Commodity and Foreign Exchange Outlooks Q3 2015: What happens when fundamentals reassert over sentiment?

The commodity cycle is turning. Excess supply is being cut back across a broad range of commodities. While it will take time to run through years of surplus stock, the trend is now set in the right direction. However, with the exception of a few select commodities such as oil, most prices do not reflect the stronger fundamentals. Sentiment remains stubbornly negative as multiple years of poor performance has jaded investors. As sentiment realigns with fundamentals there is scope for strong price gains.

Volatility has been a pervasive force in G10 currency markets in recent months, a product of the ongoing Greek saga and the focus on the potential of tighter monetary policy in the US. While sentiment has been a key driver of policy moves recently, we expect underlying growth and policy fundamentals to become more a focus for investors in the quarter ahead. Central bank policy will reassert its prominence as a currency performance determinant and the expected divergence of monetary policy, as the recovery paths of major economies differ, is expected to continue over the coming quarter.

COMMODITIES

Summary
Sentiment rather than fundamentals has been driving many commodity prices and we believe that once fundamentals regain influence, we could in some instances see a significant re-pricing. A strengthening US Dollar could weigh on prices at the margin. A summary of key trend follows:

Industrial Metals
Although fundamental conditions appear to be tightening for a range of industrial metals, other factors are keeping gains in check. A broadly stronger US Dollar and concern over Chinese demand are having a restraining affect, but we expect the influence of these factors to fade over the second half of 2015.

Gold
While gold has been trading in a relatively tight range between US$1160/oz and US$1225/oz in Q2 2015, we think the metal will trade higher by Q4 2015, as global policy stimulus will remain in place and the metal’s role as a risk hedge will become more pronounced.

Platinum Group Metals
Tightening emissions regulations in Europe should see demand for PGMs, which are used in pollution abatement equipment, increase. Meanwhile a rebound in auto demand in US and China will continue to see growth in palladium in particular. Supplies are likely to remain tight even though no substantial miner strikes have broken out this year so far.

Oil
The constant struggle for market share will see oil prices initially decline as OPEC in particular will continue to produce more than the market requires. However, the tightening supply from high cost producers outside of the US will eventually see prices recover.

Agriculture
We are currently in an El Niño weather event that has intensified to a moderate strength. For some crops, an El Niño could boost production, while for others it could damage production. Should the El Niño intensify further, we expect better growing conditions for coffee (a reduction in frost damage in South America) and soy (better growing conditions in US), which will weigh on price. Elsewhere, primarily drier, hotter weather in key growing areas could spoil conditions for wheat, corn, cocoa and sugar cane, acting as a catalyst for price gains.
PRECIOUS METALS

Gold: Haven potential

While gold has been trading in a relatively tight range between US$1160/oz and US$1225/oz in Q2 2015, we think the metal will trade closer to US$1300/oz by Q4 2015 as global policy easing will largely remain in place and the slow speed of US rate increases will take some by surprise. Physical demand is likely to continue to grow though the course of this year.

With a October/November rate hike fully priced in, we don’t think the turn in the US rate cycle will place any further downward pressure on gold prices. Indeed the market could be surprised at the slow pace of rate increases from the Federal Reserve, which could lend support to gold.

Greece’s financial situation remains precarious. Even if a short-term solution to avoid near-term default is found, we will quickly find the country grappling with the next payment deadline to its creditors which will inevitably involve another round of arduous negotiations. The fact that Greece has gone through similar scenarios so many times, has desensitised many investors to the risk of events turning particularly sour. Even the missed IMF payment has not rattled financial markets as much as we would have expected.

The upcoming referendum may shake confidence as Greece’s future in the euro area is now under threat. We too believe that Greece and its creditors will continue to muddle through, however, the downside risks associated with an accident are so great that it is surprising that more investors have not sought to hedge themselves with defensive assets like gold. Gold tends to perform well in adverse scenarios. As Greece skirts closer to its nightmare scenarios, we could see interest in the yellow metal increase.

With the European Central Bank, Bank of Japan, People’s Bank of China and many of the other world’s largest central banks continuing to pursue a policy easing strategy, the demand for hard assets like gold should remain stable. Emerging market central banks in particular are keen to diversify their currency reserves away from currencies they believe are being debased and gold is a natural candidate to help that diversification. New gold mine supply is less than 2% of the above ground stocks of the metal, protecting gold from the ‘print at will’ phenomenon that many see as a debasing force for paper currencies.

India and China, the heavyweights in the physical gold market should see demand continue to recover during the course of this year. The draconian import restrictions in India were lifted at the tail end of 2014, and we saw gold demand in the country increase by 14% year-on-year in Q1 2015 as a result. The crackdown on corruption that saw the demand for all luxury goods, including gold, fall in China is likely to have peaked. In 2014 many people avoided buying luxury goods in fear of being accused of being involved in corruption. With the country having improved its institutions, these fears are likely to ease.

