Henderson Global Investors

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Strategy Matters

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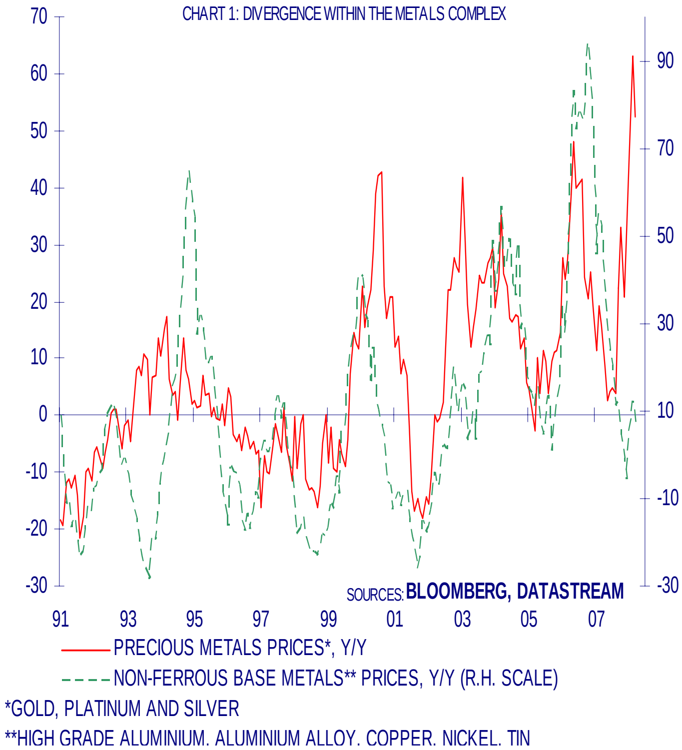
A message from the metals markets

Metals prices are in a long term bull market. Recent gains had become stretched after some investors grew complacent which lead to the recent setback in prices. Base metals may have trouble rising significantly from here in the short term but the precious metals rally should resume on renewed dollar weakness. Any bottom in the dollar will spell the end of the rally until global growth picks up again.

A divergence in the metals complex



Recent months have seen some significant divergences arise in the market for metals (Chart 1). Precious metals have risen by 52% year-on-year (y/y) at last measure while their non-ferrous base counterparts are up by a comparatively meagre 7.4% in the same period. A number of key conclusions may be drawn from these divergences and in turn some judgements made as to the future direction of the various metals.

