

FICC Research

Commodities: Daily

Focus: Copper spreads - expensive or good value?



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Focus: Much of the focus on copper recently has been on the performance of the outright 3-month price. We remain bullish on copper's prospects, and instead switch our attention to the spreads.

- The base metals had another quiet overnight session, however a weaker dollar and stronger equity markets have reinvigorated the base metals complex after Monday's lacklustre start to the week. Copper has rallied back above \$8,100 while tin has set a new all-time record nominal price, trading up to \$25,800. Short covering and the triggering of stops have been a feature of the market exacerbating some of the price strength.
- A look at short-term correlations shows that much of the latest rally in precious metals was driven by dollar weakness. At the same time, metals have seen speculative length and open interest rise across the board in recent weeks. In the physical market, scrap gold is coming to the market. We would not be surprised to see a pull-back in gold towards \$1,300.
- Movements in crude oil time spreads seem contradictory to the market consensus of a build in US crude inventory over the last week. Front to back spread of both WTI and Brent continued to strengthen. The contango between the first and the 12th-month WTI contracts has narrowed by \$1.4/bbl, compared to a week ago.

Commodity price data (4 October 2010)

Base metals LME 3-month									
	Open	Close	High	Low	Daily change	Change (%)	Cash Settle	Change in cash settle	Cash – 3m
Aluminium	2,358	2,363	2,360	2,286	3	0.13%	2,332.00	-13	-32.50
Copper	8,100	8,066	8,055	8,015	-68	-0.84%	8,085.50	-30	-15.50
Lead	2,270	2,278	2,277	2,255	-18	-0.78%	2,265.50	-11	-28.00
Nickel	23,900	24,145	23,970	23,800	340	1.43%	23,835.00	60	-22.00
Tin	24,925	25,200	25,200	24,850	300	1.20%	24,930.00	-120	0.00
Zinc	2,235	2,230	2,228	2,210	1	0.04%	2,205.50	13	-31.00
Energy									
	Open	Close	High	Low	day/day	Change (%)			
ICE Brent	83.19	83.40	83.60	82.93	0.12	0.14%			
NYMEX WTI	81.37	81.45	81.74	81.15	-0.02	-0.02%			
ICE Gasoil	721.75	722.75	724.50	718.75	-4.25	-0.59%			
API2 Q3'10	96.40	95.80	-	-	-0.60	-0.63%			
EUA Dec10	15.36	15.26	-	-	-0.10	-0.65%			
Precious metals									
	AM Fix	PM Fix	High bid	Low offer	Closing bid	Change (d/d)	EFPs		
Gold	1,316.00	1,313.50	1,320.00	1,315.90	1,315.00	-1.50	1.1/1.5		
Silver	-	21.97	22.20	22.08	21.93	-0.09	1.0/3.0		
Platinum	1,668.00	1,667.00	1,680.00	1,670.00	1,667.00	-13.00	3.0/5.0		
Palladium	566.00	565.00	572.50	561.00	559.00	-13.00	0.0/2.0		

Sources: Standard Bank; LME; BBG

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Focus: Copper spreads - expensive or good value?

Much of the focus on copper recently has been on the performance of the outright 3-month price. We remain bullish on copper's prospects, but instead switch our attention to the spreads.

Looking at the relationship between how the copper spreads - in this case the generic 3-15 mth and 15-27 mth spreads - relate to the 3-month price (see Fig. 1), the spreads are lagging well behind. Purely on this basis, both the 3-15 and 15-27 mth spreads have a lot of potential still to go in terms of how deep the current backwardation may become. Looking at how those spreads are behaving relative to stocks however (See figs 2 & 3), paints a different picture entirely.

Looking at the spreads to stocks relationship, the 3-15mth spread is in line with where it has traded historically, given the current level of on-warrant LME stocks. In terms of how the spread has traded in the past, there is undoubtedly a lot of potential for further tightness, though, unsurprisingly perhaps, it appears to be contingent on further declines in on-warrant LME inventories to <200 kt or so.

Interestingly, on the basis of historical patterns, the 15-27 mth spread is looking a little expensive at the moment, with the market appearing to be anticipating further significant declines on on-warrant LME stocks.

