

BLUE SKIES WITH A CHANCE OF RAIN: WHAT CHINA'S YEAR OF TRANSITION MEANS FOR AUSTRALIAN IRON ORE

Having recently returned from China, Stefan Hansen, Senior Research Analyst at Nikko AM, shares his thoughts on China's economy, and the impact that this will have on Australia's resource sector.

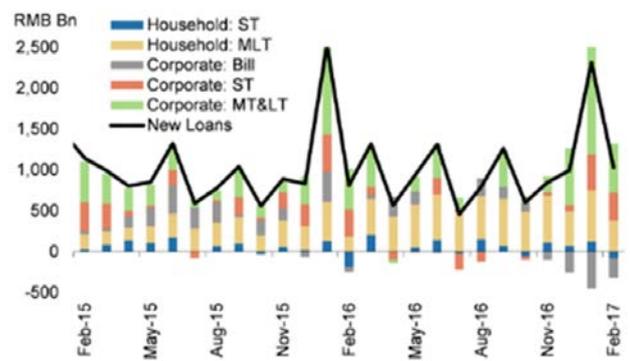
The blue skies over Beijing and the buoyant mood in China seemed to be driven by a common factor – Government policy and intervention.

China started 2017 with real momentum, following the property driven debt-fuelled stimulus of last year, and the blue skies a result of Government directives to curb pollution during March's Central Government meetings.

It's no wonder the mood on the street in China is positive. Debt funded stimulus in early 2016 helped to revive the flagging economy (see Chart 1), and recent data points to robust industrial production and economic growth. However, we do need to look beyond the headlines and high level targets. Last year, fixed asset investment focused on the real estate sector, which makes up one third of GDP. However, tightening policies have been progressively put in place to curb property speculation and price growth within select cities, and new fixed asset investment appears more directed toward infrastructure, which, from an Australian export perspective, may be less steel consuming than property.

An expectation of lower steel intensity sectors driving growth this year, iron ore prices incentivising new supply and uncertainty over growth beyond the leadership transition, all give us some comfort around our cautious positioning for Australia's resource sector.

Chart 1: Composition of new loans



Source: Morgan Stanley Research

China's economic growth to remain robust over 1H 2017...

The consensus view among the economic and industry experts that we met in China was an expectation that the solid economic growth from 2016 will continue over 1H2017, given the Government's focus on stability during the leadership transition period.

At the same time, there was also an acknowledgement that recent Government announcements to curb potential financial risks in the future are designed to slow growth.

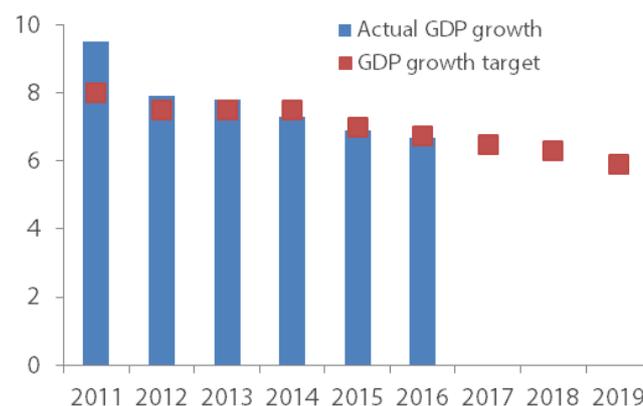
The GDP target for 2017 is now fixed at the low end of the previous 6.5-7.0% range, and while this change appears modest, it does appear to signal a deliberate intent to slow growth to rein in rising financial leverage.

...however, there is some uncertainty beyond this year.

It was telling that beyond the National Congress taking place in October/November this year, the extent of the slowdown was uncertain.

Consensus forecasts call for a continued easing of economic growth rates, with GDP of 6.3% and 5.9% in 2018 and 2019 respectively, though over the course of meetings that we were in, around 6.0% was mentioned as a potential target for next year.

Chart 2: China's GDP history and consensus targets show an easing of growth



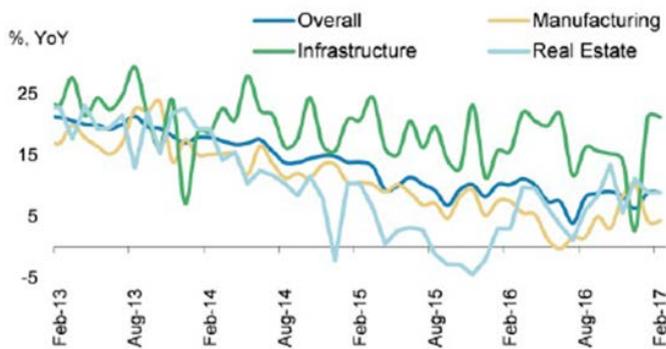
Source: Nikko AM, Bloomberg consensus

Fixed asset investment potentially less steel-intensive than last year

At the National Party Congress in March this year, the Government announced a fixed-asset investment growth target of 9% year-on-year, down from last year's 10.5% target but above the 8.2% year-on-year actual growth recorded in 2016.

