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HANDS-ON CHINA REPORT

January 11, 2010

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Strong December Commodity Imports Cap a Year of Voracious Chinese Demand

China's imports of copper and iron ore continued to rebound in December, capping a year when the country's voracious demand for raw materials drove a price rally that few anticipated at the height of the global downturn. With housing construction now recovering solidly and exports turning sharply positive in December, we expect China's fundamental demand for industrial commodities to remain strong. However, the accumulation of domestic stockpiles for key commodities such as copper and aluminum should preclude a return to the astonishing levels of imports seen in Q2-Q309. The winter season is also characterized by a slowdown in construction activity in China's northern regions due to adverse weather.

- China imported 62.2mn tons of iron ore – the second highest monthly level on record, representing a 21.7% rise from November's level. For the full year, China imported 628.3mn tons of the steelmaking ingredient (+41.5% YoY). Chinese steel demand is expected to remain healthy in 2010, supported by strong fundamental demand in the housing, auto and electrical appliance sectors. We expect import volumes will remain relatively resilient in the coming months.
- Imports of unwrought copper and semi-finished copper products surged 21.7% from November's level to reach 369,368 tons. For the full year, Chinese copper imports jumped 62.6% to 4.29 million tons (see Figure 1) and drove a 140% rally in international copper prices. Although we expect China's fundamental demand for copper to remain strong in 2010, elevated domestic stockpiles, the wider availability of scrap and lower speculation should preclude a return to the levels of import growth seen in 2009.
- Imports of unwrought aluminum and aluminum products declined 3% to 117,016 tons. Overcapacity caused by the aggressive restart of idle production since 2Q09 has led to the highest inventory build-up since 2003 on the Shanghai Futures Exchange.

Figure 1: Summary of December and full-year imports of iron ore, copper, aluminum

	Units (tons)	2009	Dec	M/M	2009 (YoY)	Dec (YoY)
Iron ore and concentrates	(mn)	628.3	62.16	21.7%	41.5%	80.0%
Unwrought Copper & Products	(' 000)	4290.0	369.368	27.3%	62.6%	28.9%
Copper Scrap	(' 000)	3991.3	440.000	46.1%	-28.4%	16.0%
Unwrought Aluminum & Products	(' 000)	2321.5	117.016	-3.0%	164.2%	69.8%
Aluminum Scrap	(' 000)	2626.2	310.000	24.0%	21.9%	126.4%

Source: China Customs, CEIC

We expect to see a change in the composition of Chinese commodities demand begin to take shape in 2010 as private sector activity continues to recover. Compared to the aggressive stimulus stance to counter the sharp slowdown a

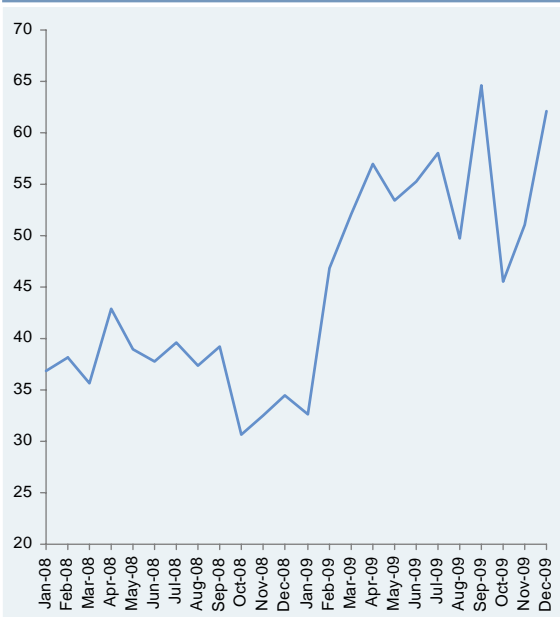
year ago, authorities are now more confident about the domestic economic picture and are scaling back some of the more aggressive measures that have been introduced.

New public sector investment projects will be more strictly controlled, with emphasis on completing projects that are already underway. At the same time, housing construction activity has accelerated and we are seeing gradually stronger demand in the downstream manufacturing industries, which is being supported by the improving external outlook and an uptrend in private consumption-driven demand.