Silver: Industrial demand deficient

The outlook for silver has improved, but only because geopolitical risks in Europe have increased and most major developed central banks continue to flood markets with excess liquidity. With investors retaining an element of caution with asset allocations in a rising volatility environment, its correlation to the gold price should be beneficial for the metal.

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 drastically, as it appears in the current environment. 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 cash costs for primary silver miners estimated to be US$7.74/oz, according to The Silver Institute.

Only 25% of silver production comes from primary silver mines, with the remaining extracted as a by-product of gold, lead, zinc and copper. 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 there could be downside risk to production this year. Supply from scrap sources, historically over 20% of global supply, declined for the third successive year in 2014. Scrap supply is also expected to fall, in response to continued low prices, and could account for less than 15% in 2015.

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. Accordingly, investors are likely to be more optimistic for the price outlook as soon as there is evidence of a sustainable decline in physical inventories, which remain at multi-year highs.

While a strong Dollar, coupled with expectations of rate 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 and expect price to reach US$18.50/oz by end 2015, as industrial demand begins to eat into stockpiles.

PGMs: Autocatalysts to spur demand
Platinum is trading at a six-year low, while palladium has lost 18% since a peak was reached in August of last year. We believe the Greek impasse and the strength in the greenback have overshadowed otherwise strong fundamentals for platinum group metals (PGMs). Although global supplies of platinum and palladium are expected to rise this year as South Africa’s production recovers from the strike hit 2014 level, we believe the net balance will continue to remain in deficit for 2015 as growth in demand will remain strong.

European new car registrations remain strong with year to date figures up 6.8% as of May 2015 according to European Automobile Manufacturer’s Association (ACEA). Western European car sales are expected to rise 6.4% in 2015 according to LMC Auto. Despite a strong start to the year Chinese new passenger car sales grew only 1.2% y/y in May according to China Association of Automobile manufacturers – the weakest expansion since February 2013. We believe the softness in data is temporary and recent stimulus measures will help boost growth in the next quarter. US auto sales are headed into a strong summer with sales rising 2% in May from a year earlier their fastest pace since July 2005 and will likely help produce new-car sales of more than 17m for 2015.

The US, Chinese and Japanese markets are all dominated by gasoline powered cars with diesels playing almost no role. India’s diesel share accounted for 50% in 2013 according to ICCT. The majority (53.6% in 2014 according to ACEA) of Europe’s new cars also remain powered by diesel engines. Traditionally diesel autocatalysts use more platinum since it operates at lower temperatures and is more resistant to sulfur poisoning that can impair the performance of the catalyst.

PGMs are likely to garner momentum from Euro 6 legislation. In less than 100 days, the ambitious Euro VI legislation will take effect aiming to cap the amount of Nitrogen Oxide (NOX) emitted by diesel vehicles at 80mg/km from the previous 180mg/km. Meanwhile the limit for petrol cars stands at 60mg/km, the same as in the earlier Euro V legislation. As of 1 September 2015 all new car models sold in the EU must meet these new low emission standards.

Greater substitution favours palladium despite the more stringent conditions placed on diesel autocatalysts which traditionally use more platinum. Recent technological developments in palladium’s most significant application, autocatalysts used in gasoline powered cars, also serve to underscore this. As the Euro VI deadline nears we have switched to a higher 2014 forecast for platinum prices, as we do not expect a sustainable decline in physical inventories until the beginning of 2015.

PGM prices to play catch-up to auto sales

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advancement allows for greater substitution of platinum with palladium. An estimated one for one substitution ratio now exists. According to Stillwater Mining Company, palladium loadings in diesel catalytic converters currently stand 30% while research has established the ability to accommodate up to 50% in light diesel applications. With palladium trading at a discount to platinum, the cost incentive to substitute is clear.

INDUSTRIAL METALS

Although fundamental conditions appear to be tightening for a range of industrial metals, other factors are keeping gains in check. A broadly stronger US Dollar and concern over Chinese demand are having a restraining affect, but we expect the influence of these factors to fade over the second half of 2015. We expect that the stronger US Dollar will continue, but its impact is likely to become more limited on industrial metals prices because it reflects the pick-up in economic activity, helping underpin demand. While individual industrial metals will continue to trade in line with their own fundamentals, we believe that an upside surprise in Chinese and European monetary policy should be beneficial for the industrial metal complex.

At the same time supply for most industrial metals remain tighter than commonly perceived in the market. Supply forecasts rarely accurately reflect in mine disruptions from strikes or weather.

Falling energy prices have not been as beneficial as perceived by many market observers, and if oil prices continue to surprise to the upside, supply could tighten further. The lack of profitability in most metal production remains perilous and we believe that production cuts are needed if prices do not rise.

Aluminium: Plagued by abundant supply

Despite the intensity of energy consumption in aluminium manufacturing, relatively low energy prices have kept production levels elevated. A decline in energy prices is unlikely to drive profitability into smelters but we believe the economic pressure to cut production needs to be more sustained and a more committed approach is needed, particularly in China.

