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Increased correlations in the commodities space

Interview with Kirk Howell

One of the toughest challenges for hedge fund traders in today’s market environment is the high degree of correlation across asset classes. And it’s no different in commodities.

Kirk Howell, chief operating officer for Kiodex at SunGard (its commodity risk management unit), has looked closely at the correlation effect in commodities this year. Initially, when he saw prices fluctuating Howell’s instinct was to suggest that there was de-coupling. “However, as I started to run correlation analyses I found the correlations to be really high, which leads me to believe that the macro overlay is still driving a lot of sentiment in trading. The market seems to have no memory from one day to the next.”

Howell found that for Brent crude/copper, for example, the correlation was 0.63; significantly higher than previous years. This gives credence to the macro story. “Year-to-date, the correlation between the S&P 500 and WTI crude is 0.63. In the last few months alone it’s been 0.7, which is phenomenal. There have been research papers written that suggest this is due to algorithmic trading but I frankly don’t think that has much to do with it,” says Howell.

There are, of course, exceptions to the rule. Agriculturals have boomed in recent weeks over threats of a real supply issue, but what makes commodities such a difficult market to trade is that the number of factors traders have to take into account are extremely high. Short-term price fluctuations make day-to-day price positioning nigh-impossible to forecast. The fact that Brent’s price dropped nearly USD30 earlier in the year was understandable given that Iran was a genuine event risk; once things cooled down, the demand picture softened considerably. As Howell explains: “That kind of thing makes perfect sense. But when you see USD3 moves day-to-day on what aren’t significant events, clients I speak to admit that they are sometimes at a loss to explain what’s going on.”

Whilst the debate for whether the end of the commodity super-cycle is in sight has support on both sides, Howell says he tends to lean towards the view that it is. It’s a question of future demand: how will the eurozone hold, if at all, what impact will a slowdown in China GDP growth have on global demand, how will the US handle the fiscal cliff issue?

“In the short-term, if you look at what’s happening from the data available, you’re seeing a worldwide slowdown in demand. The debt overhang has not gone anywhere and has in fact increased. I try to rationalise where you get growth out of that.”

What that ultimately means, in Howell’s view, is that earning alpha in the commodities space for investment managers is only going to get to harder. Managers are going to be tested on how sustainable their edge is. “I think we’re going to see a bit of a shakeup over the next year or so,” states Howell.

One sub-group that he believes should be getting more capital allocation is the volatility trading group. “They are able to take advantage of price moves in both directions and are a little less sensitive to delta one strategies. Investors, I think, should be allocating more money to these types of strategies in this environment.”

CTAs should also be considered, but the trend following model has been cannibalised somewhat; there are, says Howell, seemingly more false break-outs in the market. Investors have to therefore pick the right CTA that they are confident will do well.

“When crude hit USD80 it had all the signs that it would fall further but then it quickly reversed out and prices moved higher. That’s why it’s a challenge for trend-following CTAs.”
Energy super-cycle begins to slow as US chokes on crude

By James Williams

Looking at the smaller picture, Brent Crude had a lot of macro risk priced in coming into 2012. Expectations of Middle East unrest – in particular Iran – and a liquidity event coming out of the US saw prices reach USD123/bbl in March. By May, however, some USD30 of gains had been pared back to USD89.61/bbl on 21 June.

The bigger picture, barring the odd geopolitical shock which would support short-term positive price momentum, is markedly different: the long-term structural bull market is over. Period.

Over the last decade it was pretty easy to stay bullish on oil because no matter what happened, if price went from USD20 to USD150, supply never really went up much. Take 2008 and 2009 out of the equation and you had global supply growth of about 600,000 barrels/day non-OPEC versus global demand growth of about 1.3million barrels/day: hence the structural bull market.

“What has fundamentally changed with oil is not a demand story but absolutely a supply story. Because of the shale oil revolution US production is now rising by 20,000 barrels/day on average each week since the start of the year. The supply response is coming and that completely changes the supply/demand equation.

“The super-cycle is done. This is nothing short of epic,” says Seth Kleinman, Head of Global Energy Strategy, Citi.

That said, given that the market has low spare capacity, the potential for oil to bounce back in H2’12 is strong. Kleinman observes that even though the market has started repaying attention to Iran the macro risk it represents is still underpriced in the market. Israel is likely to refocus the international community’s attention and keep Iran under pressure, which should be enough to push prices higher.

Dominic Schnider, Head of Non-Traditional Asset Class Research at UBS Wealth Management, takes the view that over the short-term renewed price weakness for crude is on the cards because the market is oversupplied. Schnider notes that sequential growth in demand – that is an increase from 1.7million to 1.8million barrels/day from Q2 to Q3 – is unlikely to materialise as weak global
economic growth dampens demand. "We’re probably only going to get 1.5million barrels/day. On a seasonally-adjusted basis, inventories are likely to build in Q3 this year and that’s going to push prices back below USD90/bbl. That for me is the overarching story. With respect to Iran, I don’t think the US are at all interested in exacerbating the situation because if Obama is faced with high oil prices it's going to cost him the election, potentially," says Schnider.

Heading into 2013, however, Schnider is confident that crude could go up to USD105/bbl to USD110/bbl.

Sabine Schels, commodities analyst at BofA Merrill Lynch Global Research, agrees that despite the hard run-up in prices in July – which has seen Brent climb from – the market is seeing excess supplies as demand weakens: "The issue clearly is that Saudi Arabia oil output is remaining stubbornly above 10million barrels/day, Libyan production has come back on line, so in the short-term I’d say the market has maybe run up a little too quickly."

