Policy stimulus in Europe and Asia in particular are likely to drive demand for commodities higher in 2015. China, a key consumer of most commodities is likely to surprise to the upside. Despite targeting a lower level of economic growth, stimulus activity should drive commodity intensive infrastructure spending higher. Weak oil prices should spur activity in Asia driving the demand for most commodities higher. Energy will likely remain a weak-spot in the near-term although a modest rebound in oil prices will be felt in the latter half of the year as supply begins to tighten.

Policy divergence will be the key driver behind foreign exchange performance. Although the Federal Reserve is no longer indicating that it will be ‘patient’ in raising interest rates, beyond the firming jobs market it has relatively little ammunition to pull the trigger on rate hikes. The Fed is likely to raise rates slower than the market expects, leading to a short-term US Dollar pull-back, while supportive central bank policy in the Euro zone and Japan could lead to near term stabilization in the Euro and Yen.

COMMODITIES

Summary

While market pessimism about global economic growth worsened last quarter, we are more upbeat as Europe and Asia benefit from low oil, low rates and weaker FX (see “Much Ado About Zero...” by Roubini Global Economics and ETF Securities). We have ratcheted up our forecasts for Europe, where we expect a mild cyclical recovery to persist for a few quarters (thanks to monetary stimulus and a bit of good luck), and Asia too is experiencing a growth acceleration.

We expect demand for industrial metals and platinum and palladium (“PGMs”, which have high industrial usage) to benefit from the stimulus-driven cyclical rebound. Furthermore, the supply of a broad range of industrial metals and PGMs is a lot tighter than commonly perceived. If metals start to trade on fundamentals rather than sentiment, we could see some upside to PGMs, copper, nickel and zinc.

Gold is likely to continue to feel the weight of rising interest rates in the US. However, currently the price of gold over-estimates the pace of FOMC tightening. Furthermore, gold can offer a relatively cheap hedge to some of the tail risks of policy mistakes that may occur as the rise of anti-establishment political parties in Europe threatens to challenge the status quo.

The oil price war appears to be abating. While oil rigs in the US are being shut off at an unprecedented rate, oil inventories continue to rise and only with a lag do we see that US oil output will fall. The June OPEC meeting remains a pivotal point in the political game. We think that the cartel will decide to cut production with quite some reluctance. The cuts will be modest as the group will be unwilling to lose market share and will wait for other producers to reduce output before making any deeper cuts.

We remain bearish on natural gas as seasonal demand will drop off in the coming quarter. The beginning of the ‘injection’ season will see the accumulation of inventories which will keep the market well supplied.

In agriculture, we expect planting of corn and wheat to fall after a prolonged period of weak prices. Even agriculture prices have not been immune to the “currency war”. The rapidly depreciating Brazilian real has encouraged sales of coffee and sugar, depressing global prices of the commodities. A shift back to fundamentals should bode well for coffee prices. But the same cannot be said for sugar, where oversupply will continue to weigh on prices.
PRECIOUS METALS

Precious metals have been the best performing asset class within commodities, gaining 1.3% year-to-date. Contrary to our expectations, PGMs (“Platinum Group Metals”) lagged behind, with platinum and palladium falling by more than 4% over the same period. The strong appreciation of the US Dollar against major currencies, particularly against the Euro, did not bode well with commodity prices that tend to be negatively correlated with the US currency. While gold is likely to continue to feel the weight of rising interest rates in the US, we expect PGM prices to recover, as sentiment improves and investors return to focus on tighter fundamentals.

Platinum and Palladium: Precious little supply

Concerns over a potential slowdown in demand, weighed on platinum and palladium prices in Q1 2015. The extensive use of platinum and palladium in vehicle catalytic converters makes their demand particularly sensitive to economic, industrial and market conditions at a global level. Fears of a Greek exit from the Eurozone, the biggest consumer of platinum for catalytic converter purposes, coupled with expectations of higher production, prompted an 8% fall in platinum price since the beginning of the year. Palladium also suffered a loss during the period, as a strong US Dollar and negative sentiment towards commodities, weighed on the price of the metal.

South Africa holds the biggest proportion of the world’s platinum and palladium resources, which are mainly located in the Bushveld Igneous Complex. South Africa is well known for the elevated level of worker activism and government intervention in the mining industry, which have substantially affected production in the past, with 2014’s 5-month strike further corroborating this issue. While production of both platinum and palladium is expected to recover in 2015 following a disastrous 2014, social tension could mount once again in June when wage agreements in South Africa expire.

The industry’s profitability has been severely impacted by above inflation wage hikes for the past decade. Impala Platinum and Anglo American Platinum have both announced that they are looking to sell non-profitable mines, while Glencore will be unbundling its stake in Lonmin. Russia has also contributed to the general uncertainty around PGMs supply, first with its secrecy over the status and amount of Gokhran’s (the state-owned precious metals repository) palladium stocks and more recently with the tensions surrounding the Ukraine.

With supply expected to remain tight, PGM markets are expected to remain in deficit in 2015.