Currently, production continues to increase, and hit fresh record highs in April. Chinese output has risen nearly 20% from a year earlier despite overtures from the government that inefficient smelters are likely to be closed in an effort to rationalise the industry. 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 the increasingly tighter environmental standards, especially in China and the US. While cheaper oil and petroleum products may have reduced consumer incentives for more efficient vehicles, environmental regulation still favours higher demand.

However, in the near-term, aluminium will struggle to move higher under the weight of Chinese supply (and exports), as it accounts for over half of global output. Many of these themes will be slow to impact prices and we believe aluminium will continue to trade a US$1,600-US$1,900/mt range.

Copper: Negative sentiment, not fundamentals

Copper has been the second best performer in the complex over the past month, buoyed by signs of rising demand. Volatility abounds though and indications of demand have been similarly choppy. Chinese imports in April were 45% higher than a year earlier, but then in May, total copper imports were lower by 6%. One area of consistency has been the persistence of falling stockpiles, particularly in China.
Despite overall signs that economic activity is stabilising in the Chinese economy, lower import figures, particularly for copper, have capped upside for copper prices. While Chinese imports have declined recently, it is likely to be a result of elevated local production. Meanwhile, treatment and refining costs have edged lower in 2015, indicating a tightening concentrate market.

For what it’s worth, the International Copper Study Group data has shown the copper market to be in a modest surplus for January and February 2015, but recent floods in Chile could cloud the picture. One of Codelco’s mines was restarted in late April after a three week shutdown. We think negative sentiment, rather than weak fundamentals, is weighing on the metal at the moment and we continue to believe supply expectations are overblown in 2015 and this year could be the sixth consecutive year of supply deficit.

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. Already disruptions have halted production in Indonesia and Australia this year and floods in Chile have cut production from Codelco in April. Potential production disruptions linger, with workers at Chile’s Collahuasi mine staging a 24 hour walkout in June, which the company described as illegal.

Sustained weakness in the copper price has also prompted some producers to downsize production. Indeed, Codelco, the world’s largest copper miner, has previously announced that it will cut production by 5% in 2015.

We expect investors to eventually return to focus on tightening supply-demand fundamentals in H2 2015. We expect the copper price to trade back above the US$6,000/mt level in the second half of 2015 and break above US$6,500/mt in 2016 when lack of capital expenditure could sharply curtail available supply.

Nickel: Stockpiles rising

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. Stockpiling of nickel has been evident, with LME inventory levels reaching multi-year highs in early June. However, since the peak, rising demand has seen stockpiles decline 2%.

China is the biggest consumer of nickel accounting for about 50% of demand. The country is estimated to have entered last year’s Indonesian export ban with about eight months of nickel ore inventory, and with further evidence of stockpiling, the potential rise in nickel prices has been limited in 2015. 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.

Nonetheless, recent evidence of strong demand has arisen, with Chinese nickel imports surging to a four year high in May. Meanwhile freight rates across a range of cargoes have reached the highest level in 2015, underscoring better demand conditions in the Asian region.

After two quarters of declining stainless steel demand, the International Stainless Steel Institute expects that demand growth to move back to positive territory. The ISSF estimated that growth in both Q1 and Q2 2015 was strong, with Q2 demand reaching a fresh record high.

With strong evidence of rising demand, and the supply side environment remaining uncertain due to government regulations, we expect nickel price to recover to US$17,000/mt.

Zinc: Deficit to galvanise the market

Zinc has also been a strong performer on the back of falling inventories. Expectations of further stimulus from Chinese policymakers should continue to provide support, despite recent ILZSG data showing around a 4% surplus for January-April 2015. There has been a declining trend in monthly surpluses.

Although in recent months, rising mine output (Australia, China, India, Peru and Sweden), mine closures coupled with strengthening demand for galvanised steel are expected to give additional impetus to the price rally for zinc in 2015/16. 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 additional development of projects in Australia, Indonesia, Canada and Russia.
Over 40% of zinc demand comes from galvanising steel as an anti-rust protection for car manufacturing and construction. Concerns over the Chinese property market have eased somewhat in 2015, but there has been some disappointment in auto sales data, which has weighed on the industrial metals complex.

Evidence of a tightening market remain. Chinese imports of refined metals have declined in the first five months of 2015, but have been overwhelmed by a surge in zinc concentrate, highlighting rising Chinese production that is trying to satisfy local demand.

Meanwhile, LME inventories have declined 10% over the past quarter, and despite the re-stocking in China, global stocks are down 1.5%. Should demand from China remain strong, 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.

**Tin: Ore shortage continues**

Strong demand has eaten into tin stockpiles and the tightening fundamental environment looks set to continue. LME inventory levels have declined by over 30% over the quarter, to the lowest levels since December 2008.

A reversal in declining Chinese import levels occurred in April, with tin concentrate imports surging by nearly 200% yoy. Refined tin imports rose nearly 10%, with Myanmar remaining the largest tin exporter to China. Myanmar exports are likely to decline due to seasonal monsoon activity, and with stockpiles at multi-year lows, we expect a more constructive price environment.

