



Base Metals Monthly – February 2007

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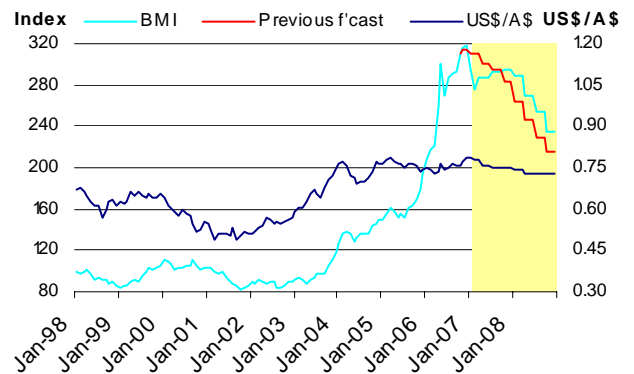
Summary – Chinese new year to boost demand and prices

- **Metals fall on speculative losses...:** Metal prices fell in January, as concerns around losses sustained by UK based hedge fund Red Kite impacted strongly on copper and zinc.
- The slump in exchange traded resource commodities in early 2007 may indicate some repositioning of risk in speculative portfolios, a reaction to high profile losses in metals and energy markets.
- As measured by NAB's base metal index, average US dollar prices fell by 7.4 per cent in January. While prices are well off peaks, they are still 41 per cent higher year on year.
- **...but China offers short term upside:** A return of Chinese purchases (following Chinese New Year) – particularly in the heavily destocked copper sector – offers upside potential for metal prices. Copper is often seen as a barometer of base metal conditions and should provide some strength across the complex.
- China's economy is forecast to grow by 9.9 per cent in 2007, continuing to underpin global base metal demand.
- **Metal markets remain in tight balance...:** Supply side growth in metals markets has continued to disappoint – as cost pressures, labour disputes and disruptions have impacted on new developments (both green and brownfield).
- However, individual market trends are beginning to diverge. Aluminium and lead markets are forecast to record surpluses in 2007, copper and nickel to be closely balanced while zinc is forecast to remain firmly in deficit.
- **...with minimal stock coverage:** stockpiles on the London Metal Exchange remain tight across most of the complex (with aluminium the least severe). Therefore there is minimal cover in the event of a supply disruption – always a risk when labour contracts are renegotiated.
- **Metal prices to rebound from current "lows":** In annual terms, NAB's BMI is forecast to average 297 points in 2007, a year on year increase of 5.6 per cent. The aggregate is forecast to track broadly sideways across the year, as the underlying metals diverge.

Summary of forecast revisions

	2006	2007 f	Previous	2008 f	Previous
Aluminium	2568	2382	2325	2113	1900
Copper	6725	6308	6875	5890	5620
Lead	1286	1385	1020	1044	780
Nickel	24270	35057	26750	27625	18875
Zinc	3275	4088	4900	4000	4000
BMI	274.7	290.0	297.2	261.8	239.1

Most metal prices to decline in 2007



Source: NAB Group Economics, Datastream

Quarterly price summary (US\$ a tonne)

	Q4 06	Q1 07 f	Q2 07 f	Q3 07 f	Q4 07 f
Aluminium	2722	2603	2375	2300	2250
Copper	7064	5732	6250	6500	6750
Lead	1622	1590	1400	1350	1200
Nickel	33085	38228	35000	34000	33000
Zinc	4194	3603	4000	4250	4500
BMI	314.9	285.3	287.6	292.0	295.1

Source: Datastream, NAB Group Economics

Commodity in Focus – Aluminium

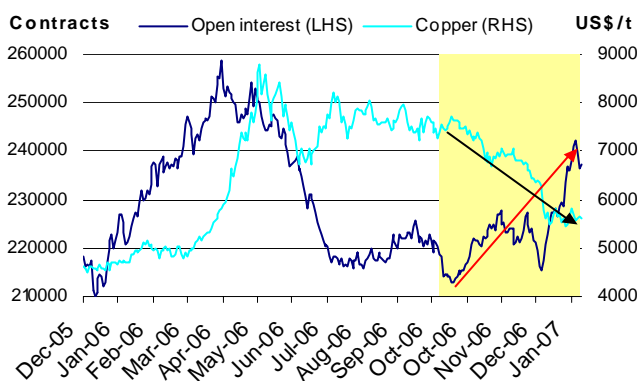
- Aluminium prices have held stronger than others in the base metal complex – particularly copper and zinc – most likely due to short covering in the futures market.
- The fundamentals of the aluminium market are weakening – with rising stockpiles and a market balance moving towards surplus.
- Cost pressures – particularly for raw material input alumina – are declining. Increased availability of alumina has allowed Chinese production (in particular) to expand. Global output is forecast to expand by around 6.5 per cent in 2007 – leading to a surplus of around 200 000 tonnes.
- Aluminium demand should remain firm – driven primarily by growth in construction and manufacturing in China. Global consumption is forecast to increase by 5.6 per cent.
- Reflecting the easing in market conditions, aluminium prices are forecast to decline in 2007. Aluminium is forecast to average US\$2382 a tonne, a year on year decline of 7.2 per cent.