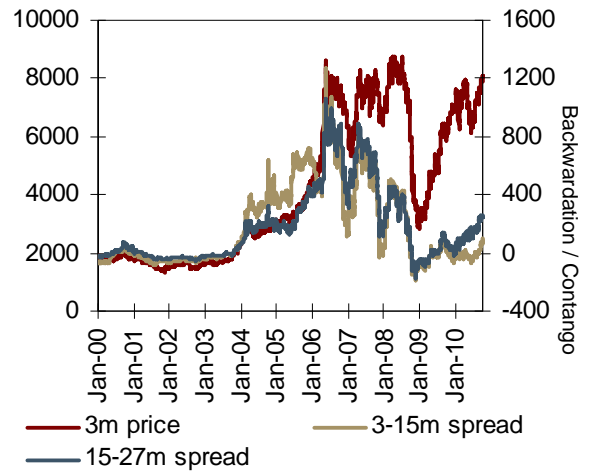
That said, while the spread historically looks a little overpriced, we would still be very reticent about lending the 15-27 mth spread, particularly given our view of copper's tightening fundamentals and expectations of further inventory draws. Instead, we actually still see good value in borrowing the spreads in this farther-dated portion of the copper curve, though we would pick our entry points and dates carefully.

The biggest question marks we have are really over the middle dated portion of the forward curve, represented by the 3-15 mth spread. Given expectations of solid physical demand and further inventory declines, we would ordinarily expect the backwardation to widen and would therefore also look to borrow the spreads.

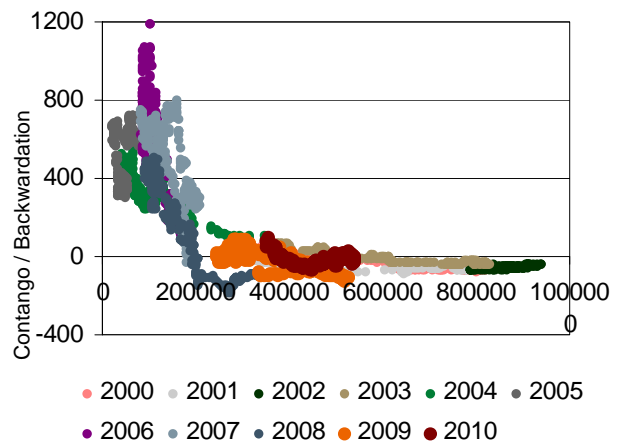
Unlike the 15-27 mth spread however, the 3-15 mth spread is, in our view, also much more likely to come under the influence of passive long-only index funds - active in the nearer dated and more liquid portion of the curve. Given expectations of new money coming into commodities in Q4 and perhaps more significantly in Q1-2011 we are concerned about the impact this may have on the nearby forward structure.

In particular, our concern is if a large influx of cash serves to shift the inflexion point, between contango and backwardation, further forward. Currently the copper forward curve is in contango out to Dec-10, before it starts to flatten and move into a backwardation. Although producer selling interest will have been rekindled with prices up around current levels, expectations of higher prices still to come means that any selling likely to be steady rather than

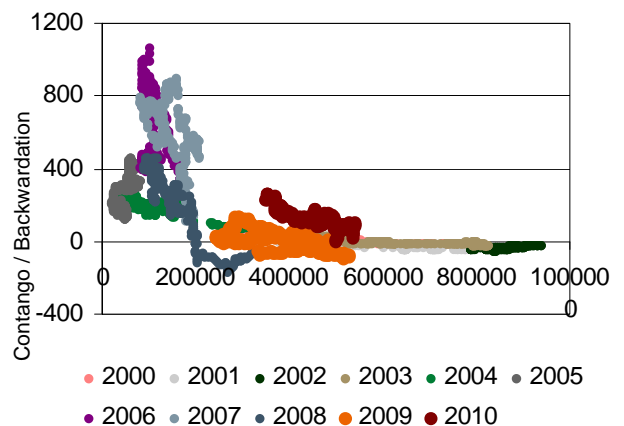
1: Copper Price (LH axis) vs. Spreads (RH axis)



2: Copper 3-15m spread vs. LME on-warrant stocks



3: Copper 15-27m spread vs. LME on-warrant stocks



Sources: Standard Bank, LME

spectacular, and is unlikely to be able to balance the fund inflows.

