

Thursday, January 05, 2012

2012 Outlook

The year 2011 spelled many events that plagued the global economy. These included the Eurozone debt crisis, US credit rating downgrade, and China hard landing fears have eroded the last fragments of optimism. Our base scenario in 2012 calls for a volatile but within a large range commodity market underpinned by a recurrent risk-off sentiment and expectation of a weak global growth. We expect the Eurozone debt woes to persist at least till H2 2012, the US unemployment problem to remain unresolved and China to deal with hard landing risks rather than being a savior in these tough times. With this scenario in mind, we expect commodities most dependent on global growth to exhibit the worst performance in 2012. We remain most constructive in gold, livestock and grains as these commodities have been typically the most resilient in past recessions.

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Crude Oil

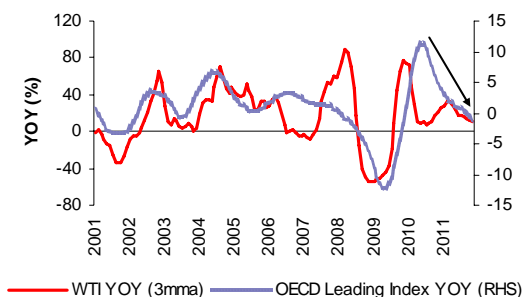
Our base scenario calls for lower oil prices, as energy is usually the most at risk in an economic slowdown due to its high dependence on global growth. Note, however, that the impact from a global slowdown on oil price is likely to be lagged given that OPEC may respond by cutting production quota to support prices while fuel consumption also tends to be rather sticky. On broad expectations, barring a recession, we expect WTI prices to fall to \$90/b while Brent may see prices declining below \$100/b in 2012, as the declining demand for crude oil and petroleum will eventually translate into swelling global oil inventories.

We watch for several key events in 2012 that will affect oil price trends:

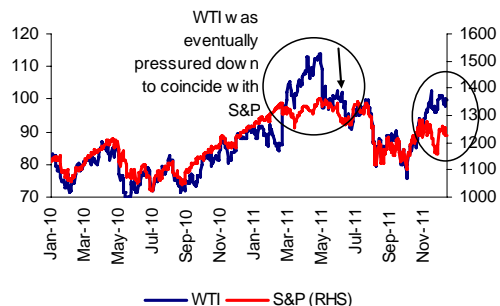
Firstly, the Iran-Israel-EU-US conflict remains a wildcard. Iran is OPEC's second largest oil producer and is responsible for 4.1% of global production. The risk of higher oil prices may derail any recovery efforts by the US and Europe and as such, the reluctance to place sanctions against Iranian oil imports may ensue. In any case, we believe that a stoppage of Iranian oil supply may pressure oil prices to as high as \$150 per barrel.

Secondly, the narrowing of the WTI-Brent gap is highly likely to continue due to the upcoming projects by TransCanada and Enbridge. TransCanada seeks to begin construction on the southern portion of the Cushing pipeline while Enbridge looks to utilize the Seaway system and construct a twin 1,170km pipeline to address the Cushing glut. Despite early opposition to these projects, the estimated addition of \$131bn or 36,000 jobs to the economy may push for the continuation of these projects. We expect the completion of these projects in mid-2013, therefore, a WTI-Brent parity remains unlikely in the interim.

OECD Leading Index suggest softer oil prices



Global slowing may translate into lower oil prices



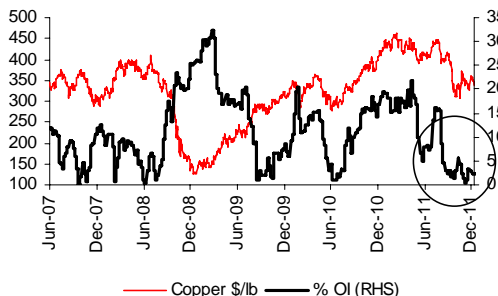
Copper

The slow pace of growth is also likely to place downward pressure on copper prices. On the demand side, we have noticed lower copper utilization in China, especially in building construction, cable output and vehicle production. Meanwhile, the prevalent bouts of risk aversion have eroded speculative demand; the percentage of open interest for copper has declined from 21.8% to its lowest at 0.25% in November and weekly net speculative positions have turned mostly negative since September. Additionally, according to a Bloomberg survey, market has also turned bearish on copper in Q4 2011. In our view, falling copper usage and poor sentiment are likely to persist going forward and could further dampen copper prices.

