Commodities and Resources

June 2010

At a glance – Commodity and Resources equity views over the next 3 – 6 months

	Commodity	Equity		Commodity	Equity		Commodity	Equity		Commodity	Equity
Energy	→	↑	**Precious Metals**	↗	↗	**Base and Bulk Metals**	→	→	**Ags and Softs**	→	↗
Crude Oil	→	↗	Gold	↗	↗	Copper	→	↗	Corn	↗	↗
Natural Gas	↗	↑	Silver	↗	→	Aluminium	↗	→	Soybean	↘	↗
Refiners	→	→	Platinum	→	↘	Zinc	↗	↘	Wheat	→	→
Oil services	↗	↑	Palladium	↗	→	Nickel	→	↘	Sugar	→	→
Alternative Energy	n/a	→	Diamonds	↗	→	Iron Ore	↘	→	Fertilizer	↗	↗
Thermal Coal	→	↗				Coking Coal	→	↗	Cotton	↗	n/a
Uranium	→	→				Steel	↘	↘	Livestock	↘	↗

→ Neutral ↑ Strongly up ↓ Sharply down ↗ Trending up ↘ Trending down

Views expressed for a resource equity sector are subjective and are for the sector as a whole. Investec will have different views for different stocks within that sector. As at 9 June 2010.

Market outlook

Commodity markets were generally weaker in May, with gas and gold the notable exceptions. Gold performed as a safe haven as equity markets crumbled under concerns over slowing Chinese growth and possible European sovereign debt defaults. Natural gas prices responded to better than expected inventory data and also to a switch in sentiment as the oil leak in the Gulf of Mexico highlighted the risks to US energy security.

However, overall the DJUBS Total Return Index finished down 6.1% on the month and S&P GSCI Total Returns fell by 13.2%, as markets sold off heavily and funds reduced risk. Base metals were down over 11% on average with zinc, nickel and lead all falling more than 15%, whilst copper and aluminium fell 7% and 9% respectively. Iron ore spot prices also dropped sharply by 16% over the month and are now back to March levels as steel prices in China fell by around 5-7% on concerns of a slowdown in growth. Unlike gas, oil prices fell back, with WTI down 14% on the month as near-term oversupply weighed on prices. Grain prices also retreated in line with the market and on an improved outlook for harvests.

Resource equities fared no better in May, with MSCI World Materials and World Energy Indices falling 10.8% and 11.9% respectively. Currently, the energy sector now looks undervalued and on the mining side we are starting to see value reappear in certain areas as the sell-off looks overdone. With zinc, lead, aluminium and platinum prices all trading below the marginal cost of production, the downside risks have reduced but with Chinese growth slowing and Euro uncertainty persisting, we do not expect a rapid rebound in commodities or equities. We still favour energy and precious metal equities over base and bulk metals and softs in general, with gas equities currently remaining our highest conviction. However, if the sovereign debt issues in Europe stabilise over the summer, low inventories in many commodities could prompt sharp rises after the holiday season.

