27 May 2010

Commodities Monthly

Correction - not a change in direction

We have revised down our near-term price forecasts following the recent sell-off in risky assets despite improving fundamentals, not least in the OECD region. While risks of further setbacks remain, what we have seen over the past month is, in our view, merely a correction, not a change in the course for commodities.

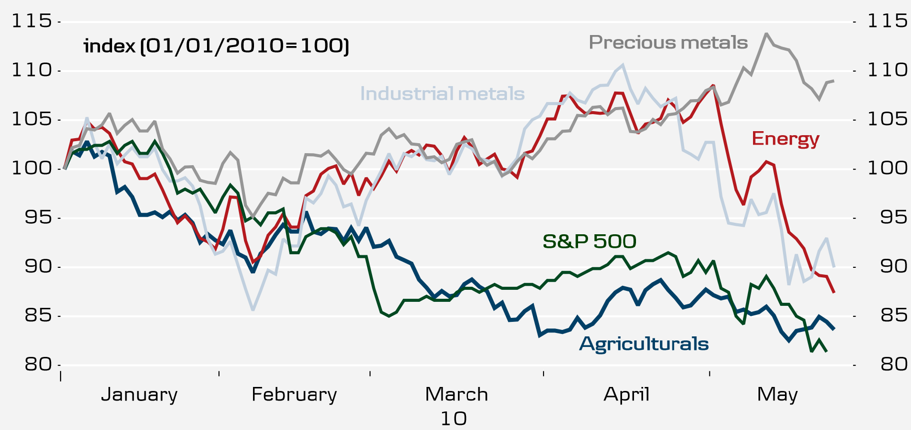
Oil prices have plunged while coal and natural gas have roared ahead. Demand looks increasingly healthy as OECD recovers and Chinese demand proves resilient. We now look for global oil demand to come in at 86.6 mb/d and see OPEC keeping production in check. The forward curve has steepened, exacerbated by future supply concerns.

We take a closer look at the market for residual fuel and conclude that the compression in bunker spreads to crude could stay within the USD5-15 per barrel range this year.

The cyclical base metals have taken a hard hit from plummeting risk appetite. Still, underlying demand looks very strong. We argue that the metals will eventually fight back as economic concerns recede. Our call for copper to outperform aluminium remains intact despite some downward level corrections.

The grain complex has proved remarkably resilient lately. We still pencil in weakness in wheat as large inventories and good crop progress weigh whereas growing ethanol demand should give a structural boost to corn prices.

Correction in cyclical commodities as risk appetite fades across financial markets



Source: EcoWin, Danske Markets. Note: GSCI spot return indices.

Key points

- We are revising down our near-term price forecasts after the recent sell-off, but see potential from current levels, as commodities have largely defied improving fundamentals of late.
- We now see Brent oil averaging USD80 in 2010 and USD90 in 2011, benefitting from a recovery in OECD demand and OPEC production restraint.
- We have pencilled in modest potential for aluminium and see prices at a mere USD2,250 in 2010. In contrast, our forecast for copper remains bullish and we see prices hitting USD8,000 towards the end of this year.
- Grains could diverge as wheat looks increasingly weak while corn stands to benefit from rising ethanol demand. Liffe wheat to average EUR131 in 2010.

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Short view: Defying fundamentals

It would seem natural to ask what has happened to fundamentals after a month during which commodities have largely seen intraday movements guided by swings in global risk appetite. The causes are not very different compared with previous months: continued fears over southern European debt problems, monetary policy tightening in China and concerns about the effects of financial regulation. However, their influence on markets for risky assets has clearly been augmented in recent weeks. Investor sentiment has continued to deteriorate despite the attempts of EU policymakers to stem the euro confidence crisis. While commodities most leveraged to the business cycle – such as metals and oil – have suffered distinct losses, gold has surged to new record highs on safe-haven demand.

Still, our economists anticipate that the rescue package, which EU policymakers eventually agreed upon in mid-May – will ultimately do its job in stabilising borrowing conditions for debt-ridden countries, see *Q&A on the EU debt crisis*. However, they also stress that the road to recovery in the eurozone will most likely be a rather bumpy one and that event and political risk remain high. Notably, we should not forget that commodities is one area that politicians seem keen to regulate in order to limit any price impact of the speculative segment. Also, the risk of another set-back in global risk appetite is certainly still pertinent and could continue to weigh in the short term.

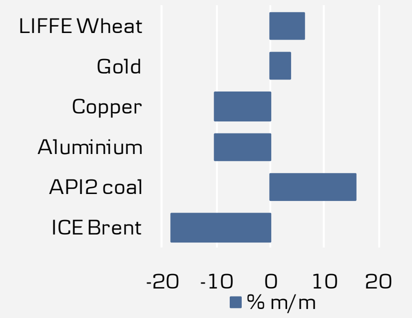
In our view, as long as Europe avoids contagion and an outright banking crisis, global growth should not be endangered by recent events as the recovery momentum currently appears remarkably strong. Indeed, we think that commodity markets have to a large degree been defying fundamentals recently, essentially pricing in a double-dip recession in Europe which is not our base scenario. Although the fact that fiscal tightening will arrive sooner than previously anticipated in the euro area should weigh on growth, commodity-intensive regions – such as Asia and the US – may in fact see even stronger activity levels than previously forecast. Crucially, we are now witnessing the first decisive indications that commodities are about to see an OECD demand recovery. For metals, this has been under way for some time now but new is an expansion in not least US demand for oil.

Thus far, we do not think that financial-market turmoil has affected the macro environment to any great extent. In fact, interest rates now look set to be lower for longer, which should be supportive for risky assets in general. Our equity strategy team projects that stock markets have corrected too far and is looking for outperformance in the coming months on the back of strong Q1 earnings.

Although the longer-term global growth outlook seems broadly intact, we cannot rule out the possibility of further setbacks in the near term. One of the things to look out for is appreciation of the Chinese yuan. We reckon that commodity markets may be spooked by this at first sight but that the complex will eventually benefit from more balanced growth. Also, our FX team now looks for EUR/USD to weaken further on a six-month horizon, arguing that political risks and relative rates could weigh on the single currency for months to come. Further out, dollar weakness could set in however. As a re-coupling of commodities with the dollar may be occurring at present, this could affect prices.

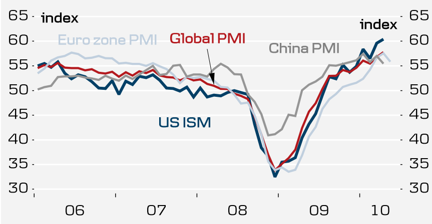
On the whole, we expect a re-coupling with supply-demand factors in the months to come, benefiting not least cyclical products such as base metals and oil, in particular distillates. Importantly, we view the recent correction as just that: a setback adjusting prices levels, leaving the course of commodities essentially unchanged. Hence, forecast revisions this time mainly relate to a revised EUR/USD profile and some level corrections. Notably, we now look for Brent to average USD80 (prev. 86) this year and USD90 (prev. 94) in 2011.

Monthly changes



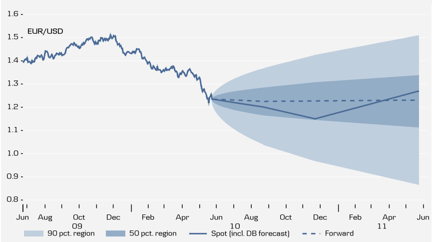
Source: Bloomberg, Danske Markets.

PMIs strong but signs of a soft patch



Source: EcoWin, Danske Markets.

More EUR weakness ahead – but worst is probably over



Source: Bloomberg EcoWin, Danske Markets. Note: historical EUR/USD spot rate, Danske Markets' forecasts, forward rates and uncertainty priced on the option market.

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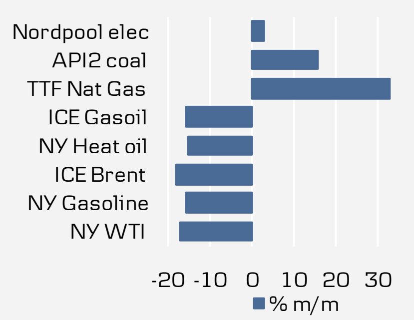
Energy: Setback amid OECD demand recovery

Setback in oil as coal and natural gas roar ahead

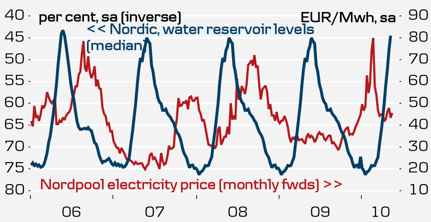
The past months have seen a considerable correction in oil prices with crude prices down by close to 18% m/m. Cracks have been only slightly more resilient and are down around 15% on the month. In contrast, the rest of the energy complex has not only held up well, both coal and European natural gas have in fact witnessed impressive price rises, held up by fewer shipments of liquefied natural gas (LNG) in Europe and cold weather in the UK. This means that the gap between spot and oil formula-based prices of natural gas is narrowing, albeit the gap remains wide. Moreover, Nordpool electricity prices have risen a little due to a shortfall of hydro power. However, the significant improvements in industrial activity in Europe – identifiable by the upsurge in PMIs in April notwithstanding the setback in May – have also helped to support the energy (excluding oil) sector.

Monthly changes



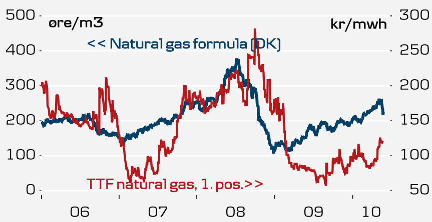
Source: Bloomberg, Danske Markets.

Electricity prices spike when water reservoir levels decline



Source: EcoWin, Danske Markets.

Natural gas spot prices start to close the gap with oil-based formula



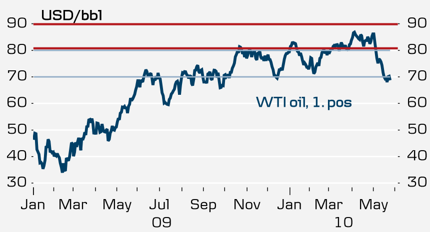
Source: EcoWin, Danske Markets.

Volatility is back in oil

Regarding oil prices, developments in recent months with marked gyrations in global risk appetite, have shifted oil prices away from the USD80-90/barrel range, which was established during March and April. Lately we have even seen prices testing the lower bound of the USD70-80 range in which prices traded during the autumn. Global risk sentiment has been impaired by European debt woes and the market has become hyper-sensitive in a rather asymmetrical fashion, reacting mainly to bad news, whereas upbeat economic data has received little attention.

We have admittedly been somewhat surprised to see the slide in prices below USD70/barrel as oil-market fundamentals have in our view actually improved. The correction has simultaneously interrupted a downward trend in implied volatility that has been ongoing since last autumn. At the same time, volatility in equity markets as measured by the VIX index has risen markedly. Although oil may continue to take its direction from risk in the near term, we look for a re-coupling with supply-demand factors in coming months and we remain confident that this will provide price support.

Oil prices shift trading range – but downward this time



Source: EcoWin, Danske Markets.