The big picture – speculative losses strain metals markets in early 2007

Aside from stratospheric nickel prices, the most notable feature of base metal markets in early 2007 has been the sliding prices of copper and zinc on the London Metal Exchange. Compared with their levels at the start of the year, prices in mid-February for copper and zinc have fallen by 14 and 28 per cent respectively – despite only a season easing in the underlying markets.

Copper prices gradually slid across the fourth quarter of 2006 before plunging in January. The direction of open interest and price on the London Metal Exchange can provide a signal to the sentiment of speculators over this time. Falling prices and rising open interest in copper indicates a fresh wave of short positions in the market.

Copper prices slide as speculators position on the short side



Source: Bloomberg, NAB Group Economics

According to the Wall Street Journal, these metals have been particularly affected by losses suffered by UK based hedge fund Red Kite. Reports suggest that the fund lost around 20 per cent of its value in January – leading to concerns that investors would withdraw their money from the fund – raising risks across the metals complex.

The losses echo those of US based Amaranth Advisors, who in late 2006 lost around US\$6 billion on natural gas futures. The slump in exchange traded resource commodities – including base metals and oil – in early 2007 may indicate some repositioning of risk in speculative portfolios in response to high profile losses.

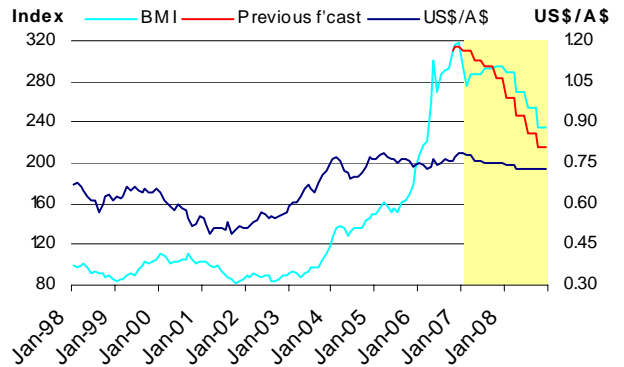
As a result, speculative investors may be less aggressive in their approach to commodity markets in the future, when compared with the inflows between 2003 and 2006. That said, it is likely that the firm fundamentals – which underpin the “supercycle” in commodity markets – will continue to entice a degree of speculative investment.

As market fundamentals – particularly those of copper – tighten in coming months, speculative inflows may return to base metal markets. Copper consumption is expected to rebound in coming months, as destocked Chinese consumers return to the market. Speculative investments will increase both the volatility of prices and the uncertainty around price forecasts.

Base metals index – prices fall in January, but short term recovery is forecast

NAB’s base metal index (BMI) fell in January – as falling copper and zinc prices dragged on the measure – down by 7.4 per cent to average 294.2 points. While many commentators have dramatised this fall, it is worth noting that despite the month on month decline, base metal prices were 41 per cent higher in year on year terms in January.

Metals prices to recover in the short term, but downward trend in 2008



Source: NAB Group Economics, Datastream

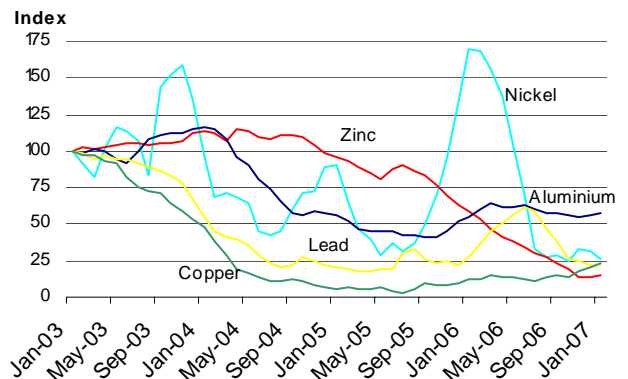
In the short term, a recovery in aggregate base metal prices is expected – largely driven by copper prices. Heavy destocking in China led to year on year declines in apparent consumption – leading to statistical agencies claiming that copper markets were in surplus in 2006. As Chinese consumers return to the spot market in 2007 – most likely after Chinese New Year in mid February – copper prices should regain strength.