However, demand fundamentals are expected to continue to favour palladium over platinum. While persistently low prices are likely to spur Chinese jewellery demand for platinum from the middle of this year, autocatalyst demand from Europe, the biggest diesel market, is likely to underperform its Chinese and US’s peers as the Eurozone continues to be plagued by low growth issues. China, the biggest single contributor to platinum demand, imported 22% less platinum in 2014, as jewellery demand faltered. However, this demand component tends to be particularly sensitive to prices and should therefore recover in 2015. Meanwhile, palladium is expected to benefit from strong auto sales in the US and China, the two biggest markets for gasoline cars. The China Association of Automobile Manufacturers expects auto sales in the country to rise by 8% to 21.3 million vehicles in 2015 while a combination of a large drop in oil prices, increased availability of auto loans and aging automobiles on the road should help buoy auto demand in the US.

Strong Auto Sales to Support PGM Prices

The United States and China are the two biggest automotive markets for palladium, accounting for 11.5% and 22% of palladium demand respectively. Automakers heavily rely on palladium to build waterless catalytic converters. As demand for new car sales is expected to recover strongly this year, we expect palladium to continue to outperform platinum.

We expect palladium to continue to outperform platinum. While we believe that platinum price will return to trade above the US$1,300/oz level as Chinese demand recovers and Eurozone auto subsidies kick in, palladium appears to be in a better position to benefit from a pick-up in China and US economic growth, the two biggest global auto markets. We expect demand for autocatalysts to remain strong in 2015 and target a palladium price of US$900/oz by Q3 2015.

Silver: Lining every cloud

The silver outlook remains uncertain, as elevated inventories and its correlation to the gold price are likely to continue to weigh on the metal. About two thirds of miners are using a long term silver price of US$19/oz or above to value their reserves, implying that most producers deem the recent correction in
silver price excessive. While we believe that a US$15-16/oz price level is a buying opportunity, the market remains plagued by years of oversupply. The mining cycle is such that new mine decisions are largely taken when prices are high. However, it may take several years to bring a new mine into production and by the time it comes on stream the price situation may have changed dramatically. Current production is the result of investment decisions that were taken when silver was trading over US$40/oz and that are no longer sustainable at current prices, as about 25% of the silver industry is currently producing at a loss. However, some producers are able to produce at substantially lower costs, with Fresnillo’s Sancito II Project estimated to have an all-in sustaining cost of only US$3.7/oz.

Only 25% of silver production comes from primary silver mines, with the remaining extracted as a by-product of gold, lead, zinc and copper. Silver production is hence difficult to regulate as its extraction might also depend on the opportunity-cost of mining other metals. However, with the silver price having fallen for the past 3 years and now trading 67% below its 2011 peak, and most metals also trading at multi-years lows, we expect production to finally realign with current prices. Scrap supply is also expected to fall in 2015, in response to low prices.

On the demand side, silver is a hybrid metal. While about 50% of its demand comes from industrial applications, with electronics, solar power and biocides replacing photographic usage, which has largely run its course, investment remains an important demand driver. While a strong Dollar, coupled with expectations of tightening in the US, are likely to weigh on silver investment demand in the near term, industrial consumption should benefit from stronger US fundamentals.

We maintain a mildly positive view on silver but revise our price expectations to US$18/oz by end 2015.

Gold: Pulled in both directions

In line with our expectations, gold has shown resilience in Q1 2015, as geopolitical risks have kept defensive assets in focus. While the strength from the US Dollar in recent months has had somewhat of an adverse impact on gold as it makes bullion more expensive for foreign investors, the correction in the US Dollar following the March FOMC meeting brought some relief to commodities.

Futures positioning has been a key determinant of gold price direction in recent months. Despite reaching the highest level since 2012 in January in response to concern over the fallout surrounding the Greek elections, speculative long gold positions in the futures market have fallen for the eighth consecutive week. Investors appear to have been reducing defensive portfolio exposures recently as the US economy’s recovery continues prompting the US Dollar’s on-going meteoric rise, while political concerns surrounding the fate of Greece and the Eurozone more widely are beginning to fade. Rising volatility could support gold in coming months if rate hike fears begin to fade and if political concerns surrounding the Eurozone mount. While in our central scenario, we don’t expect geopolitical risk to significantly interfere with continued economic growth and the demand for cyclical assets, the geopolitical environment remains tense in a number of regions.

While investment demand has been mixed, physical demand should remain supportive, with China and India representing over 50% of gold demand globally. Gold is bought in India for weddings as part of the bridal trousseau and gifts. The main wedding season runs from November through May. Demand also climbs during the festival season that runs from late August to October. India has experienced an improvement in its current account deficit in the wake of falling oil prices. India’s current account problem resulted in restrictions being placed on gold imports, and if the economic landscape improves, further loosening of these restrictions can be expected. Already in 2015, the Indian Central Board of Excise and Customs has reduced import tariffs by nearly 5% with likely more to come from the government. Indeed, imports in February 2015 are nearly 50% higher than the comparable period in 2014.

