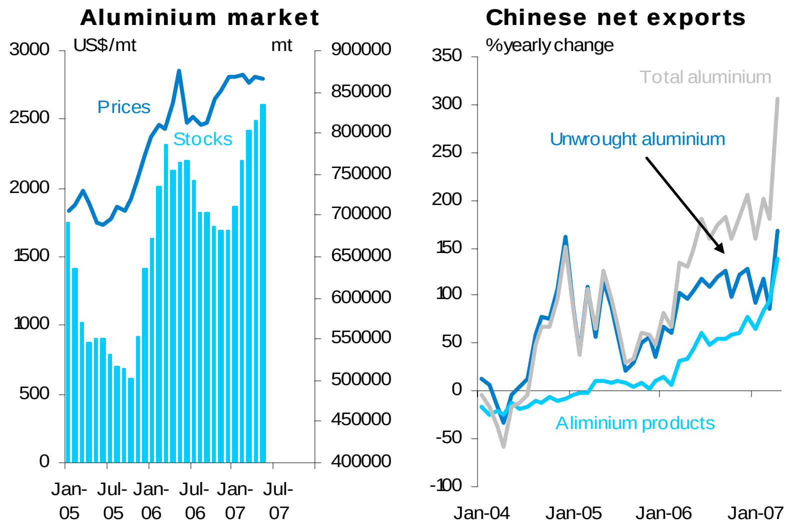
Demand for aluminium is expected to continue to grow at a strong pace in the period ahead with global economic growth set to slow only modestly in the coming year. Moreover, income growth in the developing world should drive rising demand for aluminium-intensive consumer goods, such as cars and canned foods and drinks. At the same time, global production of aluminium is rising, with the International Aluminium Institute predicting that global aluminium productive capacity will rise by around 6.7% in the next two years, largely reflecting new capacity in Asia. We expect this rise in supply will only slightly outpace demand growth and are thus looking for the aluminium market to remain relatively tight in the period ahead with stock levels set to remain below five weeks of consumption. This should keep prices relatively well supported, with a fall of around 7% expected by year-end.

Prices to remain trapped in a tight range

Developments in China remain the wildcard to this outlook. While we are confident that continued rapid industrialisation and household income growth will underpin strong growth in demand for aluminium in China, the outlook for Chinese production of aluminium is more uncertain. Chinese exports of non-primary aluminium exports, which since late 2006 attract an 8-11% VAT rebate, nearly doubled in the last six months. Chinese exports of primary aluminium meanwhile have also reaccelerated in recent months, despite a rise in the export tax on these products from 5% to 15%. The question now is whether Chinese authorities will maintain the VAT rebate in the current environment of escalating concerns over China's trade surplus. As China currently supplies around 30% of the world's aluminium the market depends on continued strong Chinese production to meet current demand and keep a cap on current prices.

China is the wild card

Can strong Chinese supply keep sustaining the market?



Source: Bloomberg, Datastream, Economics@ANZ

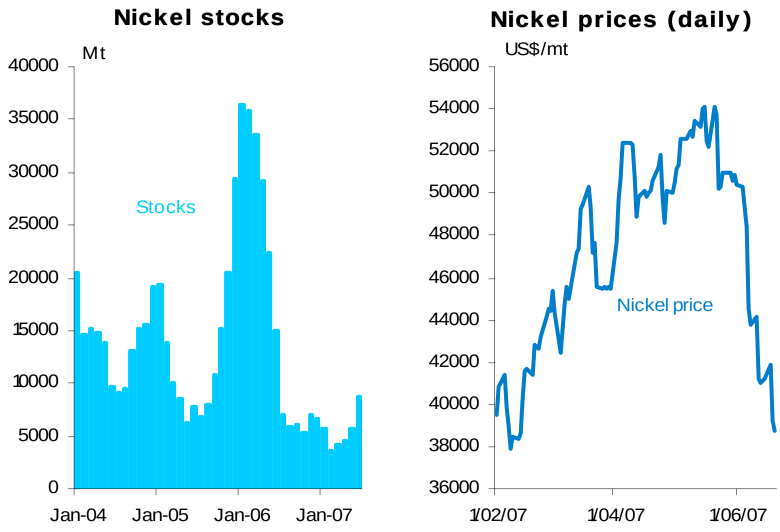
Nickel

It's been a roller-coaster ride for nickel prices in the last few months. After soaring to a record high above US$54,000/mt in early May, nickel prices have since dropped by more than 30% to currently be around US$36,000/mt, the lowest level since January. The catalyst for the recent sharp drop has been a doubling in LME nickel stocks between April and June. New LME guidelines which

A roller coaster ride for nickel

in effect lowers the inventory levels which participants have to hold in order to lend the metal has also weighed on the price.

