The Market Observer

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Australia's leading export earners under pressure

Iron ore and oil prices have been savaged recently with negative ramifications for equity performance and Australia's export earnings and although the outlook remains uncertain, the prospects for the oil price are probably brighter than those for iron ore.

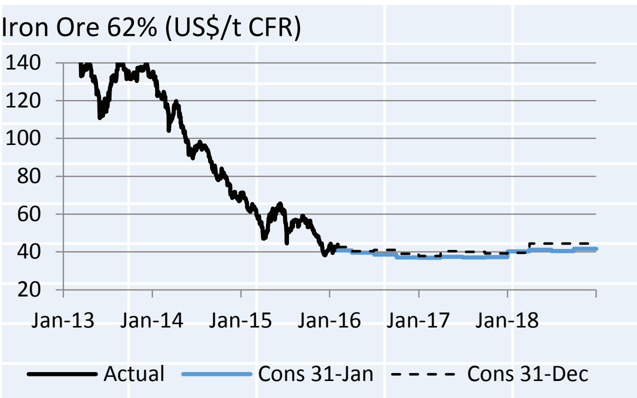
Iron ore is Australia's leading export, recording $66 billion worth of export income in 2014, while oil is an important benchmark for the price of Liquefied Natural Gas (LNG), which is our third-largest resource export, producing $18 billion worth of export income in 2014. Australian LNG exports are growing quickly, with export earnings expected to more than double over the next five years.

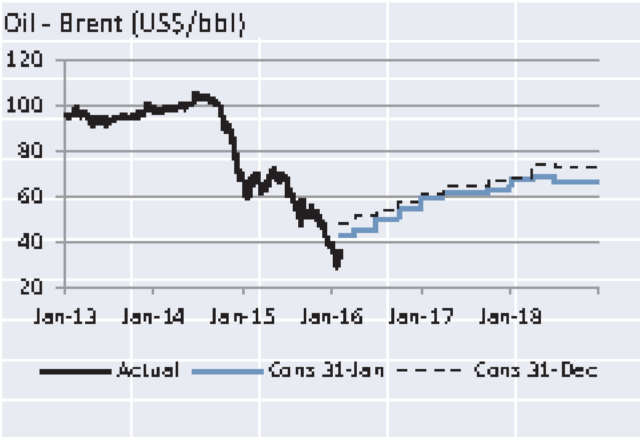
Iron Ore
Underlying iron ore demand continued to decelerate in 2015 with global steel production falling 2.9%, compared to growth of 1% in 2014. Chinese steel demand is core to the overall decline rate, with the Middle Kingdom's total steel production down 2.3% in 2015 and apparent steel consumption, or net exports, down 5.2%. The weakening Chinese property sector was the key driver, with new starts continuing to languish in Tier 3 and Tier 4 cities where significant inventory overhangs remain.

However, iron ore supply growth continues unabated. The major producers added roughly 160 million tonnes (mt) of supply over 2014 and an additional 80-100mt of low-cost supply growth was estimated to have entered the market in 2015. Anglo's Minas Rio is ramping up, Rio Tinto's 360 infrastructure was online by mid-year and Gina Rinehart's Roy Hill entered the market late in 2015.

Although 2016 is likely to be a similar story in terms of supply growth, issues at Samarco in Brazil and Roy Hill in Western Australia have tightened the market relative to expectations. New supply additions are currently expected to be about 40mt.

Low iron ore prices are eating into the cost curve in order to displace higher cost volumes and the price weakness also highlights the issue with using cost curve analysis to identify a perceived floor price. Iron Ore prices are expected to fall below the implied floor price until such time as the market is in balance. This is compounded by the apparent lack of rational economic behaviour by Chinese enterprises and the actual reduction in the cost curve, which is happening via weak currency and oil prices and producers sweating their assets.




Oil - Brent (US$/bbl)
120
100
80
60
40
20
Jan-13
Jan-14
Jan-15
Jan-16
Jan-17
Jan-18
Actual
Cons 31-Jan
Cons 31-Dec