**ENERGY**

**Oil: the fight for market share continues**

The constant struggle for market share will see oil prices initially decline as OPEC in particular will continue to produce more. However, the tightening supply from high cost producers outside of the US will eventually see prices recover.

As widely expected, OPEC maintained the status quo, keeping its production ceiling at 30 million barrels a day at its June 5th meeting. In sharp contrast to its November 2014 meeting, when the market was expecting a cut that was not delivered, oil prices increased after the meeting. OPEC had cited the increase in demand as a reason for maintaining current production levels and the market took that as a bullish sign.

However, we would caution that the rise in demand has been driven by bargain hunting that is likely to fade as prices increase. China’s filling of strategic reserves is likely to continue this year, but will not be a permanent source of new demand once the new storage capacity has been exhausted.
Despite OPEC setting its ceiling at 30 million barrels per day, in reality, it produces far more. OPEC output is currently in excess of 31 million barrels per day according to its official statistics. With oil prices significantly lower than the US$100/bbl mark of last year, individual OPEC members are forced to produce and sell more to make up for lost revenue. Individual countries are likely to produce as much as they can without care for the overall ceiling or their own quota. While Saudi Arabia’s oil minister described the last OPEC meeting as “surprisingly amicable” we believe that discord between members is rife. The smaller OPEC members are calling for production cuts, but the Saudi-led GCC block believes it will bear the brunt of the loss in market share as smaller countries produce more.

Although the financial position of OPEC members such as Nigeria and Venezuela remains precarious, Saudi Arabia with next to no sovereign debts to its name can afford to run budget deficits and play the long game.

Potential easing of international sanctions against Iran could increase supply from OPEC even more. Iran is unlikely to heed to production quotas set by OPEC as it desperately tries to rebuild the market share it has lost. Indeed OPEC has not even set Iraq a quota.

Clearly a part of the recent price gains were driven by expectations of supply tightening. While US rigs have been shut off at an unprecedented rate, actual US output has continued to increase. That reflects the fact that the most inefficient rigs were the first to be switched off and remaining rigs have been moved to more easily accessible oil.

Eventually the reduction in US rigs should lead to lower production in the US. As the productivity of a shale well can fall by as much as a half after the first year of production, a lack of new investment is likely to translate into lower production.

Elsewhere, the evidence of supply tightening is limited. Global output of oil has only just started to level out. However, the intention to reduce production is emerging. About US$100bn of CAPEX cuts have been announced across the industry. That will see projects, particularly deep-water and capital intensive ones getting deferred and even cancelled, helping to tighten the market.

However, we believe the market has reacted too early to this prospect of tightening. The premature gains in price could stifle the progress in cutting supply. The common belief across the industry that “somebody else will cut while I continue to invest and expand” obviously has its limitations.

Also it is unclear how much of the US$100bn cuts in CAPEX relates specifically to oil production as opposed to gas production or even oil projects that have not even been sanctioned yet.

We believe the optimism in supply tightening will be dialed back until we actually see supply making a material cutback. That will see prices dip initially. That price dip will be important in maintaining the current pace of demand recovery. China will continue to fill its new strategic reserves, providing a tail wind to oil demand.

Over the past month, net speculative long positioning in Brent futures contracts has contracted by 44% as investors have curbed their expectations for price gains.
Once CAPEX declines start to bite into production levels we believe that prices will stage a recovery. That decline in production will be borne by high cost producers, such as deepwater operations and other capital intensive projects.

We believe that Brent and WTI could decline to US$60/bbl and US$55/bbl respectively, before recovering to US$75/bbl and US$70/bbl in 2016.

The US shale industry is unlikely to be the main casualty from the fight for market share. Being a more nimble, price responsive industry with significantly lower lead times than conventional oil, US shale is likely to continue to be a growth industry in the long term. We believe that high cost conventional players will become the main losers from the current price war.

**Natural Gas: inventory rebuild weighs on price**

Natural gas demand to power air-conditioning in the US will increase over the coming quarter. The National Oceanic and Atmospheric Administration (NOAA) forecasts warmer summer temperatures this year compared with the mild summer last year.

Net speculative positioning is significantly short and more than 2 standard deviations below its historic average. A material increase in demand or cut in supply could cause those shorts to unwind, and drive a covering rally.

However, inventory injections this year are running significantly ahead of last year and back in line the prior 5-year average. Ample supply will therefore cap any price gains.

**AGRICULTURE**

**At El Niño’s mercy**

El Niño has the reputation for being a powerful catalyst to driving weather extremes such as floods and droughts in different parts of the world (see box on page 11). For some crops, an El Niño could boost production, while for others it could damage production.

We are currently in an El Niño weather event that has intensified to a moderate strength. The National Oceanic and Atmospheric Administration (NOAA) has increased the probability of El Niño continuing to 90% for the northern hemisphere summer and close to 85% to the end of winter 2015/16. The International Research Institute for Climate and Society (Earth Institute, Columbia University) who jointly produce the forecasts with NOAA points out that most models indicate a moderate to strong event for the course of this year.