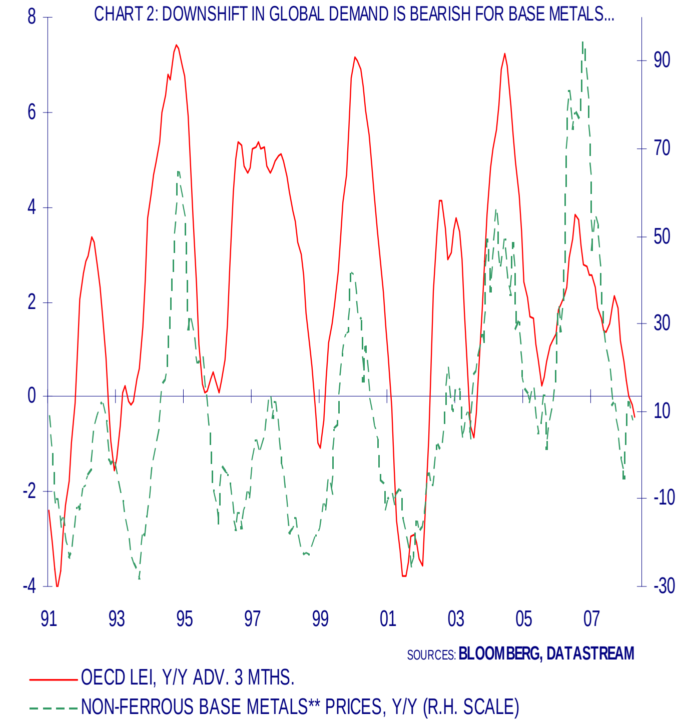
Base Metals

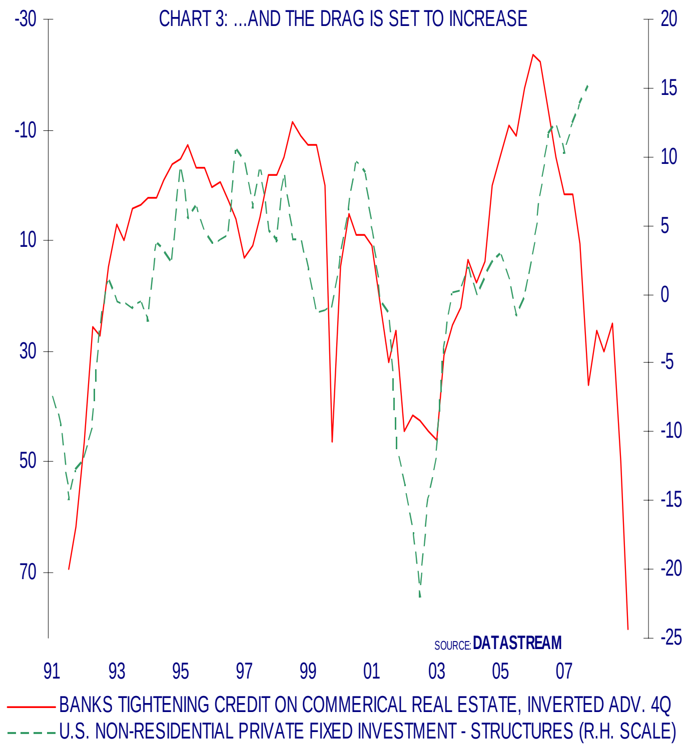
Non-Ferrous

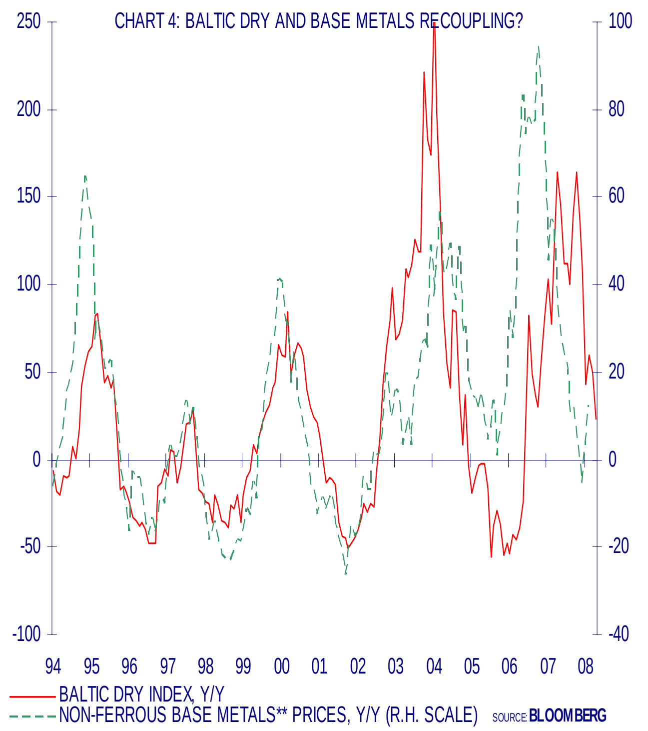
Non-ferrous base metals (hitherto referred to just as base metals), including high grade aluminium, aluminium alloy, copper, nickel and zinc, have underperformed the overall metals complex since their peak in late 2006. Given the downgrading of growth expectations since then and the likely ensuing US recession, it's clear that base metals' price action was sending a signal about the weakening of underlying aggregate demand. Since this peak, one by one, various leading economic indicators rolled over and began to fall.

