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## COMMODITIES – EUROZONE CRISIS WEIGHS ON MARKETS BUT US GROWTH AND CHINESE MONETARY EASING SHOULD PROVE POSITIVE DECEMBER 2011

**Macro factors are currently the main drivers of commodity markets. The eurozone crisis, which is weighing upon financial markets around the world, is also the principal influence in the commodities sector. It is affecting real investment in the economy as well as in risk assets. The US economic recovery and fiscal and monetary policy in China are the two other key macro drivers of commodity prices.**

Continued disagreements between eurozone leaders on how to tackle the debt crisis have prompted investors to move out of riskier assets such as commodities. The eurozone crisis is also affecting business and consumer confidence and hence global growth prospects. Consumption of commodities will inevitably slow down if global economic activity falters. Indeed, the eurozone may already be in recession.

### **Mixed signals from USA**

In the US, industry is still performing well but there are signs that businesses are postponing capital investment and hiring due to the current volatility of global financial markets, which largely stems from the eurozone crisis. This is unfortunate as the US was just regaining momentum, following the Fukushima disaster in Japan in March, which negatively impacted growth in the second quarter and possibly at the start of the third quarter.

However, we are cautiously optimistic on the prospects for the US economy provided the budget ceiling impasse can be resolved. Admittedly, US GDP grew at a slower pace than previously estimated in the three months to the end of September. Revised figures from the Commerce Department show that the economy grew at an annual pace of 2% in the period, down from the previous estimate of 2.5%. But despite the downward revision, the quarter's growth was still up from the April-June period's 1.3% figure.

The revision was largely due to a prior over-estimate of restocking by firms after Japan's earthquake seriously disrupted the global supply chain. High energy prices have also weighed heavily on consumer spending. More positively, unemployment rates fell in 36 US states in October, rose in five and were unchanged in nine - which was the best showing since April. The improving labour market has helped consumer confidence to perk up slightly. The Thomson Reuters/University of Michigan's gauge of consumer sentiment rose to 64.1 in November from 60.9 in October.

### **Ebbing inflation in China bodes well for commodities**

For commodities markets, perhaps the most important macro development is that inflation has finally begun to abate in China – slowing for the third consecutive month in October. A key sign that the pressure on prices is cooling is evident in the data for food inflation. It showed that prices fell 0.2% in October from the previous month.

In addition to a number of targeted, supportive fiscal policies, the Chinese authorities have now openly stated that they are adopting a more accommodative stance. Beijing began tightening monetary policy in October

2010 in an effort to quell inflation. The People's Bank of China has since raised the interest rate five times, and increased banks' reserve requirements nine times.

On the last day of November, China eased monetary policy for the first time in three years, reducing the required reserve ratio for all banks by 50 basis points, starting on 5 December. The move should mark the start of a monetary easing programme that we consider essential in supporting global growth in 2012.

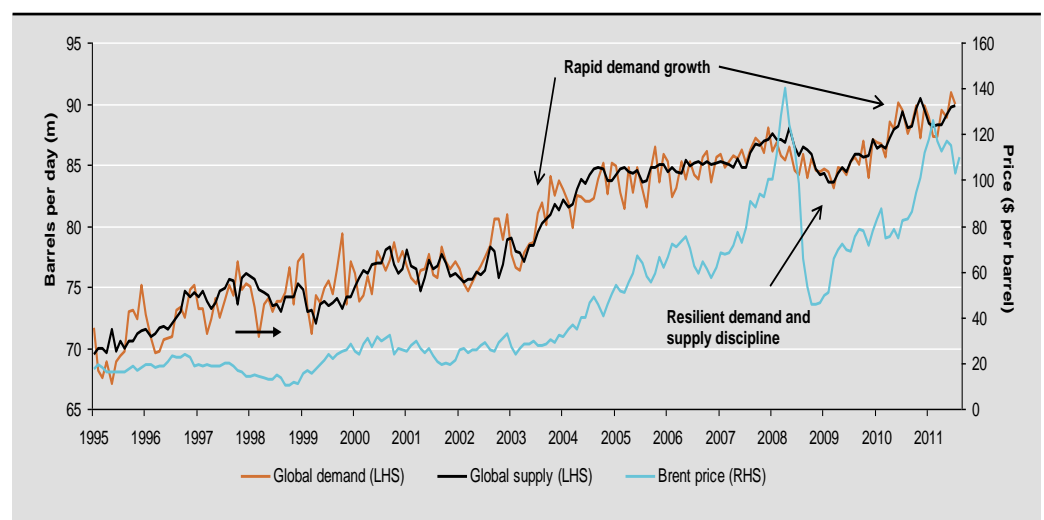
A number of other emerging economies have also begun to ease monetary policy and this bodes well for global growth and demand for commodities. Central banks in seven of the 10 biggest emerging economies increased borrowing costs in the first half of the year to stem inflation as higher commodities pushed the S&P GSCI Spot Index to an almost three-year high in April. Since then declining raw-materials' prices have helped to reduce inflation from 2011 peaks in every major emerging economy except Turkey and South Africa.

### Global oil market remains tight

In terms of individual sectors, the tightness of supply and the surprising resilience of demand over the last few months are supporting oil prices. Supply has been constrained by the continuing absence of about 1 million barrels a day of Libyan crude.

Following the end of months of fighting, Libyan production is gradually coming back on stream and had reached around 700,000 barrels per day (bpd) towards the end of November, compared with pre-war production levels of around 1.6m bpd. None of the country's 40 critical oil and gas fields were seriously damaged in the war, according to Libyan officials and international oil experts. Now, most of the important oil ports and refineries, virtually idled by international sanctions and months of fighting, are ramping back up. However, we still believe it is likely to be the tail end of next year before production will be fully restored. This will contribute to continuing tightness in the market for crude oil and oil products.

**Figure 1: Global demand and supply close to balance**



Source: Bloomberg, 28 October 2011

Meanwhile, global demand for oil is still rising, albeit modestly. The International Energy Agency (IEA) has forecast that global oil demand will rise to 89.2 million barrels per day (bpd) in 2011, up about 1%, or 900,000 barrels a day, over last year. The IEA expects demand to rise by another 1.3 million bpd next year. Consequently, some of the slack in the world oil market has gone.

There is slightly less excess production capacity, and developed countries have been drawing down inventories. The IEA says that in September industry stockpiles in the member countries of the Organization of Economic Cooperation and Development fell below the five-year average for the third straight month, the first time that has happened since 2004.

### **Buoyant US natural gas supplies**

By contrast, the US natural gas market is well supplied - this is one of the few commodities markets where production can be ramped up quickly. Gas inventories have been climbing for several months, due to soaring domestic production and weak autumn demand, reflecting clement weather conditions. In mid-November, the US Department of Energy said gas inventories had risen to an all-time high of 3.850 trillion cubic feet, topping last year's all-time record.

Precious metals have corrected back to their longer-term trend. But while both gold and silver are likely to advance long term, they may experience more consolidation into the year end. However, prices of base metals are likely to remain soft until there is a resolution to the eurozone crisis reflecting their sensitivity to economic activity. By 23<sup>rd</sup> November, copper prices had fallen by 22% during the course of the year, the first annual decline since 2008.

Macro factors are a likely to continue to exert a key influence over commodities in the coming months. The outlook for global growth and commodity prices rests upon prospects for the US, China and the eurozone, although oil prices should continue to derive support from the tightness of global supply.

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