Unlike other commodities, demand has been the key driver of price direction rather than supply. However, with prices hovering around the level of marginal cost, we do not expect supply to be able to be maintained as reserve depletion begins to occur. Recycling has been another source of supply that has contributed to a stabilisation of prices near the marginal cost of production. With recycling having fallen to the lowest level since Q3 2008, we believe the current gold price represents a floor below which it is unlikely to fall without triggering a further loss in supply. Recycling has accounted for 37% of total gold supply on average over the past 5 years but recent weakness in the gold price has seen recycling falling by 11% yoy in 2014.

Ordinarily, a positive economic environment, in which some major central banks will likely raise interest rates, will be a gold negative scenario. However, negative deposit rates in many...
European jurisdictions have enhanced the appeal of holding gold, despite it being a zero yielding asset. With investors having to pay to hold cash or bonds, gold is increasingly attractive, especially on a relative value basis as bond and equity market valuations appear stretched.

In general, we expect gold to end 2015 in the range of US$1250-US$1300/oz, as long as US interest rate hikes are modest and gradual.

INDUSTRIAL METALS
While individual industrial metals will continue to trade in line with their own fundamentals, we believe that an upside surprise in Chinese and European economic growth rates will lift the tide for all industrial metals. At the same time supply for most industrial metals remain tighter than commonly perceived in the market. Supply forecasts rarely factor in mine disruptions from strikes or weather (such as the floods in Chile taking place at the time of writing). Indeed Indonesia’s ore export ban could be replicated by other countries like the Philippines who seek to extract more of the value chain.

While falling energy prices could help sustain the production of many metals for longer, the recent fall in costs are unlikely to move the needle sufficiently, with expected site costs declines of only 3% for nickel and less than 1% for aluminium in a low oil price scenario4. The lack of profitability in most metal production remains perilous and we believe that production cuts are needed if prices do not rise.

Aluminium: Fluttering in a range
Despite the intensity of energy consumption in aluminium manufacturing, a high proportion of aluminium producing sites are located close to cheap energy sources to start off with. Hydro and coal tends to provide most of the electricity in aluminium production and they benefit the least from a fall in oil prices. Based on CRU cost models, aluminium site production costs are only set to decline by 0.7% in a low oil price scenario4. A decline in energy prices is unlikely to drive profitability into smelters and therefore we believe the economic pressure to cut production remains strong.

China’s drive to push market economics into production should bode well for tightening aluminium supplies over the medium term. However, the process of decommissioning smelting facilities will be a long road, even with China’s appetite to reform.

We believe car manufacturers will continue to substitute heavier metals in favour of aluminium to meet to increasingly tighter environmental standards, especially in China. While cheaper oil and petroleum products may have reduced consumer incentives for more efficient vehicles, environmental regulation still favours higher demand.

However, many of these themes will be slow to impact prices and we believe aluminium will simply range trade between US$1,600-US$1,900/mt.

Copper: Supply deficit déjà vu?
The copper price fell to the lowest level since 2009 in Q1 2015, as both the World Bank and the IMF lowered their forecasts for global growth on concerns over a slowdown in China. While China is turning its focus from construction and export dependent manufacturing to domestic consumption, we believe copper price overcorrected. While low energy prices have dragged down metal prices by reducing their cost of production, we think negative sentiment, rather than weak fundamentals, is weighing on the metal at the moment.

Latest figures from the International Copper Study Group (ICSG) show that copper was in deficit for the 5th consecutive year in 2014, as demand once again beat expectations. While the International Copper Study Group (ICSG) expects a 10% increase in mine supply to prompt a surplus in the copper market in 2015, we believe supply expectations are overblown.

Historically, supply disruptions have accounted for about 5% of total copper supply, on average over the past 5 years and 2015 is unlikely to be an exception. Operations at Freeport’s Grasberg mine, the world’s second-largest copper producer, were suspended for 5 days in March due to a labour dispute. In February, BHP Billiton reported a 60,000 tonnes reduction in copper production from its Olympic Dam mine in Australia due to a fall in energy prices, and we think the situation could deteriorate further in the coming quarters.

to problems at its mill. Sustained weakness in the copper price has also prompted some producers to downsize production. Indeed, Codelco, the world’s largest copper miner, has recently announced that it will cut production by 5% in 2015. BHP Billiton, the world’s largest mining company, plans to cut project spending to the lowest since 2010, following similar reductions by fellow producers such as Freeport-McMoRan. We expect more miners to follow Codelco’s example as low price expectations prompt companies to cut back on expansionary and maintenance capex.

We expect investors to eventually return to focus on tightening supply-demand fundamentals in 2015. We expect the copper price to trade around the US$6,500/mt level in the second half of 2015 and break above that level in 2016 when lack of capital expenditure will sharply curtail available supply.

Nickel: Ore shortage continues

Despite falling to the lowest level in over a year in February 2015, nickel prices are expected to recover globally in the second half of the year on declining nickel pig iron production in China, stronger demand from the European stainless steel market and reduced nickel ore availability. After rising over 50% to US$21,000/mt, the nickel price corrected together with other cyclical assets at the end of August 2014. Indonesia, the biggest nickel producer with over 30% of global mine supply, introduced an ore export ban in January 2014 to favour the domestic processing of metal commodities.