The economic picture has not really improved. Most global leading indicators continue to signal contracting growth which is inherently bearish for base metals (Chart 2). The OECD's (which makes up a good sum of global demand) LEI and industrial production growth both remain in a downtrend and underlying fundamentals suggest that the situation is set to deteriorate from here. The ongoing housing correction in the U.S. is well known and fully discounted. However, the risk of a sharp correction in U.S. non residential investment has only recently become apparent (Chart 3).

Risks outside the US are also growing. The Baltic Dry Index, which measures the cost of moving raw materials by sea on some twenty six global shipping routes, has slowed quite sharply from its peak in late 2007 (Chart 4). Before 2006, the indicator had been an accurate predictor of the future movement of global base metals prices. However, large, leveraged speculative flows have distorted the relationship since then. Notwithstanding this, the Baltic Dry continues to provide a good steer as to the demand for raw materials, which appears to be falling.

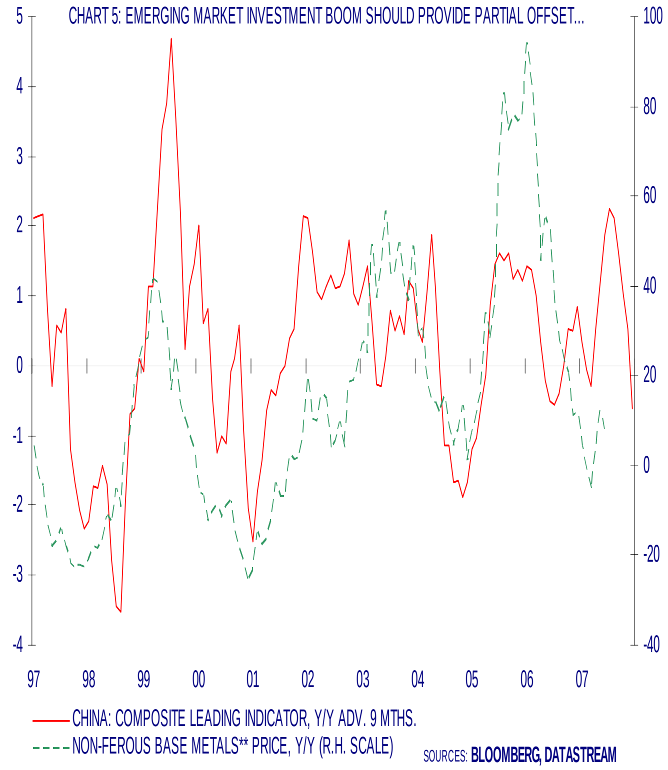


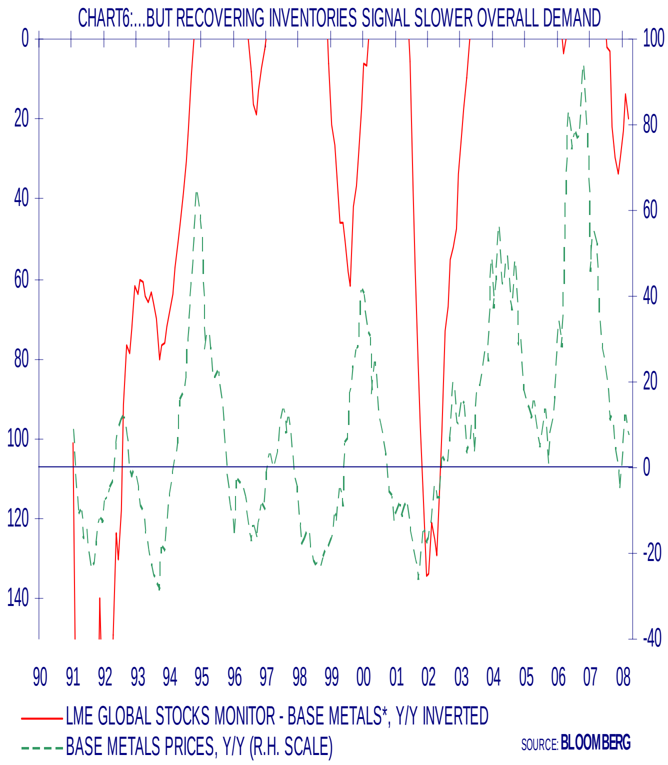




