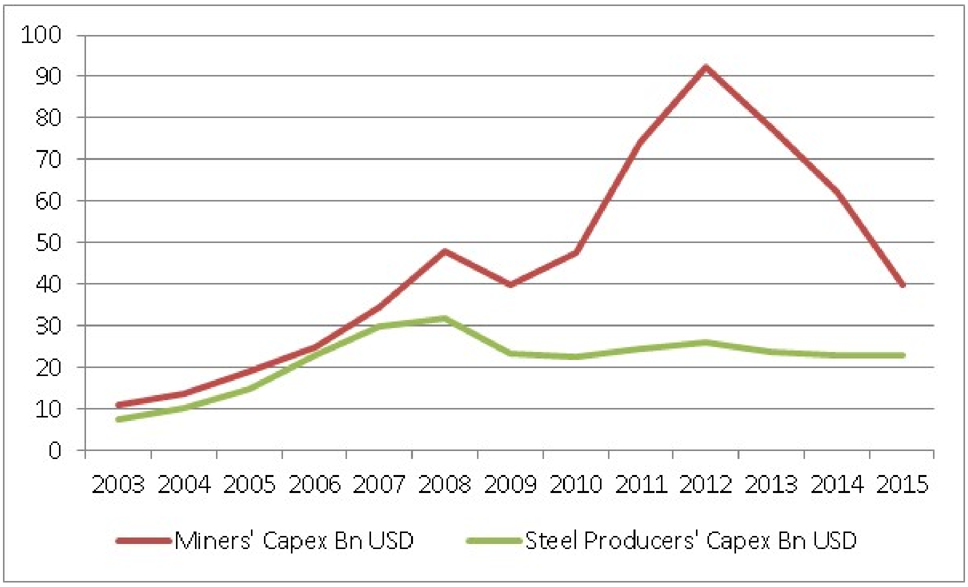
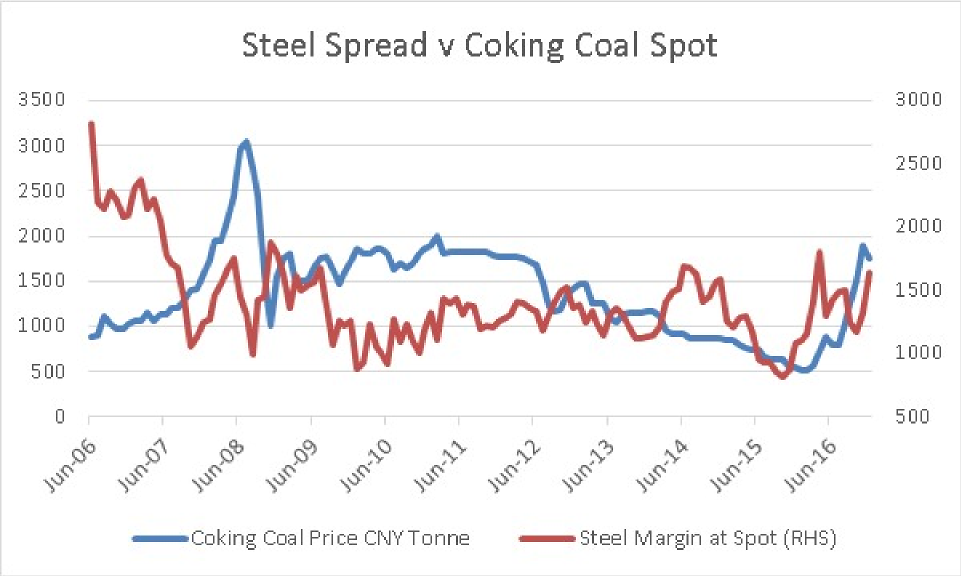
THE END OF THE BEAR MARKET FOR IRON ORE

This is my third note on iron ore. The previously two notes were written in November 2011 and June 2012 warning that iron ore looked to be entering a bear market. Having reviewed recent data on iron ore sector, the structural bear market for iron ore is over, and on at least a relative basis looks attractive.

The bear market in iron ore was caused by excessive investment in iron ore production by miners, far in excess of the investment by its main customer, Chinese steel. However, investment by iron ore miners looks to have normalised, while Chinese steel investment has flatlined.