Copper is often perceived to be the barometer of base metal market conditions – hence strengthening in this market will more than likely spread across the entire complex (in particular zinc).

However, economic conditions are weakening in key markets – particularly the United States and emerging Asia – and therefore we see a downward trend for metal prices from late 2007.

For 2007 as a whole, NAB’s BMI is forecast to average 290 points (previously 297.2), a year on year increase of 5.6 per cent. Volatility in metal prices is likely to persist in 2007, with ongoing uncertainty from speculative pressures and stock coverage remaining low early in the new year.

Metal stocks remain under pressure in early ‘07



Source: Datastream, NAB Group Economics

Commodity in Focus – Aluminium

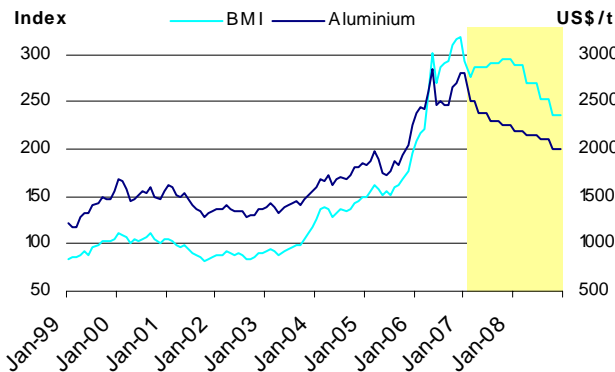
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- The fundamentals of the aluminium market are weakening – with rising stockpiles and a market balance moving towards surplus.
- Cost pressures – particularly for raw material input alumina – are declining. Increased availability of alumina has allowed Chinese production (in particular) to expand. Global output is forecast to expand by around 6.5 per cent in 2007 – leading to a surplus of around 200 000 tonnes.
- Aluminium demand should remain firm – driven primarily by growth in construction and manufacturing in China. Global consumption is forecast to increase by 5.6 per cent.
- Reflecting the easing in market conditions, aluminium prices are forecast to decline in 2007. Aluminium is forecast to average US\$2382 a tonne, a year on year decline of 7.2 per cent.

Aluminium price and stock trends

For 2006 as a whole, aluminium prices on the London Metal Exchange averaged US\$2568 a tonne, a year on year increase of 35 per cent.

On average, prices were essentially unchanged in January – down just US\$4 to US\$2810 a tonne. Despite an upward trend in stockpiles since mid December – which has added around 100 000 tonnes of the metal to warehouses (a 15 per cent increase) – aluminium prices have held firm in stark contrast to copper and zinc.

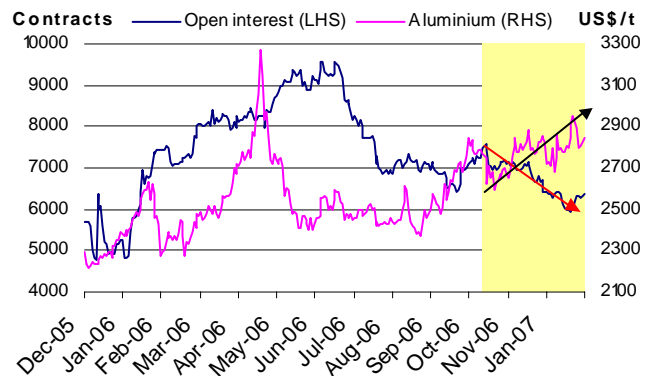
Aluminium rallies, but set to decline in 2007



Source: Datastream, NAB Group Economics

Analysing London Metal Exchange open interest data indicates that aluminium participants may have engaged in short covering – purchasing offsetting contracts to buy aluminium to close out open contracts to sell – as open interest has declined since November as prices have risen.