Right now the Brent forward curve is in quite a steep backwardation, despite briefly dipping into contango about six weeks ago, but this is more a function of supply constraints in the North Sea following the Norwegian oil strike. Whether the backwardation continues entirely depends on how bad the global macro situation gets says Schels. "If we see a much sharper deceleration in demand then the backwardation will unlikely hold up. I think in that case Saudi production will have to ease off."

Kleinman’s reasons for being short-term bullish on crude for Q4 2012 are numerous. Firstly, the market has already experienced a massive liquidation earlier in the year when speculators sold off positions. Seasonally, the market is out of the worst period, when March and April are typically the lowest points for product demand, and often strengthens towards year-end. Crucially though, what could support further upside is a supply story. Says Kleinman: “The right way to look at oil is that oil prices, in the bigger picture, are trending lower but there will be one or two geopolitical-driven spikes on the way down. The likelihood of one of those spikes happening, i.e. Iran, is high. “Supply is the question mark and two key factors have been pressuring prices on the supply side: the US and Saudi Arabia.”

The oil rig count has showed signs of waverin in the US, albeit only slightly, when WTI hit USD80/bbl in June. Kleinman says that there would be a big difference in drilling activity between USD70 and USD80; sub-USD70 some of these players would come under pressure and would auger a supply-driven floor.

For Saudi Arabia, even though they are going to continue pushing oil out at high volumes a few weeks ago they caught the Asia market off-guard by raising their Official Sales Price for Arab Medium and Arab Light well in excess of what was expected: climbing 20 cents from USD1.15 a barrel to the Oman/Dubai average plus USD1.35 a barrel. Whether that actually translates into less supply is not clear but it’s the first sign they’re taking their foot off the floor in terms of pumping oil to market.

“Put the recent liquidity event together with this US/Saudi supply picture and you have a moderately constructive outlook: on the supply side it looks like a floor is within sight. Throw Iran into the mix and I think the odds of a spike are high. "Our average price forecast for Q4 for Brent is USD105," says Kleinman.

Schels believes the case for further upside in crude this year depends on monetary easing. "The house forecast for H2'12 is an average of USD106/bbl for Brent and USD97/bbl for WTI. "Our assumption is that we’ll get more fiscal and monetary easing in emerging economies; real interest rates in emerging markets as a whole are sitting at a relatively high spread because inflation has fallen relative to the developed markets so they have room to adjust down. Also, we see the US economy deteriorating quite a lot after the elections because of the fiscal cliff and we think that is already giving a shock to confidence. We think data will worsen over coming weeks and that the Fed will respond to that with QE3 in September. “The uncertainty we face now is clearly unprecedented. The house view is that policymakers are not going to stare into the abyss and not react.”

Based on pure demand dynamics,
The commodity cooperation: Eurex Exchange and EEX

The leading international derivatives marketplace Eurex Exchange and the European Energy Exchange (EEX) have been successfully cooperating in trading of energy and related products since December 2007. Thanks to this cooperation, Eurex trading participants have access to products of the primary and secondary market that are listed at EEX.

The “plug & play” approach allows Eurex members to trade EEX products via their existing infrastructure and connectivity. The only prerequisite to access the EEX order book is the admission as an EEX trading participant through a lean admission process.

More than 27 Eurex trading participants have been admitted since the start of the cooperation and use this channel to access the EEX market. Among those you will find a variety of leading banks, brokers and funds. With the financial crisis in mind, more and more investors of the financial community choose to extend their investment focus and diversify their portfolios.

Initially, the cooperation started with CO2 emissions trading, namely with EUA Futures (European Emission Allowances) and CER Futures (Certified Emission Reductions), and continued to be expanded with the offering of the power derivatives Phelix Futures and Options as well as French Financial Power Futures.

In a next step, the initial cooperation product suite has been extended by EUAA Futures (EU Aviation Allowances) and ERU Futures (Emission Reduction Units).

Recently, the cooperation has added two more product groups. In April 2012, natural gas futures for the NetConnect Germany (NCG) and Gaspool (GPL) gas market were included for trading and clearing via Eurex Exchange. The NCG Natural Gas Futures and GPL Natural Gas Futures have monthly, quarterly, seasonal and yearly expiration cycles.

In July 2012, cash-settled, USD-denominated coal futures on the API 2 and API 4 Index followed. The futures are based on the coal price indexes from the Argus/McCloskey Report for the markets in Amsterdam, Rotterdam, Antwerp (ARA Futures) and Richards Bay, South Africa (RB Futures). They are available with monthly, quarterly and yearly maturity cycles.

The clearing houses of the two exchanges, European Commodity Clearing AG (ECC) and Eurex Clearing AG cooperate in settling the transactions and offer efficient and flexible clearing solutions. Trading participants can use their existing clearing relationships for on- and off-exchange trading and benefit from process synergies, optimized risk management and collateral pledging across various EEX product groups. Bilaterally closed transactions can be entered into the EEX trading system, and clearing will be processed automatically.

Apart from the commodity offering of the Eurex/EEX cooperation, Eurex Exchange covers a wide range of commodity derivatives. The portfolio includes futures and options on the reputable Dow Jones-UBS Commodity IndexSM family with its nine selected sub-indexes, precious metals (gold, silver and Xetra-Gold®) and agricultural products (potatoes, piglets, hogs, butter and skimmed milk powder).

Commodity derivatives help market participants to capitalize on cyclical trends in a wider variety of markets. This makes them an interesting addition to a portfolio. Eurex Exchange continuously increases its offering as part of its strategy to offer hedging and investment opportunities for its clients in all relevant asset classes.