Despite being in a downtrend, the Baltic Dry is still up 42% y/y. In recent years, strong demand fuelled by a construction boom in a number of G7 countries and an investment boom in various emerging markets (EM) drove the index higher as demand for raw materials surged (Chart 5). But as demand in G7 countries slackens and export-related industrial production in EM eases it is doubtful that EM investment alone, of which the pipeline is chock full, will provide anything more than a partial offset to the slowdown in global demand. In this environment, it is difficult to envisage a return in 2008 to the types of price increases seen during the 2005-06 period.

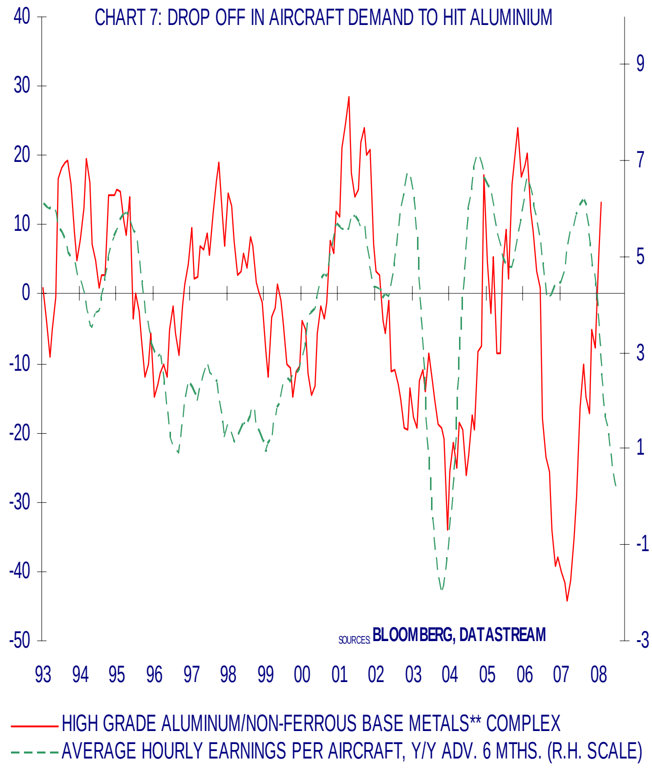
Trends in global base metals inventories seem to confirm this as they have been on the rise since July of last year. This is the first period of a sustained rise in inventories in three and a half years and, as no new meaningful supply has come on line, it is likely due to slowing demand. This trend in inventories is key as, apart from one year (2000), base metals prices have never been able to rise whilst inventories were rising in the last nineteen years (Chart 6).