Energy	
Oil	**Recent Developments:** Crude oil started the month at just over $86/bl and fell sharply during the month reaching a low of around $68/bl before ending at just under $74/bl (down over 14% on the month). This was the largest negative monthly move, in percentage terms, since December 2008. **Market outlook:** The crude price movement was in tandem with price corrections across many risk asset classes during the month. Significant and rapid de-risking by investors caused the price reaction while, in fact, crude market fundamentals did not actually change significantly during the month. However, we do note increasing concerns in the market over the strength of demand growth from China and the recent strength of non-OPEC supply, both of which could cause weaker crude market fundamentals. Looking at the supply demand balance, we still believe that crude and product stocks need to reduce significantly over the coming months to reach more 'normal' levels. We do not expect sustained high prices while US inventories maintain these elevated levels.
Gas	**Recent developments:** US natural gas prices have started to rebound from the resilient $4.0/mcf lows that have been held for the last few weeks. Over the month, Henry Hub natural gas prices rose from around $3.9/mcf to over $4.3/mcf and have continued to improve after the month end. **Market outlook:** Gas producers are starting to cut drilling again at current prices, and this has started to bring the US market back into a supply/demand balance. We estimate that only around 15-20% of all gas produced in the US has a cost of capital that breaks even at around $4.0/mcf. We expect a steady improvement in industrial activity and increasing political rhetoric towards the long-term attraction of natural gas to further strengthen the market and lead to steadily higher natural gas prices.
Base and Bulks	
Zinc	**Recent developments:** Zinc prices fell 15% in May to $1,936/t and, have fallen a further 16% in the first week of June to $1,620/t as risk aversion and increasing inventories have pushed prices down to their lowest level since July 2009. **Market outlook:** We have been bearish zinc prices for the past six months as the market has clearly been in surplus and inventories have risen steadily, even during the last three months, which are the strongest seasonally of the year. However, with prices now close to $1,600/t we believe zinc prices are close to bottoming as at these levels a number of producers are losing cash. Recent reports in China of zinc smelter closures support this view. Prices are unlikely to rebound very much in the short-term, but over the next two to three years the market is likely to tighten as several large mines close.
Met Coal	**Recent developments:** BHPB has agreed prices for Q3 2010, with Japanese steel mills at $225/t for high quality coking coal, a rise of $25/t from Q2 levels. For lower quality semi-soft and PCI (Pulverised Coal Injection) coal prices are reportedly settling at around $180/t, an increase of $10/t, reflecting a slightly less tight market as well as the fact that prices rose more for Q2. **Market outlook:** With steel prices and spot iron ore prices falling in China and Arcelor Mittal announcing the closure of three blast furnaces in Europe over the summer, it looks like demand for steelmaking raw materials will wane in the short term. However, as the Q3 price rise shows, availability of hard coking coal remains tight, and with accidents at three mines recently, supply is constrained currently. Any weakness is likely to be short-lived as mills are likely to be keen not to lose any supply in the current environment.
Precious metals	
Gold	**Recent developments:** The gold price again performed strongly in May 2010, rising by 3%. It began the month at $1,177/oz and closed at $1,212/oz. Intra-month, the metal reached a new all-time high of $1,249/oz. The main driver was the collapse in the euro. However, rather than lead to a fall in USD/gold we have seen a total breakdown in the longstanding correlations. The impact of the €750bn European rescue plan is essentially gold-bullish, as the sheer scale of the package is evidence of the gravity of the challenge facing the EU economies and of heightened sovereign risk concerns. In response to the euro zone crisis, the universe of investors who are reconsidering their attitude to gold is broadening, and ETF positioning is building once again. ETF holdings are nearing 2,000 tonnes after surging during the month. In addition, anecdotal news suggests strong physical demand for bars and coins from Europe (Switzerland and Germany). The appetite for coins has been so intense that shortages are developing. As a result, the premium paid for Krugerrands in the secondary market has risen from about 2% to 6-8%. Although coins account for a small part of the market, they are one of the best indicators of investor sentiment towards the precious metal. And right now, gold is in massive demand from investors who see it as the ultimate safe haven at a time of market turmoil and as one of the best hedges against a possible resurgence of inflation. **Market outlook:** We believe the demand for gold as a safe haven instrument could increase, and that accommodative monetary conditions throughout 2010 to try and improve economic growth are likely to support gold prices. We believe that the degree of investment demand is likely to force a peak that is nearer $1,400/oz over the next six months, with $1,000/oz becoming the long term floor. We continue to have a positive outlook for gold over the next 12-18 months.
Platinum	**Recent developments:** Beginning the month at $1,736/oz platinum fell 10% to $1,561/oz as it came under pressure following a very buoyant April trading period. In spite of heightened global risk concerns, combined ETF holdings increased month on month, with platinum registering an 11Koz rise in May (the lightest increase for 10 months). The increase in May takes total holdings for platinum to 1.02Moz. Activity levels increased dramatically on the Shanghai Gold Exchange (a proxy for jewellery demand) following a relatively subdued period of trading last month. Monthly platinum volumes in May surged from 4.0 tonnes (130Koz) in April to 6.8 tonnes (219Koz), representing a 68% or an 88Koz increase month on month. Auto sales continue to show a mixed picture as incentives were phased out in many countries. Sales in the US in May were above industry expectations and showed growth across most categories. This led some auto