The United Nation’s World Meteorological Organization (WMO) indicates that tropical Pacific temperatures are likely to continue warming, and possibly reach strong El Niño levels, in the coming months. The Australian Bureau of Meteorology highlights that over the past two weeks (to 21 June 2015), the broad warming across the tropical Pacific was reminiscent of the 1997-98 El Nino, a particularly strong event.

We believe that should the weather event intensify, it could be a significant catalyst for price gains in sugar, cocoa, wheat and
corn. Meanwhile it will be price negative for soy and coffee.

**Summary of price expectations: with and without El Niño intensification**

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Source: ETF Securities

**Arabica Coffee**

Arabica coffee has decreased by 6% in the past quarter, driven primarily by a depreciating Brazilian Real, which has encouraged farmers to sell coffee at discounted prices in US Dollar terms. With over 45% of global Arabica supply coming from Brazil, developments in the country tend to have the greatest impact on global coffee prices. Although damage to this year’s crop from last year’s drought in Brazil is expected to be significant, favourable weather in the past few months has helped the crop. CONAB and the USDA have actually increased their crop expectations, with the USDA expecting Brazilian Arabica coffee to increase by 3.8 million 60kg bags this year (+11% y-o-y).

In the absence of an intensification of El Niño, coffee could gain if the Brazilian Real appreciates. However, there is no immediate catalyst for these currency movements.

It is increasingly looking like the El Niño will intensify. El Niño tends to make the southern hemisphere winter (June to September) warmer than normal, which can reduce the amount of frost damage to coffee crops, which we believe will be price bearish for the commodity.

Elsewhere, Colombian production (over 10% of global production) is likely to be the highest in 20 years. Over the past eight years a successful tree renovation programme has seen the coffee leaf rust disease suppressed, leading to a higher output.

That rust disease is still rife in Central America and Mexico (who jointly produce 20% of global Arabica output), leading to low output from the region. However, Honduras, the largest producer in the region, has learnt from Colombia’s experience and started a similar renovation programme several years ago. Honduran production is expected to rise by 10% this year.

**Sugar**

Sugar has also been affected by Brazilian Real weakness in the same way as coffee. In addition, in 2014/15 production outstripped consumption for the fifth consecutive year, adding to excessive stocks of the commodity. However, production is likely to decline in 2015/16 while consumption is likely to rise. Both the USDA and International Sugar Organization forecast a production deficit for the first time in six years in 2015/16. In the base case scenario, price gains are likely capped by high stocks.

**Sugar Market Balance in Sight**

However, in contrast to coffee, an intensification of El Niño is likely to reduce sugar production and therefore be price positive. El Niño tends to reduce rainfall in India (the second largest producer). While the monsoon rains have started off slightly above average in India, an intensification of El Niño could hamper its progress. The largely irrigated sugar cane in India could suffer if water reservoirs are insufficiently filled in the monsoon which provides more than 70% of its annual rainfall.

**Cocoa**

Cocoa is the only agricultural commodity to have posted gains the past calendar year. A disappointing yield from Ghana has been one of the catalysts. Cocoa growing is concentrated in Africa, with approximately 70% of production in the continent. Historically El Niño has led to production shortfalls from trend (see chart below) as the weather phenomenon leads to drier spells in Africa during key growing periods. An intensification of El Niño this year could act as a further tailwind for the commodity that has been the outperformer in agricultural space this year.

**Cocoa Production Departure from Trend in El Niño years (%)**

Source: United States Department of Commerce, National Oceanic and Atmospheric Administration (NOAA), International Cocoa Organization (ICCO)
Wheat
Wheat prices have gone through a roller-coaster ride this year. Between January and April wheat lost 17%. Since that April lull, wheat has rallied 23% on the back of excess rain in the US and more recently a USDA report confirming US acreage will fall by 1% in 2015.

El Niño now threatens further weather disruption to normal patterns. The chart below, which matches the impact of El Niño to the reproductive growth phases of the crop, indicates that large producing and exporting countries/regions like the EU, Australia, US, India and China are likely to suffer production losses in El Niño events, which will be price positive.

El Niño Impact on Wheat Growing Between May and March

Corn
Although crop progress reports indicated that US planting was buoyant, weighing on price, the USDA acreage report confirmed that planting is down 2% this year. That represents the planting lowest since 2010. Corn has rallied strongly on the back of this news (reported the day before we published). Corn has erased almost all its losses in the past year after the release of the report.

Once again matching El Niño impacts with the reproductive growth phases of crops, the map below indicates that the US, China and parts of Africa will face negative growing impacts from the weather event, while Brazil will experience more positive impacts. The US and China producing 30% and 25% of global production respectively, outweigh Brazil which produces under 10% of global production. Therefore, we believe that the weather event will be negative for growing and positive for price on balance. Indeed the Brazilian reproductive growth phase will start in the early part of 2016, during what we believe will be the final stages of El Niño whereas the reproductive growth phases in US and China will be in 2015 when the El Niño is likely intensifying.

