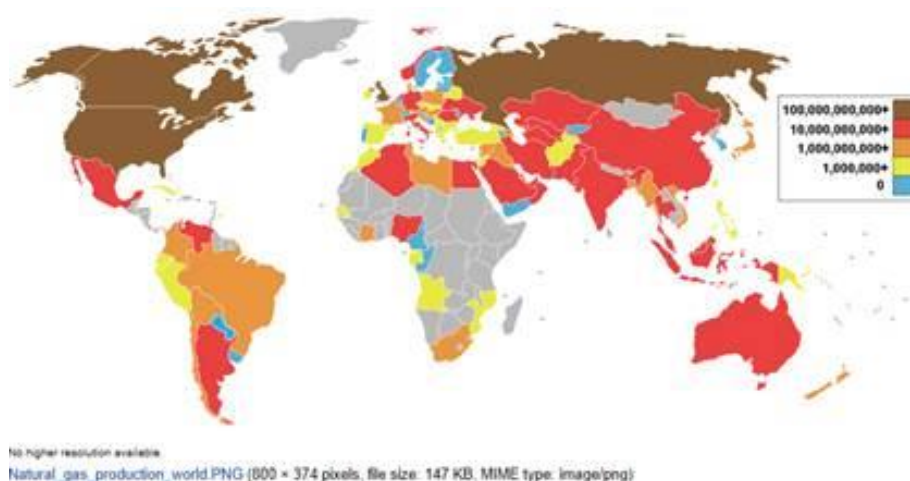


Commodities and the Australian terms of trade

17th April 2012

Commodities and the Australian terms of trade have been a key topic of discussion over the last week. The Australian terms of trade are primarily driven by two bulk commodities, coal and iron ore. Iron ore and coking coal are off course core inputs of steel production. Recent drawdown in Chinese iron ore port stocks and recent weakness in steel prices and production volumes globally have put global growth and the AUD in focus. This is fair and reasonable consideration in the short term, however a closer look at Australia's investment pipeline makes it clear that the composition of Australia's terms of trade is likely to be augmented by natural gas over the next decade.

The likes of North West Shelf, the greater Browse Basin, Gorgon and the Bowen Basin are all global blue-chip assets; Australia will see a significant rise in production volume over the medium term as a consequence.



A significant amount of money is backing natural gas to be a big winner from the confluence of factors including carbon emissions, nuclear disasters and economic growth (leads to a rise in per capita energy usage), from an investment perspective this has been particularly evident in the development of US Shale assets as well as the aforementioned Australian assets. What has caught our eye in all of this has been the actions of the Greek merchant fleet.

Approximating 20% of the world's shipping volume, the Greek fleet (Greek flagged) is still largely family owned (unlike its corporatized or state owned Asian and North American competitors), the Greek merchant fleet has historically been particularly effective in timing its increase or reduction in volumes and cargo type.

The Greek shipbuilders have committed \$5.5 billion USD for 25 shipbuilding contracts and 150,000 cubic meters of gas capacity over the last 12 months. They are consciously increasing their focus on specialty craft with an emphasis on natural gas and away from bulks. This action doesn't necessarily reconcile with the short-term view of the market, especially on the back of recent Chinese data. In our opinion however, the actions of a family owned business with significant expertise making a large long-term capital commitment would carry greater weight than the view of analysts and hedge funds who can turn over their opinions and positions in the blink of an eye.

What that means to us here in Australia has been well documented through key messages from the RBA. The message focuses on the issue of structural change here in Australia, specifically that our terms of trade is likely to rise significantly from the current elevated investment as projects are delivered over time (this will also drive productivity growth).

This supports the view that a higher dollar could well be structural over the long term. That said governments and investors alike remain transfixed on the here and now.

It seems the greater concerns to the Government are the noises around possible ratings action from the likes of Moody's. As an electorate and a country generally, our sound rating and strong fiscal position is something that is valued. Politically the occurrence of a deficit followed by a ratings downgrade would be seen as very undesirable.

The issue of fiscal withdrawal through heavy budget cuts at a time that the majority of the economy is doing it tough on the rationale of protecting our prized AAA rating may well prompt action from the RBA. This could very easily coincide with continued volatility out of Europe driving increased volatility and risk aversion.

The combination of risk off and rate cuts could very well act as a double whammy for the Aussie dollar in the short term, regardless of the upward trajectory of the terms of trade and by extension the Australian economy over the longer term.

For fixed income this environment is also likely to remain positive for long CGB versus most other sectors of the Australian fixed income market as well as being positive for duration. This will in all likelihood present attractive opportunities, especially if circumstances in Europe continue to deteriorate (which we believe is likely), however the onus right now needs to be on broader portfolio immunization.

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