# Signs of economic recovery raise metal demand

The signs of global economic recovery have revived consumer confidence level to the maximum height. With global equity markets and their respective indices have started showing upward movement relentlessly, base metals consumers are now enthusiastic about their better future performances. Experts, however, still believe that the revival in global base metals demand would largely depend upon how economies of emerging markets including Asian giants India and China perform in the rest of two quarters of the calendar year. Although, decisive actions by producers and consumers of base metals industries persuaded by huge government supports helped perform base metals in second quarter better than the last quarter of the previous and first quarter of the current calendar year. But, sustainability is of the current growth is still in the question since the global giant– the US– has not shown significant improvement in unemployment index or consumer index during these periods.

Citibank has recently upgraded the global economic growth forecasts and now expects global IP to grow at 3.8 percent in 2010 (GDP 3.4 percent). Lead indicators are turning positive pointing to the potential for further upgrades to the growth forecasts. Demand for commodities in the developed economies of USA, Japan and Europe is bottoming.

Underlying demand is turning and will be amplified by a powerful restocking cycle. However the extent of restocking remains a source of uncertainty and potential disappointment. Restocking may be dampened because excess inventory remains elsewhere in the pipeline or through a lack of confidence by businesses.

## Fundamentals support the move

Encouraged by an improving outlook on demand and economic recovery, copper rallied over nine month high to surpass $5,600 during the week ended July 24. Traders remained bullish. Brightening the economic outlook, US home sales rose for the third straight month in June and prices hit their highest level since October, fuelling hopes the housing sector is on its way to recovery. On the stock market, the Dow pushed above the key 9,000 mark for the first time since January, thanks to strong corporate earnings, besides the rebounding home sales. According to Yingxi Yu, an analyst at Barclays Capital, the overall sentiment in the metals market has improved a lot. Base metals have not much to do with the dollar, but follows stock markets closely, as the second quarter's corporate earnings were broadly better than expected, improving

outlook on the economy. The price of the metal, used in power and construction, has gained 10 percent in July. Copper supply concerns also underpinned the bullish sentiment. Violence was reported near Freeport-McMoRan's massive Grasberg mine in Indonesia, and a power problem occurred at Anglo American's Chilean Collahuasi copper mine, but so far neither has reported serious production disruptions. Echoing the nervousness on supply, Japan's copper smelters have agreed to a one-third cut in processing fees from miners for the year starting in July, as tight supplies of copper concentrate heated competition among smelters for the raw material.

## Economic recovery

Europe recently produced a raft of survey reports that suggested the worst of the recession may have passed and that industrial output has started to stabilise, helping copper scale nine-month highs and sending aluminium to an eight-month high. South Korea's key consumer sentiment index rose for the fourth consecutive month in July to the highest in nearly seven years. Thanks to Chinese buying, copper has surged 82 percent in London and 86 percent in Shanghai year to date, and some analysts think Chinese demand will remain a major driver while investors wait for western economies to recover. Analysts believe that copper may hit $6,000 in near future while aluminium may hit $2,000 benchmark. Aluminium hit fresh eight-month highs at $1,820 a ton, even as stocks of the lightweight metal, used in transport and packaging, swelling up. Commerzbank said aluminium prices may still have room to rise further, despite the steep increase in inventories, which may be largely due to reclassification of materials that were previously stored outside LME warehouses.

The Ifo institute in Munich said its business climate index, based on a survey of 7,000 executives, increased to 87.3 in July from 85.9 in June. Close to 2 million tons of aluminum stockpiles are tied up in financing transactions, so that means the market is a lot tighter than what the nominal inventory level would suggest, said a local analyst. Aluminum inventories have climbed 3.5 percent in July after rising throughout the past year and gaining as much as 29 percent in December. About 75 percent of inventory is unavailable for immediate delivery to consumers, meaning that prices can push higher in the short term despite this inventory overhang, Dan Smith, an analyst at Standard Chartered Plc in London, said in a report. Aluminum's gain in the past week is partly on the 'increasing likelihood' that the US will move out of recession by the end of the current quarter, Deutsche Bank AG said in a report. The US has been responsible for 40 percent of the rise in aluminum inventories.