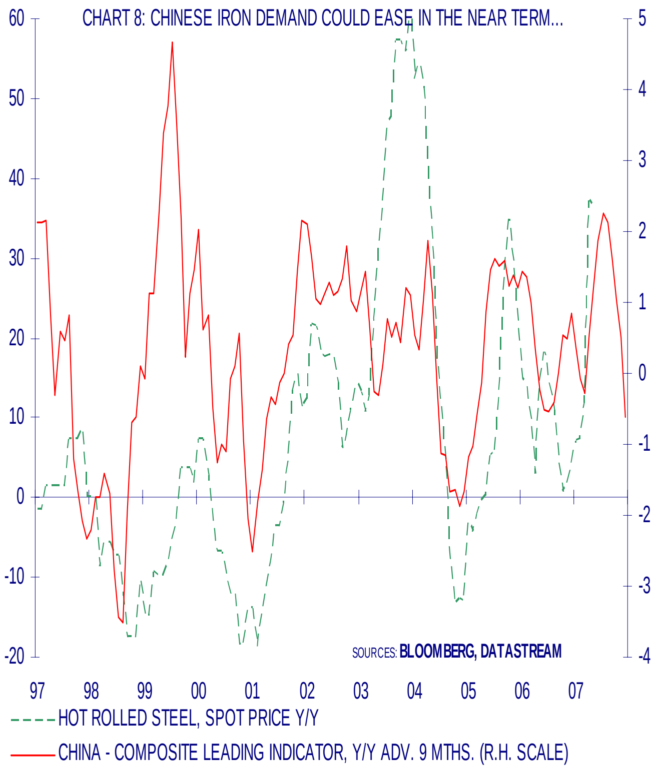
Aluminium

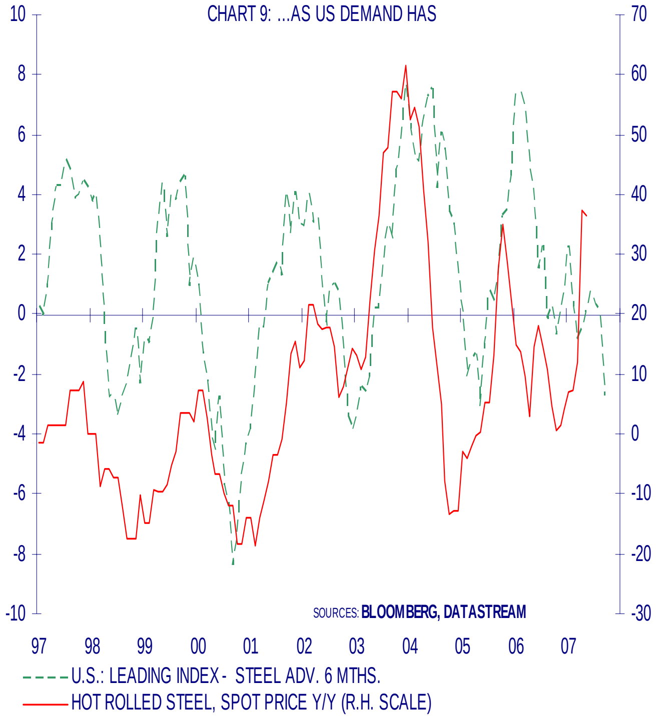
Aluminium is the most widely used non-ferrous metal and second only to iron-based metals in global usage. Its principal use is in aircraft construction followed by various industrial and construction applications. Aluminium has recently been a significant out-performer in the base metals complex but this looks set to reverse. In recent years, an explosion in the amount of air travel due to the de-regulation of various aviation markets, most notably the European Union and most recently with the 'Open Sky's' accord between the US and EU, has seen demand for aircraft balloon. For example aircraft production averaged around 15% y/y growth in the EU over the last four years. But it appears as if the commercial aviation industry has hit a snag due to the increase in competition and costs, most notably fuel. Growth in average hourly earnings per aircraft has fallen steeply since its peak in the middle of last year (Chart 7). This has generally been a bearish signal for aluminium in the past. This, combined with the slowdown in global industrial production and investment, means that aluminium will likely under perform base metals on a six-to-nine month view.