	manufacturers to raise their estimate for the US car market for 2010 to 12.3m units from 11.8m units. Johnson Matthey (JM) released its review of the platinum market for 2009, while providing forecasts for 2010. JM believes that the platinum market was in a 285Koz surplus in 2009, with supply remaining flat year on year (as producer inventories were drawn upon) and net demand falling 8.5%. Auto demand, which accounts for 25% of net demand, was the main reason for the decline, falling 45% as consumers held back on purchases or acquired smaller cars with lower platinum loadings. Jewellery, on the other hand, showed substantial year on year growth of 80% as Chinese buyers acted on lower prices and restocked the pipeline. **Market outlook:** With JM forecasting a balanced market for 2010 and a price range of $1,600-$2,000/oz for the next six months, there remains plenty of upside relative to current prices. We are less optimistic and retain our $1,575/oz (2010 annual average) on concerns surrounding European auto demand and other industrial applications. In addition, price sensitive jewellery could struggle to show significant growth on last year. Price movement thus far has been driven overwhelmingly by investors and not by buyers of the physical metal. The supply side however, remains constrained. Notwithstanding the continued rise of the ZAR PGM basket as the rand has weakened marginally, South African producers are struggling to grow volumes. Approved electricity price increases of 25% p.a. over the next three years, may continue to keep costs elevated. At current prices, junior platinum producers struggle to make sufficient returns to justify project development and hence supply growth remains limited. The market is forecast to move into a balanced position in 2010 and deficits thereafter, as auto plants begin restocking PGMs for auto-catalytic converters.
Agriculture and Softs	
Corn	**Recent developments:** Grain prices generally followed the broader commodity markets during May, with the correlation to crude oil increasing. There was little change to the fundamentals of corn, with a strong South American harvest confirmed, US plantings and emergence outpacing previous years and more signs of import demand from China. The one surprise was South African 2009/2010 production exceeding expectations but given the strong domestic currency, this has not significantly impacted international corn prices. **Market outlook:** All eyes will be on the development of the US crop and the trend that USDA yield forecasts will follow. New GM seed technology has yet to prove itself, but the warm, dry growing season forecasted over the next few months should provide ideal conditions for yield improvements.
Soybeans	**Recent developments:** Soybean prices have fallen alongside the broader commodity markets during May. US exports have continued to decline seasonally, but the trade dispute between China and Argentina kept interest in US product and supported Chicago listed futures. Fundamentals remained largely unchanged with no significant adjustments in South American production estimates. In the US, plantings have progressed slightly slower than previously anticipated given rain interruptions. **Market outlook**: Chinese buying of US soybeans should remain seasonally low for the next few months. Domestic demand for soy meal in the US has been fairly strong so far this year. However, as animals move from feedlots onto grazing over the summer and breeders are less incentivised to quickly fatten animals after livestock prices dropped the last two months, we expect consumption to be muted. This should mean the US stock levels remain sufficient until the new crop arrives in the late autumn.

Thought of the month: growing sovereign risk is increasing investment in gold and pushing gold prices to record highs. What are the implications of higher gold price above $1,200/oz for gold equities?

Growing sovereign risk is lifting our appetite for gold and is potentially also good for gold equities. Although gold has already rallied, trading around $1,240 per ounce. This is near its highest price in US dollars in 2010, when it traded at $1,251 per ounce in the first week of June 2010, and reaching nominal highs in euros, while all other industrial metals have been put under pressure due to fears about global growth in the wake of the debt crisis. We see further upside in the gold price from current levels. The two biggest headwinds facing gold, in our view, include a stronger US dollar and higher real rates.

Which fundamental factors are currently the most important for gold and other precious metals?

- The most important factor driving the gold price is investment demand, both by private investors (in the form of exchange traded funds) and government central banks. Gold has exhibited strong resilience over the past two weeks (last week of May and first week of June 2010) currently trading up to record levels as various macro events have meant more uncertainty for investors. Gold is proving to be the ‘ultimate currency’ with no concerns over its sovereign status or levels of debt, given that it is a real asset that can be stored easily. We believe the demand for gold as a safe-haven instrument could increase and that accommodative monetary conditions throughout 2010 to try and improve economic growth could support gold prices.