For further information please visit: www.eurexchange.com.
Significant potential for gas trading in Europe

Interview with Peter Reitz

How do you evaluate the energy exchange’s growth opportunities in the gas sector? EEX is traditionally strong in the power trading but also on the gas side we are seeing growing interest from market participants. Within five years, EEX has become the gas exchange with the highest number of trading participants in Europe. Gas companies are facing major challenges both on account of the energy turnaround and the evolution of the gas market into a free trading market. We offer participants the opportunity to operate on this market on a non-discriminatory and transparent basis and continue to support the market with services, such as our indices, which can be used as a reference in gas supply agreements.

How high is the share of gas trading on EEX and how does exchange trading influence gas procurement and pricing?

On the Spot Market our trading participants can already optimize their portfolios with within-day, day and weekend products around the clock. The liquid spot market forms the basis for the development of the derivatives market. Currently, the share of exchange trading at EEX in the entire short-term trading of the virtual trading hubs NCG, GASPOOL and TTF ranges between 10% and 20% while the share of EEX trading on the NCG or GASPOOL derivatives markets is about 5% to 10%.

For the future development of exchange gas trading the acceptance and use of EEX prices is decisive. In short-term trading EEX has established a daily reference price which is used by the German market area operators to settle control energy. The significance of EEX prices in long-term natural gas trading is to be further supported by our price index EGIX.

What measures are EEX using to increase exchange liquidity in gas trading and are these measures bearing fruit?

We work together with market makers since the launch of exchange gas trading in July 2007. Market makers enter bids on the buy- and sell-side to safeguard basic liquidity. In return, the exchange relieves market makers of transaction fees provided they comply with the market maker agreement. Additionally, EEX has established volume-based incentive schemes for the Spot and Derivatives Market, which financially reward participants if they shift their existing trading activities from OTC trading onto exchange.

Which aims has EEX set for itself in the field of gas trading over the next 5 years?

Compared with the established OTC market exchange trading in natural gas is still in its infancy in Germany. EEX wants to strengthen trading on the Spot and Derivatives Market. Trading structures in the field of gas are now beginning to evolve in many companies. We will support this development because we see a lot of potential in this market – both for Germany and for other markets.

What developments do you expect for exchange gas trading in Europe?

For several years, the most important European gas markets in Great Britain, Germany, the Netherlands, France and Italy have been undergoing intense transformation. Monopoly or oligopoly structures in gas supply are opening up on the basis of European directives and for the first time are creating the precondition for free trading in gas and, hence, for exchange trading. This market is still young in Continental Europe but it is growing rapidly. At present, gas trading on the TTF in the Netherlands is Europe’s leading market. On account of the two German market areas’ enormous growth on the spot market and excellent infrastructure preconditions (gas storage facilities, gas distribution systems etc), we see significant growth potential in this segment.
Schnider thinks that Brent crude should be trading in the USD80/bbl to USD90/bbl range. “Demand will be 1.5million barrels not 1.7-1.8million barrels as expected so it's the weak demand dynamics that we think will lead to further downside in oil price: USD90/bbl is not a hard floor, but a level where Saudi Arabia is likely to cut meaningful supply. In the short-term the market could fall into contango if it falls to USD90/bbl or below, but it won’t last and you should see it moving back into modest backwardation in Q4.”

As for trade ideas, Kleinman suggests in the short-term buying Brent structure which should strengthen from its seasonal trough. “The next trade to think about is to sell prompt European refining margins. The biggest trade out there is that Brent/WTI will stay wide - this is not an infrastructure story, it’s a supply story. The US is chocking on crude. Sell WTI against Brent down the curve.”

Seasonally hot weather has supported significant upside in US natural gas climbing from USD2.18/MMBtu on 13 June to USD3.18/MMBtu on 25 July. Like oil, shale bed gas production has sent US natural gas inventories this year to record seasonal levels, making them far more depressed relative to other countries: around USD8/MMBtu for UK Natural Balancing Point (NBP).

Despite prices in the US bouncing up in recent weeks, the potential for further upside, whilst certainly possible, is limited in Schels’ view: “We do think prices will continue to recover into 2013 - we see them averaging USD3.50/MMBtu although I think there’s some upside risk to that number. The reason being that this market is very flexible, it has taken a while to rebalance because producers were reluctant to cut back on outflow (thanks to strong demand).”

Low prices are a function of an oversupplied market as opposed to weak domestic demand. Production cutbacks in the current low price environment should make for a tighter market next year, says Schels, but it’s unlikely prices will go from USD3/MMBtu to USD4/MMBtu: “This would then give producers a strong incentive to increase drilling so whilst the price has some upside, it’s limited.”

Although problems in the eurozone represent a macro risk to gas consumption as demand remains weak, Schels believes that European gas prices will remain supported this year as indigenous production continues to decline. Barring further declines in coal prices, gas could be getting close to a floor as producers cut production and dry gas rigs continue to fall.

“For Henry Hub natural gas our average price forecast for Q4 is USD3.20/MMBtu,” confirms Schels.

UBS’s Schnider thinks that the floor has probably been reached and is forecasting an average Q4 price of USD3/MMBtu. In his view it’s clear the low prices seen in 2012, at one point reaching USD1.8/MMBtu, cannot be sustained, but he does think there is room for higher prices in 2H12. “This is based on the thought that we need to work through ample coal inventories at US power plants. That will cap things for a while. Once those inventories are worked off, and with the help of warmer temperatures, the whole complex will start to move higher in tandem.”

Kleinman comments: “Down the road global natural gas prices will fall, but it’s going to take a while. The US won’t be exporting LNG until 2016 at the earliest.”

With limited upside potential in US gas prices because of the sheer volume of shale reserves, and coal prices unlikely to appreciate significantly, Schnider suggests selling volatility to reflect that view: “I would sell a call option in gas because it benefits from the forward curve; coal inventories will limit the upside for gas.