China is the biggest consumer of nickel accounting for about 50% of demand. The country is estimated to have entered the ban with about eight months of nickel ore inventory, somewhat limiting the potential rise in nickel price in 2014. Since the introduction of the ban, China has turned to the Philippines, the 2nd largest global producer, to keep its nickel pig iron industry well supplied, despite the lower quality of the Filipino ore, further delaying the much anticipated market tightness. However, the beginning of the rainy season in the Philippines has slowed imports from the country since November 2014 and the situation is only envisaged to return to normality over the next few weeks. As a consequence, China’s inventories have most likely been run down to feed the local nickel pig iron industry.

We expect the absence of Indonesian ore from the market to contribute to supply tightness until 2016 when new production from China, the Philippines and Russia eases some of the supply constraint. With the Indonesian ore export ban remaining in place, China’s stocks running low, and an anticipated rise of 5% in global stainless steel production in 2015, we expect nickel price to recover to US$17,000/mt.

Zinc: Deficit to galvanise the market

Mine closures and rising demand to drive the next leg of the zinc bull market. Planned mine closures, coupled with strong demand for galvanised steel are expected to drive the price of zinc higher in 2015. Approximately 1.5 million tonnes of zinc production will be taken off the market by 2016 due to mine depletion, equivalent to about 12% of 2013 production. The zinc market is expected to remain tight until higher prices support the development of projects in Australia, Indonesia and Russia.

Provisional data provided by the International Lead and Zinc Study Group (ILZSG) indicate the zinc market was in a 309kt deficit (equivalent to 3% of global zinc demand in 2014) in the first three quarters of 2014. Metal usage increased by 7.4% over the same period, driven by a strong increase of demand from China (+13.8%) and the US (+9.2%). The increasing use of galvanised steel is projected to amplify zinc consumption in 2015, particularly in China. China is zinc’s biggest consumer, with approximately 46% of refined demand in 2013. Over 40% of zinc demand comes from galvanising steel as an anti-rust protection for car manufacturing and construction. Despite concerns over the Chinese property market, demand indicators in the other sectors remain robust.

With automobiles production in China up 7.2% yoy in the first 11 months of 2014 and the latest government policies boosting infrastructure and durable goods consumption, we believe zinc is well positioned to benefit from a pick-up in Chinese growth. Meanwhile, LME inventories have declined by 254kt last year and are now 27% below the levels seen at the beginning of the 2014. Should demand from China remain strong and inventories continue to fall, we believe zinc could return to trade at the levels last seen in November 2010. We target a price of US$2,510/mt in 2015.

ENERGY

Oil: Waiting on OPEC’s response

The major crude oil benchmarks, Brent and WTI have fallen 53% and 60% in the past 9 months, respectively, as global oversupply has led to a re-pricing of one of the most important inputs to global energy production. Liquid fuels (i.e. crude oil and its derivatives) are likely to remain in surplus for some time as global production slowly adjusts to the new reality.
The global oil market has rapidly evolved over the past decade, with the development of shale and tight oil (referred to as 'shale' for brevity) in the US driving most of that change. The development shale in the US, which began in the early 2000s, has ramped up production by close to 70% since 2010. That has reversed more than three decades of production decline.

It is clear that the resurgence in US production has come at the detriment of OPEC oil demand. Nigerian and Algerian light sweet oil exports to the US have borne the brunt of the decline. Saudi Arabia, the largest global exporter of crude oil has seen a reduction in medium grade exports to the US (its light sweet exports to the US were small in 2009 anyway).

OPEC oil exports crowded out from the US have had to find another home. OPEC, reluctant to give up market share, has not cut production despite falling prices. The price war appears to have subsided somewhat but OPEC members are likely to continue to target exports toward emerging Asia markets – a region thought to be a source of growth.

With crude oil prices remaining weak, US producers have started to take measures to reduce production. Unlike conventional wells, which can produce at relatively stable rates for sustained periods of time, shale oil wells experience a burst of production in the first few years of their lives, followed by sharp decline. Therefore the horizontal rigs used in shale oil production tend to be small, mobile and quick to switch on and off (as little as three weeks). With the prevalence of horizontal rigs in US oil extraction today, production is far more price-elastic than it has been in the past (and indeed compared to other countries). Rig counts have been fallen by a record 42% since September 2014. While part of that trend has been driven by ongoing improvement in technology that has seen efficiency gains simply reduce the need for so many rigs, it is clear that many rigs are being idled due to weak prices.

Despite rigs being idled, US oil inventories have continued to increase, highlighting the lag between production intentions and actual output. US oil inventory currently sits at an all-time high.

In the near-term, the potential exhaustion of storage capacity in the US could weigh WTI oil prices. Many traders have been storing oil, waiting for prices to rise. That has kept a floor under front-month prices as that inventory has been kept away from the market. Should storage capacity run out we could see prices drop further before they gain.