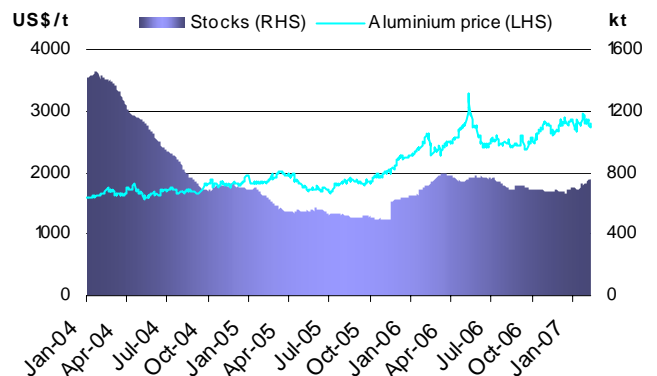
Short covering supports aluminium prices in late 2006



Source: Bloomberg, NAB Group Economics

Such a rally cannot be sustained in the face of rising stockpiles. With aluminium markets forecast to record a production surplus in 2007, downward pressure on prices is expected.

LME stocks have bottomed and are on the rise



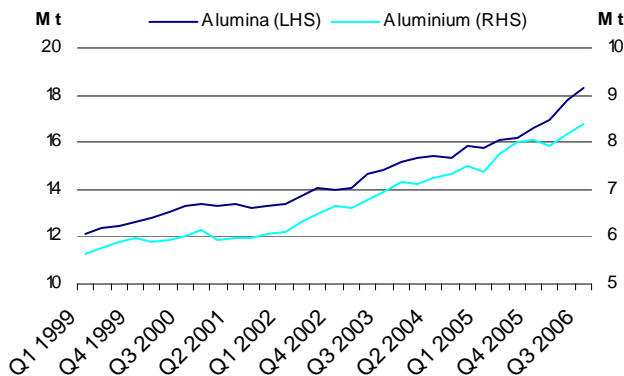
Source: Datastream, NAB Group Economics

For 2007 as a whole, aluminium prices are forecast to decline by around 7.2 per cent to average US\$2382 a tonne.

Aluminium production gains on growth in raw materials...

Shortages of alumina constrained the supply response of aluminium producers across 2005 and early 2006. Alumina prices peaked in April 2006 at US\$627.50 a tonne (Metal Bulletin). Combined with high prices for electricity, aluminium smelters faced increasing profitability risk – despite high prices for their product.

Fresh wave of alumina supply allows increased aluminium production



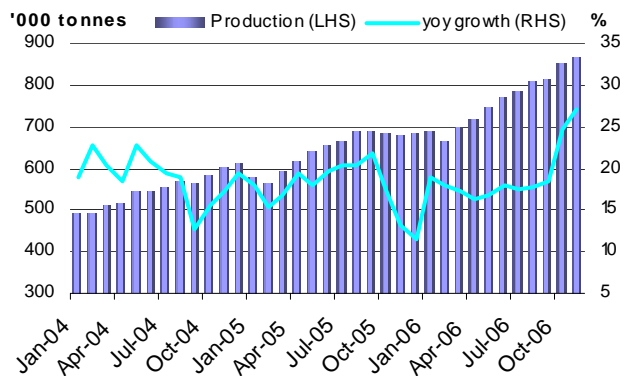
Note – 1 tonne of aluminium requires around 2 tonnes of alumina
Source: IAI

However, China's domestic alumina production has surged in the face of strong demand. In the first nine months of 2006, alumina output rose by 6.4 per cent year on year. Spot alumina prices plummeted in the second half of 2006 – falling 67 per cent by mid December – although prices have recovered somewhat in the new year.

Easing cost pressures, greater availability of alumina and a more reliable electricity generation sector allowed Chinese aluminium production to surge in the second half of 2006 – despite government measures to slow the sector.

In the first eleven months of 2006, China's aluminium production increased by 19 per cent year on year to total 8.4 million tonnes (IAI). Attempts to slow growth – such as the removal of export rebates, the imposition of export taxes and restrictions on tolling (where alumina is imported and processed solely for re-export) – appear to have had limited impact to date.