“By taking the position that there’s not much room for lower coal prices, with inventories being worked off and prices trading attractively versus marginal production costs, you could sell a put option and collect the premium.”

Citi foresees a continued narrowing of the spread between European and Asian gas prices with winter gas in Europe likely to remain supported. Its forecast figures for NBP are 52-p/th for Q3 2012, and 62-p/th for Q4 2012.

Energy Q4 Price Forecasts (USD):

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The most liquid metals market on earth

More than 80%* of global non-ferrous trading is conducted on the London Metal Exchange – that’s about $15 trillion notional, 3.5 billion tonnes, 147 million lots and a record of 3 million lots open interest in 2011.

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Investors value the LME as a vibrant futures exchange but also for its close links to industry.

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It is the combination of the two types of participant, industry and investor, that creates unparalleled liquidity and opportunity on an exchange that is used the world over as the benchmark for base metals.

Anyone who has a view on industrial metals should trade LME.

*Based on non-ferrous futures tonnage traded on the LME and other metal futures exchanges.
London Metal Exchange introduces proximity hosting

Interview with Glen Chalkley

This year saw the London Metal Exchange develop its proximity hosting service in a bid to increase trade volumes and revenues. What this allows is for LME members and clients to put their systems in a data centre close to the exchange’s matching engine, i.e. in proximity.

“A lot of our members and independent software vendors (ISVs) already have connections in these proximity data centres. Importantly, proximity hosting is a shared facility. Clients may access multiple exchanges from the proximity hosting sites; now they can add the LME to that list,” says Glen Chalkley, deputy head of business development at the LME.

The two proximity hosting sites that LME is using are Equinix LD4 in Slough and Interxion in Brick Lane, London. Clients rent space directly off of them. The LME does charge fees to trade and clear, but the exact costs will largely depend on the volume of trading and will often be tied up with a broker’s commission charges.

As Catherine Markey, head of education and marketing at the LME explains: "The brokers will charge a commission, within which is contained the proximity hosting fee so it’s practically impossible for us to say exactly what these fees are. Some offer fixed commissions or others offer commission-free trading and factor it into the bid-offer spread."

Whereas previously members connected to the exchange from points of presence across London, these two proximity hosting locations now represent the fastest access points to its matching engines. “If you want to have the fastest low latency access to our matching engine you need to be on one of these proximity hosting sites,” comments Chalkley.

Previously, the LME only allowed normal ISVs such as Fastfill Plc and Trading Technologies to connect to its trading system. Proximity hosting has now widened the net.

Says Chalkley: “Shortly after the launch of proximity hosting we started to allow market data specialists to connect to our trading system as well. These firms take our market data directly and normalise it into a feed that clients like to receive.”

One clear benefit of proximity hosting is the arbitrage opportunities in copper. Such opportunities have existed for decades but as electronic trading becomes more prevalent it’s opening up further opportunities for arbitrage between contracts on CME Group, MCX in India and the Shanghai Futures Exchange.

One of the groups therefore likely to benefit from proximity hosting is high frequency traders. And from a trading volume point of view, things are already picking up. Chalkley confirms that last year trading volumes were up 22 per cent on 2010 and are already up 10 per cent year-to-date. This probably points to the fact that more HFTs are accessing the exchange than in the past.

Markey notes that for this trading group their interest is probably in copper and aluminium “as they are the most liquid markets”. However, the LME has no intentions of taking a myopic approach by only appealing to one group.

As Markey confirms: “Other areas we think we need to be looking at would be in the OTC space as regulation forces more activity onto exchanges. For example we launched a swap product this January and we’re looking at maybe introducing more options products.”

Glen Chalkley, deputy head of business development at the LME
“The big story for gold and silver is basically over. We think gold is nearing the end of its 10-year price rally. Our central scenario is that gold and silver will peak in H2’13, based on our assumption that there will be no further large-scale monetary accommodation, notably by the Federal Reserve, next year,” suggests Anne-Laure Tremblay, precious metals analyst, commodity derivatives, at BNP Paribas.

This time a decade ago gold was trading at USD300/oz. Aside from a dip in 2008, prices have consistently trended upwards, reaching a record high of USD1884/oz last August as the Greece situation unravelled.

This year, however, prices have levelled off. Admittedly, compared to other commodities gold has fared well and is practically flat for the year, which illustrates that diversification story for gold still holds up, but there’s no denying that its price profile has confounded analysts and economists alike.

“Gold’s performance has been disappointing in H1’12. The price fell at times of high risk aversion, unlike the US dollar, which benefited from safe haven flows. However, gold held up relatively better than other commodities,” says Tremblay.

According to Julian Jessop, Head of Commodities Research and a director at London-based Capital Economics, in the global macroeconomic context it’s really a case of two very different scenarios for where gold could head in H2’12 and beyond. “If you believe the eurozone will break up then gold has a lot more upside. It might be a bit boring holding gold until this happens but if countries start leaving the euro then I think it will quickly jump.

“If, however, you think the eurozone will hold together then I think the price of gold will drift and behave more like a risk asset.”

Eurozone uncertainty and the fact that the Fed has yet to engage in QE3 has kept confidence high in the greenback at the expense of gold. Also, on the demand side, there are signs of weakness in jewellery demand in India and other emerging markets and perhaps signs of malaise among western investors with Jessop conceding: “Since prices peaked last year gold has been more volatile which has undermined its appeal as a safe haven.

“However, I don’t think the gold price has peaked. Given the extreme uncertainty that a breakup of the eurozone would create, even though the US dollar would likely do well, gold would do even better. Our forecast for Q4 is USD2000/oz.”
Suki Cooper is a precious metals analyst at Barclays Capital in New York. Cooper notes that whilst physical demand in China and India this year has been “inconsistent and lacklustre”, it’ll be interesting to see how solid that floor is “as we head into a seasonally-strong period.” Another key demand dynamic will be in gold ETPs. As Cooper explains: “They have remained remarkably resilient despite price swings we’ve seen in gold. Whether that continues or we start to interest waning will also be an important factor.”