At face value, these growth rates look impressive, but we need to consider that investment expenditure will likely be directed towards lower steel-intensive infrastructure spending (such as rail, metro and utilities) as opposed to real estate, which was the key driver of steel demand last year (see Charts 3 and 4).

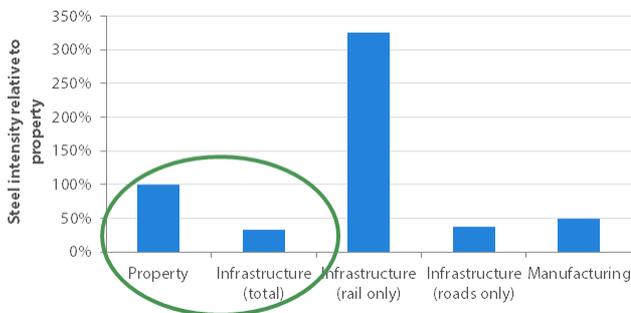
Chart 3: New fixed-asset investment is being directed towards infrastructure



Source: Morgan Stanley Research

Chart 4: Steel intensities by sector (tonnes per RMB spent) relative to real estate investment

Property construction the key consumer of steel, clearly ahead of overall infrastructure...



Source: Macquarie, Nikko AM

While on property, forecasts from three experts indicated an expectation of a 10-14% year-on-year contraction in sales, driven by selective tightening policies in major cities and changing demographics.

With a strong start to 2017, this outlook may prove too pessimistic, as property starts, which are arguably a more important gauge of steel usage, ranged from a 10% contraction to 4% growth.

Rising cost of steel is becoming political, with intervention a possibility

One area of discussion during our trip was the increasing concern around rising steel prices. The reasons for concern were threefold: Firstly, higher prices impacted the competitive nature of Chinese steel within a regional setting, as observed by the low rate of exports this year (see Chart 5).

Secondly, there is some concern over the potential for higher steel prices to flow through to general consumer inflation, and thirdly, and perhaps most importantly, concerns driven by the fact that iron ore prices have largely kept pace with steel, mitigating profitability of the Chinese steel industry, and therefore its ability to better utilise this period of steel price strength to de-lever balance sheets. The fact that almost all of the global iron ore industry is "in the money", does lend weight to the concern that pricing has disconnected from fundamentals (see Chart 6).

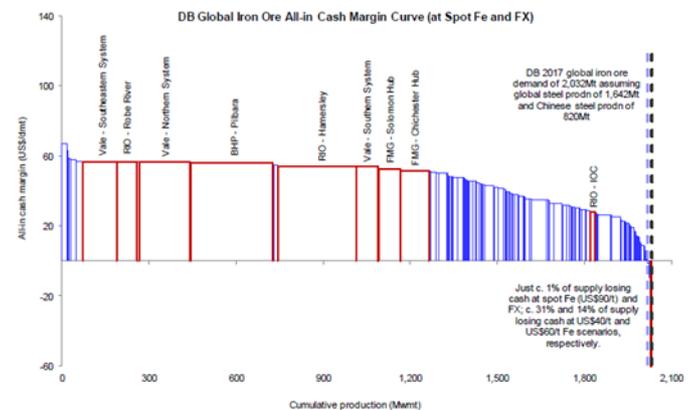
Indeed, the China National Development and Reform Commission (NDRC), at a mid-March Supply Side Reform conference, publicly stated it believes steel price strength was due to steel production capacity cuts, and an increase in the iron ore price, and should not justify further price increases.

Chart 5: Chinese steel exports well below last year



Source: Macquarie

Chart 6: Almost all miners are making a positive margin



Source: Deutsche Bank

It was acknowledged in our meetings that China's steel and iron ore futures exchanges were having a substantial influence on the seaborne ore trade.

Attempts to rein in speculation on futures markets has been attempted previously, however it appears these efforts have not been a sufficient deterrent to offset trade profitability.

Now with the NDRC weighing in on the issue, we believe the potential for action is a real downside risk for steel and iron ore prices, and indeed a key driver of recent price action.