We believe that sustained cuts to rigs will indeed temporarily reduce US oil output, a view shared by the US Energy Information Administration. That should help prices rise over the medium term.
1. OPEC’s general secretary states that OPEC would meet 4th Quarter demand with increased production.
2. Hurricane Katrina shuts down production in the Gulf of Mexico.
3. Companies in Gulf of Mexico restore production and natural gas inventories increase, easing concerns of insufficient fuel for the winter.
4. President George Bush makes states that “all options are on the table” to keep Iran from developing nuclear weapons.
5. Conflict between Hezbollah and Israeli forces escalates.

6. Excess supply in the US following a mild winter.
7. Dollar drops as investors speculate that the Federal Reserve will cut the Fed Funds rate again to 4.25% from 4.5%.
8. Israeli war planes practise over Iraq, stoking speculation of an airstrike against Iran.
9. Further drop in Dollar over fears that the US government would have to rescue Fannie Mae and Freddie Mac.
10. Forecasts released that show Tropical storm Dolly missing oil installations in the Gulf of Mexico.
11. Traders rush to close out WTI October contract on last day of trading while the Dollar weakens against the Euro.
12. Recession raises concerns over falling levels of global fuel demand.
13. OPEC holds meeting to stem oil slide, cutting daily output target to 24.8mm barrels per day.
14. OPEC keeps output target the same. EIA reports that U.S oil inventories fall by 5m bbl, the most since September 2008.
15. Dollar slips below 1.5 EUR/USD for first time since August 2008 and gasoline stockpiles fall more than expected.
16. US manufacturing expands at the fastest pace since 2004 (ISM 60.4 reading).
17. European debt crisis causes Dollar to strengthen. Fears of contagion from Greece rise.
18. Brent’s premium to WTI rises to US$19.54/bbl due to unrest in the Middle East escalating while stockpiles in Cushing accumulate.
19. Fears that unrest in Libya will spill over to other parts of North Africa and the Middle East increase.
20. NATO destroys Libyan government tanks; unrest has triggered violence in Egypt and Tunisia.
21. Osama bin Laden’s death.
23. Sanctions against Iran and positive economic signs from US and Germany lead to the longest oil winning streak since 2010.
24. Start of two day summit in Brussels to discuss European debt crisis, in particular economic issues in Spain and Italy.
25. US jobless claims hover near highs witnessed earlier in the year in January.
26. Brent premium to WTI increases to US$ 23.18/bbl. OPEC believed to be cutting crude shipments and maintaining tight supply in global markets.
27. Conflict in Syria causes western powers to prepare for intervention following the alleged use of chemical weapons by President Assad.
28. US domestic crude production grows and stockpiles of petroleum products build.
29. Geopolitical tensions increase over Russia’s presence in the Crimea and violence in Iraq.
30. OPEC refuses to cut production at November meeting.
31. Oil ministers acknowledge the existence of a price war between US shale producers and OPEC/traditional oil sources.
32. OPEC cuts global oil demand forecast for its oil by 100k bbl for 2016.

The cartel continues producing above its quota for seventh straight month and US inventories build to record levels.

Rapid reduction in the Baker Hughes rig count (fewest since 2011) and oil and gas producers indicate reductions in future capital expenditure.

For Investment professional use only, not for public dissemination – Past performance does not guarantee future results.
The question is how OPEC will respond to the beginning of the supply tightening in the US when the group meet again in June after Saudi Arabia has announced price hikes for Asian customers. While the decisions of the cartel are increasingly difficult to predict given that their actions no longer match their stated objectives and relationships between the members are extremely frayed, we believe the group will consider a small cut to production appropriate given that the rest of the world is responding to weaker prices. It is likely to understand that the US can indeed switch production back on quite quickly should prices rebound. Therefore it is unlikely to make anything more than a modest cut while it waits for a more meaningful pullback in US production.

Oil prices are likely to continue to respond to geopolitical events, as they have done in the past (see box below). While these events are difficult to predict, any deterioration in relations between Saudi Arabia and Yemen could drive prices higher. At the same time, easing of sanctions against Iran could pull prices lower.

We expect WTI and Brent to trade at around US$55/bbl and US$65/bbl by year end. In the short-term however, prices could fall further due to storage capacity concerns.

**Natural Gas: Seasonal demand dissipates**

As the current heating season draws to an end, the US natural gas price (US$2.62/MMBtu) sits at a third of the level it started at in November 2014. The price has suffered a similar fate to its crude counterpart; collapsing in response to the exponential growth of shale production and fears of domestic oversupply. Natural gas has failed to gain much support from seasonal heating demand, as improvements in rig efficiency and strong levels of Canadian imports have muted the impact of the recent cold weather. We see risks for US natural gas skewed to the downside in Q2 2015, as seasonal heating demand drops off and growing production quickly replenishes inventories.