Nickel prices have plummeted on rising stock levels



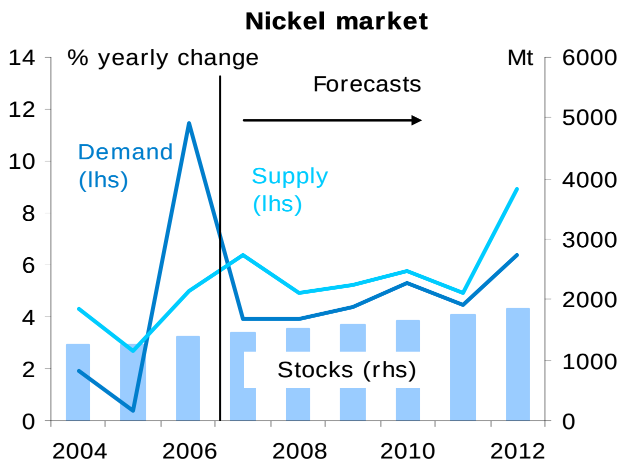
Source: Bloomberg, Datastream, Economics@ANZ

Stocks have rebuilt, but demand is still growing strongly

Despite this recent sharp fall, fundamentals for the nickel market suggest relatively high prices will be sustained and indeed we could see prices retrace back towards US$42,000 in the short-term. Despite recent increases, stocks remain near record lows and are thus vulnerable to further drawdowns in light of the strong global outlook for stainless steel consumption.

That said, while demand for nickel is expected to grow strongly this year, it is unlikely to match the phenomenal 11% growth rate achieved in 2006. Moreover, nickel production is slowly catching up with supply expected to rise by around 6% in 2007, following a rise of 5% last year. Overall, we expect supply and demand trends will be enough to allow the market to be broadly in balance in 2007 with stocks expected to modestly rise. These trends should keep nickel prices relatively well supported at around US$40,000 by year-end. This is slightly higher than current prices, with the recent correction looking a little overdone, but still implies a 25% decline from this year's peak.

The nickel market should slowly return to balance



Source: ABARE, AME, JP Morgan, Datastream, Economics@ANZ

Prices may move back above the current trough

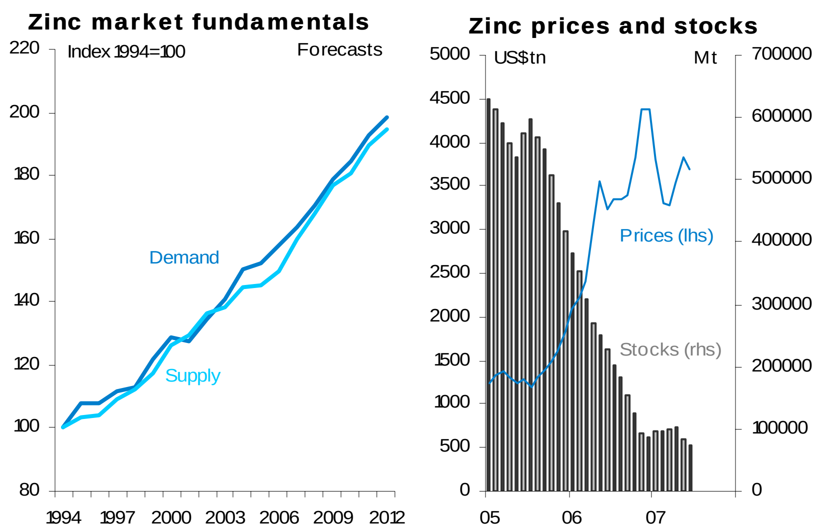
In today's strong global economic environment and given the tight state of nickel markets we would be unsurprised to see prices move higher than our forecasts over the coming year. On the other hand, increased production of low-grade nickel pig iron, which has increased sharply in China in the last few years, is probably the main downside risk to our price forecasts. Over the medium-term prices may come under pressure as steelmakers increase substitution away from nickel to different, and less expensive, stainless grades.

Zinc

Zinc prices defy tight market fundamentals

In the last six months zinc prices have confounded by failing to respond to market fundamentals. Global demand for zinc is running above global supply, stock levels, as a result, have fallen to record lows, and yet prices have been unable to move higher. Instead, zinc prices remain trapped around US$3,500, well below the peak of US$4,600 achieved back in November 2006.

Zinc prices have failed to respond to a tight market



Source: ABARE, AME, JP Morgan, Datastream, Economics@ANZ

A surge in Chinese exports has kept prices under pressure

It appears that developments in, where else, China has been the main driver of zinc's relative underperformance. Having been a net importer of zinc for most of the last decade, China suddenly became a large net exporter of zinc in the first part of 2007. This was underpinned, not by slower domestic consumption and imports, but instead by a sudden, an unexpected, sharp rise in local production and exports.

China close to becoming a net zinc importer again

Source: Bloomberg, Economics@ANZ

Zinc prices could spike higher on signs of easing Chinese production

In the last few months Chinese net exports of zinc have slowed, providing in turn some stability to zinc prices. We expect Chinese zinc production will continue to ease as authorities pursue efforts to slow energy-intensive exports and consolidate this industry, moving smaller players into the nest of larger companies. With Chinese demand for zinc unlikely to slow much from the strong 13% rise of last year, softer production growth should see Chinese net exports of zinc return to a more neutral level. This in turn should provide support to prices at current levels and indeed may prompt some upward spikes, back above US$4,000 in the short-term.

By year-end we expect zinc prices will fall towards US$3,300, largely driven by a further deterioration in the US economy and in particular the US housing market. While volatility around this end-point forecast is inevitable, the continued low level of global stocks should ensure that any downward correction in zinc prices doesn't extend beyond US$3,000. As with most metals, developments in China pose the main risks to this outlook. Uncertainties over Chinese production cloud the global supply outlook while stronger than expected zinc consumption in China is a strong possibility given the inevitable investment and construction boon that is occurring ahead of this year's election. A more resilient US economy meanwhile may also keep zinc prices supported above our end-year target.

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