Instead, we would be happier having an outright long position in this middle portion of the copper forward curve and would keep any borrowing activity contained in the farther-dated spreads.

Base metals

The base metals had another quiet overnight session, however, a weaker dollar and stronger equity markets have reinvigorated the base metals complex after Monday's lacklustre start to the week. Copper has rallied back above \$8,100 while tin has set a new all-time record, trading up to \$25,800. Short covering and the triggering of stops have been a feature across the complex, exacerbating some of the price strength.

Aluminium was the main talking point overnight, with the LME stepping in and canceling a number of trades that occurred shortly after the open of LME Select. Prices have since shrugged off the early confusion, with the metal trading back above \$2,350 heading into the afternoon.

The base metals continue to look very solid, and look set to make further gains over the short term. Given the busy end to the week however, in terms of the BOE and ECB rate announcements and the NFP figures, position squaring activity may start to emerge as we head towards the weekend.

By Leon Westgate

Precious metals

A look at short-term correlations shows that much of the latest rally in precious metals was driven by dollar weakness. At the same time, metals have seen speculative length and open interest rise across the board in recent weeks. In the physical market, scrap gold is coming to the market. We would not be surprised to see a pull-back in gold towards \$1,300.

With the Bank of Japan cutting its overnight lending rate to a range of 0%-1% this morning (which spurred a flurry of buying in precious metals in Tokyo) and our expectation for more quantitative easing from the Fed in November, we would see any pull-back as a buying opportunity.

Gold support is at \$1,311 and \$1,300, while resistance is at \$1,330 and \$1,335.

We maintain that liquidity (and not necessarily inflation) is a leading long-term driver of gold. From monetary easing in Japan and the US, platinum, palladium and silver should also benefit. But we find that the causality between liquidity and PGM prices is much weaker than between liquidity and gold. Our target for platinum is still \$1,800 and \$650 for palladium in Q1:11.

Platinum support is at \$1,662 and \$1,655. Resistance is at \$1,689 and \$1,700. Palladium support is at \$555 and resistance is at \$580.

Fundamentally, we remain bullish on copper. Combined with our view on gold, we believe that a pull-back in silver is likely to be short-lived. Silver support is at \$21.80 and \$21.65. Resistance is at \$22.35 and \$22.70.

By Walter de Wet

Energy

Front-month crude closed slightly lower yesterday amid the dollar rising. Front-month WTI finished the day 11c/bbl lower at \$81.47, while front-month Brent closed 47c/bbl lower at \$83.28/bbl.

Movements in crude oil time spreads seem contradictory to the market consensus of a build in US crude inventory over the last week. Front to back spread of both WTI and Brent continued to strengthen. The contango between the first and the 12th-month WTI contracts has narrowed by \$1.4/bbl, compared to a week ago.

In contrast, ICE gasoil moved up by \$7.25/te yesterday, as there seemed to be no end for the strike by the French port workers. It was also reported that the strike might be joined by refinery workers. This is helping to keep the first two months ICE Gasoil contracts in backwardation.

The latest Eurozone PMI index implies that growth in Europe's services and manufacturing industries weakened in September. The Composite PMI Index fell to 54.1 in September, from 56.2 in August. This did not stop the euro's continuous gain over the dollar. Over in Asia Pacific, the Bank of Japan has pledged to keep its interest rate between 0% and 1% and set up a \$60billion fund to buy government bonds. Australia's central bank has surprised the market by keeping its benchmark rate unchanged at 4.5%.

In the current economic climate where countries compete in devaluing their own currencies, oil prices are influenced more by *investment money seeking to preserve value* than by either *the real economy or the fundamental supply and demand balance*. The trigger for oil to move out its current trading price range could well turn out to be new developments on monetary policies.

WTI front-month support is at \$80.70 and \$79.90. Resistance is at \$82.30 and \$83.15.