Cooper is less bullish on gold price than Jessop, forecasting a price of USD1665/oz for Q3 and USD1720/oz for Q4. “We are working on the basis that prices find support from the physical market during a seasonally strong period and expect them to move higher, but only gradually.”

The best-case scenario is that there is no further quantitative easing, which Cooper confirms is the house view. She says that in terms of how the price profile plays out for gold they are forecasting an average price of USD1750/oz in 2013 and that the inflection point will come when real interest rates show signs of turning positive. In that sense, she agrees with Tremblay on the gold rally nearing its end.

“Given the importance of real interest rates to the gold market and the interest rate guidance, gold prices could start to come under further pressure by 2014.”

Moreover, Jessop believes the eurozone crisis will be a rolling one that could support gold prices over a number of years. “If Greece were to leave the euro and then recover strongly I think it would impossible for governments of other countries like Portugal to say it’s worth staying in there. Our working assumption, therefore, is that Greece leaves by the end of 2012, followed by Ireland and Portugal in 2013.”

What is clear in 2012, as far as Tremblay is concerned, is that gold price has become a market liquidity issue. Without further liquidity, gold prices aren’t going to do much, and if anything could fall further as investors get increasingly disappointed with performance.

“Further monetary accommodation is key to our positive price scenario for gold in H2 12. If the Fed disapoints, if there is no QE3, then gold’s outlook would turn negative. “Our US economist expects Bernanke to announce QE3 at the end of August and that should trigger a strong rally not only for gold but for other precious metals. Our Q4 average price forecast for gold is USD1800/oz.”

The demand story is more acute across the rest of the precious metals complex.

Silver has seen investor demand drop off a cliff in 2012, and at USD2754/oz (as at 25 July) is way off its April 2011 high of USD4794/oz. From the supply side, silver is in a worse position than other precious metals because two-thirds of it is mined as a by-product. Unlike platinum, the silver spot price is not a concern to producers and as such is still a market in surplus.

Aside from lack of investor demand, the biggest change in 2012 is that industrial demand has waned against fears of global economic recovery. This, says Cooper, has been seen most clearly in the solar energy industry.

“Last year there was a lot of talk regarding subsidies for the solar industry but in 2012 we’ve seen those subsidies being scaled back. China is one of the world’s largest producers of solar cells, with Europe being a large end-consumer. The slowdown in silver consumption in photovoltaic cells in China is not necessarily due to lower Chinese consumption but rather a slowdown of demand in Europe.”

Weak demand and a supply surplus currently makes silver highly vulnerable and has the largest downside risk. Nevertheless, given that gold should see further upside in H2 12, Cooper thinks that silver will likely piggyback off that.

“Our forecast is USD31.5/oz for Q4, which is quite positive from where we are at the moment but it’ll remain the most volatile precious metal.”

Tremblay is even more bullish on the potential for silver, given that it’s a geared play on gold. “Our assumption that QE3 will be announced at the end of August is underpinning our view that silver could well be the outperformer of the precious metals complex in the last few months of 2012. “We forecast a Q4 average of USD39.45/oz.”

Jessop thinks that today’s fragile macroeconomic environment and the demand for safe haven assets suggests that gold has the potential to do better than silver. Two features underpin Capital Economics’
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Knut Andersen
Sales Director

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Rare strategic metals: a portfolio diversifier

Interview with Knut Andersen

Swiss Metal Assets (SMA) is the only company providing a turnkey solution in the acquisition and storage of rare strategic and precious metals in the Americas. The firm is based in Panama with representatives in the USA, UK and Italy. Its trading partners are Schweizerische Metallhandel AG and Haines & Maassen, both based in Germany.

SMA’s objectives are quite simple: to stockpile rare strategic metals on behalf of clients (and itself), in Switzerland and Panama, with a view to then offering them back to the market in three to five years’ time at elevated prices.

“Demand in the market is outstripping supply,” says Knut Andersen, Sales Director: “We are basically taking about 10 per cent off the total market in Europe each year; right now we have over a year’s supply of Hafnium.”

Most investors, while familiar with rare earth metals, probably have never heard of rare strategic metals, despite the fact that they are used in 80 per cent of household products and electronic gadgets; albeit in small proportions.

SMA offers its clients the choice of four metal ‘baskets’. They are: Key Industries, Energy, Construction and Engineering, and Defence. Indium, Gallium, Hafnium, Tellurium, Tantalum and Bismuth are six of the 12 strategic metals offered by SMA, and make up the Key Industries basket.

“The A, B & C baskets are stored in Switzerland because the industries who buy them are based in Europe. The defence basket is stored in Panama because the military industries who buy them are mainly based in the Americas,” confirms Andersen.

Tellingly, China controls 97 per cent of the market. As mentioned, rare strategic metals are used in electronic gadgets - iPhones etc - which the burgeoning middle classes in Brazil, India and China are increasingly looking to purchase. “This will put a lot of additional strain on the supply side in addition to the increasing demand from the developed west and east and prices over the next five years could skyrocket,” says Andersen.

Indeed, for the past three consecutive years the 12 metals offered have appreciated, on average, by 20 per cent per annum. This is helped by the price inelasticity of strategic metals. Even though the price of consumer electronics has fallen in recent years, strategic metals have moved in the opposite direction.

The entry level position is for the Energy basket starting at about USD6500. The Construction and Engineering basket is about USD10,500; the Key Industrials basket is about USD18,000, and the Defence basket is about USD23,500.