April promises to be a volatile month for natural gas prices as investors attempt to price in the impact of the first injections into underground storage, marking the end of winter and its associated heating demand. In the last three weeks alone the price has dropped 6%, representing the seasonal shift from winter. In comparison, this time last year the polar vortex eroded US gas stocks to the lowest level since 2003 (822bcf), which was 45% below the 5-year average at the time. More importantly, what followed was the most rapid build in gas inventories witnessed in over 12 years. The accumulation was supported by US shale production which averaged 41bbcf/d during the period. In comparison, current stocks sit 12% below the 5-year average and shale gas production has grown 12% to 46bbcf/d. Hence, now that injection season has started the natural gas price will likely come under pressure from bearish fundamentals.

We believe that production growth will continue on its upward path until the second half of the year, largely underpinned by improvements in rig efficiency and progression of projects designed to ease the bottleneck of gas supplies in the North-eastern Appalachian basin. In response to low prices, producers have focused on the application of techniques such as pad drilling and high grading to reduce costs and maintain output levels.

This has allowed producers to maintain production while utilising far fewer rigs – an example is the Marcellus formation, which is responsible for 36% of US shale gas output - production in February has risen 19% while the total rig count fell 15% in a single month. The price has suffered a similar fate to its crude counterpart; collapsing in response to the exponential growth of shale production and fears of domestic oversupply. Natural gas has failed to gain much support from seasonal heating demand, as improvements in rig efficiency and strong levels of Canadian imports have muted the impact of the recent cold weather. We see risks for US natural gas skewed to the downside in Q3 2015, as seasonal heating demand drops off and growing production quickly replenishes inventories.

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### Historical March-May El Niño Precipitation Patterns

Source: NOAA. Difference from average March-May precipitation (top) and how often that anomaly occurred (bottom) during ten El Niño years between 1953 and 2010.

However, those conditions are currently extremely weak and the probability of El Niño lasting until the Northern Hemisphere summer stands at only 50–60% according to NOAA. Thus we have gone through another season without a real El Niño. We don’t expect a crop impact from current El Niño conditions and it would be unusual see any acceleration in atmospheric response to the elevated sea temperatures during the spring.

That doesn’t rule out another El Niño developing later in the year, but the ability of meteorologists to forecast past the Northern Hemisphere spring remains low. Having said that, it is worth keeping El Niño on the radar as there is generally a positive correlation between elevated subsurface sea temperatures in March and El Niño conditions developing in between November and January (a period more likely to have a crop impact). At the end of March subsurface anomalies had a reading of about 1.5, favouring El Niño conditions later this year if the correlation holds. However, there is no causal linkage between temperatures today El Niño later in the year and the spread around the best-fit remain quite wide.

### Using March Subsurface Sea Temperatures to Predict El Niño Later in the Year

Source: NOAA.

Winter (November-January) Oceanic Niño Index (ONI) values (vertical axis) shown against March subsurface temperature anomalies. Each dot represents the value for a particular year (1980-2014) corresponding to March and November-December. The ONI is one ENSO index that is used to determine El Niño and La Niña states, which are shaded in red and blue (note: there are others). The solid red line is based on least-squares linear regression.

### Grains: Corn and wheat supply likely to tighten in new planting season

US farmers intend to reduce planting of corn and wheat this year after a strong crop last year. USDA surveys point to corn planting falling to a 5-year low.

Given that last year near-perfect weather conditions contributed to a strong yield, we doubt that corn and wheat output will be matched this year. Reduced planting should therefore bode well for corn and wheat prices. Soy on the other hand will see its planting increase in the US, adding to the surplus that has been driven by strong yields in South America.

### US Wheat, Corn and Soy Planted

Source: ETF Securities, Bloomberg
Softs: Victim of currency wars

Arabica coffee has fallen over 60% since mid-October 2014. While the price had rallied excessively in 2014 in response to the drought in Brazil at the time, the recent crash in prices appears equally excessive. In fact the 2014 drought which lasted into the February 2015 had damaged Brazilian coffee bushes, threatening a poor yield for 2015. That has not changed regardless of the recent rain in Brazil. Brazil produces approximately 45% of global Arabica coffee, placing it in the driving seat for coffee prices.

Brazilian Real weakness has encouraged farmers to off-load existing stock, keeping the market well supplied for now, but a second year of Arabica supply deficits in a row should drive some tightness later this year. The Brazilian Real has fallen by over 40% to a 14-year low against the US dollar, highlighting how unusual the situation is. But coffee stocks are not unlimited, providing a floor to coffee prices.

Speculative shorts in Arabic coffee have risen sharply and we believe the market will be ripe for a short-covering rally once the rain subsides and if the Brazilian Real firms.

Sugar has also been affected by the real weakness. Brazil produces approximately 25% of global raw sugar. Recent rain has also placed favourable growing conditions on this year’s crop. However, in contrast to coffee, we don’t expect a rapid recovery in sugar prices even if the Brazilian real firms. The global sugar market is likely to go into its fifth consecutive year of supply surplus. India has awarded its sugar mills a subsidy to export up to 1.4 million tonnes of sugar, which threatens to flood the global market with more supply. And lastly ethanol production in Brazil, a key source of demand for cane is likely to remain subdued amid the political and economic turmoil in the country and low petroleum prices. With Brazilian ethanol production consuming less cane, the price of cane will likely fall, allowing sugar to be produced at a lower cost.
CURRENCIES

Summary

The pervasiveness of negative interest rates – be they official rates or deposit rates - as a policy tool across Europe has led to widespread G10 currency weakness against the US Dollar. Central bank policy and the expected divergence of monetary policy, as the recovery paths of major economies differ, has been the main performance driver for G10 currencies and we expect this to continue over the coming quarter.