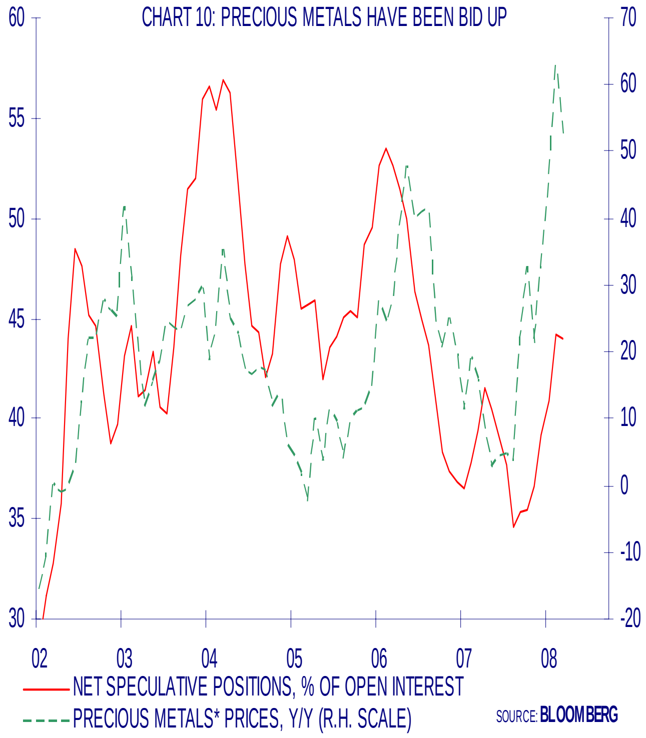
Ferrous

Ferrous metals appear to be set for a correction of their own. Fundamentals are very similar between ferrous and non-ferrous metals; however, there are some differences in usage. Steel is a primary structural component in construction and other investment projects whilst non-ferrous metals comprise more secondary components in construction such as copper (piping), aluminium (windows, doors and facades) and others. Steel is also used in white goods, shipbuilding and heavy equipment which, taken together, means that it is highly leveraged to investment spending (both residential and non-residential). Despite the ongoing investment boom in emerging markets (Chart 8), steel's exposure to the construction sector means that it is vulnerable due to impending weakness in G7 investment in non-residential structures (Chart 3). Chart 9 confirms that the slowdown may already be underway in the US. Because ferrous products are not traded in spot markets (iron ore prices are negotiated annually by a handful of global producers/consumers and steel prices/quantities are also negotiated on various schedules), the direct investment implications of this are not as interesting. From a global growth perspective, it will be key to watch what the next round of iron/steel price fixing yields as any backup in prices would confirm that, in fact, a broader slowdown is underway.

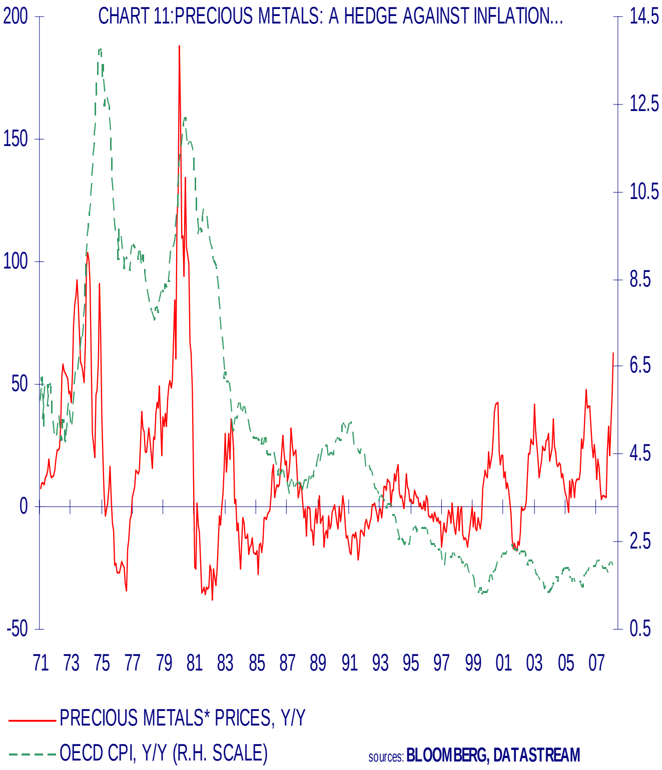




Precious Metals



Before the most recent correction, investors had pushed the prices for gold, silver and platinum to record highs (Chart 10). Speculators have been increasingly involved in precious metals markets in their run-up and data on their positioning shows that they have been unwinding positions since the second last week of February (in the case of Gold). That unwind has partially coincided with a stabilization in the US dollar free fall in the second half of March. In the past, investors have used precious metals, in particular gold, as a hedge against various risks. In the early and late 1970's and early 1980's it was high inflation which caused investors to pile into precious metals (Chart 11). In the recent past, precious metals have been