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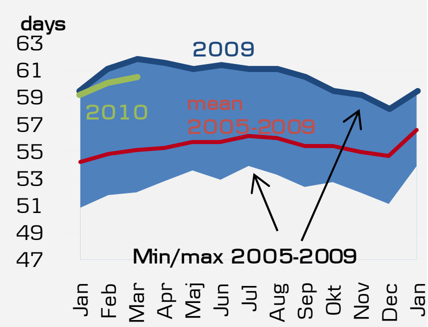
Demand: OECD recovers and Chinese demand proves resilient

In 2009, oil prices rose largely on mere expectation of a recovery in oil demand. Now as confirmation that consumption is picking up on a global scale is arriving, paradoxically the market has reacted by sending prices slower.

OECD recovers gradually

In the OECD region, total product demand has improved is now back within the min/max range for the past five years, as both US and European demand are recovering fast. The latter has been helped by pronounced strength in German consumption. At the same time, OECD forward demand cover has edged higher to 60.5 days in March. This is partly due to an increase in OECD stocks, but it is worth noting that April-June is in fact the weakest time of year in terms of demand, thus weighing on the forward-demand calculation. Indeed, days of consumption that can be honoured based on current inventories are below levels seen in 2009. Overall, we view this as conclusive evidence that OECD demand is evoking on a gradual but significant recovery path.

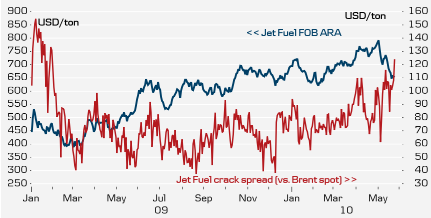
OECD forward demand cover



Source: IEA, Danske Bank.

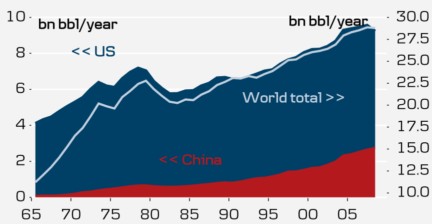
April saw a week of severe disruptions to flight traffic, with some 70% of all flights cancelled. IEA estimates that close to 1.2 mb/d of jet fuel demand was lost during the eight day period. This is equivalent to 20% of total consumption under normal circumstances. While the episode may not be over yet – we have already seen air transport impaired somewhat in May – this should have little effect on oil consumption for 2010 as a whole. Notably, demand for other products rose as people searched for alternative modes of transport.

Jet-fuel crack declines on ash cloud



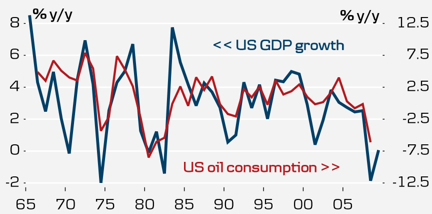
Source: EcoWIn, Danske Markets.

Distribution of global oil consumption



Source: EcoWin, Danske Markets.

Cyclicality in US oil demand



Source: EcoWin, Danske Markets.

Non-OECD remains resilient

Within the non-OECD, China continues to steal the limelight. Chinese apparent demand – i.e. refinery output plus net product imports, rose more than 10% y/y in March. Consumption looks strong across products, with the exception that Chinese demand for residual fuel oil look set to decline further this year as minor refineries no longer process heavy oil to the extent seen previously. The picture is very similar for India, whereas Brazil and Argentina see marked rises in especially gas oil production on increased agricultural activity.

Chinese imports resilient in April despite extraordinarily strong March figures

	Latest	1M ago	m/m	1Y ago	y/y
Copper (1000 tonnes)	436	456	-4%	400	9%
Aluminium (1000 tonnes)	93	95	-2%	440	-79%
Crude Petroleum Oil	21	21	1%	16	31%
Steel Products	2	2	-8%	2	-7%
Soybeans	4	4	5%	4	13%
Iron Ore & Concentrate	55	59	-6%	57	-3%

Source: Bloomberg, Danske Markets. Note: all figures in 100,000 tons unless otherwise stated.

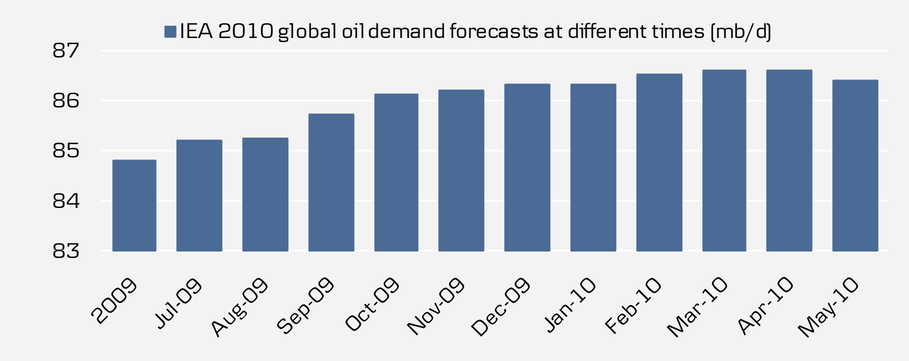
Chinese import data remain a focal point for commodity markets. In April, commodity imports declined for most products following extraordinarily strong March figures and sustained price rises. However, imports of crude oil actually rose a little and are up 31% y/y. Coal imports were down slightly, whereas LNG imports hit an all-time high. Chinese energy consumption is growing fast, with electricity use up more than 20% last month. Hence, buying abroad does not purely lead to stockpiling in China. All in all, this shows that non-OECD demand remains resilient and we would not be surprised to see a small increase in crude imports in the months to come following the recent price slides.

However, we should not ignore the risk that a soft patch in global demand could hit oil consumption in coming months. Indeed, whereas the US ISM rose above 60 in May both the Euroland and the Chinese PMIs dipped a little. These are the first signs that momentum is fading and underline that both regions may be starting to worry about fiscal and monetary tightening measures ahead, respectively.

IEA lowers global 2010 oil demand forecast for the first time

In its monthly Oil Market Report for May, the IEA cut its global oil demand forecast to 86.4 mb/d for 2010, contrary to our expectations of an upward revision on the back of higher IMF forecasts for global growth. The main reason for this was changes to non-OECD historical data: 2000-04 demand was raised while 2005-08 figures came in lower than previously projected. On the whole, the IEA now forecasts non-OECE demand to be 40.9 mb/d while OECD demand was kept unchanged at 45.4 mb/d for the year on average. At the same time, higher forecasts for economic growth from the IMF were largely balanced by the negative effects on demand from a higher projected oil price this year. Notably, the IEA now looks for crude prices to average USD77 per barrel in 2010, which compares with our forecast of USD80.

IEA global oil demand forecasts for 2010 in different Oil Market Reports



Source: IEA, Danske Markets.

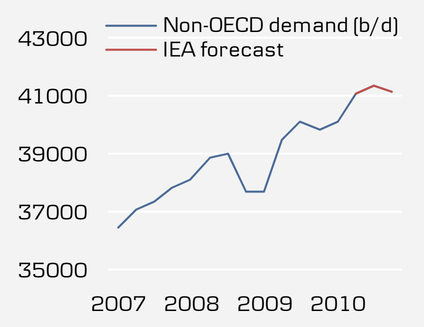
As a result of the changes to historical non-OECD data we have also revised down our 2010 demand forecast slightly, to 86.6 mb/d. However, as our economists remain slightly more optimistic on OECD growth than the IMF, this spills over to our oil demand forecast. In contrast, we are more or less in line with IMF on the Chinese outlook and thus broadly agree with IEA on non-OECD demand this year.

Global oil demand with forecasts

mb/d	2008	2009	Danske 2010	IEA 2010
OECD	47.6	45.5	45.7	45.4
non-OECD	38.4	39.3	40.9	40.9
Total demand	86	84.8	86.6	86.3

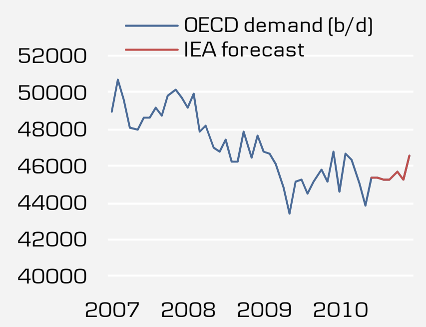
Source: IEA, Danske Markets.

Non-OECD total demand



Source: IEA, Danske Markets.

OECD total product demand

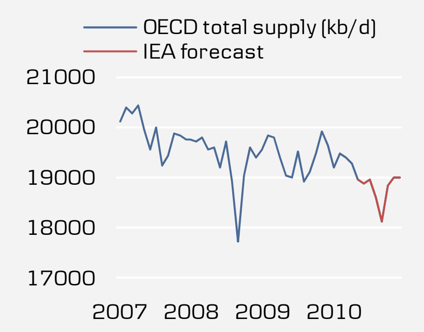


Source: IEA, Danske Markets.

Supply: OPEC supply creeps up, but members starting to worry

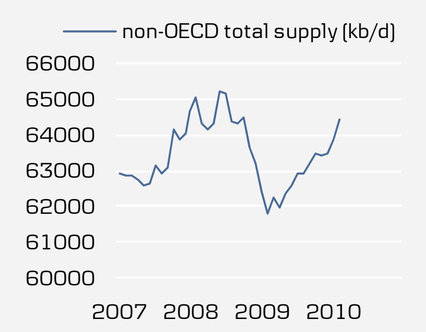
During the month of April global oil supply was largely unchanged as a rise in OPEC output was offset by a decline in non-OPEC production, the latter caused primarily by seasonal factors reducing supply from the North Sea and Canada. In line with the IEA we expect non-OPEC supply to rise a little this year as declining production in Europe is more than offset by rising supplies from Russia and Asia.

OECD supply is waning but IEA looks for a small rebound later this year



Source: IEA, Danske Markets.

Non-OE CD output has increased as OPEC raises production



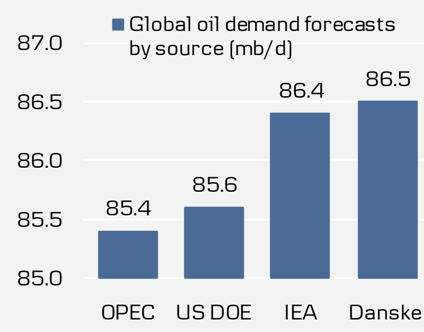
Source: IEA, Danske Markets.

BP's leaking oil rig in the Gulf of Mexico has so far had little impact on ongoing oil operations in the area and the Deepwater Horizon rig was in itself too small to matter in terms on the output side. However, there are now indications that the incident could imply tighter offshore safety measures and may lead to fewer new offshore licences been auctioned going forward. Thus while the near-term supply picture is largely unaffected by the spill, it is essentially putting "peak oil" worries back on the energy outlook agenda.

The IEA estimates that OPEC compliance fell to a mere 55% in April, with OPEC-11 production now running at 26.8 mb/d compared with a quota of 24.8 mb/d. Angola and Nigeria continue to produce more than their allotted quotas. Not least, Iran increased production significantly last month. However, weaker demand for the heavier, sour Iranian crude – partly due to unattractive prices and partly due to the threat of UN sanctions – has led the country to add to floating storage rather than increase shipments abroad.