While we expect some near-term consolidation in USD gains, over the longer term we expect the USD rally to resume, with the Euro and Yen likely to be the underperformers. Both central banks (ECB and BOJ) have committed to aggressive QE programs and the flood of liquidity is likely to keep these currencies under pressure as any tightening of policy is not expected ahead of 2016 at the earliest.

USD: All about the Fed

The USD index reached the highest level in 12 years in March, and alongside record speculative long positioning, the rally appears stretched. The USD’s rally is being driven by the continuation of the US economic recovery and investor expectations for tighter policy from the Fed, in stark contrast with those for other major central banks.

Despite removing the much publicised ‘patient’ approach toward policy normalisation, the Fed remains pragmatic. Indeed, little has changed on the economic front; economic indicators have been relatively soft. Meanwhile wage growth remains weak and household spending has moderated recently. Despite improving economic activity, inflation indicators have begun to trend lower. As a result, we feel there is scope for a modest reversal in the USD rally.

While market expectations currently indicate that the Fed will hike rates around September, we feel this is priced into current USD cross rates. With the USD Index indicating that the current strength of the rally has moved out of line with interest rate differentials the risk is skewed towards a near-term USD correction. Additionally, we expect further caution to appear after the soft March jobs data, leading to near term consolidation for the USD.

European Central Bank (ECB) has committed to aggressive QE program and that depends on the path of inflation. In turn, if QE can stimulate demand, the Euro may start to form a bottom late in early 2016.

We expect that parity in EUR/USD, if it occurs, will be a long time coming and will be subsequent to the US Fed beginning its policy tightening cycle. However, we feel that the current strong stimulus from the ECB will engender a recovery, albeit very gradual and quite late – over 5 years after the global financial crisis. We expect the Euro to grind lower in coming months toward 1.05 against the USD as rate hikes are increasingly priced in for the US.

CHF: Surprise Surprise

While the ECB and the BOJ are dominating the front lines of the currency wars, there have been some casualties. The Swiss National Bank (SNB) lost its balance sheet battle with the market as the ECB’s QE programme threatened to overwhelm...
its resources. Despite the surprise removal of the floor for EUR/CHF, the SNB expects its move further into negative territory for rates ‘is set to have a corrective effect on the Swiss Franc’s overvaluation. Indeed the SNB expects short-end interbank rates to be significantly negative until inflation becomes positive in 2017. Negative rates are a clear deterrent for banks to hold cash and with the lowest official rate in the world, the attraction of holding the Swiss franc as a safe haven asset is long gone.

Risks for the Swiss economic growth are heavily skewed to the downside as the jump in the currency begins to exert adverse effect on economic activity. As a result we expect that the recent strength in the Franc could unravel as the pace of growth gradually builds in neighbouring economies and weakens locally.

We anticipate EUR/CHF will likely to move back toward the 1.10 level over Q2 2015. The SNB anticipates remaining active in currency markets but we feel that unless more concerted action is taken by the central bank, CHF is unlikely to attain the floor 1.20 level again in 2015.

**CAD: Pulled in different directions**

As we anticipated, the Canadian Dollar has strengthened against the Euro, and come more into line with interest rate differentials, and we expect a further appreciation over the second quarter as the external sector provides further assistance, partially offsetting weakness in economic activity dependent on the energy sector. While the Bank of Canada (BOC) has become more supportive with policy rate reductions, a direct result of the lower oil price on the economy. The central bank expects that recent rate cuts have stabilised the inflation profile and we feel that the benefits of lower oil prices on consumption will allow the BOC to maintain its current policy stance and not ease further.

The Canadian economy also has the twofold benefit of a large proportion of its exports heading south to US markets. Firstly as the US economy continues to improve, export volumes should benefit. Secondly, as the US Dollar remains above historical levels, Canadian exports have become more competitive, giving additional impetus to the external sector, while at the same time hampering import competitiveness and prompting domestic substitution.

We anticipate that as the market becomes more comfortable with the next move in Canadian rates being higher that policy will gradually fade as a driver of CAD in coming months. As oil prices will also provide upward impetus for the Canadian dollar.

**GBP: Slow and steady**

The British Pound has been the main European beneficiary of the accommodative policy from European central banks. The pound has strengthened considerably as the ECB has been forced to pursue a full blown QE policy to offset deflationary forces. The rise in GBP has come at a time that expectations have been sharply unwound that the Bank of England would begin to tighten policy in 2015. Hawkish members of the MPC have become dovish as low oil prices and sluggish wage growth have pushed inflation to zero for the first time on record. Business investment has been an area of weakness in an improving economic environment, surprising to the downside as the energy sector makes cutbacks. We expect the uptick in UK economic momentum to continue with consumer confidence at over decade highs, in turn boosting retail sales to a decade high. We expect the GBP to stabilise against the USD, but against the Euro the outlook is more favourable and we expect further appreciation in the medium term, notwithstanding the potential impact of the upcoming general election.