## Rising demand

China's copper imports are slowing after record purchases, likely ending an 81 percent price rally this year, according to Sumitomo Metal Mining Co., Japan's second-largest smelter of the metal. 'Excessive imports mean much of the purchased metal was just stored, raising the risk that they may sell it back to the market and depress prices,' Koichi Kaku, general manager at the Tokyo-based company's copper and precious metals sales department, said. Imports may have exceeded manufacturing demand by as much as 1.3 million metric tons in the first half, he said. Copper is the best performer this year on the UBS Bloomberg Constant Maturity Commodity Index. China's imports in the six months ended June 30 soared 160 percent from a year earlier, boosted by stockpiling and a 4 trillion yuan ($585 billion) stimulus package. A drop in purchases could cap prices amid a global recession. The International Monetary Fund said that the world economy will contract by 1.4 percent this year.

Chinese copper demand should be growing by 7 to 8 percent this year, or about 400,000 tons annually, in line with an expansion in gross domestic product. Imports of refined copper jumped 401 percent on year to a record 378,943 tons in June, bringing first-half purchases to 1.78 million tons. Of the total, metal for use in manufacturing may be as small as 500,000 tons. Copper exports by Sumitomo Metal Mining exceeded its domestic sales for the first time in the first half, led by Chinese demand. The company didn't ship the metal to China in July on the spot market because of a lack of demand, only supplying volumes committed under term contracts. Sumitomo Metal Mining plans to maintain its copper production cut until the end of the year to March 31, 2010 as domestic demand is slow to recover.

China's implied aluminium demand rose by nearly 11 percent in June versus the month before on an annualised basis, while copper resumed consecutive growth on the back of record imports. Nickel demand surged ahead after a sharp rise in imports, boosting year-to-date demand to over 40 percent versus 2008, while zinc demand slowed to a standstill in June following a one-fifth rise during the first half of the year.

In contrast, Japan's copper demand may drop 20 percent from a year earlier to about 1 million tons, as consumption by cable and wire makers will decline amid a construction slump. Sumitomo Metal Mining plans to produce 401,000 tons of copper in the year to March 31, 11 percent below the capacity of its Toyo smelter in Ehime prefecture, western Japan. The plant will be shut for about a month from Sept. 17 for maintenance. Unless domestic demand improves, the company may increase shipments to other Asian markets such as Taiwan, Indonesia, Thailand, Malaysia and South Korea, as exports to China are set to decline in the second half. Japan's copper cathode exports to China surged to 219,850 tons in January to May from 86,186 tons a year earlier. Total exports of the metal rose 87 percent to 323,587 tons in the period. Reminding investors that an uncertain economic picture could yet puncture the demand outlook, stocks of copper rose 3,225 tons to 271,725 tons to their highest level in a month.

## A surprise for the market : Citibank

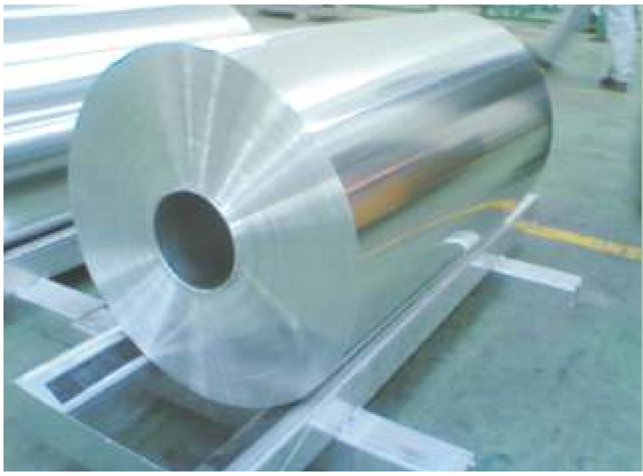
The latest Citibank report said that the meteoric rise in base metal prices is a surprise for the market. Although, worry is that some of the increase will prove unsustainable in the second half of the current year, a marked pullback is not expected. The risk that prices collapse back to trough levels (determined by cost reductions and margin compression) has now passed, the report said.

China's imports have ballooned and this has been the most important source of upward price momentum. Although underlying demand is improving, much of the increase in imports has gone into strategic and speculative inventory. The inventory buying has already ended for many commodities. For many commodities (e.g. copper) although not all (e.g. aluminium) the speed of supply adjustment to deteriorating demand was dramatic. As a consequence the excess stockpile is less than in previous cyclical downturns. This means that market will tighten rapidly as demand recovers.

Constraints are greatest in copper and coal, (especially coking coal). In zinc, the potential supply shortfall could be met from new supply, especially in China. In aluminium, there is plentiful smelter capacity in China. In nickel, there is also adequate supply, unless the laterite leaching projects are an economic failure. Citibank expects a period of weaker prices in the offing as China's import surge ends. However, the depth and length of the slowdown is likely to be moderated by investment buying. Also, China's SRB can be expected to resume buying if prices retreat to sufficiently attractive levels.

