

The View From The Outer

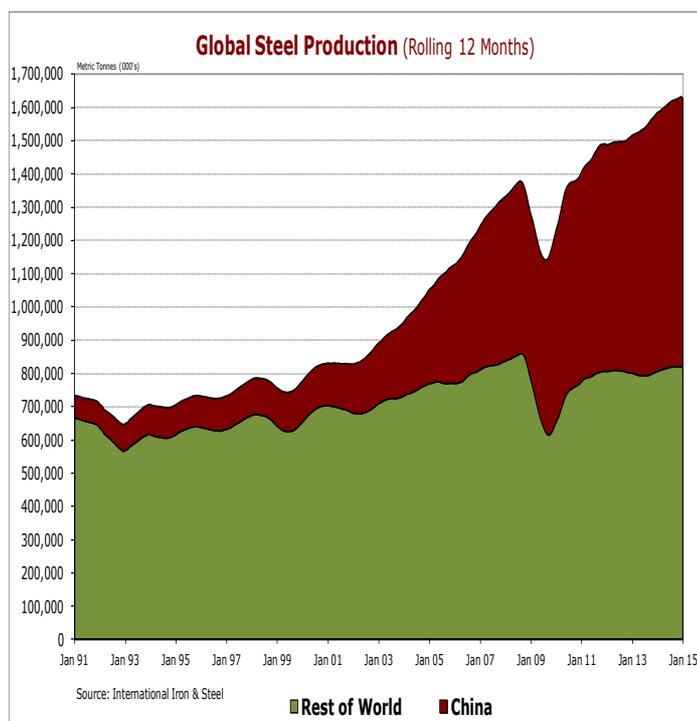
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APRIL 2015



The iron ore price: “Are we there yet?”

- Since mid-March, the spot iron ore price has been trading below the GFC lows seen in April 2009.
- The resource majors are driving their cash costs per tonne sharply lower and (quite rationally from an individual company perspective) rapidly and profitably expanding production. Meanwhile, production closures elsewhere (as is often the case) take longer to occur than many expect.
- From the perspective of the iron ore price, this rapid supply build-up is occurring as steel production in China looks to be stagnating in response to weakness in the Chinese property market.
- Ongoing policy support, such as China’s latest moves to support housing demand (including this week’s announcements of reductions in housing taxes and reduced restrictions on down payments for second homes) are welcome and positive of themselves. They are, however, insufficient to quickly reduce the excess supply without a sharp reduction in new home construction. This cycle still has some way to run.



How important is the Chinese property market?

The transmission mechanism from weakness in the Chinese property market to the Australian economy is quite direct and substantial. The property sector in China accounts for 24% of Chinese steel consumption, weakness in which reduces iron ore demand. Australian iron ore exports in 2014 totaled \$A 66 billion. This represented 25% of