By Walter de Wet

Base metals

Daily LME stock movement (mt)

Metal	Today	Yesterday	In	Out	One day change	YTD change (mt)	Cancelled warrants (mt)	Cancelled warrants (%)	Contract turnover
Aluminium	4,348,850	4,352,000	2,300	5,450	-3,150	-280,050	239,425	5.51	178,108
Copper	374,450	373,800	2,400	1,750	650	-127,875	18,350	4.90	103,557
Lead	197,850	194,375	3,600	125	3,475	51,350	8,100	4.09	23,865
Nickel	123,540	123,594	-	54	-54	-34,470	4,260	3.45	26,995
Tin	12,540	12,495	70	25	45	-14,225	425	3.39	6,497
Zinc	614,825	615,825	-	1,000	-1,000	126,775	47,050	7.65	53,058

Shanghai 3-month forward prices

COMEX active month future prices

Metal	Open	Last	1d Change	Open	Close	Change	Change (%)
Aluminium	-	-	-	Ali Dec'10	-	-	-
Copper	-	-	-	Cu Dec'10	366	365.20	-1.20
Zinc	-	-	-				

ZAR metal prices (4 October 2010)

	Aluminium	Copper	Lead	Nickel	Tin	Zinc	ZAR/USD fix
Cash	16,254	56,356	15,791	166,130	173,762	15,372	6.9700
3-month	16,709	57,035	16,108	170,732	178,192	15,769	7.0711

Energy

Energy futures pricing	Price Change		Price Change		Price Change		Price Change		Price Change	
	1-month forward	2-month forward	3-month forward	6-month forward	1-year forward					
Sing Gasoil (\$/bbl)	93.91	0.81	94.63	0.88	95.16	0.55	96.66	0.87	-	-
Gasoil 0.1% Rdam (\$/mt)	722.75	-4.25	720.00	-4.25	720.25	-4.00	727.50	-3.75		
NWE CIF jet (\$/mt)	761.45	6.78	766.88	7.22	772.16	6.82	782.64	6.00		
Singapore Kero (\$/bbl)	95.13	1.12	95.43	0.98	96.01	0.60	97.71	0.87		
3.5% Rdam barges (\$/mt)	456.75	4.25	458.75	3.75	460.75	3.50	469.46	2.62		
1% Fuel Oil FOB (\$/mt)	471.00	2.75	477.00	1.75	482.25	2.25	494.46	2.12		
Sing FO 380 Cargo (\$/mt)	100.15	-	100.15	-	100.15	-	100.15	-		
Sing FO180 Cargo (\$/mt)	479.50	4.50	483.25	4.25	486.50	4.00	494.71	3.37		
Thermal coal	Q4-10		Q1-11		Q2-11		Cal 11		Cal 12	
API2 (CIF ARA)	95.80	-0.60	97.00	-0.70	98.30	-0.70	99.00	-0.75	106.01	-0.65
API4 (FOB RBCT)	89.40	-0.70	92.10	-0.40	93.30	-0.50	94.00	-0.45	99.90	-0.65

Precious metals

Forwards (%)	1-month	2-month	3-month	6-month	12-month		
Gold	0.40200	0.42200	0.44200	0.49200	0.53400		
Silver	0.57000	0.57000	0.58000	0.61000	0.62000		
USD Libor	0.25688	0.27359	0.29063	0.46313	0.77700		
Technical Indicators	30-day RSI	10-day MA	20-day MA	100-day MA	200-day MA	Support	Resistance
Gold	69.19	1,305.44	1,284.81	1,229.35	1,179.99	1,317.00	1,330.00
Silver	70.19	21.66	21.02	18.88	18.14	21.90	22.24
Platinum	64.48	1,651.40	1,620.26	1,556.93	1,583.93	1,668.00	1,685.00
Palladium	60.57	560.55	549.02	486.12	478.38	558.00	574.00
Active Month Future	COMEX GLD	COMEX SLV	NYMEX PAL	NYMEX PLAT	DGCX GLD	TOCOM GLD	CBOT GLD
	Dec'10	Dec'10	Jan'11	Jan'11	Oct'10	Aug'11	Dec'10
Settlement	1,319.40	21.9800	563.00	1,672.10	1,314.90	3,553.00	1,319.70
Open Interest	613,046	153,636	24,450	38,375	2,145	109,894	2,412
Change in Open Interest	-592	-1,096	-648	-567	-	-1,472	-77

Date: 4 October 2010

Sources: Standard Bank; LME; Bloomberg

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