

MOVE OVER OPEC, THERE IS A NEW COMMODITY CARTEL IN TOWN... CHINA

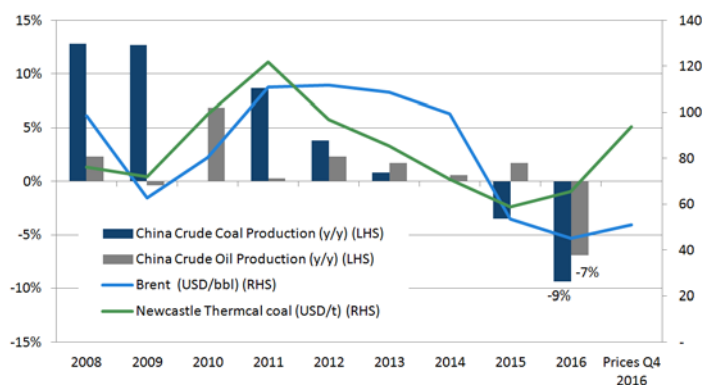
Founded in 1960, OPEC has been coordinating and unifying petroleum policies amongst its members and influential in determining the oil price direction. Its last major action was last November when it announced a reduction of 1.2 million barrels a day by January 2017 and even pulled along another major non-OPEC oil producer, Russia, into the deal. But why this change in OPEC strategy when back in 2014 it abandoned adjusting oil production and pledged to “pump its competitors out of the ground”?

In considering OPEC’s move, I have considered if OPEC took a page from China’s playbook of 2016? For years, several of China’s primary industries have been plagued with oversupply. These oversupply issues were evident from the vast coal fields spread throughout China through to the steel and aluminum industries in eastern China to the aging oilfields of Petrochina and Sinopec, which in turn has led to poorer profitability. In the past, excuses like social security and national interests have always existed for not rationalizing these sectors but in 2016, China went out and did something different. China’s action in 2016 had a profound impact on commodity pricing and the rules by which the commodity industry participants play by.

A page from the Chinese commodity playbook

During 2016, China took various actions, more directly in coal but more subtly in the oil and gas sectors, which had a significant impact on production.

Image 1: Chinese coal and oil production



Source: NDRC, Bloomberg

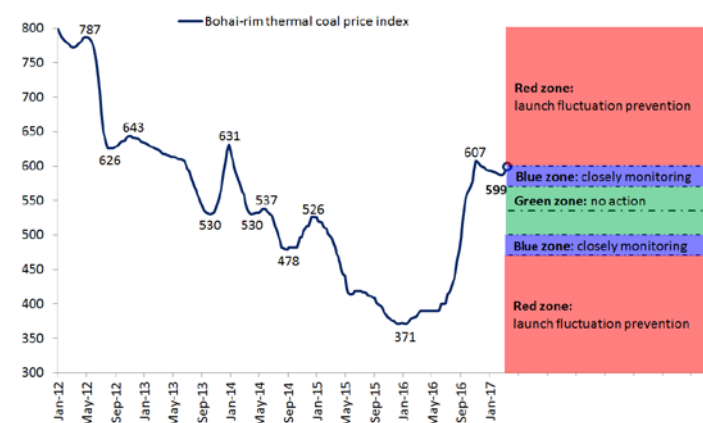
What happened in Chinese coal?

For the last five years, coal mining profitability in China (and globally) has been on the downtrend. Combined with diminishing demand from alternative sources of power and increasing coal supply, the outlook for the Chinese coal miners seemed increasingly uncertain.

In mid-April last year, a subtle directive was issued, in which working days for all coal mines was reduced to 276 days a year from 330 days. The price impact was not immediate; from April to June 2016, thermal coal prices were relatively muted, but afterwards, port inventories and stockpiles at the power producers needed replenishing and coal prices reacted. By November, when the 276 day rule had been fully executed, coal production was down 12% year on year and coal prices had almost doubled. The Chinese government had a new problem that it had not faced in four years, what do to do about high domestic coal prices?

By mid November, the National Development and Reform Commission (“NDRC”) called a meeting with the top ten Chinese coal producers and laid out its game plan. The plan was simple, the NDRC established a target range of coal prices and when the coal prices were above this, the producers were allowed to increase production, and when the prices are below this, the producers have to cut back production.

Image 2: 276 day rule takes full impact on coal prices



Source: CQ Coal, Citi Research

With these actions, the NDRC solved two problems, the low profitability of its coal mines was eliminated overnight and the use of coal would be reduced, thus helping it hit its power mix requirements.

So from here on into the foreseeable future, coal pricing will be dictated and controlled by the NDRC.

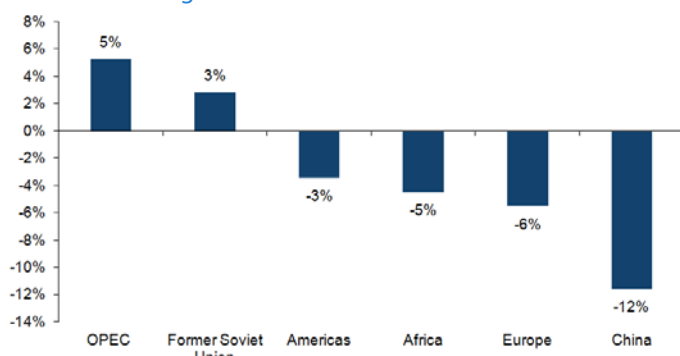
What about Chinese oil production, what happened there?

Which oil producing block cut oil production the most in Q4 2016. Answer – China.

China is a relatively small producer of oil, at 4% of global supply in 2016. However, its production decline of 0.5 million barrels per a day from Q4 2015 to Q4 2016 is sizeable compared to OPEC's proposed production cuts 1.2 m barrels a day. Whilst most journalists have written about OPEC's proposed cuts, China's production cuts have not been given much press coverage. What happened here? China crude self-sufficiency has taken a backseat. Rather than focusing on production growth, Chinese SOEs were encouraged to improve efficiency and profitability. Hence, this has encouraged the closure of high cost, uneconomic wells - even at the expense of production volume.

With the release of China's 13th 5 year plan, China's ambition for growing oil production looks relatively subdued with flat production an optimistic outcome.

Global Oil Production Q4 2015 vs Q4 2016 year on year production changes



Source: IEA Oil Market Report

What cartel is next? – Steel and Aluminium

The results of the China's action in coal and oil are still in the early days and their determination and ability to control the coal market is yet to be fully tested.

What commodities sectors could be next for the China? Commodities that stand out next are steel and aluminium. China has laid the ground work for steel with its 13th five year plan for the steel industry. With capacity reduction targets, frameworks for new capacity additions to only replace obsolete capacity and increasing the state owned enterprise share of production to 60% (from the current levels of 35%), the steel capacity and production from China looks likely to be restricted.

Aluminium could be a story for later this year. The Ministry of Environmental Protection released a draft air pollution prevention plan which requires aluminum smelters in Hebei, Shandong, Henan and Shanxi to suspend aluminum smelters and alumina refineries to suspend production from the end of 2017.

Unintended Winners

China's policies in the last year have had a series of "unintended" winners. The most obvious winners from China's coal policies were the seaborne coal exporters. Whilst China has restricted its domestic coal production, Chinese imports of coals increased 25 percent year on year leading to a significant increase in profits for Australian and Indonesian exporters of coal. However, it has become pretty clear that the fate of these unintended winners is clearly in the NDRC's hands.

Conclusion and Takeaways

China has had a significant impact on the supply side in two key global commodities during 2016. Going forward, look out for further actions from China on the supply side of commodities.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan.

Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to

lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.