The clear advantage of holding these metals relates to wealth preservation and the preservation of purchasing power from the ravages of currency devaluation and inflation.

“As the client physically owns the metals they enjoy the benefits of 100 per cent allocation and segregation. They also benefit from being currency risk free during the period the metals are owned, as you can sell in whatever currency you want.”

“Owning strategic metals clearly brings upside benefits and makes for an effective portfolio diversifier. Andersen recommends that investors use a three- to five-year investment horizon. “If you’re looking at 12 months, stick to gold and silver.”

In today’s volatile markets, Andersen notes, investor interest is building, both as a result of increasing prices in the metals “but also because clients are worried about market volatility. They want something safe, tangible and liquid with low volatility. This is really for a part of your portfolio that you want to put away and forget about for a few years.

“I would compare buying these metals now with buying gold at USD300-400 an ounce,” says Andersen, emphasising the upside potential now available to the owners of these strategic metals.
Precious Metals Q4 Price Forecasts (USD):

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<thead>
<tr>
<th>Precious Metal</th>
<th>Spot price*</th>
<th>Capital Economics</th>
<th>BNP Paribas</th>
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<td>695</td>
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</tbody>
</table>

*As of 27 July 2012

momentum in H2’12 could be supported by the fact that prices are currently too low to incentivise mine supply, certainly in Greenfield projects.

“We will likely see operations being scaled back which will support higher prices. Also, the response we’ve started to see coming through from China following lower platinum prices bodes well for demand. Given our GDP outlook for H2’12, by Q4 we could see much healthier price levels for platinum.

We’re forecasting USD1615/oz.”

Jessop has a more bearish stance, forecasting USD1350/oz for platinum and USD540/oz for palladium. In his view, not enough macro risks are being priced into these precious metals.

“For platinum and palladium, where there is a large industrial demand component, I wouldn’t be too positive on price.”

As palladium is being substituted for platinum in diesel catalysts, from a supply perspective it is the only precious metal in deficit in 2012. Tremblay observes that palladium has performed well at times of higher economic growth in recent years:

“Our bullish view for palladium is underpinned by a rebound in economic growth in Q4, and beyond into 2013. We have a Q4 average price forecast of USD710/oz. Palladium though is not a short-term play like silver. Silver’s downside could potentially be great once the gold rally ends.”

Whilst the demand picture is relatively more robust than platinum, with continued growth in the US and Chinese gasoline-biased auto markets, there are also expectations that Russian state stock releases will slow down. However, as Cooper says, the market still needs to see more concrete evidence of this. “We expect demand to recover in H2’12 and we forecast prices to average USD695/oz for Q4.”

Cooper thinks we could see a divergence across precious metals going forward. Silver is likely to be in surplus for the next two to three years and will be highly vulnerable to downside exposure. For Platinum Group Metals (PGMs), they could see further price traction.

Says Cooper: “Significant uptake of electric vehicles poses a key risk for PGM demand. However, this is not our base case scenario.”
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--- | --- | --- | --- | ---
Lyxor ETF S&P GSCI Agriculture & Livestock 3 Month Forward | LU0692028615 | AGLG LN | AGRL LN | 0.35%
Lyxor ETF S&P GSCI Inverse Agriculture & Livestock 1 Month Forward | LU0692027484 | AGSG LN | AGLS LN | 0.40%
Lyxor ETF S&P GSCI Industrial Metals 3 Month Forward | LU0692031080 | MELG LN | METL LN | 0.35%
Lyxor ETF S&P GSCI Inverse Industrial Metals 1 Month Forward | LU0692029852 | MESG LN | METS LN | 0.40%

The index tracked by a Lyxor ETF may be volatile, investors’ capital is at risk and investors may get back an amount less than originally invested.
Next-generation approach to managing roll costs

Interview with Nizam Hamid

According to Nizam Hamid, Head of ETF strategy at Lyxor in London, investors taking exposure in the commodities space are looking to move away from first-generation indices, which take a more simplistic approach to managing roll costs, and looking for more sophisticated, next-generation solutions.

Earlier this year, Lyxor duly obliged by launching a range of "smart" commodity ETFs based on its newly created Optimix TR and Momentum TR indexes.

"We use four different roll strategies. The most straightforward roll is static enhancement, which rolls the third nearby with the fourth nearby to minimise the impact of negative roll yield," explains Hamid.

The second methodology is seasonal enhancement. This rolls once or twice a year and is used for commodities exhibiting seasonal behaviour such as crop periods for grains or climate pressure for energy commodities. Thirdly, dynamic enhancement is used for commodities that exhibit unstable forward curves such as oil and most industrial metals. Finally, there's roll timing. As Hamid confirms: "The rationale for this is to benefit from standard rolling investors who typically roll positions between the fifth and ninth day.

"We are therefore buying when standard roll investors are selling. Our long positions are then expected to benefit by the upward price pressure of the new positions being put on by standard roll investors."

The new ETFs give investors exposure to 24 different commodity contracts. One of the main impacts on investors' exposure is the cost of carry. Optimix TR and Momentum TR look to address this. Says Hamid: What we're offering through Optimix is a smarter way of managing that carry cost. If you want to own commodities long-term, having four different roll methodologies is a real benefit and investors appreciate that. It's solving a problem they understand actually exists, and that's important."

"When looking at the yield curve, price signals are able to best match what's been seen in historic pricing and mis-pricing. Having four methodologies, one of which is dynamic, allows you to capture most events driving prices within the commodity space."

This best-of-breed approach is being met with favour by potential investors, although it is still early days for the Optimix range in terms of building significant AUM. Launched this January, each ETF has about EUR20million in assets. Hamid notes that interest is starting to grow from institutional investors - to whom these products are targeted - such as insurance companies who are looking at developing long-term positions in the commodities complex.