On the whole, we remain confident that oil demand will exceed OPEC's current forecast of a mere 85.4 mb/d in 2010 and thus that we will see a faster-than-expected rise in OECD demand and hence in stocks than both OPEC and the market anticipate at present. In fact, a range of OPEC officials have voiced concerns over the slide in prices and while outright cuts in quotas seem unlikely, it cannot be ruled out that a meeting to discuss the need for improved compliance will be called extraordinarily should prices decline further. We believe the cartel has little reason to worry, however, but OPEC action could work to put upward pressure on crude prices.

Global 2010 demand forecasts



Source: OPEC; DOE, IEA, Danske Markets.

Global oil supply with forecasts

mb/d	2008	2009	Danske 2010	IEA 2010
OECD	19.3	19.4	19.4	19.4
non-OECD	28.8	29.4	30.2	30.2
OPEC	35.6	33.3	34.2	n.a.
Misc	2.7	2.7	2.7	n.a.
Total supply	86.4	84.8	86.5	n.a.

Source: IEA, Danske Markets.

Stocks: Oil market to see a small deficit this year

On balance, we anticipate that the global oil market will see minor stock draws during the course of the year. The last time a decline in global stocks was seen was 2007 – last year the market was largely in balance. With consumption simultaneously picking up, this should lead forward-demand cover to decrease gradually, albeit we may not reach the 52-54 days for the OECD region that OPEC prefers until the end of the year.

Global changes in oil stocks

mb/d	2008	2009	2010
Stock change	0.4	0	-0.1
Prices (USD/bbl)	102	71	80

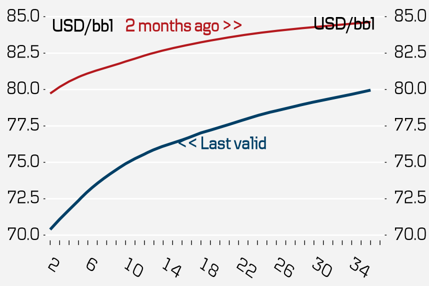
Source: IEA, Bloomberg, Danske Markets.

Forward curve: downward shift as contango steepens

The massive sell-off within the oil segment has implied a marked downward shift of the crude forward curve. However, the slope of the curve has also clearly changed with a pronounced steeping of the contango.

First of all, a continued build-up in stocks at the delivery point in Cushing Oklahoma has exerted downward pressure on the front end of the WTI curve, despite the fact that North American inventories of crude have been relatively stable since New Year. This has been partly caused by logistics in the Mid-West and extended Q1 maintenance at US refineries. The differential between Brent and WTI prices has already narrowed and we expect this to continue in coming weeks. Notwithstanding, this episode highlights that the WTI contract does not constitute a very good benchmark for global crude prices as regional factors have a large influence on prices.

WTI forward curve

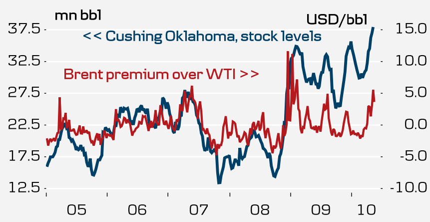


Source: EcoWin, Danske Markets.

Second, worries over the regulatory effects of the BP oil leak has fuelled market worries of future supply shortages and thus exerted upward pressure on far-dated contracts. As an example, December 2018 contracts still see crude prices above USD90/barrel. It is worth noting however that OPEC currently has large spare capacity and with Iraq planning to expand operations markedly over the next decade, it is in our view too early to price in a supply crunch.

As a result of the current steep contango in the front of the curve, we have maintained our tactical recommendation of an underweight in commodities in order to mitigate the significant negative roll yield, see *Tactical Monthly* .

Cushing build-up depresses WTI



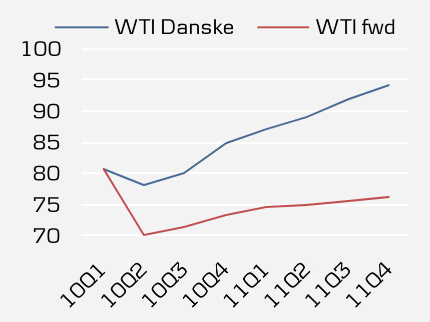
Source: EcoWin, Danske Markets.

Oil-price forecast: current levels look attractive from a buying perspective

Our fair-value models for crude oil highlight before the May sell-off, both WTI and Brent prices were actually broadly in line with model indications. This suggests that with unchanged fundamentals we could expect to see prices bouncing back in the near future. However, a version of the model augmented with financial factors such as the stance of US equity and bond markets does not point to undervaluation at present, rather the contrary. Indeed, as long as risk appetite among investors stay muted so will oil-price increases.

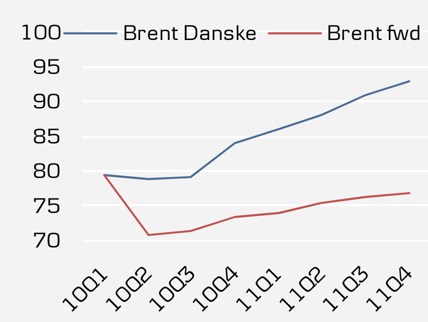
As a result, we expect to see volatile, but on average broadly flat, trading in the rest of Q2. However, the market should eventually eye the improvement in underlying fundamentals and see a rebound in H2. Consequently, we have revised down our oil profile only slightly and now pencil in a Brent average of USD80 in 2010 but we see prices edge higher going into 2011 to arrive at an average of USD90. The spread between Brent and WTI should normalise to one dollar in Q3.

WTI: Danske Markets vs forward



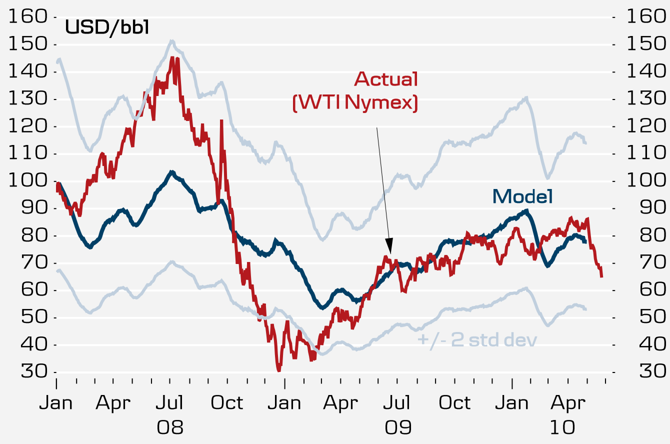
Source: Bloomberg, Danske Markets.

Brent: Danske Markets vs forward



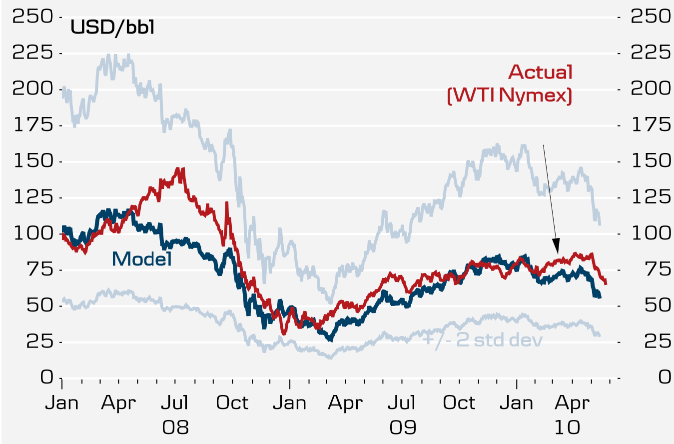
Source: Bloomberg, Danske Markets.

Fundamentals-based model of crude prices suggests sell-off is overdone



Source: EcoWin, Danske Markets. Note: variables include US stocks, China IP, US IP, non-com pos, EUR/USD.

Financial-factors augmented model of crude prices is inconclusive



Source: EcoWin, Danske Markets. Note: variables include US stocks, non-com pos, EUR/USD, S&P500, 2-10 spread, 3m-2y spred.

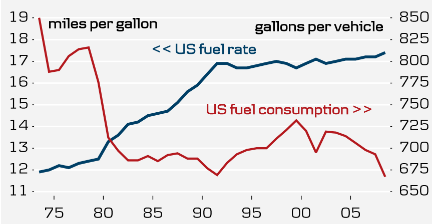
Products: light-heavy spreads to widen moderately

Preceding a detailed description of the bunker fuel-oil market, we review recent developments in light-middle products. We conclude that light-heavy spreads could widen in coming months as notably demand for diesel sees a cyclical upturn.

Gasoline

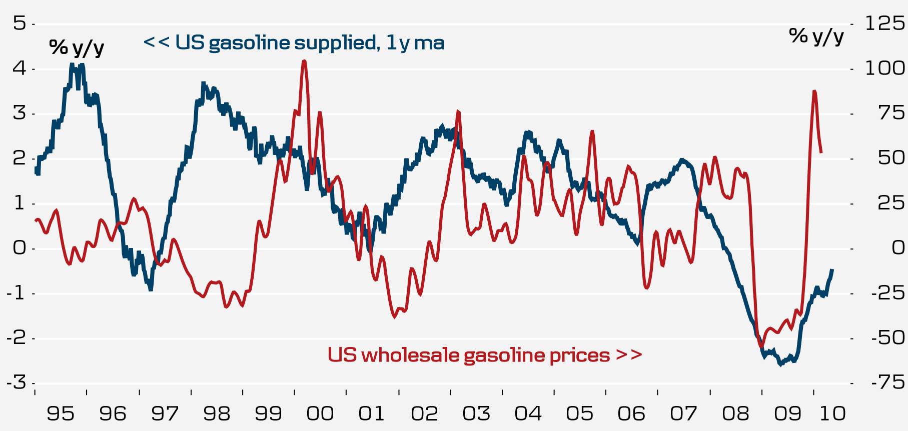
The gasoline crack spread increased at the start of the year despite the fact that US gasoline stocks remain well above the maximum for this time of year seen over the past five years. US wholesale prices have spiked as a result and in Europe the combination of a higher crack spread and a stronger dollar is feeding through to end users, albeit the recent slide in crude prices has mitigated the impact lately. The main reason behind the widening crack is extended maintenance on behalf of refineries and expectations of a robust US driving season. However, a shift toward more fuel-efficient cars implies that even if mileage increases, fuel consumption could rise relatively little. With refinery utilisation being ramped up as refiners chase the increase in margins, we look for muted price increases for gasoline going forward.

More fuel-efficient cars in place



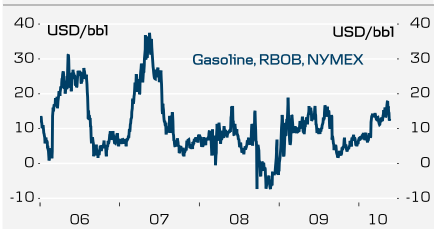
Source: EcoWin, Danske Markets.