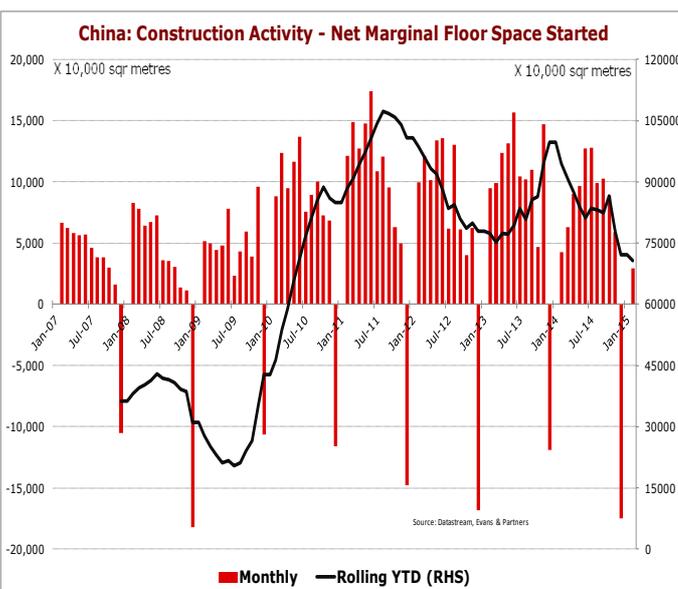
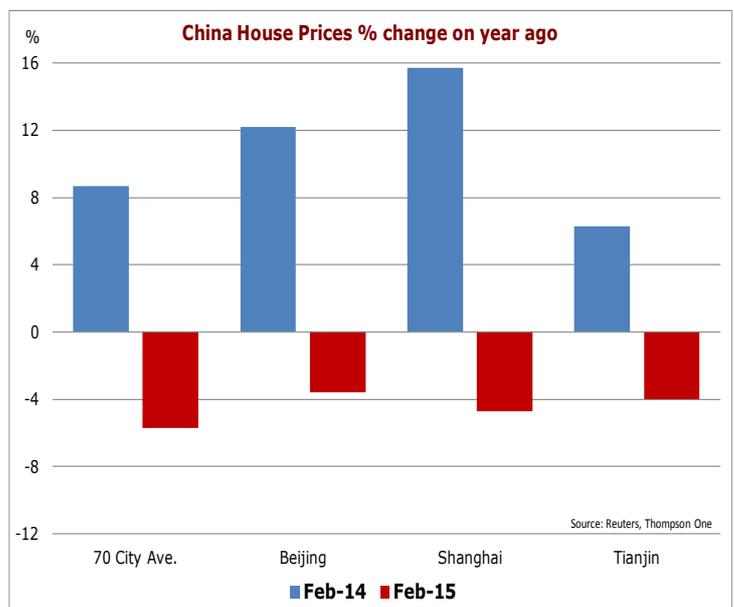
Australian Merchandise Exports. More broadly, China is our largest export destination at \$A 89.5 billion in 2014 or 34% of Merchandise Exports. (Source: ABS catalogue number 5368.0).

The iron ore price fell by 47% over the course of 2014. It has fallen a further 25% since. At the company level this means lower profits and capital expenditure, job cuts and lower wages. The economist might express it this way: lower commodity prices flow into Australia's Terms of Trade, which are now down 26% from the peak in the September quarter 2011. This depresses income flows relative to production volumes. Consequently, Trend Real Gross Domestic Income (GDI) growth was zero over the year to the December quarter 2014, while Trend Real GDP growth was 2.3% over the same period. (Source: ABS catalogue number 5206.0).

China house prices still falling and lead indicators of construction activity declining

House prices declined in 66 of the 70 cities measured by the National Bureau of Statistics in February. Over the year to February, prices declined on average by 5.7%, with overcapacity and price declines most severe in the lower tier cities.

This week has seen a further series of measures announced to support new home sales and property investment. The minimum down payment on a second property has been cut to 40% from 60%, restrictions have been eased on using retirement savings to buy an apartment and taxes on sales of properties held for over two years have been abolished. The PBOC has also stepped up the pace of monetary easing in recent months. We also note the comments from the PBOC Governor Zhou Xiaochuan re the need for vigilance given the speed of the decline in inflation. To our mind, significant scope exists to ease monetary policy further.



Initiatives to boost demand are yet gain traction. Prices need to fall further to improve sales, which over January / February 2015 are well below year earlier levels.

Lead indicators of construction activity, such as Net Marginal Floor Space Started, shown left, have been falling on a rolling 12 month basis since February 2014. Excluding the seasonal fall in Net Marginal Floor Space Started each December (see chart left), February 2015 was the worst monthly result since July 2009.

Needless to say, the outlook for steel demand from the property sector is particularly weak. Any additional infrastructure related fiscal stimulus is likely to be modest as China looks for "a more sustainable, higher quality expansion." In answer to the question "Are we there yet?" given the surplus in the iron ore market over the next two years, in our view, the answer is no.

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