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CORRECTION IN COMMODITY PRICES NEARLY COMPLETED

By George Boubouras, Head of Investment Strategy and Consulting
UBS Wealth Management Australia, June 2012

COMMODITY MARKET OUTLOOK HAS DETERIORATED SIGNIFICANTLY IN THE JUNE QUARTER

The June quarter has been unforgiving for commodity prices. The risk-off trade was the overwhelming investment theme, very much in contrast to the previous quarter. It is a further reminder for investors that elevated volatility is a direct result of the shorter and more volatile economic cycle that markets are experiencing. The various policy decision makers globally; monetary, fiscal or increasingly new regulatory policy; will continue to be core drivers of the investment cycle and sentiment in general going forward.

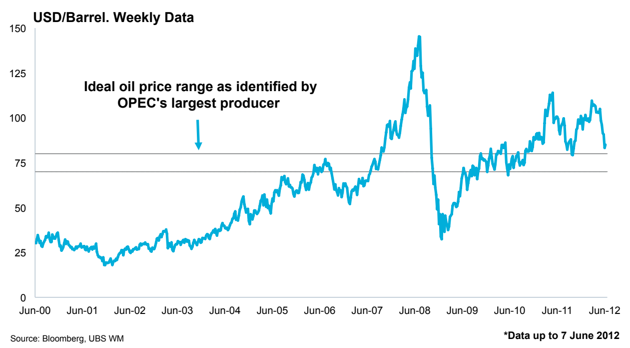
The ongoing uncertainty from Europe and the recent slower momentum out of China and the U.S. will result in some lower growth revisions. While global conditions will still be expansionary, commodity markets will always react to expectations. When you combine the challenges from Europe, markets can, and will, overshoot on the downside (as well as the upside). It is also important to reflect that any worsening of global conditions would pre-empt further coordinated global stimulus. This would be supportive again for the commodity cycle, but it would be a September quarter timeframe as markets will eventually start to reflect fundamentals once again. Further, the commodity cycle acceleration will not be as robust as previous years, partly reflecting the movement towards more infrastructure, public housing and domestic demand as growth drivers in China in the years ahead. This different composition of China's growth profile going forward will ultimately create more durable and sustainable growth in the years ahead.

ENERGY - PRICE WEAKNESS ULTIMATELY A NET POSITIVE FOR FUTURE CONSUMPTION

The recent weaker than anticipated economic data globally combined with the broad macroeconomic fears from the ongoing European debt crisis has ultimately driven the crude oil prices lower. With a backdrop of accumulating inventories, sufficient supply and relatively high speculative positions in the sector in the first half of 2012, lower Brent and West Texas Intermediate (WTI) is expected to be the result. We therefore have a shorter term three month bearish outlook on oil and look for a recovery late in the September quarter. There needs to be a noticeable expansion in demand, particularly from both the U.S. and larger emerging economies, to offset weakness in demand from Europe. We do not anticipate a catalyst that will drive prices higher in the shorter term.

Chart 1: Crude oil prices weaker in the June quarter. We maintain a bearish three month outlook given a soft growth environment for crude oil consumption and anticipate a recovery towards year-end as global growth momentum improves.

Oil Spot Price - West Texas Intermediate (WTI)



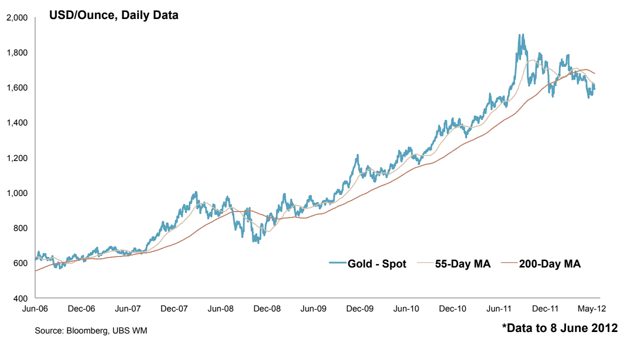
Given the global demand for energy generation is increasingly driven by the emerging economies, and will continue to be a core contributor to electricity generation in developed economies, the global market demand for thermal coal is expected to remain stronger than coking coal, unless there is increased global supply from both other markets. Demand for electricity generation via thermal coal is set to grow more consistently given the largest market is the Asian region, dominated by China. Further, the long term and large capital expenditure in LNG will continue to be a core driver domestically. Uranium remains a core mix for global energy generation globally as it continues to be part of the diversification of energy generation.

PRECIOUS METALS - REMAIN BEARISH IN THE SHORT RUN

Given the base case house view is no Quantitative Easing III (QEIII) by The Fed, we continue to have a bearish three month view on gold but a more bullish outlook on a 12-month horizon as demand will start to improve. The build up of supply, specifically the additional 50-60 tons of mine supply in 2012, combined with lower central banks purchases and more subdued jewellery demand, all suggest a supply surplus to grow. Our three and 12-month forecast for gold is currently US$1,520 and US$1,820 ounce (UBS Wealth Management forecast) respectively. The risks to the forecast are clearly the prospect of QEIII, or a hybrid of further quantitative easing plus an extension of "operation twist" by the Federal Reserve. Further, any additional increase in the European Central Bank (ECB) balance sheet to support the European banks would also imply there may still be demand for gold as an alternative.

