Observations After a Week in China

As most of you are aware, Peak has been a strong believer in the industrialization and urbanization of China, and how Australian Resource companies have been extremely well positioned to benefit from this. While this has served our clients well over the last eight years, we are ever vigilant to changes to this investment thesis. To that end, we make a practice of visiting China regularly, in order to gain first hand, a sense of what is happening.

I was fortunate enough to again attend the Bank America Merrill Lynch China Conference again this year. This was a two day event in Beijing where a comprehensive array of companies, government officials, bureaucrats, industry experts and analysts presented. The benefit to investors is that it provides a comprehensive overview of the key trends at work in China.

Prior to the conference, I spent two days en-route from Shanghai to Beijing, via a number of visits to industrial parks, with a specific focus on solar energy and urbanization away from the coast. This included a trip on the impressive high speed train between Shanghai and Beijing that covers 1300Kms in around five hours. (Project commenced in April 2008, completed in Nov 2010)

Key conclusions included:

- After more than a year of monetary and fiscal tightening, (designed to slow inflation and reduce speculation in the property market), it is clear that authorities have been successful on both counts.

- Property prices are now falling to varying degrees across the various market segments. Falls are most pronounced in segments where developers have been most active, and where their access to funding has become an issue. Price declines of 10-20% seem quite common.

- Ramifications of a correction in housing prices are expected to have greatest impact on property developers rather than the banks. In China, equity levels are generally high, providing a much higher level of support compared to what is experienced in the west.

- Inflation appears to have now seen a peak of 6.5%, confirmed by October number coming in at 5.5%. With food prices declining sharply, there is confidence that inflation will continue to decline into year-end, and likely to average 4.5% in 2012.

- On the back of these trends, it is apparent that policy settings are being eased. A range of measures including tax reforms, increased spending on education, health, support for low wage earners, energy conservation programs indicate that fiscal policy is being eased.

- Conditions in credit markets are also beginning to be eased. At this stage, banks are being encouraged to increase lending, particularly to more distressed businesses. So far, there have not been any official cuts to interest rates or Reserve Ratio Requirements, but it is only a matter of time.

- One of the key initiatives of the Twelfth Five Year Plan is a rebalancing away from Fixed Asset Investment (now in excess of 50% of GDP) towards Consumption (currently around 30%). A range of measures including tax reform, significant wage increases, greater emphasis on “quality” of growth rather than “quantity” through better health, education, a cleaner environment, greater range of services.

- The major implication of this for Australia, is that generally, Consumption is less “commodities intensive” than investment spending (particularly iron ore and coking coal ie the bulks). With urbanization at 50%, there is still quite some way to go to reach developed world levels of 75%. But it may be that the rates of growth from here on will gradually moderate.

- Combine this with a significant ramp up in production capacity of both iron ore and coal in Australia, Brazil, Africa and Mongolia over the next 3 or 4 years, leads us to become more cautious on bulk commodity prices specifically. Volumes may well continue to rise, but we may have seen the best of the prices.

Peak Investment Partners Pty Ltd ABN 12 109 434 880
Authorised Representative of Peak Investment Holdings Pty Ltd AFSL 304008
Level 7, 55 Hunter Street, Sydney NSW 2000 GPO Box 2058, Sydney NSW 2001
www.peakinvest.com.au Email: info@peakinvest.com.au Telephone: 61 2 9239 9308

- China remains deeply committed to a cleaner environment. Substantial investment is being made in wind and solar to accompany hydro. There is a major push into increasing gas as a percentage of energy usage (15% of energy usage by 2015). Some 28 nuclear power plants are under construction in China.

- In summary, China will continue to grow in the 7-9% region over the next year or so (providing the majority of global growth), consumption will gradually gain momentum as investment moderates, policy setting will be eased providing support for markets (both equities and property), inflation will fall quite sharply and an emphasis on “quality” of growth will deliver significant social reforms. Risks continue to be the need for political and legal reform and the need for greater inclusiveness of youth.

Sector Summaries

Economic

- Over the last decade GDP grew at 10.2% pa and inflation was 2.2%. These were the Golden Days. Going forward, growth will be slower and inflation higher.

- Economic rebalancing between investment and consumption will occur over the next five years. Excess capacity is now evident in a number of industries, while quality of life factors are becoming an increasingly important issue.

- Fiscal and monetary policy are now being eased, which will offer support to asset markets

- Inflation will materially decline over the next few months, now that food prices are declining.

Property

- Compared to a year ago, prices are now clearly stable to falling.

- Generally prices are down an average 10-20%, but with wide variation.

- Stress points confined to segments where developers have been most active and now experiencing funding issues.

- High equity levels of home owners will see this through. Developers wont be so lucky.

Inflation

- CPI peaked at 6.5% in July, was at 6.1% in Sept and today was 5.5% for September. Further significant falls are likely towards 4.5% over the next few months.

- Food prices account for 30% of China’s CPI, and pork is a significant part of that. All have been declining recently.

- Local views are that inflation could be running in the 4-5% range in 2012.

Capacity to Stimulate

- Budget revenue up 30%

- Business profits up 28.2%

- 50% increase in health spending

- 30% increase in education spending

- 26% increase in low wage support

- 26% increase in energy conservation measures

Steel

- ML view is 690Mt in 2011, 730Mt in 2012 and 760Mt in 2013. Twelfth 5 year plan supports this slowing of growth.
- Property accounts for 30% of steel consumption
- As economic rebalancing gathers pace, early cycle products such as steel and cement will see slower rates of growth
- Consumer goods are more aligned with aluminum and copper

Iron Ore

- The recent sharp correction appears related to a sharp downturn in demand from China mills (responding to property developers being funding constrained), in conjunction with shipments being diverted from Europe to Asia
- Medium term issues in Iron Ore are capacity expansion of up to 300mt of seaborne trade pa by 2016, but relatively smaller increases in demand. One needs to see a significant step up in demand in India and elsewhere to provide support to the price.
- We would not ignore the recent market sell off as a warning of future pricing. While there will most likely be a recovery to $140-$160, we think the best of the iron ore prices have been seen.
- Focus on the low cost producers-ie BHP and RIO

Coal

- Very hard to get a clear reading on this.
- Lots of talk about consolidation in the disparate Shanxii mines, however quality issues as well as degree of mining difficulty, appear to make the threat unclear as far as importers are concerned.
- Shaanxi coal not of a high quality. Needs to washed and blended. Is high sulphur generally.
- Also an issue increasingly supply coming in from Mongolia
- Thermal coal longer term, imported market pretty questionable.

We thank you for your support and look forward to speaking with you In the near future.

As always, if we can do anything to assist you, your family and your friends, we are always here to help.

Ian Wenham
Director
02 9239 9342

Richard Nicholas
Director
02 9239 9315

Andrew Martin
Director
02 9239 9310