

**COMMODITIES**  
PETER BUCHANAN

**A Strong Start But Growth, Policy Risks Could Cool the Party**

It's a new year so we've zoomed out for a broader look at the landscape this month. Commodity markets followed up 2008's epochal sell-off with an epic rally in 2009. The S&P GSCI Index and CRB both racked up their best performance in three decades, as the emerging market economies paced by China helped to lead the world out of its deepest, broadest recession since World War II, breathing life back into global resource demand.

The global economy should expand by 3.8% this year and 3.5% in 2011 (Chart 1). That's a percentage point shy of the pace before the Great Recession, but not so bad given earlier beaten down expectations. Those averages, however, mask some sharp variations, among countries as well as over time. Growth in the US, and other industrial countries should start the year at a decent clip, but slow appreciably from there, as the forceful two-pronged lift from fiscal policy and inventory rebuilding fades. The emerging markets will again be in the driver's seat this year. In a change, investors will clearly be focusing not just on economic prospects in those countries, but also discretionary changes, as rising inflation in some countries like China pressures policymakers.

Chart 1—Global GDP Growth

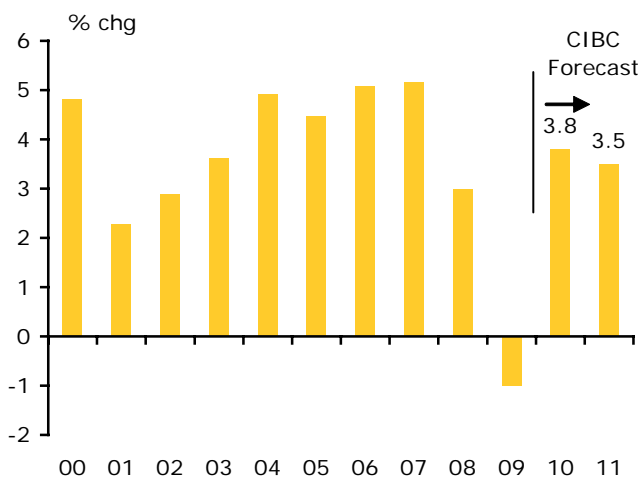
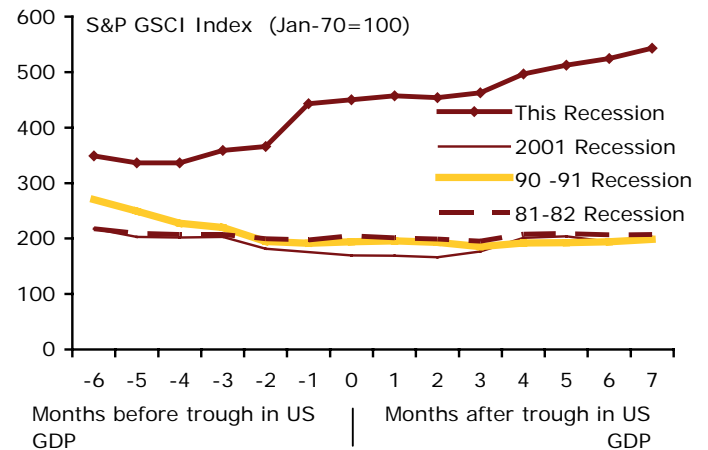


Chart 2—Commodities Have Rebounded Earlier and Steeper Than in Past Cycles

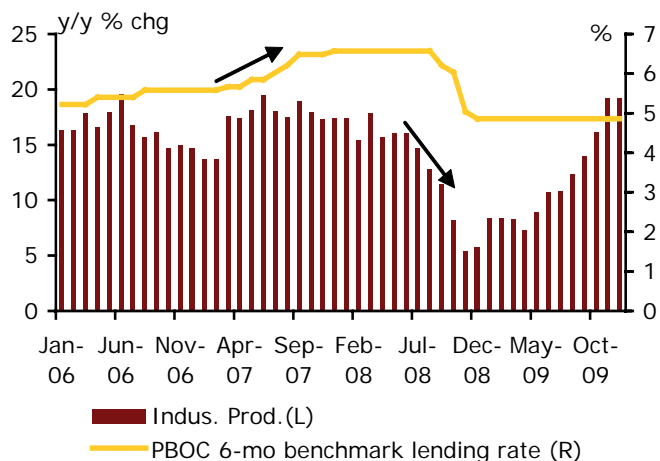


**Risk of 2<sup>nd</sup> Half Bull Market Correction as Rally Outpaces Fundamentals**

Resource prices for the most part never fell as low in this recession as past ones and have raced out of the recovery starting gates earlier and faster (Chart 2). Barring a double dip—which we don't currently envision—the global economic recovery is still in its infancy. While that suggests further headroom looking two to three years down the road, the rally's sheer exuberance in the context of a still somewhat uneven global recovery creates appreciable nearer term risks.