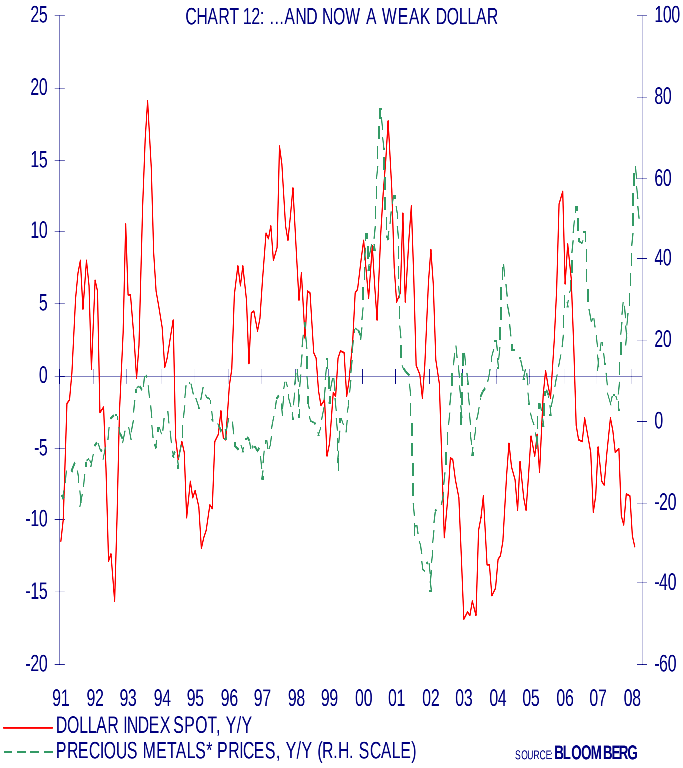


used as a hedge against a falling U.S. dollar (Chart 12). The 'dollar sell off' has become more prevalent than 'stagflation' during periods of economic distress on account of the ever-increasing US current account and budget deficits.

Despite the recent stabilization in the dollar, it is likely that there is some more downside left. The risks to the dollar, and thus potential tailwinds for precious metals, are more U.S. based financial losses and further delays in monetary easing from other central banks, most notably the BOE and ECB. But fundamentals specific to the metals themselves are not supportive.