Gasoline prices have spiked more than what seems justified by demand



Source: EcoWin, Danske Markets.

RBOB gasoline crack spread

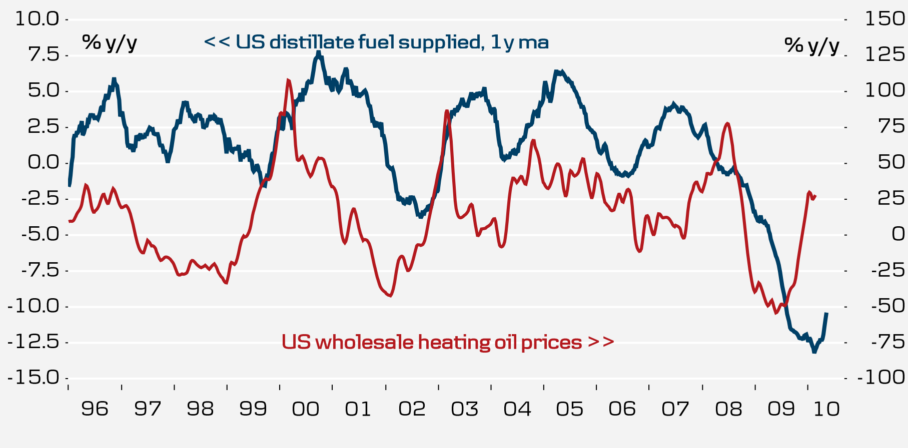


Source: EcoWin, Danske Markets.

Distillate

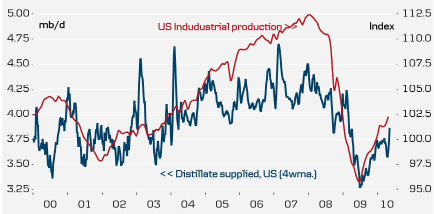
We are more upbeat on distillate demand. Particularly, demand for diesel could be in for a rebound as it stands to receive support from rising industrial activity which increases the demand for transport of both people and goods. The crack spread for heating oil has risen, albeit less so than gasoline, underlining that the distillate consumption has only recently bottomed out. This signals that middle distillate prices could have some further way to go this year and we look for the crack to trade in the USD15-20 per barrel range late-2010.

Price of heating oil has risen in anticipation of higher distillate demand



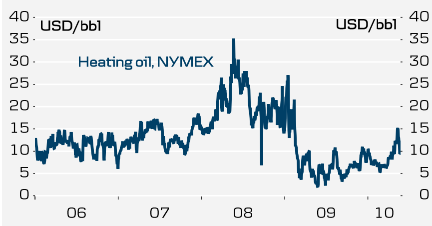
Source: EcoWin, Danske Markets.

Distillate demand highly leveraged to industrial activity



Source: EcoWin, Danske Markets.

NYMEX heating oil crack spread



Source: EcoWin, Danske Markets.

Bunker

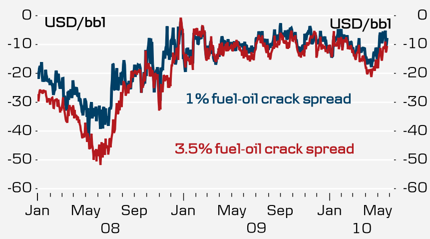
We consider the bunker market in details in the following section and conclude that the bunker crack spread to crude oil is likely to remain at a relatively small discount to Brent during 2010.

Bunker fuel: Crack spread to stay compressed for now

Fuel-oil crack compressed during the crisis

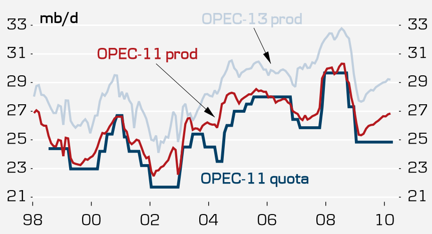
In the wake of the deepening of the global financial crisis in late 2008 and the corresponding plunge in oil prices, OPEC cut production quotas markedly. Production fell from close to 30 mb/d to a mere 25 mb/d, as members initially delivered very high rates of compliance with pledged cuts. Although global inventories of oil have risen significantly as a result of the slump in demand during the recession, there is little doubt that the massive OPEC output decline eventually helped to stabilise the oil market. A relatively quick recovery in Asia, expectations of an eventual recovery in OECD demand and a search for yield in an environment of plentiful liquidity helped induce a gradual rise in the oil price throughout 2009.

Residual-fuel crack spreads



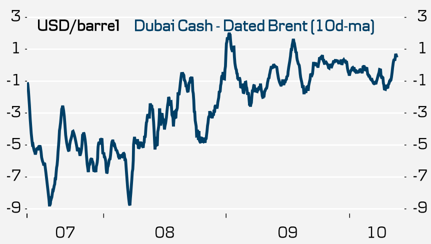
Source: Reuters EcoWin, Danske Markets

OPEC has cut quotas but compliance is down sharply



Source: Reuters EcoWin, Danske Markets

Heavy-light discount has been falling

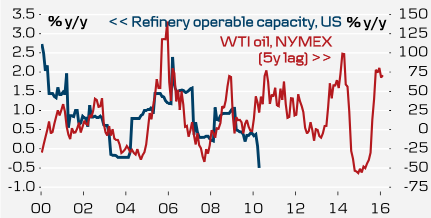


Source: Reuters EcoWin, Danske Markets

In terms of crack spreads, one important effect of the OPEC production cuts was that the cartel put less heavy oil and relatively more light oil on the market: when required to produce less, members unsurprisingly choose to produce the more valuable light oil. At the same time, a lot of new refining capacity – using new technology that enables refiners to tilt production towards more light product per barrel of crude – came on stream just as the crisis accelerated. Notably, the reaction of refining capacity to prices is subject to an approximate five-year lag.

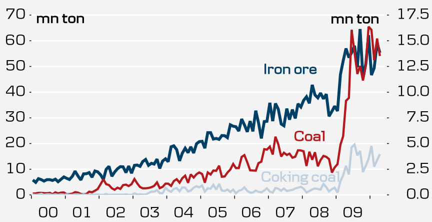
Taken together, this implied that relatively little fuel oil was produced, leading global fuel oil stocks to be run down and, correspondingly, prices to edge higher, despite the simultaneous collapse in global trade.

Refining-capacity additions lag prices by five years



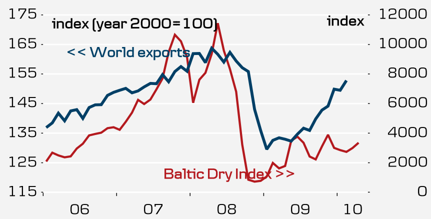
Source: Reuters EcoWin, Danske Markets

Chinese imports of freight-intensive commodities



Source: Reuters EcoWin, Danske Markets

Global trade, and freight indices, collapsed in crisis



Source: Reuters EcoWin, Danske Markets

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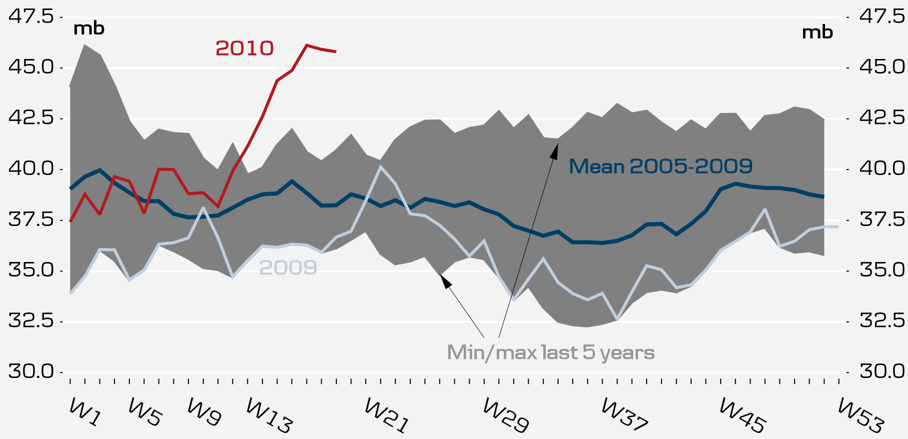
US residual fuel stocks depleted in wake of crisis but spike of late

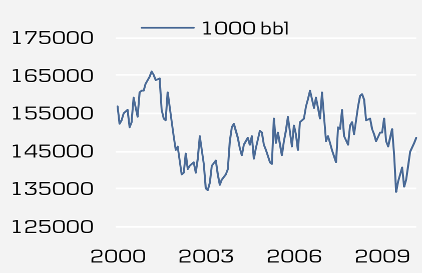


Source: Reuters EcoWin, Danske Markets

Fuel-oil stocks on the rise as both OPEC and refiners increase production

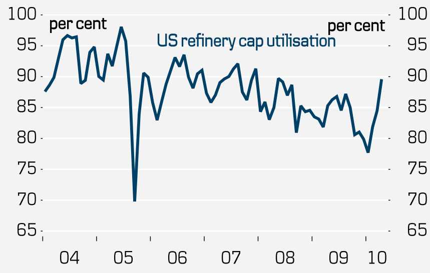
At the start of 2010, residual oil stocks started to rise across the OECD region and US inventories have seen a noticeable spike since March. This coincides with a rise in OPEC output, which introduced relatively more heavy oil to the market. At the same time, the US has seen a rise in utilisation of existing refining capacity, which means that less up-to-date technology is being used, thus producing more fuel oil out of each barrel of crude. These factors contribute to explain the build-up in OECD stocks lately.

OECD residual fuel stocks



Source: IEA, Danske Markets

US refinery utilisation edging higher

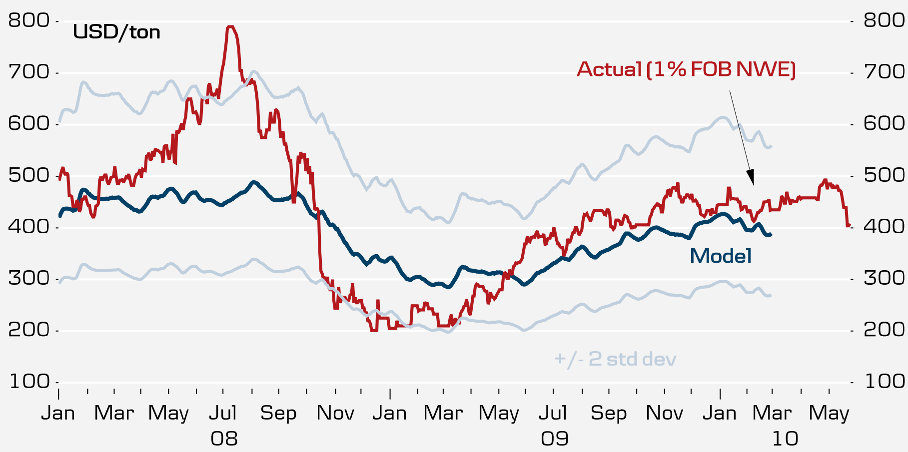


Source: Reuters EcoWin, Danske Markets

However, since April the discount to crude at which fuel oil trades has narrowed once again, and it now stands at a mere USD10, in spite of the rising stocks. Although demand for fuel oil within the OECD has yet to see a marked rebound, strong growth in world trade has increased, not least Asian demand for bunker fuel.