Emerging markets still appear to have lots of steam. China's recent tightening moves will take time to materially slow near-20% annual production growth there, if history is any guide (Chart 3). Investors are also treating commodities these days as an investment class, reinforcing demand. Restocking, only getting underway in many industrial countries, should also lift demand. While those forces should help to keep the rally on track for now, recoveries never move in a straight line. We would not be surprised to see a 10-15% bull market correction in the second half of the year, as industrial economies like the US decelerate and emerging market central banks start or intensify their restraint efforts.

**Chart 3. History Suggests China's Tightening Moves Won't Slow Economy Immediately**

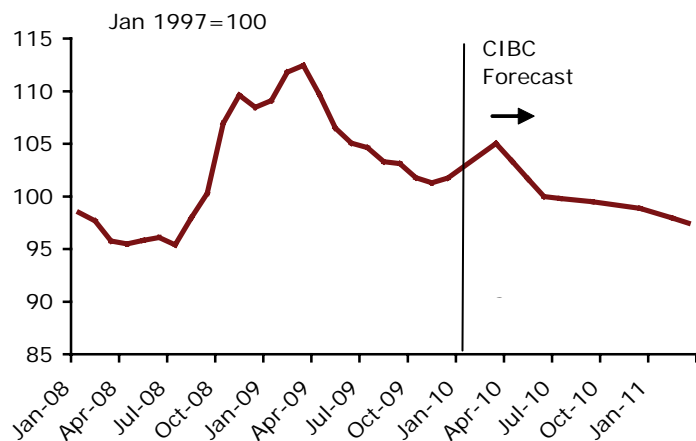


One of 2009's drivers, a downsized greenback, also likely won't offer such steady support this year. While the greenback will likely end the year lower than today in trade-weighted terms, we think the currency's relief rally could continue for 2-3 months more. In the short run, that could also help to temper still-supportive fundamentals in some sectors (Chart 4).

**Oil Rally Has Outpaced Underlying Fundamentals**

A severe start to the winter in many countries has helped lift both oil and gas in the last month. Although a continuing recovery and rising supply curve could offer longer term support, the size of oil's run-up from its recessionary lows appears unwarranted on a number of fronts. OPEC spare capacity remains at unusually high levels, at 5-6 mn/bbls per day (Chart 5, left). Demand in China grew by 6% last year but in what is still the world's

**Chart 4. US Dollar Broad Trade-Weighted Index**



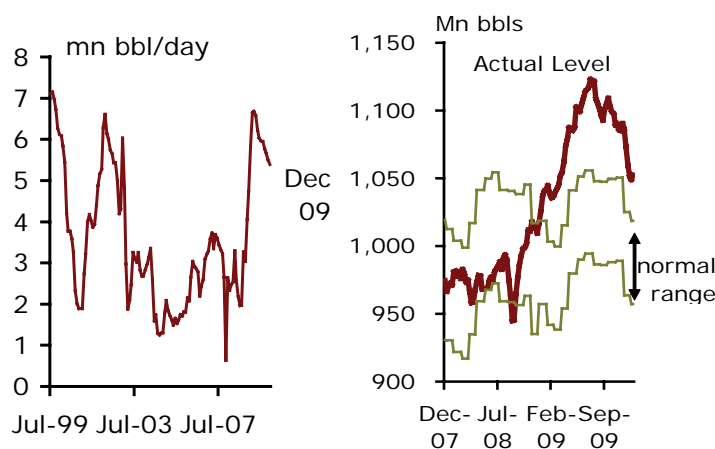
largest market, the US, it remains nearly 10% below its pre-recession peaks. Our forecast of an average well head price of \$75/bbl this year and \$80 in 2011 implies some downside risk for prices in the near term, and a slower ascent thereafter than some observers expect. Meriting caution, inventories in both the US and the OECD remain on the high side (Chart 5, right).

