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Industry View
Cautious

Chinese Steel Industry Record Steel Output with Big Decline in Net Imports in 2005

Conclusion: With rapid capacity expansion in flat products by Chinese mills, we have seen two major trends in 2005: 1) accelerating steel production; 2) a continued dramatic decline in net imports (implying import replacement). Despite a recent moderate steel price rebound in China, we believe overcapacity will remain an overhang unless exceptionally strong demand in the US and elsewhere induces Chinese exports to increase and thus also pushes up domestic prices, given the current deep domestic price discount.

Rapid Production Growth: With December crude steel output reaching 32m tonnes in China, full year crude steel output jumped 29% yoy to a record high of 348m tonnes in 2005, roughly in line with our forecast of 350m tonnes. 2005 finished steel production surged 38% yoy to 369m tonnes. Overall, robust capacity expansion by Chinese steel mills has been put into operation and raised total production. 2005 crude steel output growth of 29% is the fastest in the past ten years, and we expect a slowdown to 11.5% in 2006 given a current weak steel pricing environment and decelerating investment in the industry.

Dramatic Decline in Net Imports: 2005 was also characterized by a rapid decline in net imports of finished steel, given that Chinese steel mills swiftly expanded capacity in flat products to replace imports. Although China remained a net importer of finished steel in 2005, net imports dropped 65% yoy to 5.3m tonnes. If we include semi products, China already turned into a net exporter of 458kt tonnes in 2005. (Exhibit 5)

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January 23, 2006
China Steel

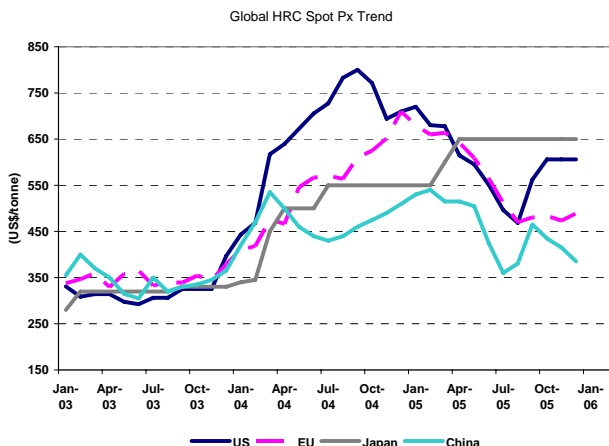
China became a net exporter in December, the first time on a monthly basis in 2005. Net exports of finished steel were 40kt in December, compared with 550kt of net imports in November. We believe the deep domestic steel price discount vs. the global price (the HRC price discount vs. the US is over US\$200/t) has induced Chinese steel mills to increase their exports.

Apparent Consumption Solid, but Lagging Production Growth: Apparent consumption growth in 2005 was 32.3% yoy to 374.6m tonnes. However, it lagged production growth of 38%.

Stabilizing Domestic Steel Prices: There are signs of a domestic steel price recovery in some grades of flat product, while long product prices remain weak. Prices of HRC and CRC have rebounded by 2~3% recently on a week-on-week basis, owing to increasing exports, which moderate domestic oversupply pressure to a certain extent. We see limited downside in domestic prices given that current prices are already lower than the cash operating cost of an average Chinese steel mill. However, given the current overcapacity overhang, we do not anticipate a strong price rebound ahead unless exceptionally strong demand in the US and elsewhere continues to drive up exports from China or a domestic production slowdown in response to the weak prices. Going forward, we see export growth and the global steel price gap as the two leading indicators of domestic steel price trends.

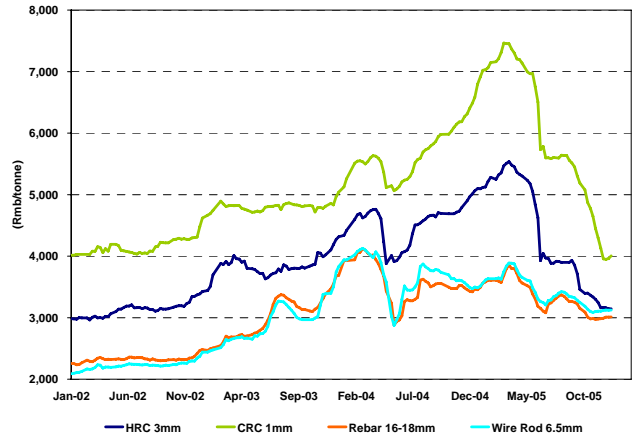
We maintain our Cautious view on the Chinese Steel industry, but would closely watch the export growth trend.