Iron ore

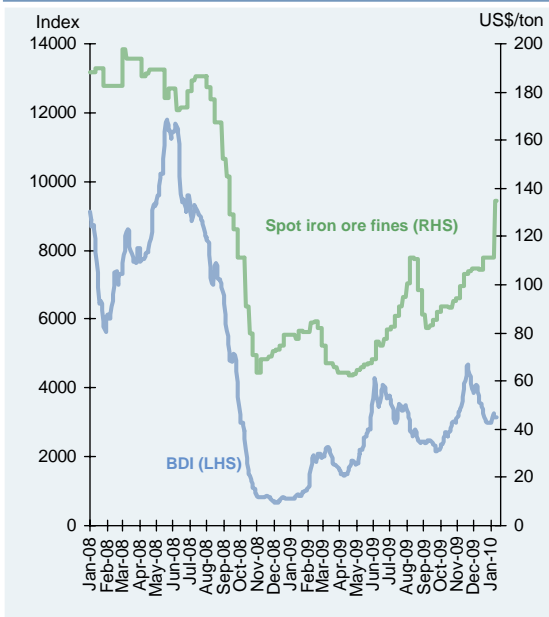
China imported 62.2mn tons of iron ore in December – the second highest monthly level on record, representing a 21.7% rise from November's level (see Figure 2a). For the full year, China imported 628.3mn tons of iron ore (+41.5% YoY) on the back of an estimated 18.8% increase in steel production (according to World Steel Organization estimates). Fundamental demand for the steelmaking ingredient remains strong, as seen in the ongoing strength in property construction, improving industrial output and a stronger-than-expected 17.7% YoY growth in exports in December.

Figure 2a: Monthly iron ore imports (mn tons)



Source: CEIC, Bloomberg

Figure 2b: BDI and spot iron ore fines prices (Index, USD/ton)



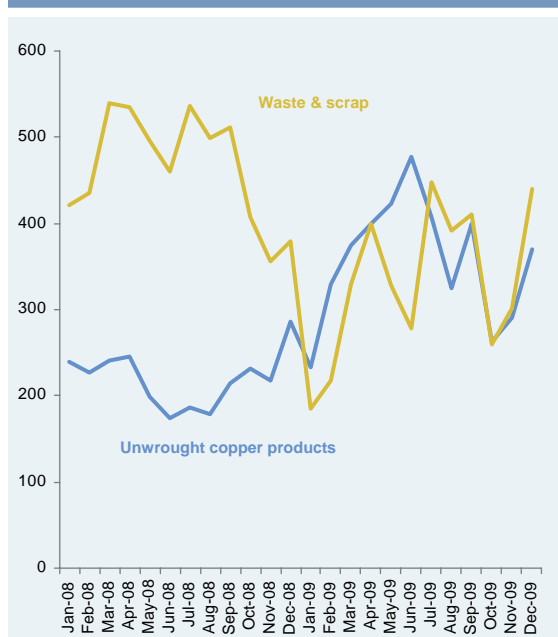
- J.P. Morgan expects global economic growth to recover to 3.3% in 2010 from -2.6% in 2009, suggesting stronger world steel demand in 2010 and support for iron ore prices. The spot price of iron ore fines at China's main ports currently stands at US\$135, having gained 76.5% from mid-2009.
- With annual contract price negotiations underway, market participants are anticipating a 20-30% price increase from last year's level. Chinese steel producers may be taking advantage of current prices and relatively low freight rates to augment their stockpiles.
- Pre-stocking ahead of the Lunar New Year holidays is also believed to have played a role in December's higher imports.

Copper

China's December imports of unwrought copper and semi-finished copper products rose by 21.7% from November's level to reach 369,368 tons (+28.9% YoY). For the full year, Chinese copper imports rose 62.6% to 4.29 million tons (see Figure 3), a figure that was spurred upward by periodic LME-Shanghai arbitrage opportunities and the State Reserve Bureau's strategic stockpiling campaign earlier in 2009. Over the course of the year, international copper prices surged by more than 140%. Although we expect China's fundamental demand for copper to remain strong in 2010, elevated domestic stockpiles, the wider availability of scrap supplies (China's copper scrap imports rose 46.1% MoM to 440,000 tons in December) and reduced speculation should preclude a return to the levels of import growth seen in 2009.

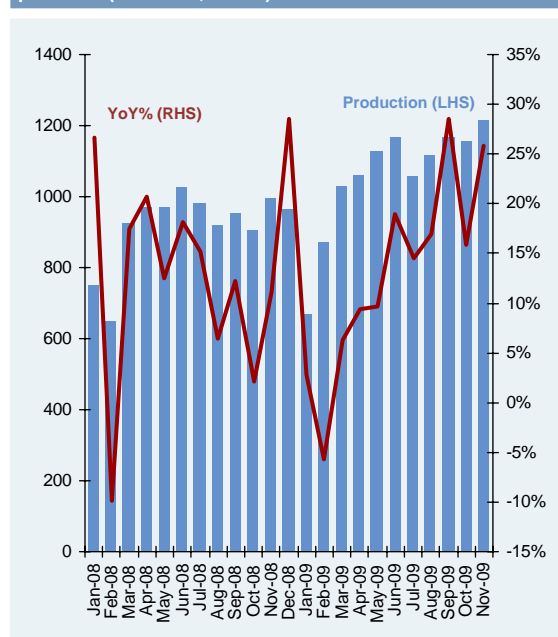
- The window for arbitrage between Shanghai and London reopened in mid-December, a factor that should support copper inflows in the near-term. The premium of Shanghai copper over LME prices currently stands RMB1901/ton before freight.
- China's production of copper reached a record for the fourth consecutive month in November, with refined production increasing 5.5% MoM to 421,000 tons (+21% YoY). The recent surge in output has been supported by the wider availability of scrap supplies, following various initiatives to encourage the replacement of household appliances and automobiles in rural areas