"Clients' exposure to the broad commodities ETF space is quite negative: they've taken out about EUR2billion over the last year and AUM has dropped by about a third. However, the feedback from clients is that when they look to get back that broad commodity exposure the smarter types of indices that we’ve now developed are what they want to invest in.

"We're quite pleased with the groundwork we've made, therefore, in terms of understanding our clients' needs. I think when people have the view that the commodities cycle will turn they will look at these ETFs as the most cost-effective way of earning that exposure."

The commodities space, however, has been challenging this year. Most inflows this year have been going to precious metals, in particular gold: precious metal ETPs have attracted EUR7billion of net inflows over the past 12 months.

With that in mind, Hamid says that going forward Lyxor might look to develop something in the gold equities space.

"We've seen some interest from clients looking at gold-related stocks on the equity side and it's an area we are considering."
Copper and aluminium prices depend on 2H12 China consumption

By James Williams

Within the S&P GSCI Enhanced Commodity Index, industrial metals returned -4.7 per cent through early June 2012. Whilst not exactly exciting, the space at least held up stronger than energy, which was down -11.1 per cent. Widespread deleveraging and a move to net speculative short positioning in response to continued fears in the eurozone have caused some analysts to revise down their short-term forecasts, with Goldman Sachs, for example, reducing its three-month forecast for copper from USD9,000/mt to USD8,000/mt.

As the Goldman Sachs team wrote in their Commodity Watch report on 11 June 2012, despite reducing their near-term forecasts their base case is still for solid upside on a three-month basis in aluminium (+11 per cent) and copper (+10 per cent). The house view is even more positive for Q4 2012 and is based on the macroeconomic assumption that the US will engage in QE3, Europe will develop a sufficient policy response and China will loosen its monetary policy.

Goldman’s average price forecast for aluminium and copper in Q4 is USD2,400/mt and USD9,000 respectively.

Despite weak macro data, the micro fundamentals for copper have been resilient in 2012. On the one hand ex-China demand has softened (particularly in Europe), but on...
the other hand demand for social housing construction projects in China has supported consumption levels.

What’s more, because mine supply has been coming in lower than expected, the copper market has been in deficit since April; globally, inventories in copper have been declining on a seasonally-adjusted basis.

Wrote the Goldman Sachs commodities research team: “In our view, the strength in apparent refined copper demand in China so far in 2012 reflects strong property sector completion growth, with both residential completions and social housing completions growth likely contributing to robust copper offtake from the construction sector.

“As social housing completions are not projected to peak until 1H13, this dynamic will likely support Chinese copper and aluminium consumption through at least the end of 2012.”

Daniel Brebner is Head of Metals Research at Deutsche Bank. Expanding on the macroeconomic view shared by Goldman Sachs, Brebner thinks that based on global physical fundamentals “prices are likely higher than they should be”, due to the expectations of further monetary easing by China, the US and Europe in Q3. “These expectations have risen over the past quarter as economic indicators globally have deteriorated. This has lent an element of support to the base metals complex in our view,” Brebner.

Brebner confirms that Deutsche Bank’s Q4 average price forecasts across the base metals complex are: copper, USD8,200/t; aluminium, USD2,100; nickel, USD19,000/t, and zinc, USD2,000/t.

This is a more conservative forecast for copper compared to Goldman’s. On the supply side Brebner says that copper continues to disappoint. It should improve over the next several years but there remains a “high probability of further disappointment” that the growth rate could be considerably lower.

Demand remains a key variable and forms the basis for Brebner’s outlook: “While we believe that European inventories are at very low levels, we also believe that inventories in China are the opposite; stocks of copper are elevated and equally importantly that stocks of semi-finished and finished products are also very high.

“Therefore we expect that if Chinese growth begins to recover in the second half of 2012 it may take some time for the copper market in China to tighten sufficiently to push imports higher.”

Sanjay Saraf, Director of Metals Research at GFMS – a Thomson Reuters firm - has the same Q4 price forecast for copper as Brebner at USD8,200/t and thinks that copper has scope to outpace the other base metals “if we see Chinese demand coming back rapidly”.

“In general, miners are finding it difficult to add more copper to the market. Supply tightness for copper is keeping it buoyed. If you look at copper relative to its costs of production it has a greater cushion to its cost curve than for the other metals and that’s partly because of this ongoing supply tightness.”

Some market analysts think copper prices could fall to USD5,000/t in 2013 and although Saraf thinks it quite unlikely, it nevertheless depends on the macroeconomic climate that develops. “If you see continued fall in global GDP growth, a China hard landing and a potential eurozone break up then that sort of price level is certainly within the realms of possibility.

“We still expect to see copper prices in excess of USD7000/t next year, and probably higher than USD8000/t. That’s based on the assumption of more quantitative easing taking place, and in China we’ve already seen a couple of interest rate cuts.”

Aluminium prices – which have fallen from USD2,151/mt to USD1,885/mt through June – now represent good short-medium term risk reward with Goldman Sachs’s trade recommendation being long September 2012 aluminium USD2,150/mt calls at a premium of USD18.8/mt.

“With minimal to no growth in output likely at current prices (even from supposedly low cost areas such as Xinjiang and Gansu in China), any significant growth in aluminium consumption would result in aluminium tightening and prices moving higher,” wrote the research team.

Saraf is not quite as bullish about aluminium’s upside potential given that it has a large stock overhang: around five million
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Having fallen sharply earlier in the year, Brent Crude has staged a recovery in recent weeks, rising from 89.61 on 21 June to 106.8 as of 20 July. In terms of spare capacity, the cushion is thin. With the threat of Iran closing the Straits of Hormuz, and the possibility that the US could engage a third round of quantitative easing, there are clear macro risks to cause supply outages and support further upward price pressure.