China's aluminium production accelerates despite measures to cool the sector



Source: IAI, NAB Group Economics

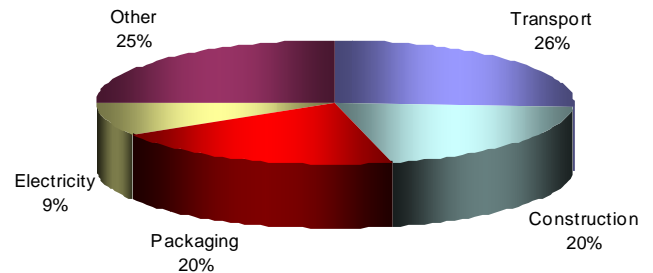
Lead by China, aluminium production is forecast to increase by around 6.5 per cent in 2007 to 36.1 million tonnes. Growth in other regions is likely to be more subdued – with production continuing to contract in Europe.

...while the demand side remains firm

The transport and construction sectors account for almost 50 per cent of global aluminium consumption, and continue to grow strongly. Growth is driven by requirements for light

weight but durable materials – particularly in vehicle manufacturing.

Transport and construction continue to drive global aluminium demand



Source: IAI

China will continue to drive growth in aluminium consumption in 2007. According to government research agency Antaika, China's consumption of aluminium is set to increase by 23 per cent in 2007 to total 10.6 million tonnes (Reuters).

Global aluminium consumption is forecast to increase by 5.6 per cent to total 35.9 million tonnes. This should allow a surplus of around 200 000 tonnes in 2007, placing some downward pressure on spot prices.

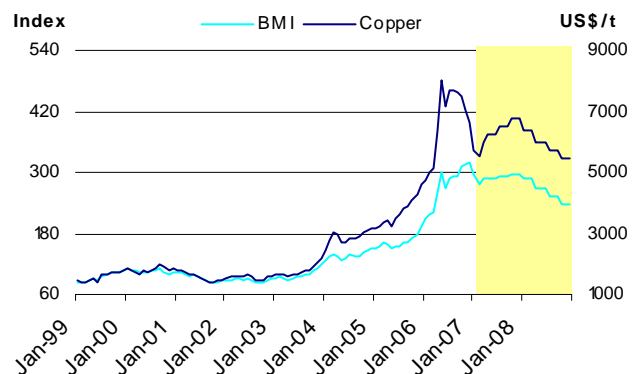
The outlook for other metals

Copper – watch for the rebound

Copper prices surged in 2006, increasing by around 82 per cent to average US\$6725 a tonne. However, the red metal ran out of momentum by the end of the third quarter – with prices steadily declining, as stocks have built and investors built short positions.

Prices slipped by around 14 per cent in January, with LME copper averaging US\$5695 a tonne. As discussed above, some of this decline could be attributable to speculative influence. While stocks have almost doubled since early October – to around 215 000 tonnes in early February – they remain tight (at around 4.5 days of consumption).

Copper prices to rebound on Chinese demand



Source: Datastream, NAB Group Economics

Sentiment in copper markets has clearly been impacted by reports of falling consumption in China. Both the International Copper Study Group (ICSG) and World Bureau of Metal Statistics (WBMS) report China's apparent consumption (production plus net imports plus adjustments) having contracted year on year. For the first eleven months, WBMS estimate Chinese consumption at 3.25 million tonnes, down around 2.8 per cent.

However, heavy destocking by both China's State Reserve Bureau (estimated to be 200 to 300 000 tonnes across the year) and copper consumers contributed to the decline in imported copper. When combined, this destocking could more than account for the reported market surplus of 2006. An actual decline in copper consumption is inconsistent with an economy that grew by over 10 per cent, and increased electricity generation capacity by 20 per cent (Reuters).

The return in Chinese imports was evident in December 2006 – with net imports rising to 92 000 tonnes, the highest level since September 2005. Restocking, as well as strong consumption in line with economic growth, will boost Chinese copper usage in 2007.

Global copper consumption is forecast to increase by around 4.2 per cent in 2007 to total 17.9 million tonnes. Asia is forecast lead the growth, with usage increasing by 9.1 per cent (ICSG), however China offers upside to this forecast.