Our fair-value model for bunker fuel suggests that current pricing is close to fair. Our corresponding model for crude prices indicates that the same can be said for the Brent crude price. These models are based on the assumption that fundamentals stay the same in the coming months, but supply and demand fundamentals are changing within the fuel-oil market at present.

Bunker fuel close to fair pricing



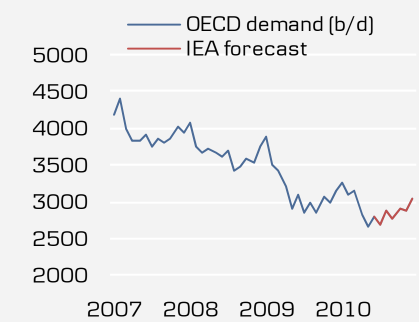
Source: Reuters EcoWin, Danske Markets.

Note: Monthly data since 2002 for Chinese industrial production, US residual fuel stocks, EUR/USD, world export volume and OPEC production levels.

On the supply side, OPEC has raised production in recent months but we think that the cartel will be careful not to increase output too much going forward. We have already seen the first signs of some OPEC members worrying about the recent price slide, hinting that a discussion of quota cuts may be necessary in order to stabilise the market after the recent correction. As a result, we believe that the cartel will keep production around current levels during the course of the year. This should imply that the composition of crude oil in terms of heavy vs. light fuel is likely to remain more or less unchanged. However, refiners look set to increase run rates as margins are improving in line with higher crack spreads; this could mean greater use of "old" refining technology, thereby shifting the product composition towards more fuel oil.

In contrast, on the demand side we remain confident that global oil consumption will exceed OPEC's current forecast. Therefore, we see a faster-than-expected rise in OECD demand, and hence drop in stocks, than both OPEC and the market anticipate at present. This could work not only to put upward pressure on crude prices, but also to postpone a normalisation of the bunker fuel crack spread, as demand for fuel oil should rise relatively fast due to the ongoing pick-up in global trade.

Residual fuel demand



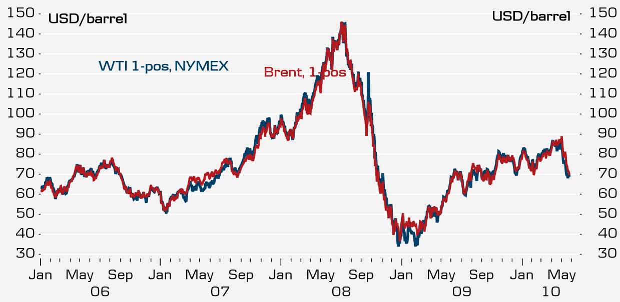
Source: IEA, Danske Markets

Bunker forecast: discount to Brent to stay within range of USD5-15 per barrel this year

Going forward, we see the fuel oil market as largely balanced, so we look for the bunker crack spread to stay compressed, i.e. to continue to trade at a USD5-15 per barrel discount relative to Brent for the rest of the year. We view the risks to the crack spread as lying more heavily on the downside, i.e. a decline in prices can be ruled out if OPEC continues to increase production and refining utilisation increases rapidly.

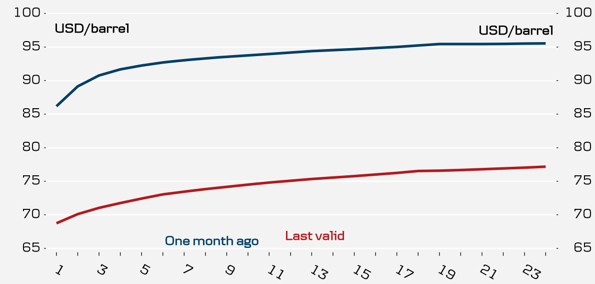
Energy charts

Crude oil prices



Source: Ecowin

WTI futures curve



Source: Ecowin

Natural Gas, Henry Hub, 1-pos

Source: Ecowin

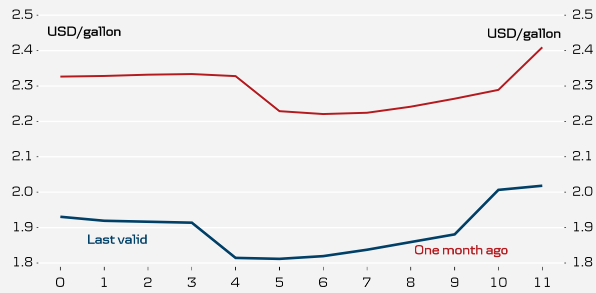
Fuel Oil, 3.5% CIF NWE

Source: Ecowin

Gasoline RBOB, 1-pos NYMEX

Source: Ecowin

RBOB gasoline futures curve

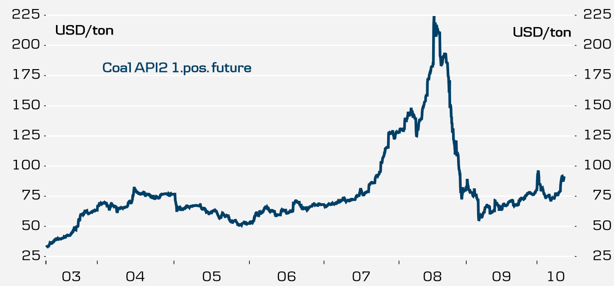


Source: Ecowin

Heating oil, 1-pos NYMEX

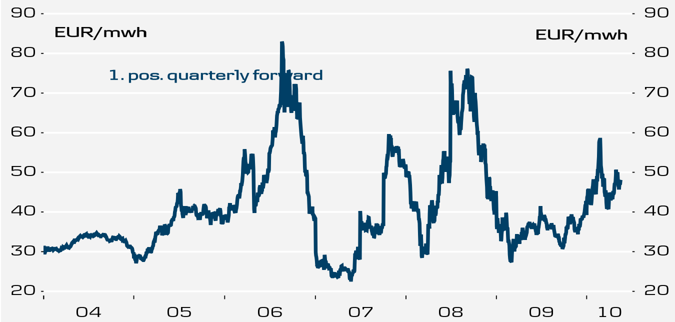
Source: Ecowin

Coal, 1-pos, API2



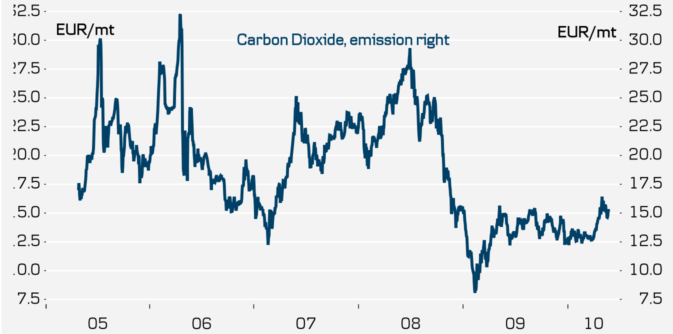
Source: Ecowin

Electricity price, Nordpool, 1-pos, quarterly



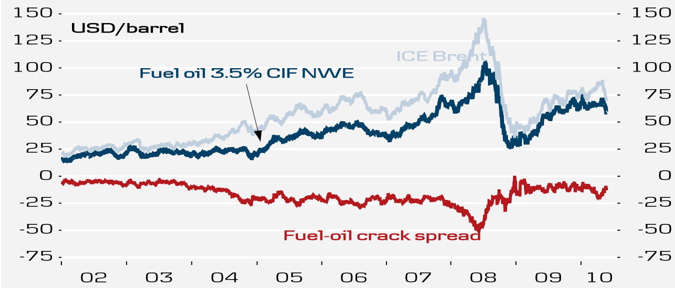
Source: Ecowin

Emission rights, CO_2, ICE ECX



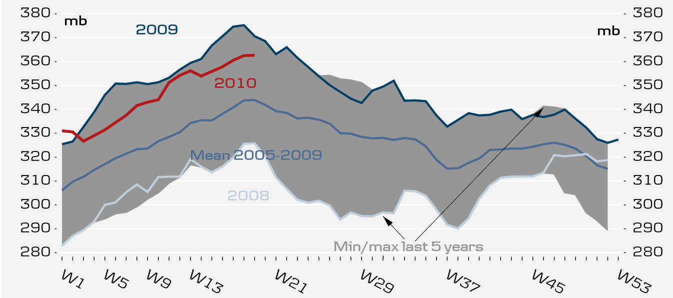
Source: Ecowin

Bunker fuel oil and crack spread



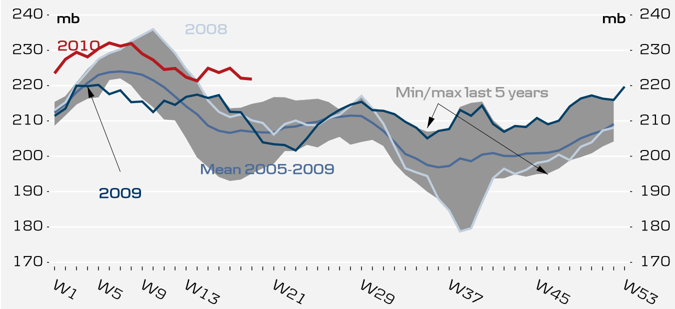
Source: Ecowin

Total crude oil stock, EIA



Source: Ecowin

Gasoline stock, EIA

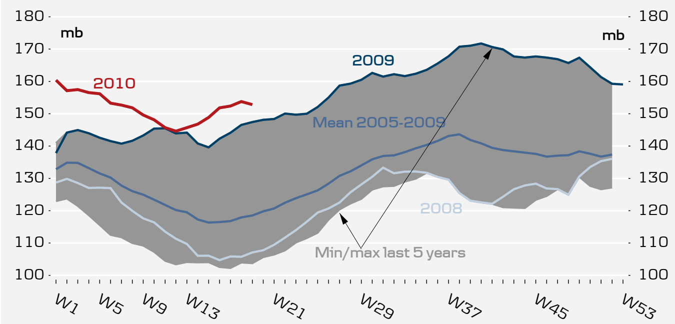


Source: Ecowin

Gasoline crack spread, NYMEX 1-pos

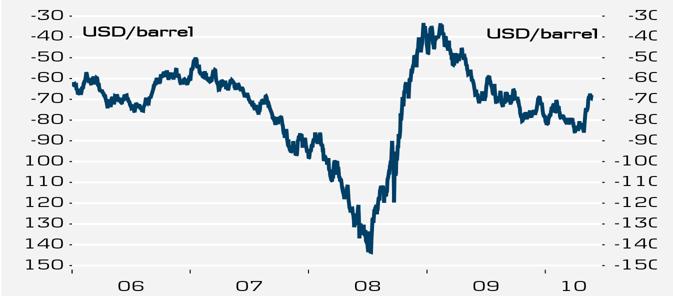
Source: Ecowin

Distillate stock, EIA



Source: Ecowin

Heating oil crack, NYMEX 1-pos



Source: Ecowin

Base metals: Fundamentals improve despite European debt concerns

Base metals have been in for a severe setback for the last month. Global concerns over contagion of the sovereign debt crisis in Europe, the stronger dollar and more Chinese tightening measures have been a very bitter cocktail for the market to absorb. Not least, China is of utmost concern for base metal markets as it has been the single most important driver for metals since the beginning of 2009.