El Niño Impact on Corn Growing Between May and March

Soy
US soy planting intentions were raised once again this year adding to the negative weight on the price. The developing El Niño scenario provides no respite for price declines. The top three producers, Brazil, the US and Argentina are likely to see their production rise in the weather event. Countries like India and China that will likely suffer production declines in the weather event are significantly smaller in terms of their contribution to global production.

El Niño Impact on Soy Growing Between May and March
EL NIÑO: WHAT, WHY, WHEN AND HOW?

What is an El Niño?
An El Niño is the local warming of surface water around the equatorial zone of the central and eastern Pacific Ocean off the Peruvian coast. While warming of surface water is described as local, an El Niño affects atmospheric circulation world-wide (what meteorologists call a “teleconnection”). El Niño has the reputation for being a powerful catalyst to driving weather extremes. An El Niño typically creates droughts in Australia and parts of Asia including India and Indonesia while bringing unusually wet weather to parts of the US for example. However, the characteristics of the El Niño vary according to its timing and amplitude. For example in the northern hemisphere summer, an El Niño is associated with wetter-than-usual weather on the West coast of the US whereas in the winter there is no significant change in precipitation levels in that region associated with an El Niño.

Why and when does an El Niño matter for agricultural futures prices?
The growing of agricultural products is very sensitive to weather patterns. The right amount of sun and rain at the right time is important to produce the yield expected. At the extremes, droughts can ruin a crop because of insufficient water or floods could wash away plants or delay the process of harvesting a good crop from the ground, causing it to spoil. El Niños have historically had significant impacts on agricultural commodity prices but the specific impact on the price of any individual commodity will depend on the El Niño’s amplitude, timing, and locational factors such as where the crop is grown and how prepared the farmers are for extreme conditions. Most agricultural commodities are traded globally and have close substitutes. So even though a futures market contract could be very specific in terms of what is deliverable, the supply and demand dynamics of close substitutes can impact its price e.g. a supply deficit in Chinese wheat could drive demand for US wheat. A disruption during a crop’s reproductive growth phase causes it the most damage. However, a perfectly developed crop could face damage if there are excessive rain delays during harvesting.

How intense will the event be?
The El Niño has intensified to a moderate strength and scientists appear more certain this month that the El Niño event will remain at least at a moderate strength during the course of this year. There is over a 90% chance that the weather event will remain in place to the end of the year according to the pure model based results surveyed by NOAA and most of these models point to a moderate to strong event.

1 For example see “Does El Niño Affect Business Cycles” by Laosuthi and Selover for a causality test analysis of the correlation between commodity price inflation and El Niños between 1950 and 2000
### CURRENCIES

**Summary**

Volatility has been a pervasive force in G10 currency markets in recent months, a product of the ongoing Greek saga and the focus on the potential of tighter monetary policy in the US. While sentiment has been a key driver of policy moves recently, we expect underlying growth and policy fundamentals to become more a focus for investors in the quarter ahead.

Central bank policy will reassert its prominence as a currency performance determinant and the expected divergence of monetary policy, as the recovery paths of major economies differ, is expected to continue over the coming quarter. Policy rates will remain low or negative to support economies and this will predictably exert continued downward pressure on exchange rates. Currency wars continue to be a feature of monetary policy and those countries that are significantly exposed to the global trade environment continue to talk down the value of the local currency. Such rhetoric tends to be most effective when backed up by actual policy commitment. As a result, we have seen relatively poor performance from commodity currencies and expect this to continue in the near term.

While choppy trading is likely to remain a feature of currency markets in 2015, we remain bullish on the US Dollar in the medium term, expecting tighter policy by end-Q3. We feel that any weakness is a good opportunity to establish long positions.

The Euro and Yen likely to be the underperformers. Both central banks (ECB and BOJ) have committed to aggressive Q(Q)E 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: Rate hikes imminent

After some expected consolidation, the US Dollar looks primed for further gains in the second half of 2015 as the US Federal Reserve embarks on its long anticipated tightening cycle.

The USD’s rally will be 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.

The Fed has been balanced in its communication with investors, noting that the economic recovery remains solid enough to justify the beginning of policy tightening this year. A gradual and well communicated tightening cycle combined with the Fed maintaining a healthy balance sheet is unlikely to derail the US recovery, but it should keep the USD well supported.

The weakness in the US in Q1 was largely a result of temporary factors and appears to have faded. The central bank has been careful to convey that any increase in rates must be justified by the sustainable improvement in the underlying economy. To that end, the US economy, particularly the labour market, continues to improve. While US labour market conditions are a key indicator that the US Fed is looking to give it justification for tighter policy, a vital ingredient is wage growth – the link between jobs and inflation – but having a medium term time horizon is important.

There is stronger evidence of wage growth alongside rising household spending. In turn, the strengthening economic environment has seen inflation indicators begin to improve.