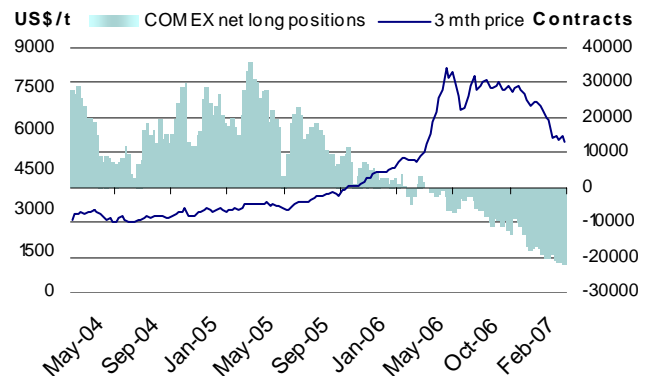
On the supply side, refined production is forecast to increase by 3.8 per cent to 18.1 million tonnes. This growth is driven by an 18 per cent increase in refined output from Latin America and a 6.4 per cent increase in Asia (ICSG).

However, refined production will be vulnerable to industrial activity. A myriad of disruptions in 2006 led to a sharp destocking of copper concentrate – both at mines and smelters. With labour contracts set for renewal at a number of South American operations, disruptions are a significant risk.

According to the ICSG, the copper market will record a production surplus of around 176 000 tonnes in 2007. However, this represents a narrowing of the market balance, relative to 2006. With strong demand from China – as participants restock – the copper market may record another deficit.

As a result, we would expect to see a reversal of the recent trend of increasing net short speculative positions on the Commodity Exchange (COMEX). While net short for the bulk of the year, non-commercial short positions have accelerated since October 2006 – when copper markets switched from backwardation to contango – a market state where near term contracts are less expensive than longer term ones. Contango markets provide incentives to take short positions – since rolled over contracts at expiration make a profit. However, they also signal plentiful immediate supply, but risks of shortfall in the future – in line with our forecast for market conditions.

Copper appears a “sell”, but stronger fundamentals point to a turn around



Source: CFTC, Datastream

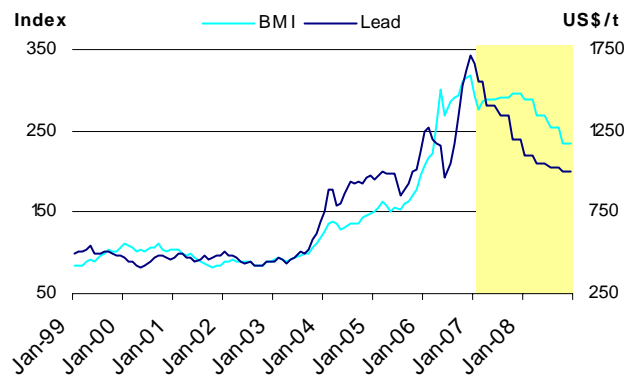
Reflecting the current market weakness, forecast copper prices have been revised downwards this month, however, the path of prices has also been revised – with copper expected to rise modestly across the year. Copper is forecast to average US\$6308 a tonne in 2007, a year on year decline of 6.2 per cent.

Lead – surplus points to lower prices

Lead prices were highly volatile in 2006 – with prices surging on high Chinese demand. Lead prices rose by around 32 per cent to average US\$1286 a tonne. Prices were elevated well above this mean level in the second half of the year, as the stock coverage tightened significantly.

Prices eased away from peaks in January, down around 2.7 per cent to average US\$1670 a tonne. LME stockpiles trended marginally higher early in January, and amounted to around 1.8 days of consumption at the end of the month.

Lead to fall as market returns to surplus



Source: Datastream, NAB Group Economics

Global lead demand remains driven by growing lead-acid battery manufacturing in China. Expanded battery production is not only meeting demand from the country's surging auto manufacturing sector, but is also displacing battery production in other regions, notably Japan, South Korea and Taiwan (EIU).

In 2007, global lead consumption is forecast to increase by 2.6 per cent to 8.21 million tonnes. Continuing the trend from recent years, China is expected to be the key growth consumer – with consumption increasing by 10 per cent. In contrast, consumption in the United States is forecast to

decline by 3 per cent and European usage is expected to remain stable (ILZSG).

Global lead production is forecast to increase by 3.0 per cent in 2007 to around 8.27 million tonnes. Higher refined output in China – an increase of around 4.5 per cent – is expected to contribute the majority of this growth (ILZSG).

In 2007, the market surplus is expected to build to around 55 000 tonnes – allowing a moderate stock build in exchange warehouses – with this level equivalent to under two and a half days consumption (ILZSG).