- The gold purchase in November 2009 by the Indian, Sri Lankan and Mauritian central banks highlights the growing trend of central banks and governments in emerging economies to increase gold holdings as a means of diversifying their currency reserves. This demand for gold by emerging economy central banks has reversed a decade-long trend of central banks in the economically advanced countries selling gold. In addition to this potential shift of central banks from being net sellers to net buyers of gold, the continued weakness in real interest rates continues to provide strong support to gold prices over the medium-term.

- Whilst it is true that a weak US dollar has typically been good for precious metals and a strong US dollar bad, we have an interesting situation now whereby the cause of the stronger US dollar is primarily concern over sovereign debt in the Euro area. Gold, as the ultimate default insurance, may choose to look beyond a strong dollar to the cause of that strength. In other words, gold may argue that ALL fiat currencies are being ‘debased’ (some just more than others) by residual systemic risk, an echo from the credit crisis peak. Therefore, gold's current appeal is highlighted by this alteration in its relationship with the US dollar – we are seeing a reversal of the usual inverse correlation. We now have both US dollar strength and gold strength, further underlining the strength of gold at present.

What is your general outlook for gold and precious metals over the next 12-18 months?

- If continuing sovereign risk concerns are likely to elicit stronger safe-haven buying in gold than currency-related selling, then further sovereign risk concerns may be bullish for the bullion market. After the rating downgrading of Spain and Portugal, market chatter revolved around the possibility that other euro-zone nations may be downgraded by S&P or other credit rating agencies. This would represent a widening of sovereign risk concerns that, in this regard, are likely to be bullish for gold.
- Notwithstanding the growing chorus of bullish sentiment, debate remains strong as to how “real” this recovery is. With the fear of a significant financial crisis waning, debate is now turning again to how the recovery will play out. In almost all but a global soft-landing scenario, we maintain our positive outlook for the gold price for the following reasons:
    - Safe-haven buying as an alternative currency (gold is the only currency whose production is going down, not up in double digits);
    - The outcome of printing money is inflation, and gold is an inflation hedge (which soared tenfold in the inflationary 1970s); and
    - No supply response to high gold prices is anticipated. Gold industry mine production is on a declining trend of approximately -1% per year.

Which precious metals offer the best investment opportunities?

- We believe that gold is an attractive investment both from a capital appreciation perspective and as a diversifier – it has a very low correlation to other financial assets and can act as a diversifier within a balanced portfolio. We believe that gold has finally broken clear of the $700 - $1,000 per ounce range that has dominated the last two years, with new parameters being established. We believe that the degree of investment demand will force a peak that is nearer $1,400 per ounce over the next six months, with $1,000 per ounce now becoming the long-term floor.
- We are also currently bullish on palladium. The combination of restricted supply from South Africa, the cessation of Russian stockpile sales, and a resumption of demand from auto manufacturers (particularly from the petrol-heavy Chinese car markets which use palladium-rich catalytic converters), should lead to a market showing multi-year deficits. Palladium has large potential upside from this fundamental perspective, as well as from an investment point of view. Palladium exchange traded funds are attracting much investor interest as the metal looks very cheap, particularly relative to its sister metal, platinum.

Our view on gold equities and why we believe they have the potential to outperform gold itself?

- We believe that selective gold equities are poised to benefit from the strong underlying gold price, and that their upside potential may look even greater than that of the precious metal itself. From a historical perspective, certain gold equities look very attractively valued now, in our view.
- Companies that have significant free cash generation, a production growth profile, have implemented their austerity measures in 2008/09 and are managing operating costs below $500/oz should exhibit improving operating margins and may show significant upside in 2010 – possibly by as much as double that of gold itself.
- Lastly, if gold companies continue with strong free cash flow generation and remain disciplined on the M&A front, then there is a possibility that certain companies may look to pay a dividend to shareholders.

How have you positioned your portfolio to reflect these views?

We have positioned the portfolios overweight gold producers with good cost control where operating costs are sub $500 per ounce, operations (costs) in weakening currencies, those with strong balance sheets who do not require funding, are exhibiting growing production profiles and most importantly have strong free cash flow generation. Specific examples of such companies in which we have overweight positions include Barrick Gold, GoldCorp, Randgold Resources, Africa Barrick Gold, Agnico-Eagle and Kirkland Lake Gold. We also have a large position in palladium, via the palladium exchange traded fund, which provides physically backed exposure to the underlying commodity.

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