JFCP - Investing in Practice

February 2010

Outlook for China and commodity prices

JF Capital Partners has recently met with a host of proprietary contacts over the last two weeks focussing on the outlook for China and commodity prices.

We have summarised the main points below. We have also described how it has changed our underlying assumptions and thinking.

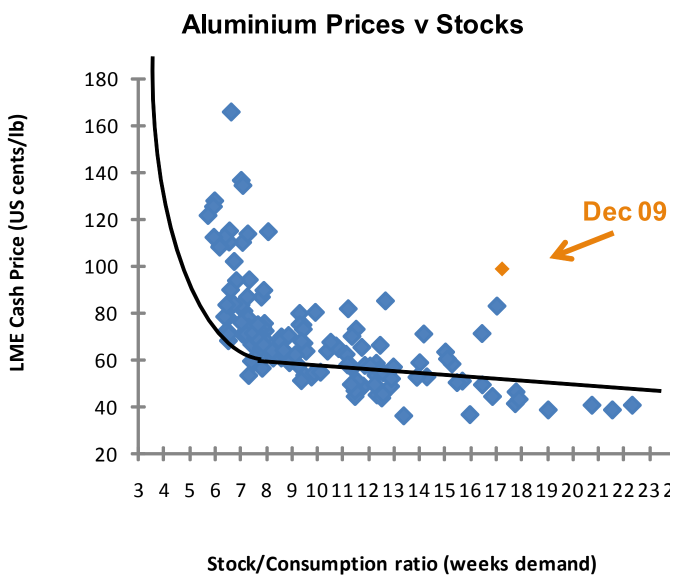
China's commodity demand will slow in 2010

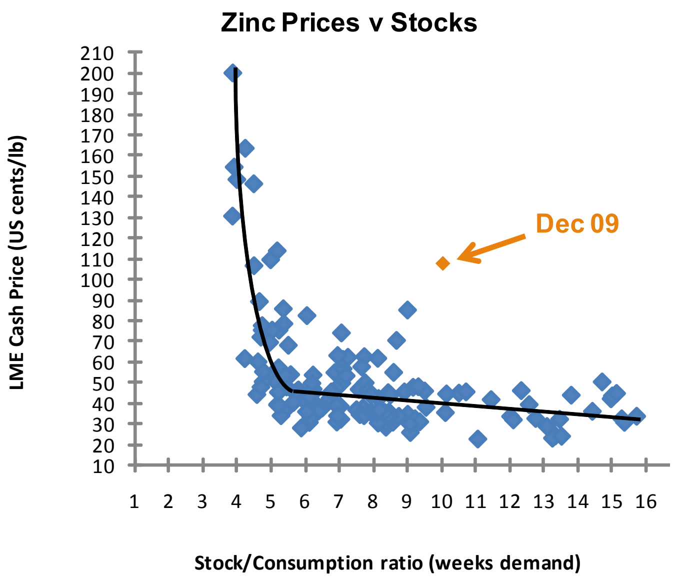
Views on the sustainability of Chinese commodity demand are fairly mixed. Pivot (proprietary contact) believe the investment driven demand of 2009 will collapse given Chinese consumption cannot match the fall in investment demand, whilst Antaike (proprietary contact) think demand will remain robust driven by continued investment.

At JFCP, our probability weighted assessment assumes that the reality lies somewhere in between, but there is no doubt China's commodity demand cannot increase at the same rate as 2009. Demand will be lower for three main reasons: (1) Stimulus spending will be cut and infrastructure spending will be lower; (2) China's State Reserves Bureau (SRB) strategic buying is over; and (3) cuts in bank credit and a reduction in money supply will lead to less speculative activity. The National Development and Reform Commission's (NDRC) ability to manage the economy will continue to be dynamic. That is, the NDRC can change policy as conditions change for the better or worse. The NDRC has the ability to increase spending and relax credit restrictions if the economy slows, or continue to tighten if inflation continues to grow.

Bulks (iron ore and coal) will fare better than base metals in 2010

Current base metal prices are expensive relative to our base case commodity prices assumptions. Relative to history, inventory levels to price show all base metals, in particular aluminium and zinc, are fully priced as shown in the charts below. While base metals and gold will continue to benefit from higher inflationary expectations, lower demand from China and anaemic demand from the European Union and the US will mean that prices will fall to better reflect demand and supply fundamentals. No SRB buying and less speculation will add to any base metals price weakness. Bulks (iron ore and coal) will fare better as a result of relatively robust demand and extreme weather that has caused shortages in China as well as limiting the supply response from potential suppliers. These views are supported by our proprietary contacts at Antaike, BCA and Chalco.