While market expectations currently indicate that the Fed will hike rates around the October/November meetings, we feel that investors have taken their eyes off policy tightening and that the situation around Greece is driving the USD. The USD Index has consolidated and has moved broadly back in line with interest rate differentials in recent months. Accordingly, we feel that any weakness is an opportunity to re-establish long positions.

### Currency volatility rising

![Currency volatility rising](source: Bloomberg, ETF Securities)

### Rate Hike to Boost the Dollar

The market view on EUR/USD is becoming increasingly polarized, with some expecting gains in the face of rising volatility. We expect downside risks to come more into play and would feel any near-term rally as an opportunity to establish short positions.

Volatility has not been absent from Euro crosses in recent months and the EUR/USD has traded a wide range. ECB
Risks for the Swiss economic growth continue to be 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 if the SNB takes additional action and/or the threat of Greek crisis fades. Balance sheets across central banks will remain elevated to support economies.

At the time of writing the SNB reported intervention in the fx market to offset currency strength. With the SNB remaining active in currency markets but we feel that unless a material policy change is made by the central bank, CHF will not attain the floor 1.20 level again in 2015. However, the SNB is certainly moving closer to the point of again making FX a policy target. We anticipate EUR/CHF will likely move back toward the 1.10 level over Q3 2015.

**CAD: Stable outlook**

The Canadian Dollar (CAD) has been the strongest performing 'commodity currency' thus far in 2015, buoyed by the rebound in crude oil prices in recent months.

While the Bank of Canada (BOC) cut its policy rate early in 2015, a direct result of the lower oil price on the economy, the move has stabilised the inflation profile. We feel that the benefits of lower oil prices on consumption, combined with the resilience of domestic spending and the improving prospects of the US economy has given the BOC comfort to maintain its current policy stance.

The Canadian economy also has the twofold benefit of a large proportion of its exports heading south to US markets. After the Q1 weakness in the US, the external sector should benefit from the rebounding US economy and the weaker CAD. Canadian exports have therefore become more competitive, giving additional impetus to the external sector, while at the same time hampering import competitiveness and prompting domestic substitution.

We expect that CAD will soften against the USD, as oil prices falter in coming months. However, against EUR, its prospects are much better. With both the Euro and Canadian economies trying to regain a more sure footing, once the near-term volatility associated with the Greek crisis begins to fade, these

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**CHF: More than willing to take action**

The Swiss Franc (CHF) has been the strongest performing G10 currency in 2015, and that is keeping growth trajectory for the local economy subdued.

The Swiss National Bank has kept policy settings unchanged but looks increasingly likely to again attempt to counteract what it sees as an overvalued currency. SNB President Jordan recently stated that the Swiss Franc is ‘significantly overvalued’ and that a potential Greek exit could prompt further CHF strength. Recent events have increased the chance of a Greek tragedy, but the SNB’s rhetoric is becoming increasing concerned about the impact of a strong local currency. Jordan also indicated that the current -0.75% policy rate is not the lower bound and further action in coming months to offset currency strength cannot be ruled out. 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, regardless of what the SNB suggests.
fundamentals should reassert. The recent stronger EUR/CAD is in line with our view, and now that the exchange rate is now more in line with interest rate differentials, we expect a degree of stability.

GBP: More promising signs

Volatility has historically been an adverse influence on the value of the British Pound. The pound has remained strong as the ECB has pursued its QE policy to offset deflationary forces. The fresh strength in GBP has come at a time when expectations have begun once again to price in rate hikes by the Bank of England. Hawkish comments from the Bank of England’s Weale have indicated room for moderate rate hikes, as early as this year. If such a stance gains traction, and is bolstered by continued improvement in the underlying economy, GBP should find strong support.

Business investment has remained flat as companies have cut CAPEX budgets, mainly from the construction and mining sectors. Nonetheless, we expect the upturn in UK economic momentum to continue with consumer confidence near decade highs, in turn continuing to lift retail sales. Despite no real evidence of wage or CPI growth, accelerating consumer credit should help support demand.

We expect recent GBP strength against the USD to reverse somewhat as rate hike expectations in the US again take hold. Against the Euro the outlook is more favourable and we expect further appreciation in the medium term. However, EUR/GBP is trading near the bottom of its recent 0.70–0.74 range and as such is likely to require a strong catalyst to break to the downside in the near-term.

If more doves turn to hawks on the MPC, a break of 0.70 to the downside for EUR/GBP is possible. However, a temporary near-term move higher is likely as additional clarity surrounding the Greek crisis lifts the Euro.

The gradual pace of economic improvement of the Japanese economy appears in line with the expectations for the Bank of Japan. The central bank continues to add to the monetary base via its Quantitative and Qualitative Easing (QQE) policy at a steady rate, and is expected to do so until the inflation target is achieved. Inflation is currently hovering around the 0% level (2% with the consumption tax effect). We expect that against the Euro, JPY will continue to exhibit its long held relationship with money supply and is likely to continue to trade a range, albeit with downside risks for EUR/JPY as the European Central Bank also pursuing aggressive monetary stimulus.