Metals with greatest sidelined capacity are at greatest risk from restarts given prices increases and contango available in all these markets. Base metals have rallied an average 50 percent since March 09 and operations curtailed in the fourth quarter of the previous year have started to reopen. Closed operations will take time to resume, yet operations running reduced capacity could rapidly increase production. Additionally, developing countries with mobile and flexible labour can shutdown and resume production more quickly and at lower costs than western world operations. Despite relatively depressed prices and low margins, aluminium has seen the greatest level of restarts with 70 percent of the production restarts in China. These smelters could be might seek to hedge given the strong contango available in.

Copper suffered the least supply cuts, yet of the curtailed production 39 percent has already resumed production highlighting the flexible nature of top end of the cost curve. Nearly all the copper restarts have been in central Africa, given its flexible labour force. Zinc concentrate production



within China is also extremely price sensitive. Concentrate production hit lows of 111kt in January and the latest April statistics show domestic mine supply increasing to 210kt with higher prices. Again contango's have been available for producers looking to lock in (albeit marginal) profitability. Nickel has seen the greatest mine curtailments of all the metals (22 percent of production cut). Yet, it has limited risk from hedging given most the restarts have been Ni-in Pig.

## Rally not to sustain

According to the latest observations by the London-based base metals research firm Economist Intelligence Unit (EIU), the prices of most industrial raw materials, including oil, have rallied strongly since the beginning of 2009, and particularly in the second quarter of the year. However, the Economist Intelligence Unit believes that the rally will fizzle out as hopes of an early return to strong economic growth fade. Prices were supported in the first half of 2009 by a return of investor risk appetite, fuelled by optimism about economic recovery and financed by massive fiscal and monetary easing across the global economy. Markets chose to ignore data showing the steady accumulation of stocks and weak demand. Rising prices also led to consumer hedging (creating demand in the market) due to concerns about further price rises. Meanwhile, the US dollar exchange rate continued to have an impact in the markets, with its relative weakness contributing to the rise in prices. And finally, a marked contango, or premium in forward prices, encouraged speculative physical buying and storage for later sale.

Metal consumption is expected to pick up in the second half of the year, partly owing to some stockbuilding but also to the beneficial impact of fiscal stimulus. However, the EIU believes this positive development has already been more than factored into prices. Within the industrial raw materials (IRM) index, average annual base metal prices are expected to fall by nearly 35 percent in 2009, with only a modest recovery of 13 percent in 2010. Stocks, which had been at historically low levels in 2006-08, will build, but lower output will prevent a massive accumulation.

In 2010-11, EIU expects a limited rebound in the prices of most industrial raw materials. Although it expects some recovery in the global economy, the growth in consumption will not be sufficient to create supply bottlenecks. However, concerns about long-term supply could resurface in 2011, particularly as investment in the raw materials sector will be scaled back in 2009-10 in the wake of lower prices, weak demand and less accessible financing. Capacity closures in 2009 may also become permanent if demand fails to pick up markedly.

## EIU's observation

Prices have risen more strongly than expected in the second quarter of 2009, due to optimism about a rapid turnaround in the global economy and some return of investor risk appetite. Prices will stabilise at a lower level in the second half of 2009 and rise only modestly in 2010 in tandem with only a gradual recovery in demand. The EIU's IRM index is forecast to fall by 35 percent in 2009, relative to 2008, and to rise by just 13 percent in 2010.

A rapid response by the industry to the downturn in aluminium demand has led EIU to revise up price forecasts. However, prices will remain relatively weak in 2010. Prices are expected to start rising in 2010, reflecting low inventories throughout the supply chain of copper, mine production shortfalls, a dearth of major next-generation projects, smelter production cutbacks, scrap market tightness and stockpiling in China. Lead prices rallied in the second quarter of 2009 despite poor market fundamentals, suggesting the gains might be difficult to sustain. EIU expects prices to recover strongly in the second half of 2010 as demand picks up. A gradual recovery in nickel demand from the second half of 2009 will mean that prices will rise gently in 2010. Tin price rose strongly in the second quarter, despite weak demand and rising stocks. EIU expects the price to fall back, before stronger demand in 2010 supports a price increase. Lower zinc mine output and smelter cutbacks mean that zinc stocks have remained low, despite weak demand. This will support prices in the medium term.