However, looking at crude from a purely fundamental viewpoint, there seems to be a good match between supply and demand according to Christian O’Neill, energy analyst with Bloomberg Industries: “On the Iran issue, there is sufficient spare capacity to make up lost production from the embargoes, but should Iran shut the Straits of Hormuz it would definitely affect supply; between 14 and 15 million barrels a day move through there. I think the likelihood of that happening is on the lower end of the scale though.”

Demand has been weakening this year on the back of sluggish global economic growth and in O’Neill’s view investors should have a defensive position within the energy sector. Under normal GDP growth conditions of 3 per cent, incremental oil demand grows at 1.1 to 1.2 million barrels per day. Over the past five years, China alone has accounted for 65 per cent of that demand. Given that the US, Europe and China are muddling along this year, oil demand is well below that trend.

“We think there were a lot of expectations priced into crude as we entered into 2012 which continued to build as we expected a potential conflict in Iran and more quantitative easing. Now, with some of that not playing out, the market has drifted back: inventories are high, demand is weakening and you’ve got high diesel and gasoline prices.”

“Therefore, going strictly on fundamentals we think crude prices should be even lower than where they are today.”

O’Neill believes a more defensive position is needed by targeting lower beta companies such as integrated oils whose stock prices have smaller moves to changes in the underlying commodities. “You still have exposure to energy but have lower volatility and leverage than exposure to E&P and Drilling & Service companies.”

Those who were expecting higher oil prices to persist in 2012 have been reliant on fat tail ‘Black Swan’ events, which have yet to materialise. Says O’Neill, “Putting macro risks aside and focusing purely on fundamentals our bias would be that WTI crude could be lower than USD84 before year-end.”

O’Neill notes: “Energy has been a high beta sector in the overall market the past two years, suggesting growth and momentum participants are investing in the space. For the underlying equities to keep attracting these investors and reach new highs, crude oil prices would need to reach new highs as well. This is unlikely absent geopolitical events or fiscal easing.”

Given that energy has been the worst performing sector in the S&P this year – down almost 4 per cent – it is starting to attract initial interest from value investors. “Until longer-term price discounts emerge, energy could be a tough place to be relative to the market. We’ve had a stiff correction off the peak of the February/March high but stock prices are still not close to the levels that long-term value investors would build larger positions,” says O’Neill.
tonnes in LME warehouses alone. “A lot of aluminium is tied up in financing deals. That’s keeping availability in the market restricted which isn’t supporting market price so much as supporting premiums, but is nonetheless providing some support to prices. As long as the aluminium forward curve remains in contango and interest rates remain low then stocks will likely remain tied up,” explains Saraf.

The GFMS house forecast for aluminium in Q4 2012 is USD2,075/mt. Both Saraf and Brebner are therefore predicting a more modest bounce compared to Goldman’s forecast of USD2,400/mt. “We believe that aluminium prices will bottom in the current quarter and gradually recover into 2013,” confirms Brebner.

“As well as the Chinese government lowering power tariffs in order to support the domestic aluminium industry, actions have also been taken by the Indonesian government to ban exports of metal ores. This has taken the market by surprise and could have important positive consequences for the nickel and aluminium markets going forward.”

Aluminium prices on average are probably the ones that have fallen furthest below their marginal costs of production. Because of this, Saraf thinks that the downside risk for aluminium is relatively limited, noting that producer results are already showing that margins are being squeezed.

“The restricted availability of the stock could mean that if we started to see some increase in demand consumers might scramble for stock and create a short-term price rally on the back of that. But in terms of a sustained fundamentally-led price rise in aluminium, we’re not so sure of that,” comments Saraf.

Aluminium’s large stock overhang means that further production cutbacks are needed before prices start to recover. Interestingly, as Brebner alludes to above, even though producers like Alcoa in Europe are already beginning to do this, the regional government in Henan Province, China recently introduced power price subsidies to prevent further cutbacks after levels were cut by 700,000 tonnes.

The Goldman Sachs team does not think that such a stock overhang will hinder price recovery in aluminium, pointing to the fact that it traded up to USD2,800/mt in early 2011 with similar overcapacity and stock levels to that seen today.

As for nickel and zinc, the former metal has been dogged by a lot of new projects coming on stream. This has led to a market in surplus. Factor in weak Chinese demand and, unsurprisingly, the price outlook doesn’t look great. Goldman Sachs have an average price forecast of USD18,600/mt for nickel and USD2,200/mt. Saraf, meanwhile, forecasts USD17,750/mt for nickel and USD1,960/mt for zinc. Current prices for nickel and zinc are USD16,603 and USD1,855/mt.

“On the demand side, with the market for stainless steel not being that strong, that has certainly affected the market for nickel. Also, we are starting to see some new High Pressure Acid Leach projects coming on, which in the past have suffered from production problems. We are also continuing to see strong nickel pig iron production in China,” observes Saraf.

A weak demand outlook also applies to zinc and in a similar trend to aluminium, stocks have risen this year but the fact that they are getting tied up in financing deals will tighten immediate availability. “A slow down in the auto market is affecting demand as well, so we expect demand for zinc to remain relatively weak.

“People have talked about some of the big mines closing down as they reach the end of their life, but it might be another couple of years before we see those closures biting into the zinc market,” says Saraf.

Looking ahead into 2013, Deutsche Bank’s Brebner believes that further monetary expansion will improve conditions in base metals: “We remain worried, however, that the spectre of deflation could once again emerge to put renewed and possibly more forceful downward pressure on the complex in late 2013.”

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*As of 27 July 2012