The market fears that the current financial turmoil will continue and that governments on a global basis will have to tighten fiscal policy to consolidate ballooning budget deficits. It would lead to lower global growth and the pick-up in OECD demand that we have seen this year would be reversed. The price action has been quite violent with 3M LME copper and aluminium down more than 15% since the beginning of April. However, the strong spring performers, nickel and zinc, have been even harder hit, down more than 20% from prices seen mid-April.

Base metals have been relatively popular among speculators - for instance, hedge funds - as a proxy for global recovery and strong Chinese growth. Hence, when the market sentiment suddenly turns bearish and everybody opts to get out of "the same door" the reaction can be quite substantial. In such a situation, the base metal markets do not offer enough liquidity, and high and rising volatility is almost inevitable. When the market is scaling back on risk and searches for liquidity, the base metals markets become the victims.

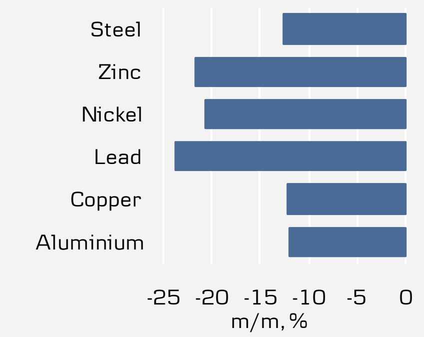
It is often said that one should not try to catch a falling knife. However, we argue that the current situation is very different from the post-Lehman period in 2008. The global economy is not heading for a recession. The US economy is recovering and China is still roaring ahead, despite the latest measures to cool the Chinese housing market. Global growth is expected to top 4% this year.

In our view, the real numbers both for the OECD and the non-OECD economies are showing a much more positive picture compared with what the latest price action might imply. But that said, in a situation where the market is extremely nervous, normal valuation tools are of little use and further liquidation of long positions cannot be ruled out. It could easily send prices lower – justified or not.

But all in all we argue that the market will eventually turn higher as economic concerns recede. We still forecast that demand will continue to recover during 2010 and 2011. This is a setback, where the market adjusts to a new risk picture, but the fundamental picture has not changed significantly. We still expect that eventually the fundamental picture will dominate the current financial concerns – we do not see this crisis hampering global growth enough to justify the latest correction in prices. We therefore recommend clients to take advantage of the latest pull-back in prices to lock-in base metal exposure.

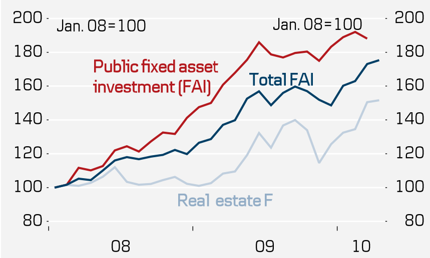
Accordingly, with this view in mind we have made few changes to our base metal forecasts on this occasion. Average price forecasts for copper and aluminium in 2010 are, however, revised lower to USD2,250 and 7,450 a metric tonnes from the previous USD 2,350 and 7,900. It primarily reflects a stronger USD forecast from our FX team *(see FX Forecast Update, 17May)* and of course that the current crisis is expected to weigh on sentiment for some time. In the following pages we take a closer look at the copper and aluminium markets. For an update on nickel and zinc market we refer to the April issue of Commodities Monthly.

Monthly changes in base metals



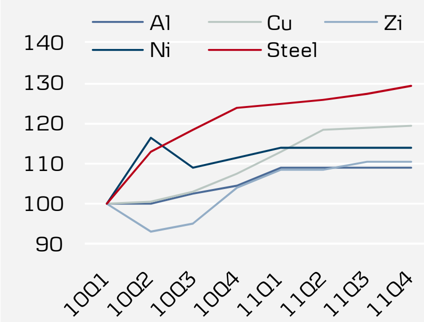
Source: Bloomberg, Danske Markets.

Chinese investment activity still strong



Source: EcoWin, Danske Markets.

Danske Markets forecasts: expected relative performance of base metals



Source: Bloomberg, Danske Markets.

Note: index=100 for 1001.

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Aluminium: Prices close to marginal costs

Demand side improving still

Aluminium prices are down more than 8% since the start of the year and alone the last month prices have retreated by more than 12%. Hence, aluminium is no longer “lagging” other base metals as was the case earlier this year with inter alia zinc and lead down more than 25% YTD.

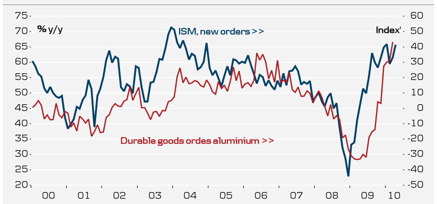
But the demand picture for aluminium has, in our view, in fact improved over the last couple of months. According to the independent consultancy group CRU Chinese apparent demand rose by 17.4m tonnes ann. in April compared to 15,1m tonnes ann. in March. The CRU apparent demand measure is based on estimated production plus net primary trade and stock changes. Hence, there are in fact signs of further acceleration in Chinese demand. However, the proposed measures to cool the Chinese housing market might have a negative impact going forward.

But also outside China the outlook is strong. US durable goods orders for aluminium rose by 43% y/y in March and the ISM new order index that lead aluminium orders stood at 65.7 in April. The same picture is reflected in the data from the US Aluminium Association which reported that orders from aluminium mill products in the US and Canada rose by 12.5% in March. Especially, aluminium intensive car production is being ramped up on a global basis. US production is now up 133% since the beginning of 2009 and Chinese car sales are up 75% in the same period.

Japan’s shipments of rolled-aluminium products grew a stunning 29% y/y in April. It was the fifth straight month of expansion underlining that also the recovery in Japan is spurring demand for aluminium.

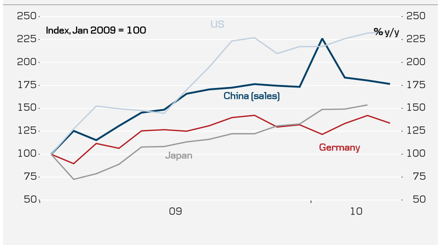
According to CRU, global aluminium demand in April for the first time passed the level reached in December 2007. Furthermore, the production surplus was a modest 29,000 tonnes in April. It is the lowest surplus since late 2007. It is quite likely that the global balance briefly will turn into a deficit over the coming months.

US durable aluminium orders rise strongly in March



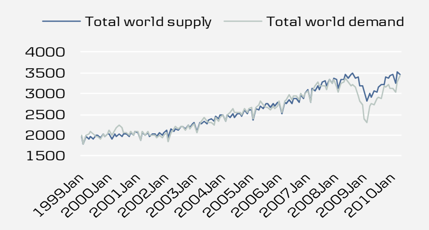
Source: Ecowin

Global car production continues to recover...



Source: Ecowin

... and global aluminium demand has recovered above 2007 level



Source: CRU, Danske Markets

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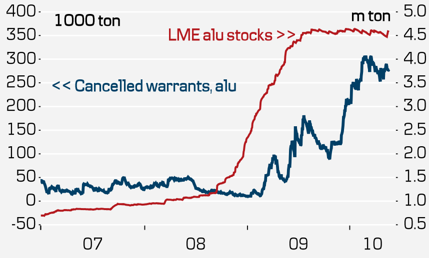
Hence, the aluminium demand in H1 2010 seems to have surprised on the upside and the tighter market has been reflected in rising spot premiums in the spot market. The tightness in the spot market is of course still very much distorted by warehousing or financing deals, i.e. physical investors selling their metal forward to take advantage of the steep contango in aluminium.

CRU estimates that the profits from these deals are now less than 1% per annum for 15-month deals, but that deals are still carried out. The big uncertainty in the aluminium markets is if expiring deals are rolled over or not. According to CRU, most deals are still rolled over, but investors now prefer shorter-term contrasts (2-6 months) and 70% of expiring deals in May are estimated to have been rolled over to shorter-term contracts. The shorter-term contracts indicate that the aluminium market is becoming even more uncertain for the rest of 2010.

Many analysts use LME cancelled warrants as a proxy for aluminium demand as these reflect metals being prepared to leave the warehouses. Cancelled warrants fell back slightly during April, but have recovered once again in May. We doubt the slightly lower reading in April reflects weaker end-user demand. It might instead reflect that LME warehouses recently added new incentives to keep the warehouse deals in the LME system. But the latter issue also underlines that using cancelled warrants as a proxy for final demand should be done with care.

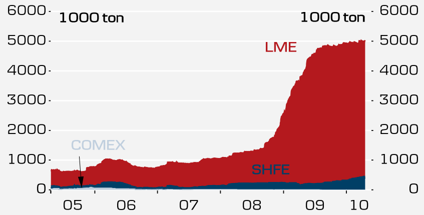
We prefer the stocks-to-consumption ratio as a key indicator of market tightness. Stocks are still plentiful, but the pick-up in demand has been notably and the reported inventory for days of consumption has fallen from 122 days in August last year to currently 94 days. However, this is still a historically high level, well above the 40 to 60 days that was the norm a few years ago.

Cancelled warrants in aluminium still high



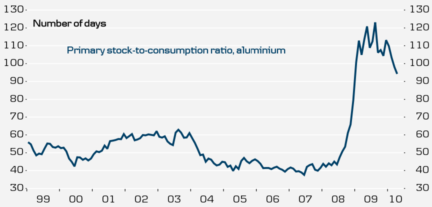
Source: Ecowin

Global stocks are still high…



Source: EcoWin, Danske Markets.

… but rising consumption pushes the stock-to-consumption ratio lower



Source: CRU, Danske Markets.

Lower prices and higher costs to dampen Chinese production

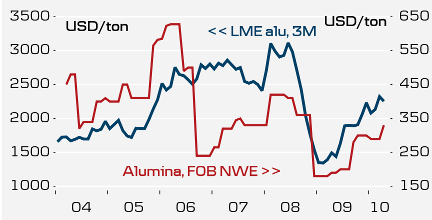
The aluminium market is not just haunted by huge stocks, but also by a significant surge in supply, not least due to a ramp-up in output from China during the last 12 months. During the financial crisis, China cut back production significantly; however, as prices subsequently recovered smelter activity was once again stepped up to a new record high. In April, the Chinese trade surplus for aluminium widened once again to 167,000 metric tons as export surged to 260,000 metric tons.

However, the latest April data points to stabilisation in Chinese production. It might reflect that smelter costs are now clearly on the rise in China. Electricity tariffs that account for close to 50% of costs in China have recently been hiked due to higher coal prices. According to Bloomberg, China will raise surcharges for some aluminium companies by as much as 100 percent from June. The purpose is to curb overcapacity and save energy by forcing producers to replace smelters with more energy-efficient capacity or to simple close down. According to United Rusal, the world's biggest producer of aluminium, the new power tariffs might push production costs up by USD100 a metric ton. Other local producers mention that production costs might rise as much as 1400 yuan or more than USD200 a ton.