GBP uncertainty on the back of elections is a considerable risk. Sterling is likely to continue to experience rising volatility in coming months, as the lack of a clear favourite in the upcoming general election and the trend of rising popularity of parties on the fringe in European politics could lead investors to question the conviction of the current British government in adhering to budgetary prudence. Rising volatility could spark an unwind of the Pound’s current strength against Euro and could see further downside against the USD.
rates and we expect that the Krona will remain under pressure against the Euro with the Swedish economy dependent on the external economic environment. The Riksbank then followed its negative deposit rate move by pushing official rates into negative territory for the first time in February 2015.

We expect that the Swedish Krona will remain soft against major crosses until there is clear evidence of a sustainable rise in price pressures and an improvement in external demand. Certainly, the committed, supportive stance from the Swedish central bank will continue to have a deflating effect on SEK after it noted that it is 'still ready to make monetary policy even more expansionary'. We expect that EUR/SEK could make gains against the Euro in the medium term, grinding toward 9.25 by year-end.

**NOK: Oil negativity to fade**

Meanwhile, its Nordic neighbour has seen the Norwegian Krone remaining under pressure as oil prices continue to struggle against the weight of abundant global supply. The lacklustre performance of commodity prices has added to the downward pressure exerted by central banks for currencies that are highly leveraged to commodity trade, like the AUD, CAD, NOK and NZD. Nonetheless we expect improving commodity landscape will cease to be a weight for commodity currencies in H2 2015.

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**JPY: Slow and steady**

Recent communications from the Bank of Japan suggest that the central bank is comfortable both with the progress made on the Japanese economic front alongside its current policy stance. In view of this, we do not expect any significant moves to occur for the Yen. We expect that the recovery will be slow and steady and that the quantitative easing program from the BOJ will continue at its current rate.

The first tendrils of wage growth appear to be starting to take root, in turn helping inflation stabilise around the 2% level, in line with the BOJ target. Although there has been some volatility in industrial activity, survey evidence shows that business attitudes are stabilising in the manufacturing sector. We expect that USD/JPY will grind higher toward 125 by year end.

**SEK: Negative rate pioneer**

Elsewhere in Europe, the combination of QE and low/negative rates has also been used to counter the appreciation of the Swedish Krona, by the Riksbank, in a bid to ward off the threat of deflation. Despite rising trend growth in 2014, inflation has only just nudged above zero in February 2015, far from the 2% central bank target. Additionally, while household consumption is improving, industrial production remains firmly in negative territory in 2015.

The Swedish central bank was the pioneer of negative deposit
AUD: Jawboning the Aussie lower

The Australian dollar remains mired below the 0.80 USD level and looks unlikely to break higher on a sustainable basis for the foreseeable future. Interest rate differentials and the terms of trade remain the key drivers for the Aussie Dollar and are likely to continue to pressure AUD lower in coming months.

The Reserve Bank of Australia (RBA) appears determined to support the non-mining economy with accommodative policy, and continues to help the AUD lower with its rhetoric indicating the currency remains overvalued. AUD reached the lowest level in nearly six years in March, and recently almost hit parity with the New Zealand Dollar. While Australian official rate is the second highest in the G10 (only New Zealand has higher official rates), it looks set to move lower in coming months. The RBA will continue to be measured in its policy stance and appears to be looking at a higher hurdle rate than the market expected for a rate cut.

Meanwhile, despite the stabilisation of Chinese economic activity, AUD remains susceptible to fragile sentiment surrounding the Chinese growth path. The Australian Dollar’s linkage to its terms of trade will add an additional layer of downward pressure as long as commodity prices, particularly bulk commodities like coal and iron ore, remain depressed. We expect that AUD will move gradually toward 0.75 USD over the next quarter.

Kiwi: Unjustifiably high?

The Reserve Bank of New Zealand (RBNZ) contends that despite a strengthening underlying economy, the local currency remains ‘unjustifiably high’.

Both the household sector and business investment have been rising strongly, helping the NZ economy post the strongest growth in since 2006 in Q4 2014. Despite this the NZD has lost ground and reached the lowest level in four years in March 2015.

Nonetheless the RBNZ remains somewhat concerned about risks to the dairy sector, as a result of dry weather conditions – some parts of the South Island are in drought and parts of the North Island are also susceptible. New Zealand is the world’s largest exporter of dairy products, which accounted for nearly 40% of the total value of its merchandise exports in 2014. As a result, NZD remains closely linked with dairy prices.

As yet though, inflation expectations remain in a downward trend as a result of oil and dairy price declines. The housing market is expected to provide some impetus to inflation rates, and a gradual rise toward the central bank target price level is anticipated, but progress is likely to be restrained in line with other G10 countries.
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