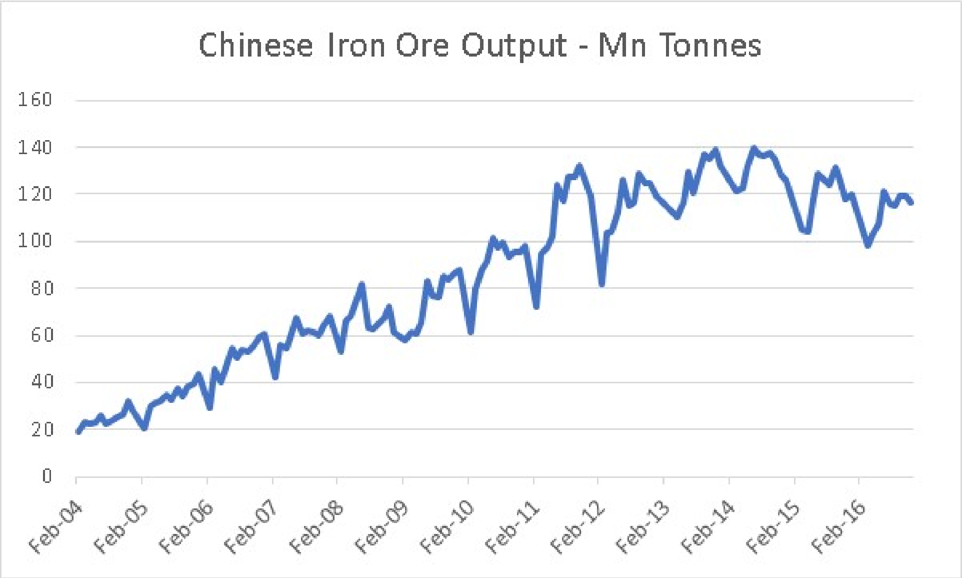


Chinese steel production has stabilised over recent years. More importantly, the Chinese steel industry has consolidated. Demonstrated by the fact that as coking coal prices rise, margins on Chinese steel producers can now be maintained. This indicates that large Chinese producers have achieved some pricing power.

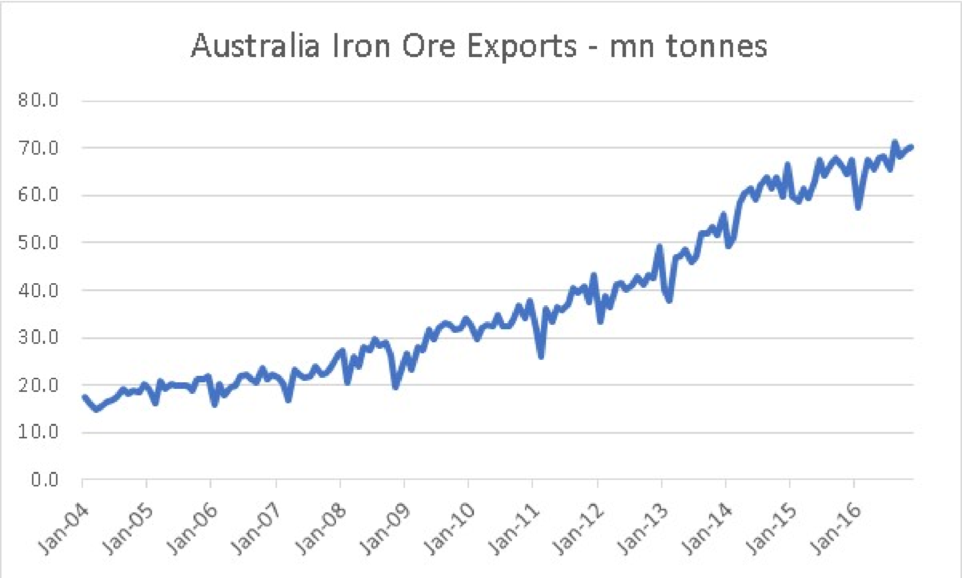


Rising coking prices in 2008 and 2011 caused steel margins to fall, but the recent increase has seen steel margins remain high.

China is the world largest iron ore miner, producing 30% of the world volume, at 1.3 bn tonnes. Australia is next at 0.8bn and Brazil follows at 0.4bn tonnes. However Chinese iron ore mines are very low quality, and we are now starting to see Chinese iron ore production decline.



So even though Chinese steel production is not rising, Chinese imports of iron ore are beginning to rise. Australian iron ore exports are beginning to rise after a few years of no growth.



The other key change for the steel market is that Indian steel production is now quite sizable, making it the 4th largest producer in the world. Growth in India is beginning to turn world ex-China steel production positive, likely increasing the shortage of iron ore.

China has cut its own iron ore production to rely more on imports, while the rest of the world is increasing its demand for iron ore. Mining capital expenditure has fallen dramatically, and output from the world's biggest producer is falling. Iron ore looks structurally attractive relative to other assets that are reliant on Chinese growth.

INFORMATION

Issue Date: 17th January 2017

Source: Bloomberg, unless otherwise stated

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