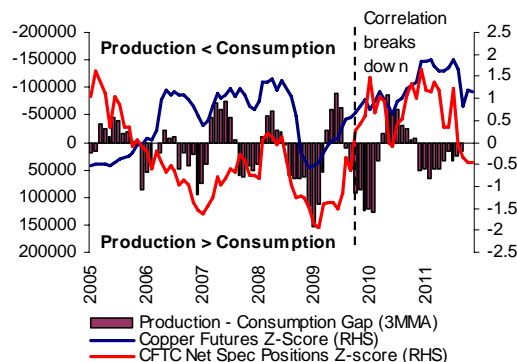
On the production front, copper mines strikes in Peru, Chile, Bolivia and Indonesia had occurred on several occasions in 2011 and may continue to exist in 2012. Despite the supply disruption, we believe that global copper supply will still exceed demand amidst the weak global growth expected in 2012. Note that a production surplus of copper has been evident since the start of 2011 and had persisted till now despite the curtailed production from the major copper producers.

As a whole, barring a recession in 2012, we expect copper prices to be range bound between \$3.10 and \$3.80/lb.

Falling Copper % Open Interest signal a bearish tone into 2012



Speculation Driving Copper Prices?



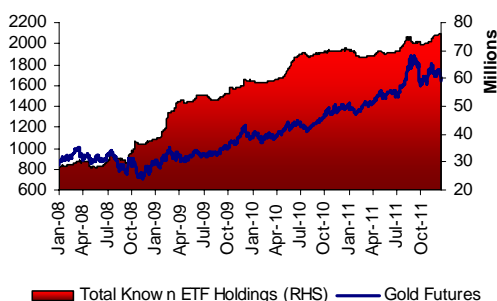
Gold

Going forward into 2012, we still recommend gold as safe haven against headline risk events such as a disorderly default event in the Eurozone sovereign debt crisis. Gold has enjoyed unsurpassed performance across asset classes, growing continuously in price and consumer base since 2001, and seeing a price increase by almost 20% on a compound annual growth rate for the past 10 years. In our view, we believe that this trend will continue into 2012, especially since gold prices will be largely driven by the negative real interest rate environment as central banks are expected to cut interest rates or keep them at historical lows to support growth.

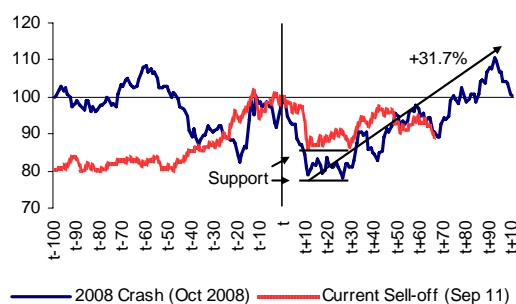
At this juncture, we view current gold prices around the \$1,600/oz handle as relatively fair. The correction witnessed in September, which was largely caused by a gold sell-off to cover losses in risky assets, has led to a significant fall in speculative demand. The percentage of open interest has fallen back to its 5-year average of 30%, suggesting that the extensive speculation previously seen has now faded. The safe haven status of gold is also still uplifted by the sustained increase in total known exchange-traded fund (ETF) holdings: total ETF holdings rose by about 3.2 million from its September trough to new highs in excess of 75.8 million. Market sentiment also sustained its bullish outlook as 70% of total surveyed¹ still believe in higher gold prices due to the need to protect wealth, according to a Bloomberg survey.

Additionally, central banks' continued interest in gold for reserve diversification will provide some support for gold prices next year. In 2011, gold purchases made by central banks were seven times higher than 2010, and this sets a bullish tone for gold as the bullion is increasingly being viewed as a store of value by both investors and global authorities. As such, we believe gold prices to target \$1,800/oz by end-2012.

Gold ETF holdings still inching up despite volatile prices



Gold futures: The silver lining after the storm?



Palm Oil

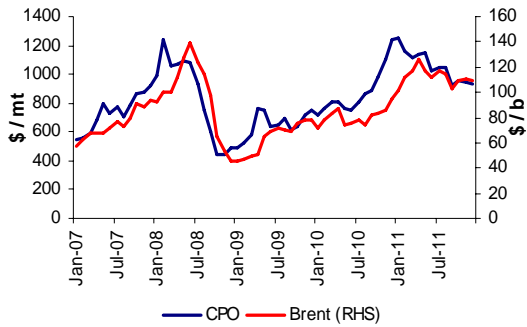
Palm oil as an alternative fuel may come under pressure as a looming economic slowdown weighs on crude oil prices. Our forecast for Brent oil prices to come under \$100/b, or about \$750/mt, may put pressure on current palm oil prices at \$943/mt on price competitiveness basis. Nevertheless, demand for palm oil as an ingredient for food, as well as possible supply disruptions, may provide support at \$800/mt with downside risks.

