



Too Much of a Good Thing?

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There is ample evidence in the measures we watch that a more normal commerce, still significantly reduced from a year ago, has returned to the 3rd rock from the sun. Though inter-country trade in finished goods is still way down, leading indicators for raw goods point to a healthy resumption in activity. We attribute that to an increased domestic focus in the growth economies, which is what we had laid out as our base case for sector gains. We are not, however, feeling sanguine about all this.

It is equally clear that recent commodity price gains have been fueled as much by the rapidly declining greenback as by shifting fundamentals. While we agree with the underlying tone of that sentiment, we are cautious about what it means for the near term. The largest concern is against rising **oil** prices since this is most likely to damage fragile economies. There is no current supply constraint on oil, nor is there even much excess storage left for this anti-dollar to become a de facto reserve currency, as happened in late 2007.

Capital is pulling out of the bond market, and our concern is that too much of that may head for oil. The 40% gain in crude oil prices since the beginning of May, to a current \$72 for WTI, is not yet what we consider perilous. It has resulted from improved sentiment as well as a dropping dollar. Economies do need some optimism in order to prosper. Big capital spends like the oil sands do need sustained higher prices to get funded. But this latest rise has been steep. Other considerations aside, we would be happier with some oil consolidation.

That said, the LME **copper** stockpiles do continue to decline. About 2/3 of the 350 Kt of added stocks that built up between mid-2008 and mid-February of this year has gone. Much of this is being sucked into China where figures for May show a continued expansion of manufacturing despite export weakness. We said when these stockpiles were rising that some of the copper on offer at the LME was a way to make cash in a debt starved environment. We assume that some of the decline in these offers is sellers now holding back, hoping improved sentiment, and a weaker greenback, will mean more near term price gains.

After peaking above \$2.30 (breaching the psychological \$5000/tonne level) in last week's Asian market, copper's price again looks like it wants to consolidate. We would like to see that happen in order to better gauge the actual excess. Another 100 Kt drop in the LME warehouse numbers would reach the top of the range they held for three years ahead of the debt crunch. At that 200Kt level a major mine site disruption could drain the excess. But we aren't there yet.

Other base metals that typically have bigger excesses appear still to continue chasing copper gains. **Nickel** operations in Sudbury will be shut in for the summer to help drain some of that excess, so this is a market worth keeping an eye on.

We are not rushing to the exits. We do think the base pricing for most metals has been pulled up, and we continue to think that medium term pricing, for copper and zinc in particular, will be governed by supply constraint. But given the recovery in the sector, we don't think you should ignore the gains to date this year.

The **gold** sub-sector, however, has shifted into its next phase that rewards risk taking and successful exploration stories. That is where we are focused. While this is partly a response to the weakening greenback, it is also a shifting of gains from the larger gold players to those that may jump higher. In this shift, higher volume is the key, and usually the prelude, to future gains. Ω

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