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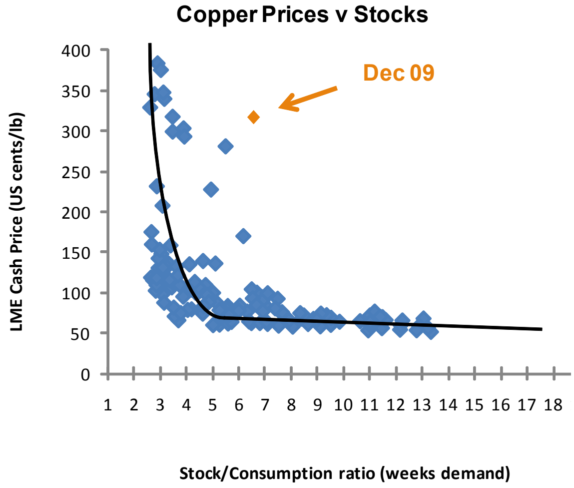
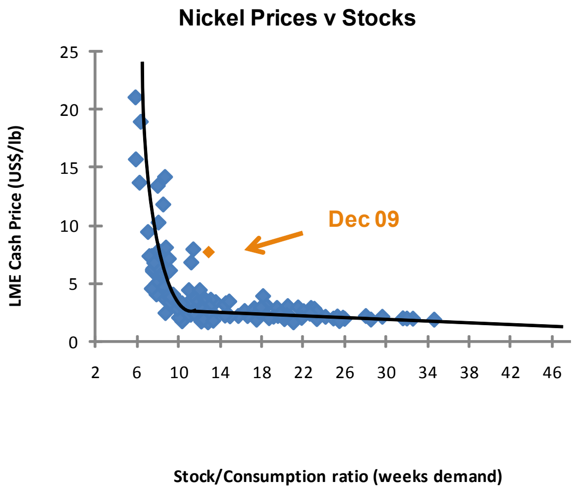
Longer term outlook remains solid but Governments will want a bigger slice of profits

We expect as China's urbanisation consolidates, India grows (albeit at a slower rate than China) and the "extra" half a billion people in South East Asia move towards urbanisation, that underlying commodity demand will remain strong. Supply will vary between commodities but in general, grades will fall and costs of production will increase. We envisage no major change to underlying risk in our commodity price assumptions as the correlations between commodities will stay fairly high given the economic drivers rather than individual commodity factors discussed above.



As illustrated by the charts opposite, based on history, commodity prices are high relative to inventory levels. This is particularly the case for Aluminium and Zinc.



How have we changed our forecasts to reflect what we have learned

Increased our short-run coal forecasts

We have raised our 2010 Japanese Financial Year price to US$95 a tonne for thermal coal, US$190 for coking coal and US$135 for semi-soft and PCI. We have then staggered the price back to our long-run price over three years. While the market is forecasting price increases for coal and iron ore next year, we think weak demand and supply responding to higher prices once weather improves will lead to falling bulk prices.

Increased iron ore price forecast

Following lengthy discussions with one of our proprietary contacts, Neil Bristow (ex-Head of BHP Strategy), who gave us a comprehensive review of the iron ore market in China, we learnt that based on cost of production in China, our long-run iron ore price forecasts were too low. We have therefore increased our long run price to US$63 a tonne or US$Fe unit 1.00 (from 0.95). This has resulted in the BHP valuation increasing by 3.5%, to $55.67 and the RIO valuation increasing by 5.0% to $100.67. We have also increased the proportion of iron ore sales sold on the spot market rather than under contract. The spot market has recently been as much as 100% higher than the contract price. JFCP is currently forecasting a 50% increase in the 2010 contract price.

Increase tax and sovereign risk assumptions

We are presently considering the potential impact of any Resource Rent Tax on the resources sector. Our initial assessment of yet to be proposed Henry Review taxation initiatives would reduce the BHP valuation by 5%. There is potential for other western world countries and developing nations to implement similar taxation/royalty schemes which would be reflected in higher risk numbers.

About Us

JF Capital Partners is a research driven investment manager that specialises in building tailored, risk controlled portfolios.

With more than ten years experience, we have managed money through bull and bear markets.

Our strategies

JF Capital Partners offers five strategies to investors and all strategies can be managed on an after-tax basis.

- Benchmark Based
- Benchmark Insensitive
- Long-short 150/50
- Absolute Return

For further information on our investment strategies, please contact Wes Campbell or Richard Balderstone.

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