Wage growth continues, albeit at modest pace, but if sustained in coming months, it will contribute to a more stable pricing environment. The improving wage environment is being assisted by a stronger jobs environment, and the unemployment rate is at the lowest level in nearly 20 years.

Low unemployment rates are helping support a robust retail environment. But while household balance sheets are strengthening, some indicators of business activity have disappointed. Nonetheless, while there has been some volatility in industrial activity, survey evidence shows that capacity remains tight, that manufacturing confidence continues to rise, which should lead to an improving outlook for business investment.

With signs that the BOJ’s QQE strategy is showing results, we...
expect that USD/JPY will grind higher toward 125 by year end, consolidating not far from current levels.

SEK: More and more stimulus

The Swedish central bank, the Riksbank, is currently one of the most aggressive central banks in the G10 currency space. To offset deflationary forces and nurse the economy back to health, the Riksbank is providing support via a combination of negative interest rates and quantitative easing (QE). Since February, when the central bank announced its foray into quantitative easing, it has injected SEK80-90bn and cut rates by 0.15% to -0.25%. Indeed, since February, the QE injections have come at an increasing rate, with April’s announcement of SEK40-50bn the largest by at least 33%.

In a stark turnaround from the first quarter, industrial production has rebounded strongly. Although consumer lending growth remains on its prior robust trend, retail sales have faded. Despite some positive signs from the economy, rates are not expected to get back into positive territory until late 2016, as there is little evidence of wage or price growth – an issue that will remain a significant drag on currency performance.

We expect that the Krona will remain under pressure against the Euro with the Swedish economy dependent on the external economic environment. At every turn, the Riksbank has continued to indicate its ‘readiness to do more’ highlighting the commitment of its policymakers. 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 a material improvement in external demand. We expect that EUR/SEK could make gains against the Euro in the medium term as a more sustainable recovery is witnessed, grinding toward 9.25 by end-2015 and 1.20 by year end.

NOK: Rebounding with oil

While the Norwegian Krone took the biggest hit on the downside as oil prices declined in late-2014 and early-2015, it has also outperformed other commodity currencies (notably the Canadian Dollar) in the subsequent oil price rebound.

Although the rebound in oil prices is a positive for the Norwegian economy, there are risks to the outlook. Household spending has remained buoyant despite a decline in consumer confidence and the housing market is also remaining resilient, likely sustained by the low level of interest rates.

However, investment in the petroleum industry is expected to continue to decline sharply in 2015 but tail off in 2016/17. Business investment has also been a soft patch, despite the sharper-than-expected rebound in oil prices, coupled with a softer outlook for growth and employment in coming months.

While near-term there is a threat to oil prices in our estimation, going into year-end and early 2016, we expect that the stronger commodity market fundamentals to give greater buoyancy for energy linked currencies, particularly NOK and CAD.

AUD: RBA wants lower Aussie

The Australian Dollar downside risk remains elevated and as such is unlikely to breach the 0.80 USD level to the upside. 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) remains determined to provide support with accommodative policy. While we expect that rates are now on hold after May’s rate cut, jawboning the AUD lower has long been a favoured tactic of the central bank. While interest rates aren’t expected to be cut further in coming months, the easing bias is likely to cap gains for the AUD.

Growth in business activity in the non-mining sectors of the Australian economy remains lacklustre but continues to outperform business investment in the mining sector. Consumer confidence remains elevated, helped by a stronger employment environment, a consumer friendly government budget and lower oil prices.

Meanwhile, despite the stabilisation of Chinese economic activity, AUD remains susceptible to fragile sentiment surrounding the Chinese growth path. Certainly sentiment and
policy rhetoric is driving the currency, as its correlation with the OECD leading indicator has broken down in recent years.

The Australian Dollar’s strong link to the external environment via 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: Remains overvalued

While nearly reaching parity with the its antipodean counterpart, the AUD, the NZ Dollar has been in sharp decline ever since. Expectations are rising for the Reserve Bank of New Zealand (RBNZ) to continue to cut rates, amid calls that it made a mistake in raising rates in 2014. The RBNZ raised interest rates four times, in aggregate by 1.00%, in the four months to July 2014.

Until June 2015, where it cut rates, pressure has been rising to get inflation back on target. The central bank has recently published a report indicating that for around five years it has a ‘persistent bias’ in overestimating the rate of inflation. And recent declines in dairy prices and oil prices have certainly not aided their track record.

While household spending is being supported by lower oil prices and low interest rates, there is continued fears surrounding farm incomes as a result of falling dairy prices. NZD remains closely linked with dairy prices, as New Zealand is the world’s largest exporter of dairy products.

We expect further weakness in the NZD, as rate cuts weigh on the currency. Indeed, the market is expecting another two rate cuts over the next 12 months and in turn the NZD is the worst performing G10 currency this year. With the RBNZ calling for a further ‘significant downward adjustment’, the balance of risks is firmly tilted to the downside for the local currency.
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Commodity and Foreign Exchange Outlooks

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