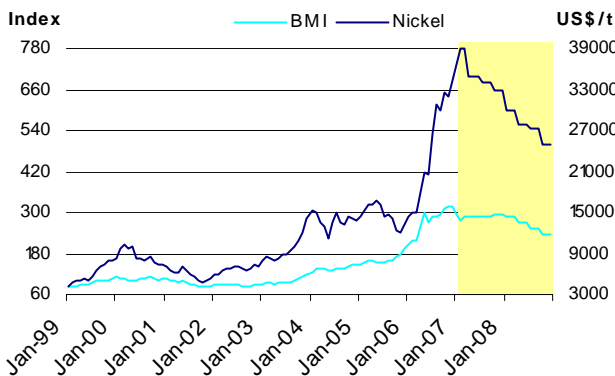
With only a modest stock build in 2007 – insufficient to restore stocks to “comfortable” levels – lead prices are forecast to trend only gradually lower. Lead is forecast to average US\$1385 a tonne in 2007, a year on year increase of 7.7 per cent.

Nickel – supply side delays to keep nickel elevated

Nickel prices rose almost exponentially in 2006 – as surging demand strained supplies – almost emptying stockpiles of refined metal. For the whole year, prices rose by 65 per cent to average US\$24270 a tonne.

Nickel prices continued to climb in January, bucking the trend of other metals, increasing by 6.2 per cent to US\$36683 a tonne. Stockpiles continued to dwindle, with LME stocks at the end of January totalling less than a day’s consumption.

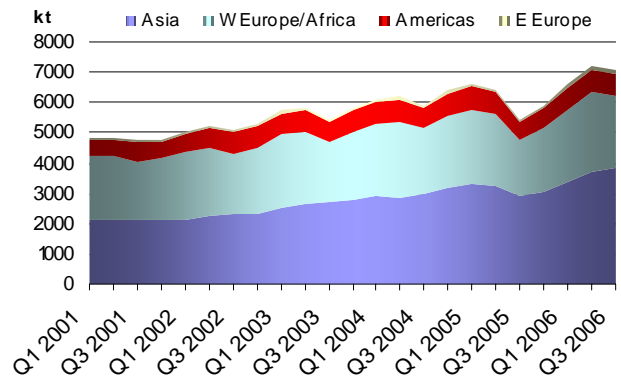
Limited downside for nickel in 2007 as tight market persists



Source: Datastream, NAB Group Economics

The surging demand for nickel has been driven by stainless steel production – with output in the first nine months of 2005 increasing by 13 per cent to 20.9 million tonnes. China has accounted for the bulk of this growth – with output over the period up by over 50 per cent (ISSF).

Surging stainless steel output drives nickel to record



Source: ISSF

Stainless steel demand is likely to remain firm in the short term – providing support for nickel – with the International Stainless Steel Forum reporting that steel destocking continued across 2005/06. Steel makers have been able to pass on increased costs for both iron ore and nickel to consumers. Prices for Asian benchmark stainless steel were 91 per cent higher year on year in early February.

In 2007, global nickel consumption is forecast to increase by 5.8 per cent to reach 1.45 million tonnes (INSG). Growing stainless steel production in China will remain a key driver of nickel consumption.

Refined nickel production is forecast to increase by 7.4 per cent in 2007, to total 1.45 million tonnes. However, delays at the two largest nickel projects – Goro in New Caledonia and Ravensthorpe in Western Australia – may limit this growth. Both projects initially targeted first production in 2007, but have been delayed until next year. With stockpiles already perilously thin, nickel prices look increasingly risky.

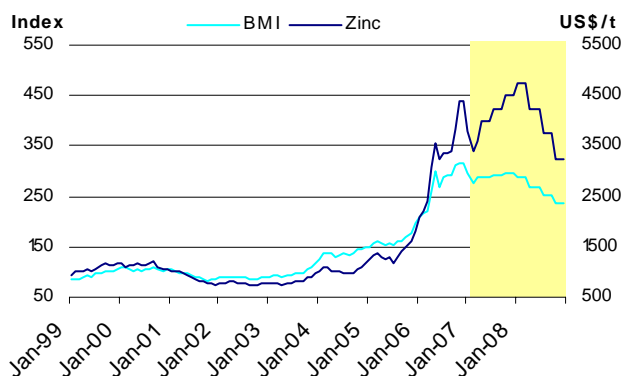
Reflecting this risk, forecast nickel prices have been revised upwards this month. Nickel is forecast to average US\$35060 a tonne in 2007, a year on year increase of 4.4 per cent. With prices well above this level at present, this forecast may prove too pessimistic if there are any disruptions on the supply side.