CRU estimates that 1.3m tons of Chinese capacity will be affected by the higher electricity surcharge and says that many Chinese producers will be unprofitable at the current prices. In our view, the surcharges have steepened the costs curve and made it even more costly for the less energy efficient smelters to produce. If prices do not recover, we should expect to see a drop in Chinese primary production of aluminium.

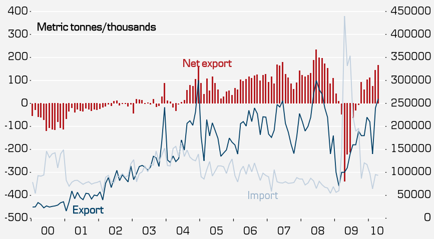
The cost push also underlines that the downside for aluminium from a fundamental point of view is limited. However, saying that, the upside is still capped due to the significant stock overhang from the global recession in 2009.

Input costs on the rise



Source: EcoWin, Danske Markets.

China now a net exporter of aluminium



Source: EcoWin, Danske Markets.

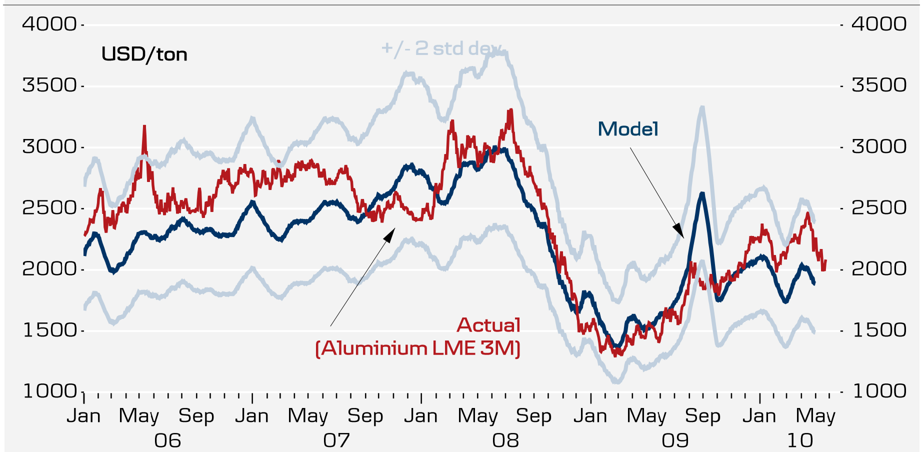
Chinese production surging

Source: IAI, Danske Markets.

Current pricing in line with our fair value measure

Weighing together a range of factors determining supply and demand for aluminium within our fair-value model for the metal, we find that current LME pricing is relatively close to our fair-value model. Our model takes into account the level of LME stocks, US motor vehicle sales as well as industrial production in both the OECD region and China; finally, we allow for a separate effect of EUR/USD.

Aluminium prices close to our fair-value model

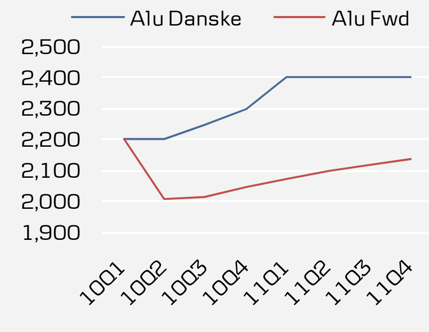


Source: EcoWin, Danske Markets.

The model only provides a fair-value estimate as of today. Looking forward we continue to look for an improvement in the fundamental picture, which it is expected to outweigh the current financial jitters. But we have never been overly optimistic about aluminium prices due to the huge stock overhang. The market will be very exposed if the financing deals for some reason is not rolled over going forward.

On the other hand we see prices well supported at USD 2,000 a metric ton due to the new Chinese power surcharges and rising alumina prices. But due to the current setback in prices, the stronger dollar and the growing concern over the European sovereign debt crisis, we have revised our forecast somewhat lower. We project aluminium to average close to USD2,250 in 2010 and USD2,400 next year.

Danske Markets forecast vs. forward



Source: Bloomberg, Danske Markets.

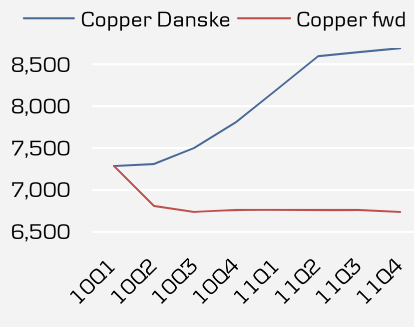
Copper: Still a tight market

Take advantage of correction and buy copper

Copper has also suffered over the past month and prices have fallen by more than 12%, with prices now down 8% YTD. However, prices are still high in a historical context and still up close to 50% y/y.

We have long favoured copper due to its close correlation with global growth. We still see global growth topping 4% this year and with a market balance close to being in balance in 2009 and most likely turning into deficit in 2010, the outlook is quite favourable – despite the current financial jitters. We expect 3M copper to average USD7,500 a metric tonne in 2010 and USD8,500 in 2011 compared with previously USD7,900 and USD8,600. Hence, we think copper has a clear upside risk compared with the current forward curve. Furthermore, the copper curve is relatively flat, making long positions inexpensive compared with, say, the steep contango found in aluminium.

Danske Markets forecast vs. forward



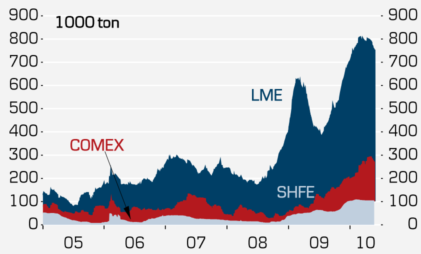
Source: Bloomberg, Danske Markets.

Still tight market balance in copper

LME stocks started to decline in April and the trend has continued in May. However, stocks are still well above the level seen in the period 2005-08. The less important Shanghai stocks have also started to decline in May.

The stocks-to-consumption ratio has continued to decline and it is now below 3.5 weeks as a result of the lower stock level and an increase in demand. The relatively low level of demand cover illustrates the tightness that continues to characterise the copper market. Contrary to most other base metals, no significant buffer was built up during the economic recession in 2008 and 2009. The main reason was that global demand actually rose by 0.8% in 2009 and production more or less the same despite the strong price recovery seen during the course of 2009. The so-called refined balance, which is the difference between refined production and refined usage, rose a modest 170,000 metric tonnes in 2009, which is less than two weeks of Chinese copper imports.

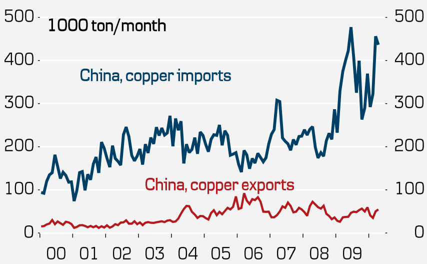
Global copper stocks have started to decline



Source: EcoWin, Danske Markets.

The latest preliminary data from the International Copper Study Group (ICSG) showed that usage of copper rose by 163,000 metric tonnes or close to 6% in the first two months of 2010 compared with the same period in 2009. The rise in consumption is not a surprise, but we note that demand was concentrated in Japan (+50,000t) and the EU (+15,000t), whereas apparent demand in China according to the ICSG was unchanged and actually declined marginally in the US. Brazil, India, Korea and Taiwan also contributed to yearly growth in copper usage. According to the ICSG data, copper usage rose in all regions except North America in the first two months of 2010. The data underlines that demand has become truly global with even the EU and Japan contributing to growth.

Chinese copper imports rise again



Source: Ecowin

The standstill in Chinese demand might be a bit of a disappointment for the market. However, these data are based on apparent demand and do not take into account any unreported stock draw in unofficial stocks. It also reflects the somewhat lower Chinese imports of copper in January and February. However, the latest import figures show a new surge in Chinese imports in March and April. Hence, the demand numbers for these months looks significantly stronger. Chinese imports of copper are now close to the levels seen in the beginning of 2009. But the big difference is that this time imports are not supported by strategic purchases from the State Reserve Bureau as was the case one year ago.

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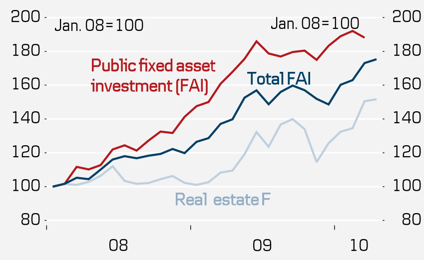
Wide scale infrastructure projects across China held a firm hand under copper prices last year and look set to do so this year as well. However, from 2011, support from fiscal stimuli relating to these projects will run out. Fiscal and monetary tightening in China is, in our view, one of the significant risk factors regarding the copper outlook.

Over the past month we have seen new measures to cool the booming property sector in China. Furthermore, both interest rate hikes and an appreciation of CNY are on the cards in the coming months according to our China economist. The current financial jitters might delay any appreciation and rate hikes, but if the market calms we believe these issues will return to the agenda. The market continues to be very sensitive to news out of China that policymakers try to dampen economic growth.

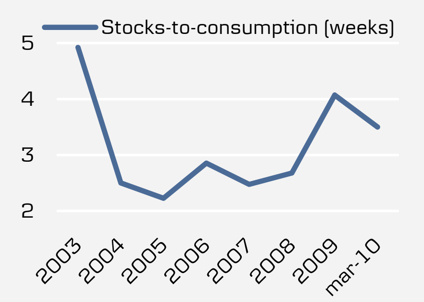
That said, the latest numbers out of China underline that growth is still very strong. In April industrial production increased by 17.8% y/y. Our China economist says that domestic demand still looks strong, with investments still rising despite a decline in credit growth. The overall picture is that growth in investments has accelerated since Q4 09. That said, Chinese growth is poised to moderate slightly in the coming months. But remember it comes after the surprisingly strong Q1 with GDP growth at 11.9% y/y. We still expect Chinese growth to be at or above trend in the coming quarters.

Chinese investment activity still strong



Source: Ecowin

Stocks-to-consumption declining in copper



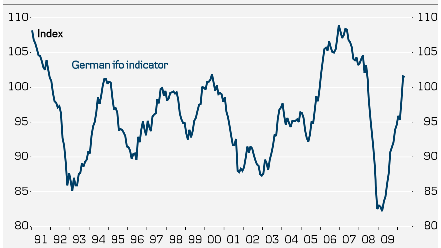
Source: ICSG, Danske Markets.

Fiscal tightening in Europe a concern, but strong export sector

In Europe we currently see an unprecedented tightening of fiscal policies for the next couple of years. It is not just the indebted so-called PIIGS countries that tighten fiscal policies, but also relatively economically healthy countries like Germany. The fiscal tightening has give rise to concerns that Europe will fall back into recession, and derail the recovery in commodity demand in Europe. However, the European export sector is actually in very good shape. The German ifo indicator points to very strong growth in Q2 and Euro area industrial new orders rose by 5.2% m/m in March. It all underlines that the manufacturing recovery is very strong at the moment. In our view, the fiscal tightening is being mitigated by an expanding export sector. The latest depreciation of the euro and low rates further supports the export sector. The latter should help European copper demand going forward.