Chart 2: Gold price has continued to weaken in the June quarter as there has been subdued demand for the physical. Any additional quantitative easing would be a catalyst for a spike in investor demand.

Gold Price



BASE METALS AND BULK COMMODITIES

Iron Ore

The June quarter was a period of subdued iron ore prices driven by China's demand (the single largest importer). Inventory levels (where disclosed) at the various large steel mills in China are lower compared to the beginning of the year. Further, there is a draw down on existing inventory levels, a clear indication that expectations are for lower prices in the months ahead. The current 2012 daily average of Australian iron ore prices has been US$141 per metric tonne (Tianjin Port, China import fines 62% iron ore spot). Expectations are for prices to range in the $US120 to $US140 range in the second half of 2012. Ultimately China's fiscal and monetary policy will dictate the need for steel mills to adjust their plans for further investment. Expectations are for further stimulus and additional clarity on the social housing and infrastructure programs.

Coking Coal

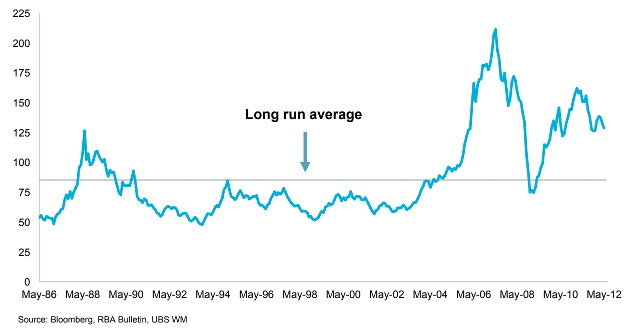
As the largest global exporter of high grade coking coal, Australia is around 55.0% of the world export volume (AME data*). Our two largest trading partners, China and Japan, import around 22.0% and 18.0% respectively (AME data*). Similar to the iron ore spot price, and for the same reasons, the spot market for Australian coking coal also looks soft. Of note, the quarterly contract prices that were consistently above spot for nearly a year have reversed in recent months. Since late 2010, when there was a very robust growth outlook across both developed and emerging economies, the spot price has fallen from nearly US$350 to around the current low US$200 levels. For steel producers in China, the demand for seaborne met coal has fallen as supply sources from domestic suppliers has increased. This looks set to continue despite a difference in the grade of coking coal globally. This suggests the subdued price outlook is anticipated to continue in the sector. There needs to be an additional Chinese stimulus, combined with a further global stimulus such as more quantitative easing (not our base case) to be a catalyst to drive coking coal prices higher than market expectations. In the meantime, there appears to be no major catalyst to drive spot high grade coking coal prices higher in the September quarter.

Base Metals

The weaker than anticipated economic data in the June quarter from both China and the U.S., combined with the renewed concerns in Europe has resulted in much weaker base metal prices given their sensitivity to future activity. Base metals - copper, lead, nickel, tin, zinc - have all weakened following the strong recovery in the March quarter. Base metals, particularly copper, are clearly more cyclical versus bulks and will always be more sensitive to global growth revisions. The price weakness in base metals on the London Metal Exchange (LME) in recent months looks set to consolidate in the September quarter as we anticipate further stimulus from China to ultimately drive activity.

Chart 3: Base metals are a more cyclical and therefore more volatility exposed to. The RBA Commodity Price Index in SDR terms shows the June quarter weakness in price following weaker than expected data from China and the U.S.

RBA Commodity Index Index - Base Metals



SUMMARY AND RECOMMENDATIONS

The moderation in the economic data from both China and the world's largest economy, the U.S., combined with the renewed European concerns in the June quarter have driven commodity prices lower. The correction in some commodity sectors, particularly the cyclical base metals, and energy, have been very severe. The backdrop for weaker commodity prices is set to remain in the shorter term.

The recent weaker economic data will clearly lead to lower global growth expectations in the months ahead. Further, the composition for global growth looks set to remain very uneven by regions, therefore, impacting different sectors and adding additional uncertainty for commodities. The change in the Chinese growth profile towards more public housing, infrastructure and domestic demand will imply more subdued commodity demand.

As we head into the September quarter, our base case asset allocation recommendation is for our underweight to commodities to remain. We anticipate further China stimulus in the months ahead, with a back drop of global liquidity conditions remaining. European concerns have added to the uncertainty. Our base case is for no further quantitative easing from the Federal Reserve but the prospect of this happening has increased in recent months. If there was a QEIII and an additional European liquidity injection, then this would be a catalyst to drive commodity prices higher.

The correction in commodity prices is nearly completed, sometime in the September quarter is the expectation. Commodities as a sector are driven by shorter, more pronounced, business cycles that have been a key development in recent years. Commodity prices are increasingly impacted by monetary, fiscal and now regulatory policy as well as a more mature growth profile from the increasingly large emerging economies. Australia, a small open economy that will remain a net resource, energy and food exporter, will simply be a price taker.

**The AME Group is a global firm of independent economists in the metal and mineral industries with research offices in Australia, Hong Kong and the United Kingdom and affiliations in North America, South America, Africa and China.*

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