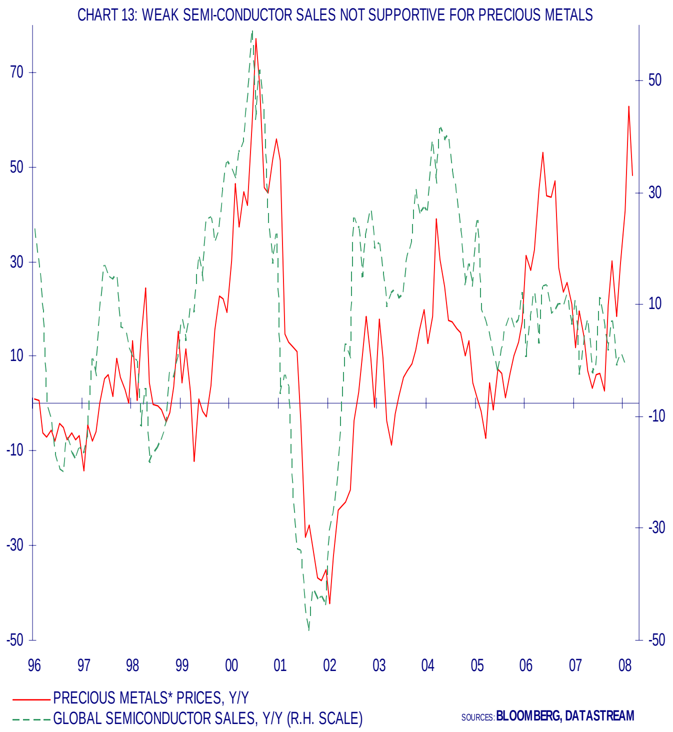
Gold

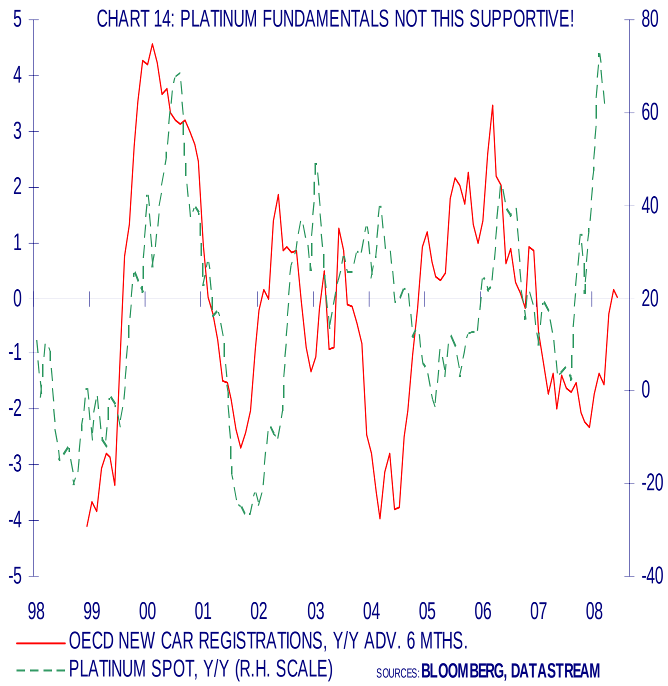
Total consumer demand growth for gold has averaged 3.8% y/y from 1984 until 2007 but has slowed more recently and actually fell by an average of 3.5% y/y in the 2006-07 period. The non-consumer demand picture isn't much better. The other major use of gold is in the manufacture of semi-conductors, which also uses platinum, silver and a host of other non-ferrous base metals. As tech investment has been quite weak in recent years, global demand for semi conductors has fallen and actually contracted by 0.67% in January. Given the weakening in economic conditions and tightening of credit, the prospects for tech investment are poor on a six-to-twelve month horizon. This represents a headwind for gold and other precious metals (Chart 13).



Platinum and Palladium

Apart from its use in jewellery, platinum, along with palladium, have a number of other uses the most significant of which are as catalysts in automobile and truck exhaust systems. Despite there being a structural tailwind behind auto production from the emerging markets, the cyclical picture is less positive. With the potential for up to a 1% increase in the US unemployment rate and growing weakness in other economies, demand for both cars and trucks will likely slow. OECD new car registrations have been falling since late 2006, but have recently recovered to around 0% which is not enough to support the price of platinum at its current level (Chart 14), if the US dollar were to bottom.





Conclusions

Despite a strong structural backdrop we remain cautious on both base and precious metals from a cyclical perspective. A looming recession in the US coupled with budding signs of slowing growth in emerging markets leads us to believe that base metals will have trouble rallying from here. We are somewhat more upbeat on precious metals in the short term as the US dollar could have some more downside from here. But as economic weakness spreads and more central banks cut rates, the dollar should find a bottom against major currencies. The dollar will likely continue to weaken against emerging currencies, but this will not be enough to send precious metals higher.

From a longer term perspective, rising demand from investment spending in emerging markets should ensure that the multi-year metals bull market remains intact whilst wealth gains and demand for autos from those same regions will allow precious metals to follow a similar path. Finally, the abundance of liquidity which will eventually be created when more central banks ease monetary policy will sow the seeds for the next up leg in commodities, especially energy and metals. But one of the main catalysts will have to be a resolution to the US housing crisis which may require some sort of government bailout for homeowners.

Adrian Pankiw
Economic Analyst
Henderson Global Investors