Henry Hub natural gas spot prices have risen from 8-year lows last fall to \$5.70/Mn Btu recently. As the economy recovers, we expect prices to benefit from improving demand, particularly from industrial users and power generators. Unless temperatures continue to match recent extremes, however, US inventories are likely to enter the Spring shoulder season on the high side. US dry gas production, moreover, rose by nearly 4% last year even with drilling cutbacks. Given rising conventional production, a subdued recovery and still-above-average storage levels, we expect price increases, but not dramatic ones, over the next 12-18 months. Henry Hub prices should average \$6.50/Mn Btu in 2011, compared to \$5.50 this year.

Paced by a doubling in copper and zinc prices, the base metals segment readily eclipsed most other commodity segments last year. A stronger-than-expected recovery in some consuming countries and interest in commodities as an investment contributed to 2009's forceful gains. While China's imports have settled back in recent months, they remain much above historical levels, suggesting some resilience in demand (Chart 6).

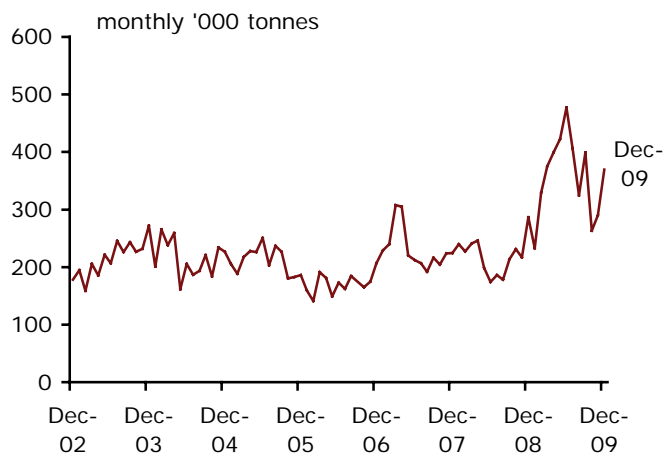
Copper remains our favourite area for exposure within the metals group, based on supply and demand fundamentals, although neither it nor other segments

**Chart 5. OPEC Spare Capacity (L) and US Oil/Product Inventories Still High (R)**



will emerge totally unscathed in the event of a broadly based temporary pullback in resource prices in the second half of the year.

Chart 6. **China's Unwrought Copper Imports**



## Raising Year-End Target for Gold But Fed Tightening a Risk For 2011

Notwithstanding our caution on the next 10-12 months, we've raised our year-end target modestly for gold to \$1250/oz for the end of 2010. The US dollar's relief rally has reduced, though not eliminated, the near-term risk for the metal from what we believe was earlier excessively bearish dollar sentiment. Helping non-interest bearing assets and gold in particular, a weak recovery will also keep the Fed on hold until early 2011. While stable US rates, a renewed selling trend in the dollar and equity market disappointments could help gold as the year wears on, rising rates are likely to weigh once policy does turn in 2011. Inflation also isn't likely to come roaring back in the next year or two, even with strong recent money supply growth. We consequently see the metal ending 2011 back at the \$1150/oz mark, 10% or so off its interim peaks.

Table 2—**Spot Commodity Prices**

		Average					
		15-Jan	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	78	72	100	62	75	80
RBOB gasoline	\$/gal	2.04	2.09	2.49	1.69	1.80	2.10
Heating Oil (NYH)	\$/gal	2.03	2.03	2.86	1.65	1.95	2.15
Natural Gas (Henry)	\$/Mn Btu	5.77	6.97	8.89	3.82	5.50	6.50
Gold	\$/troy oz	1128	695	872	1088*	1250*	1150*
Copper	\$/lb	3.36	3.24	3.16	2.35	3.50	3.30
Aluminum	\$/lb	1.03	1.20	1.17	0.76	0.85	0.80
Nickel	\$/lb	8.40	16.86	9.57	6.69	7.80	6.50
Zinc	\$/lb	1.11	1.48	0.85	0.76	1.10	0.90

\* end of period

## Recommendation Summary:

Our favoured trade this month given our time profile for crude prices is a short exposure in the forward part of the NYMEX strip.

Sell Oct-10 light sweet crude (approx. 8225). Stop 8500. Time Horizon 7-8 months.