Figure 3a: Imports of copper ('000 tons)



Source: CEIC, Bloomberg

Figure 3b: Production of refined copper and copper products ('000 tons, YoY%)

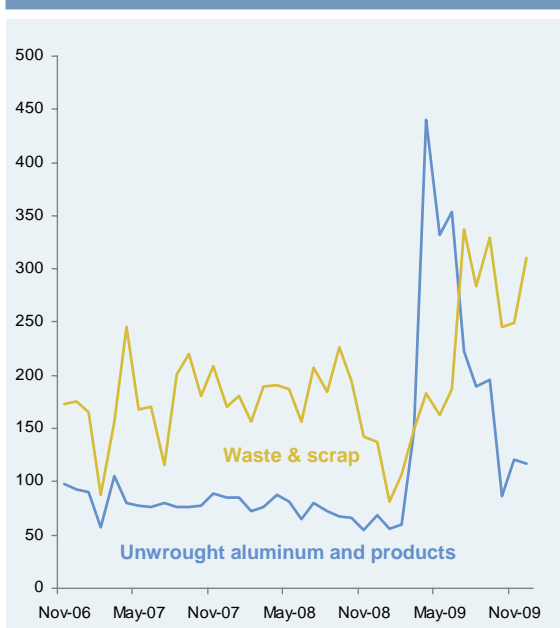


Aluminum

Imports of unwrought aluminum and aluminum products decreased 3.0% MoM to 117,016 tons in December, but were up 164.2% YoY in 2009. China's imports of aluminum scrap increased 24.0% to 310,000 tons, up 21.9% YoY in 2009 (see Figure 4a).

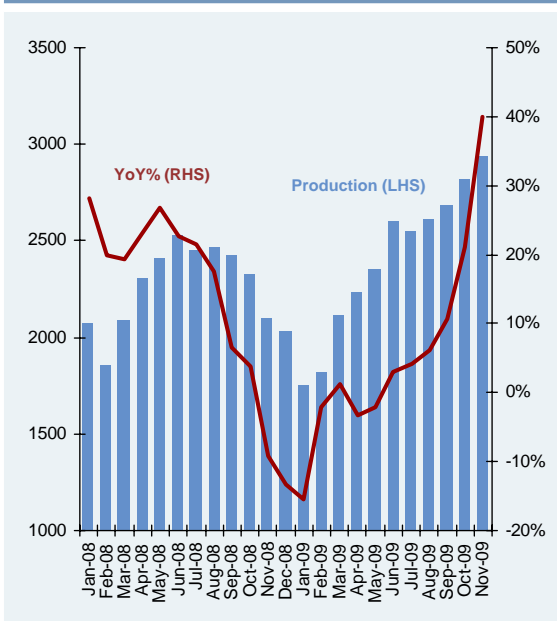
- Domestic production has increased sharply during the year (see Figure 4b), with primary aluminum output reaching a record 1.35mn tons in November, 7.1% above October's level. On an annualized basis, production levels in November reached 16.2mn tons, compared to 10.7mn tons based on January's output level.
- While demand for the metal has recovered rapidly, overcapacity caused by the aggressive restarting of idle production since Q209 has resulted in a record build-up of inventory (Shanghai Futures Exchange inventory reached 297,722 tons on January 11 – the highest level since 2003). According to Reuters, Chalco had restarted 100% of its production capacity by the middle of December, up from 88% - 90% at the end of October.
- Despite elevated inventory levels, Shanghai aluminum prices have bested LME gains, rising 13.6% since the beginning of December, compared to a 10.9% gain in London. Poor winter weather conditions in China and related power supply and transport concerns have helped drive domestic aluminum prices. Aluminum smelting is electricity intensive, accounting for about 50% of production costs.

Figure 4a: Imports of aluminum ('000 tons)



Source: CEIC, Bloomberg

Figure 4b: Production of primary aluminum & aluminum products ('000 tons, YoY%)



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