Nevertheless, it is important to note that weather will remain the biggest wildcard in determining palm oil supply in Indonesia and Malaysia in 2012. The current La Nina episode is estimated to

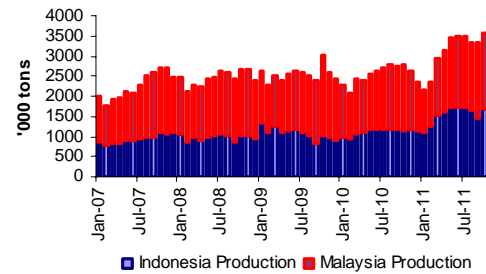
¹ According to Bloomberg survey of 26 traders, eighteen of 26 surveyed are bullish on gold prices, 2 bearish and 6 on hold.

last till early 2012 and may continue to affect harvesting efforts. Due to the erratic weather, market expectations over palm oil supply in 2012 are mixed; domestic players in Indonesia and Malaysia expect production levels to grow by as much as 6.5% yoy while some industry analysts expect production growth to turn slightly negative towards H2 2011. Despite the mixed expectations, we expect a production recovery in 2012 based on two reasons: (1) 2012's La Nina episode will be less severe, according to World Meteorological Organization, and (2) production tends to rebound in double-digit percentage points after the monsoon as heavy rains tend to spur pollination in oil palm trees.

Tight Correlation between Palm Oil and Brent



Malaysia and Indonesia Palm Oil Production



* Indonesia Palm Oil production from Jul-2011 are estimated.

In conclusion, our base case scenario in 2012 favors the safe haven commodities like gold, while growth-link commodities like base metals and energy may exhibit bearish trends. We also remain constructive in livestock and grains as these commodities have been typically the most resilient in past recessions. Please view the following table for our sentiment ranking on commodities.

Bullish/Bearish Commodities for 2012

Commodity	Sentiment	Rationale
Gold	10 (Most Bullish)	<ul style="list-style-type: none"> • Eurozone debt woes and persistent economic headwinds to encourage gold as a safe haven asset. • Negative real interest rate environment to persist. • Central Banks' increasing interest in gold to diversify reserves.
Corn	9	<ul style="list-style-type: none"> • Poor weather in 2011 resulted in tight US inventories. • US' move away from gasoline into biofuel may encourage ethanol production.
Wheat	9	<ul style="list-style-type: none"> • An essential food staple and a fairly price inelastic commodity. • Poor faith in Russia's wheat supply which triggered speculative bets on higher wheat prices may persist.
Soybean	8	<ul style="list-style-type: none"> • Biodiesel demand in US may see higher demand for soybean. • Poor weather may threaten supply
Livestock	7	<ul style="list-style-type: none"> • Livestock prices are generally less sensitive to changes in economic growth. • Higher agricultural prices may translate into higher feed prices.
Silver	6	<ul style="list-style-type: none"> • A quasi industrial-precious metal. • The global slowing may see lower demand for silver as an industrial metal. • However, its appeal as a precious metal may provide some support.
Cocoa	5	<ul style="list-style-type: none"> • Ivory Coast may see increased cocoa supply due to political efforts. • Demand is expected to remain soft into 2012 as the global slowing may translate into reduced consumption of luxury consumables. • However, threats that Ivory Coast farmers may abandon its cocoa crops due to poor income yields may limit downside.
Sugar	5	<ul style="list-style-type: none"> • Lower production estimates into 2012 due to poor weather may support price. <ul style="list-style-type: none"> ○ Australia, the world's third-largest sugar exporter, lowered output forecast 7.1% yoy for the year up to June-2012 ○ Brazil's output which supplies more than half of global trade is expected to remain tight.
Palm Oil	4	<ul style="list-style-type: none"> • CPO as a biofuel may see as lower prices as falling competing crude oil prices are expected. • Higher supply in 2012 is expected due to a less-severe La Nina phenomenon. • However, palm oil as a main ingredient for many consumables may provide some support.
Crude Oil	3	<ul style="list-style-type: none"> • Global slowing to affect crude oil demand • Faster-than-anticipated return of Libyan supply may see further downward price pressure • However, OPEC may limit production to provide price support.
Base Metals	2	<ul style="list-style-type: none"> • Slowing Chinese demand and continued de-stocking remains to be the most significant factor for copper's decline. • Global slowing to reduce base metal demand as a raw material for construction, vehicles and industrial production • However, production disruptions especially from copper mines may limit downside. • Chinese buying may return should bargain copper prices emerge.
Natural Gas	1 (Most Bearish)	<ul style="list-style-type: none"> • Historical over-supply to persist and allow for lower prices. • Global slowing to adversely affect demand.

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