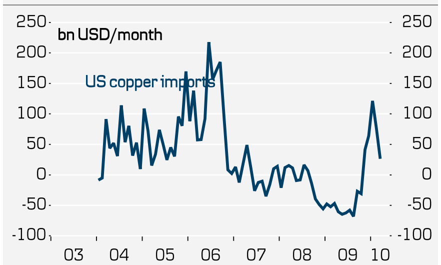
However, the European and US real estate markets have still not escaped crisis mode. Housing starts and building permits in the US appear to have bottomed out at the end of last year, but these still have a long way to go before more 'normal' levels are reached. US copper imports have recovered firmly in the beginning of the year, but the latest import data has been somewhat weaker.

German manufacturing is strong



Source: EcoWin, Danske Markets.

US copper demand drops in March



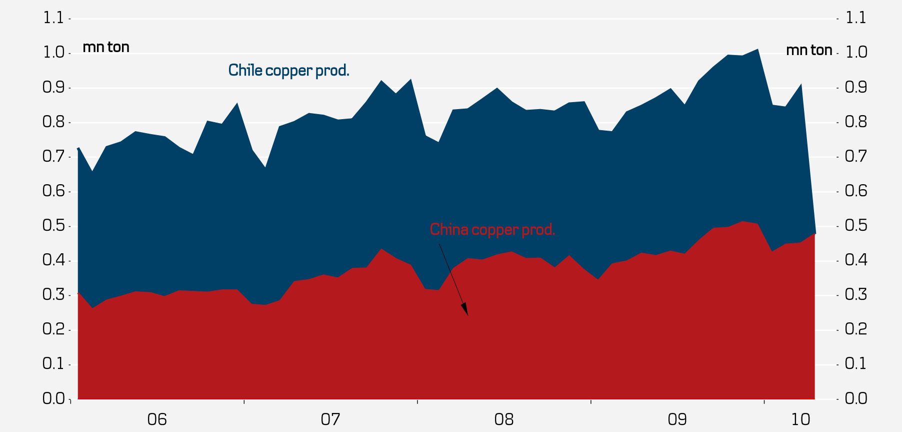
Source: EcoWin, Danske Markets.

Mine production yet to stage recovery

Despite the surge in prices in 2009, world mine production rose a modest 1% in January and February compared with the same period in 2009. Production in the two leading producers, Chile and Peru, was basically unchanged over this period. However, world refined production rose more than 165,000 tonnes or 6% as production of scrap jumped 30% y/y. All in ICSG says that the market surplus for the first two months was 144,000 tonnes.

The modest rise in world mine production underlines that the global copper market will probably move into deficit in 2010. The strong rise in production from scrap in the beginning of 2010 is not sustainable. It reflects the very tight scrap market that existed in the beginning of 2009 as global manufacturing nose dived.

Still no recovery in global mine production of copper

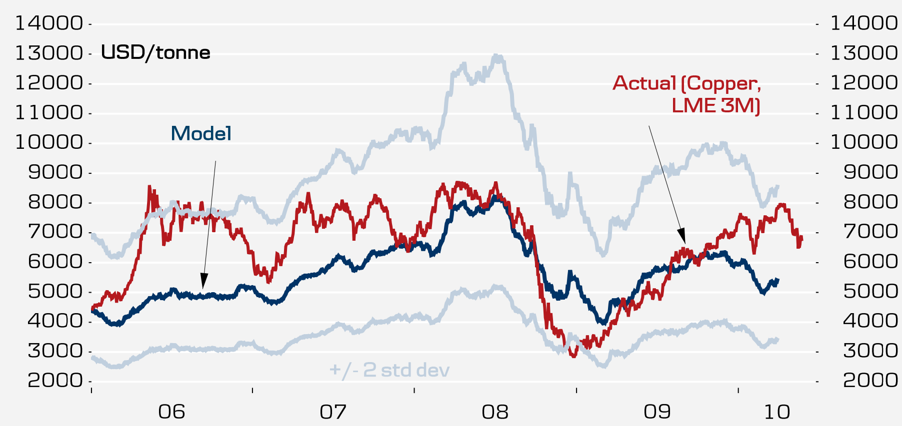


Source: EcoWin, Danske Markets.

Dollar strength the main reason for decline in fair value

Despite the latest correction in prices, copper is still above the model's fair value measure. However, the model still points to a rather wide interval for reasonable pricing, ranging from just above USD3,000 to above USD8,000. The dollar decoupling seen since December is the prime reason for the gap between the model-implied fair value and actual prices witnessed in past months. The model does not take into account future changes in the variables such as copper stocks and activity data. We forecast these to improve going forward, whereas EUR/USD is expected to be a negative drag on the fair value for copper.

Copper prices still below upper band of our fair value measure



Source: EcoWin, Danske Markets.

Prices will rise when market focuses on fundamentals again

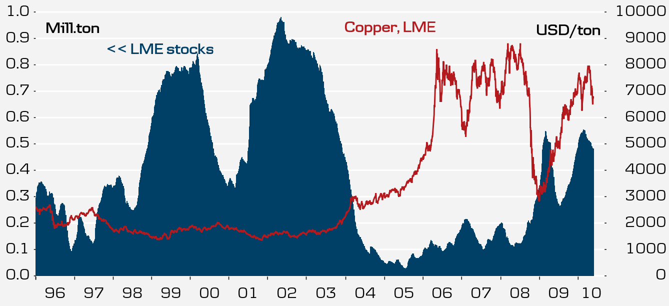
Despite the current concerns about the European debt situation, we continue to have a positive view on copper. We have a relatively optimistic outlook for demand and continue to see supply-side difficulties.

Hence, we keep our rising profile for copper prices throughout our forecast horizon. But the forecast is based on the notion that the European crisis does not turn into a true global crisis, and that commodity markets once again start to focus on fundamentals, where copper looks quite strong. If that does not happen, prices will not recover.

All in all, we expect copper prices will average close to USD8,000 this year and reach new record highs in 2011. These averages come about on the back of a steadily rising price profile throughout our forecast horizon.

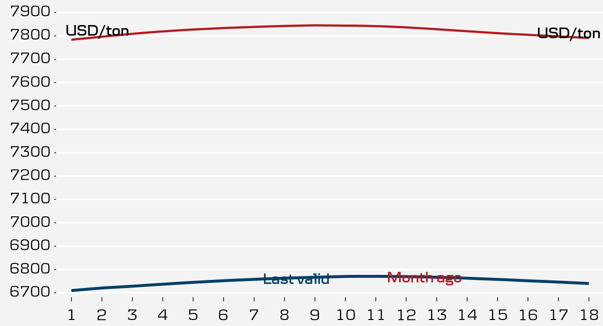
Base metals charts

Copper, LME



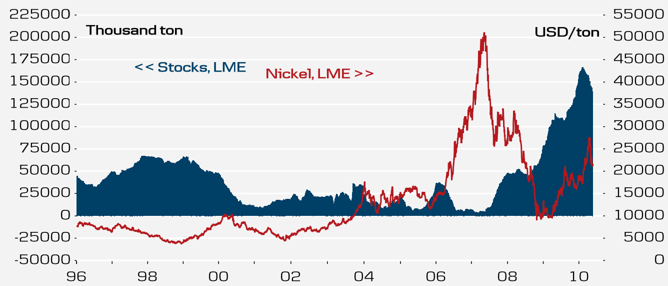
Source: Ecowin

Copper forward curve, LME



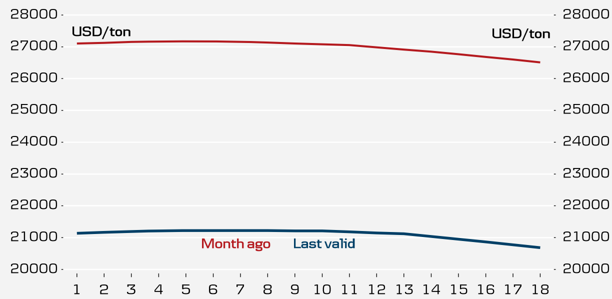
Source: Ecowin

Nickel, LME



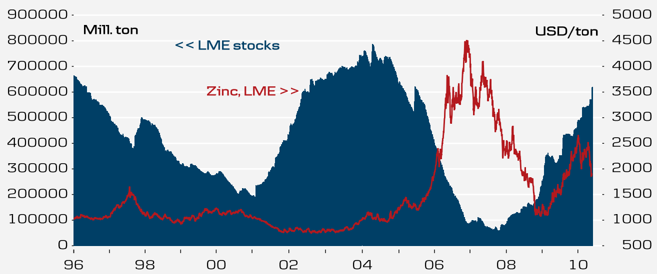
Source: Ecowin

Nickel forward curve, LME



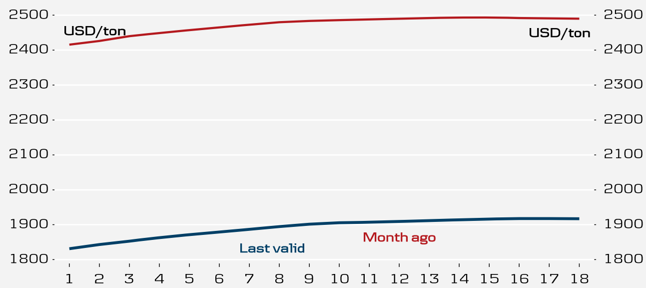
Source: Ecowin

Zinc



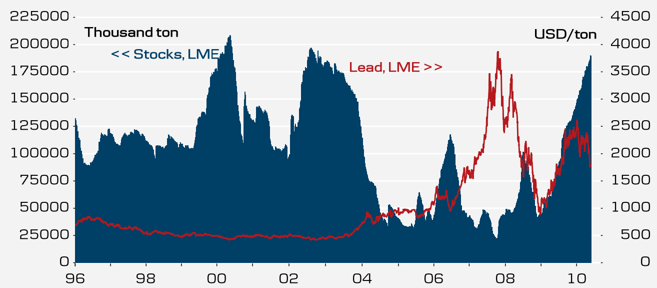
Source: Ecowin

Zinc forward curve, LME



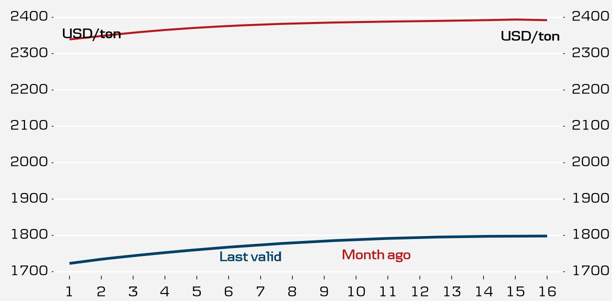
Source: Ecowin

Lead, LME



Source: Ecowin

Lead forward curve, LME



Source: Ecowin