February 6, 2008

ZINC MARKETS – EARLY SUPPLY DISRUPTIONS?

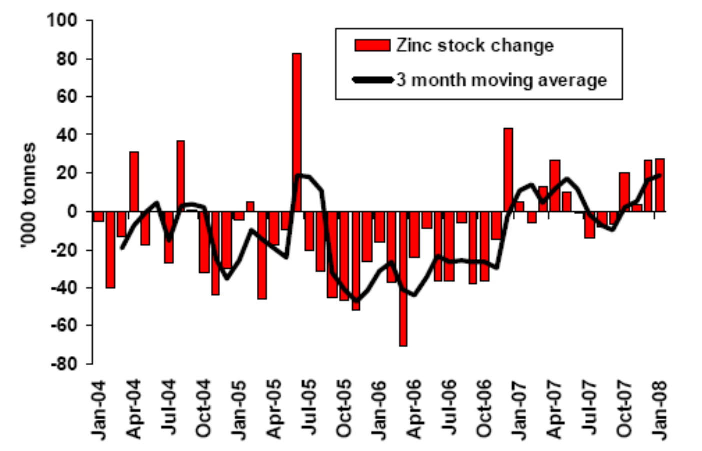
In the January 11, 2008 Zinc Overview it was suggested that the surplus being forecast for 2008 may not happen. Since publication a number of major disruptions are changing the outlook for mine and metal supply. Initially it was power shortages in Africa, followed by power supply constraints in Chile and now unusual winter weather in southeast China are causing havoc to power production in that market. These events have focused attention on how tight power is in many of the rapidly growing industrial economies, and highlighted power as one of the key factors in determining metal supply and indirectly metal prices. In China this is turning into a seasonal event. In past years, mine and operational failures, strikes and environmental problems have disrupted zinc supply. 2008 is not off to a good start as we are not through February and metal production forecasts are being downgraded.

In China the power outages hit China's biggest zinc smelter. In Hunan province up to 600,000 tpa of zinc smelting capacity has been shut down. It has been estimated that if the cold weather persists up to 220,000 tonnes of zinc production could be lost and 100,000 tonnes of consumption (Brook Hunt Jan 2008). This is very significant given that the previous forecast was for a surplus of 384,000 tonnes in 2008 (see Jan 11, 2008 Zinc Note). This disruption is likely to have ripple effects on concentrate imports and metal exports in China and indirectly on treatment and refining charges (TC/RC). A surplus of concentrates will lead to higher TC/RC which will impact the small mine producers in China who are also likely suffering due to the severe winter conditions also affecting local mine concentrate supply.

Metal Inventory Increases

The accompanying chart illustrates the build up of inventories that commenced in late 2007 and is continuing at a slow pace. The loss of production should mitigate the rate of inventory build up in mid-year. Importantly, most of the increase in January was on LME with very little increase in Shanghai warehouse indicating near balance in Chinese supply-demand; this of course is expected to change as the recent smelter shutdowns in China take effect.

Zinc stocks continue to build up January



Source: LME, ILZSG, Macquarie Research, February 2008

Economic Outlook

The recession word is ubiquitous in the United States as the housing industry continues to decline and the ripple effects are observed through the US economy. Others are more optimistic and see a slow down and the economy improving in second half of the year as the stimulus of the 1 3/4% decrease in interest rates by the US Federal Reserve takes effect. The better than expected 2.3% increase in US factory orders in December suggests that there is life in the US economy outside the housing industry. It is also interesting to reflect on the emerging consensus view at a recent major mining conference that a slow down in the US will have little effect on Chinese GDP growth which continued strong with Q4 2007of 11.2% growth.

Current zinc metal prices fully reflect an outlook that includes a significant increase in zinc inventory in 2008 and beyond. If there are more disruptions in zinc mine and metal supply, or zinc demand increase due to economic recovery in North America, current zinc prices certainly appear to be oversold.

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