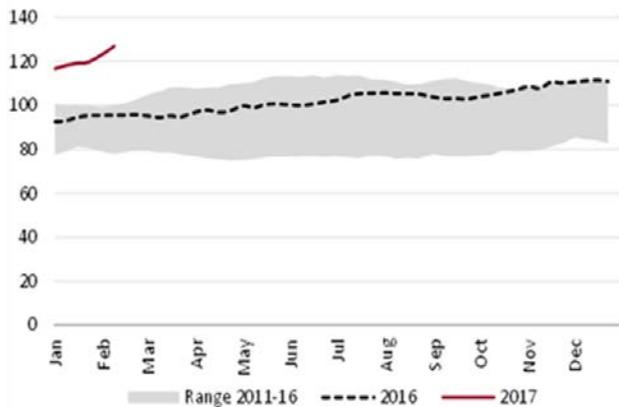
Traders having an influence on steel and iron ore markets

Another suggestion from industry experts around the fundamental disconnect in iron ore prices has been that it was due to the influence of traders, as opposed to direct iron ore consumers.

The view was that traders are keeping seaborne iron ore markets tight to support prices, and stockpiling ore that cannot be passed on to mills.

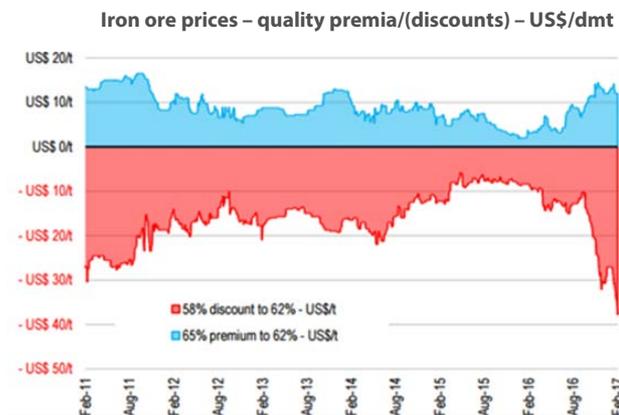
We see some evidence of this in ore stockpiles at Chinese ports, which are at multi-year highs. Any unwind, via steel price intervention or growth in Chinese domestic iron ore production, could see a rapid destocking event that would depress prices (see Charts 7 and 8).

Chart 7: Iron ore port stockpiles at multi-year highs...



Source: UBS Research

Chart 8: ...as are low-grade iron ore discounts



Source: UBS Research

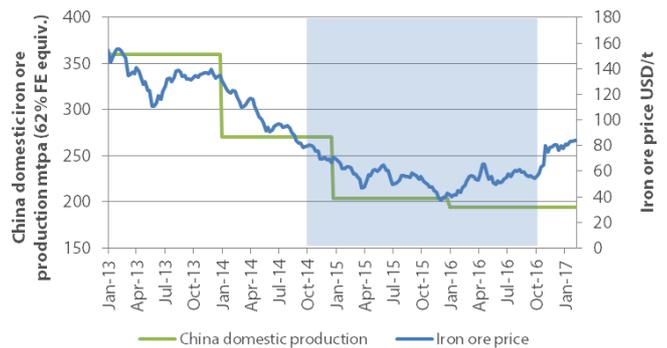
China's domestic ore mines incentivised to return

The issue of China restarting idle mines is posing substantial downside risk to iron ore prices. Even Rio Tinto's Chief Executive, Jean-Sebastien Jacques, recently highlighted that this as a major concern for iron ore pricing.

Both the Shanghai Metals Market and MySteel expect Chinese domestic iron ore production to add at least an additional 30Mt this year, as output responds to higher prices. We are starting to see evidence of this now, but expect more in the near-term as winter conditions ease (see Chart 9). Indeed, Deutsche Bank recently reported that Chinese domestic production is running at operating rates of 280Mtpa, 60Mtpa higher than 1H2016 levels, while non-traditional suppliers (excluding Australia and Brazil) have lifted rates by around 25Mtpa.

There was some debate around the issue of permitting, restaffing and refinancing of Chinese mines, some of which have sat idle for extended periods. Even if half of this additional capacity was brought to market, we believe this would exceed market expectations, and contribute to oversupply.

Chart 9: Chinese domestic iron ore production versus iron ore price



Source: Nikko AM, Bloomberg

Weakness in iron ore may create future value opportunities

Our visit to China increased our conviction that additional and unexpected iron ore supply, combined with stable to weaker demand, will see it retreat to a lower, more fundamentally-driven price range during 2017, which is supportive of our underweight call for the broader resources sector.

Under this scenario of weakening iron ore prices, future value opportunities may be generated among a set of miners with substantially lower balance sheet risk and cash margins closer to what we would view as genuine mid-cycle levels.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or

distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will

be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to

buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.