Zinc – fundamentally sound, but can zinc break the copper shackles?

Zinc prices soared in 2006, as plunging LME stockpiles in the face of surging demand pressured markets. For the year as a whole, zinc prices averaged US\$3275 a tonne, a year on year increase of 136 per cent.

Despite the strength of underlying market conditions, zinc prices fell by 13 per cent in January – in line with copper – to average US\$3810 a tonne. Zinc prices traditionally move closely with copper, despite quite different underlying markets.

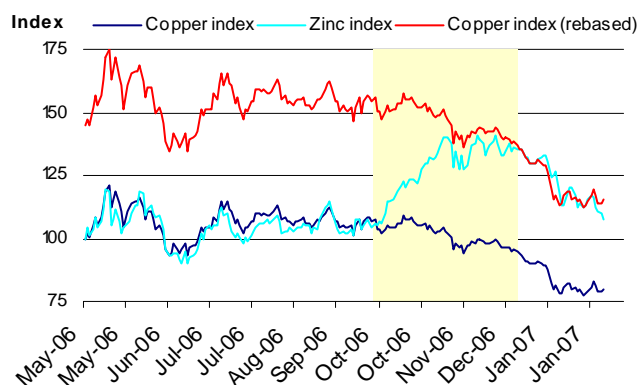
Zinc to resume upward momentum



Source: Datastream, NAB Group Economics

Zinc managed to break the shackles of copper in October 2006, rising substantially higher. However by mid-December, the weight of weaker copper prices and rising zinc stocks impacted – driving zinc lower. Zinc prices in early February – near US\$3000 a tonne – were just two-thirds of the peak in late November 2006.

Zinc's breakout stalls in December



Source: Datastream, NAB Group Economics

Rising zinc stockpiles on the LME – in sharp contrast to the trend of the previous two years – came as Chinese exports increased sharply. Alarmists feared a slowdown in China's zinc consumption – however the change will be short lived. LME stocks at the end of January were equivalent to a little over three days consumption.

In September 2006, China's government removed tax rebates on zinc exports while an export tax commenced in January 2007. The increase in exports reflected a short term profit opportunity in advance of this policy change.

China's demand for zinc – driven by galvanised steel demand in the construction, infrastructure and manufacturing sectors – will continue to underpin global consumption.

In 2007, global zinc consumption is forecast to increase by 2.6 per cent to reach 11.35 million tonnes. China's zinc consumption is forecast to increase by 6.2 per cent, with China expected to account for 30 per cent of zinc demand.

In contrast, consumption in Europe and North America is expected to remain static (ILZSG).

Delays in mine developments, reflecting the lagged development cycle of zinc relative to other base metals, have restricted the availability of zinc concentrate. Mine output is forecast to expand by around 7.3 per cent in 2007, to 11.1 million tonnes (ILZSG), however concentrate will remain in short supply until 2008.

Growth in mine output is expected in Australia, China, Bolivia, Canada, India, Kazakhstan and Portugal, as new mines and expansions come on stream (ILZSG).

Global refined production is forecast to increase by 4.9 per cent in 2007 to around 11.2 million tonnes. China is expected to drive growth in refined zinc supply, with output expected to rise by around 10 per cent in 2007 (ILZSG).

Despite the growth in Chinese output, global zinc markets are forecast to record another production deficit in 2007, around 154 000 tonnes, though narrower than the level in 2006.

Reflecting the current weakness in zinc prices, forecast prices have been marginally revised downward. However, the tight fundamentals should provide sufficient support for zinc to resume its upward trend. Zinc is forecast to average US\$4088 a tonne in 2007, an increase of 25 per cent.

Monthly price summary (US\$ a tonne)

	Oct 06	Nov 06	Dec 06	Jan 07
Aluminium	2654	2702	2814	2810
Copper	7499	7028	6645	5695
Lead	1531	1624	1717	1670
Nickel	32693	32100	34530	36683
Zinc	3822	4381	4388	3810
BMI	310.7	316.4	317.8	294.2

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Annual price summary (US\$ a tonne)

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Copper	2868	3691	6725	6308	5890
Lead	888	976	1286	1385	1044
Nickel	13852	14716	24270	35057	27625
Zinc	1048	1385	3275	4088	4000
BMI	137.1	162.8	274.7	290.0	261.8

Source: Datastream, NAB Group Economics

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