Exhibit 1
Global HRC Monthly Price Trend



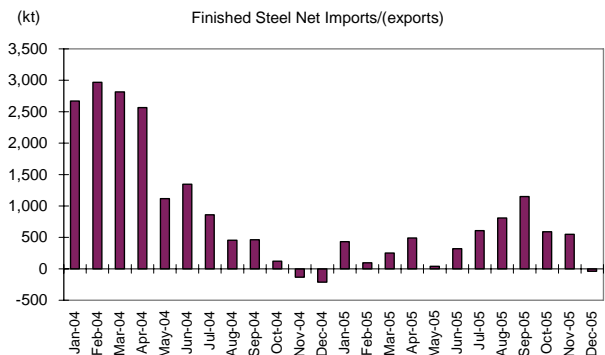
Source: CRU, Morgan Stanley Research

Exhibit 2
China: Domestic Weekly Steel Spot Price Trend



Source: Mysteel, Morgan Stanley Research

Exhibit 3
China: Monthly Net Imports/(Exports) of Finished Steel



Source: Mysteel, Morgan Stanley Research

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Exhibit 4

China: Finished Steel Supply and Apparent Consumption

	Output (kt)	YoY (%)	Imports (kt)	Exports (kt)	Net Imports (kt)	YoY (%)	Apparent Consumption (kt)	YoY (%)
Jan-05	26,110	23.3%	1,925	1,492	433	-83.8%	26,543	11.3%
Feb-05	25,368	12.1%	1,588	1,489	98	-96.7%	25,466	-0.5%
Mar-05	30,655	28.3%	2,460	2,207	253	-91.0%	30,908	15.7%
Apr-05	29,531	28.3%	2,560	2,070	490	-80.9%	30,021	17.4%
May-05	31,106	36.4%	2,160	2,120	40	-96.4%	31,146	30.2%
Jun-05	30,366	28.8%	2,520	2,200	320	-76.2%	30,686	23.1%
Jul-05	31,361	28.9%	2,138	1,530	608	-29.4%	31,969	27.0%
Aug-05	32,695	28.6%	2,150	1,340	810	78.3%	33,505	29.5%
Sep-05	32,252	22.1%	2,500	1,350	1,150	148.3%	33,402	24.3%
Oct-05	33,105	23.7%	1,930	1,340	590	385.6%	33,695	25.4%
Nov-05	33,058	18.5%	2,100	1,550	550	-516.4%	33,608	21.1%
Dec-05	33,727	22.0%	1,780	1,820	-40	-81.0%	33,687	22.8%
2004	295,552	26.6%			15,039	-50.2%	310,591	17.8%
2005	369,333	37.9%	25,810	20,508	5,302	-64.7%	374,635	32.3%

Source: Mysteel, Mysteel, Morgan Stanley Research

Exhibit 5

China: Monthly Imports and Exports of Steel

(kt)	Net Imports/(exp)				Imports				Exports			
	Finished Vol	% YoY	Semis Vol	Total Vol	Finished Vol	% YoY	Semis Vol	Total Vol	Finished Vol	% YoY	Semis Vol	Total Vol
Jan-05	433	-83.8%	-460	-27	1,925	-40.8%	100	2,025	1,492	156.6%	560	2,052
Feb-05	98	-96.7%	-690	-592	1,588	-52.8%	150	1,738	1,489	276.1%	840	2,329
Mar-05	253	-91.0%	-1,320	-1,067	2,460	-28.9%	140	2,600	2,207	241.9%	1,460	3,667
Apr-05	490	-80.9%	-680	-190	2,560	-24.6%	120	2,680	2,070	149.7%	800	2,870
May-05	40	-96.4%	-460	-420	2,160	1.4%	130	2,290	2,120	109.5%	590	2,710
Jun-05	320	-76.2%	-440	-120	2,520	3.3%	130	2,650	2,200	101.1%	570	2,770
Jul-05	608	-29.4%	-530	78	2,138	-3.9%	120	2,258	1,530	12.1%	650	2,180
Aug-05	810	78.3%	-300	510	2,150	15.8%	80	2,230	1,340	-4.4%	380	1,720
Sep-05	1,150	148.3%	-24	1,126	2,500	40.8%	114	2,614	1,350	2.9%	138	1,488
Oct-05	590	385.6%	-110	480	1,930	18.4%	50	1,980	1,340	-11.1%	160	1,500
Nov-05	550	-516.4%	-276	274	2,100	17.1%	106	2,206	1,550	-19.5%	382	1,932
Dec-05	-40	-81.0%	-470	-510	1,780	-8.9%	70	1,850	1,820	-15.9%	540	2,360
2004	15,039	-50.2%	-2,230	12,809	29,273	-21.2%	3,830	33,103	14,233	356.4%	6,060	20,293
2005	5,302	-64.7%	-5,760	-458	25,810	-11.8%	1,310	27,120	20,508	44.1%	7,070	27,578

Source: Mysteel, Mysteel, Morgan Stanley Research

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Industry Coverage: China Steel

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