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8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob. 852-9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

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COMMODITY PRICE TREND AND THEIR IMPACT ON ON ASIA AND LATIN AMERICA

Summary

- Most prices of soft commodities are falling and,given reasonable weather,may continue to stay weak. All this augurs well for inflation in Asia where the CPIs are heavily weighted by food, but is poorer news for Latam food exporters.
- Hard commodities offer a diverse picture with export restrictions favoring nickel and with iron ore and coal prices staying under pressure while the Chinese economy slows.
- The modest G3 recovery will moderate demand for oil thus relieving some of the supply restrictions ..Overall mixed picture for exporters and importers of commodities.
- Gold has lost its luster and will stay dull for the rest of 2014

Investment Conclusions

- In sum, commodities as an investment class are now too diverse in their price dynamics to allow for grand summaries such as being" bullish or cautious".
- The AUD, always a good proxy for commodities, has been slowly decoupling from commodity dynamics and stayed strong and may offer a hedge for commodity overweight portfolios.
- Low asset price volatility and higher USD rates in 2014-15 will not favor gold.
- Brazil's difficult 2014 year will not improve (iron and agro) and neither will Chile's outlook (copper)
- Indonesia's export outlook mixed

Metals,energy and the role of China

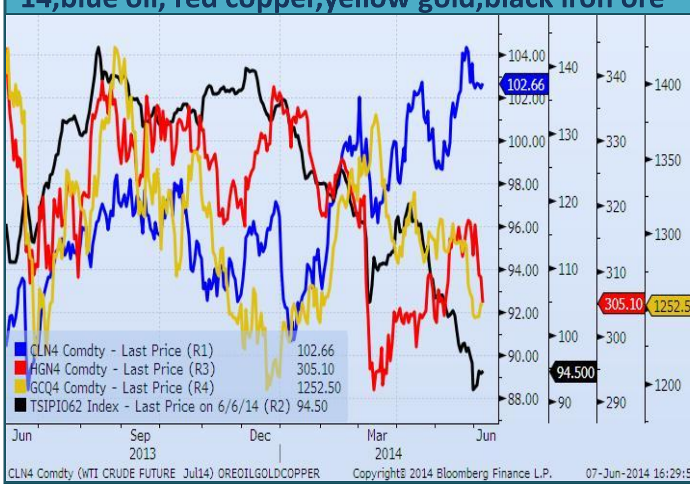
The price of copper and that of iron ore (measured by Chinese imports) have declined and are likely to stay weak as demand from China flattens out while supplies stay strong. (Chart 1) Demand for copper is driven by construction and that of iron ore by steel output which, in its turn, also reflects construction activity and consumer goods such as white electrical goods and cars.To the extent that the dominant role of China in the imports of these hard commodities keeps their prices down, this is of indirect benefit to China as low prices are the outcome of its own low demand. The picture is more complicated insofar as the price of nickel (linked to stainless steel output) has risen because of export restrictions by Indonesia.

The picture becomes more complex in the case of oil and coal. The price of oil has peaked but sharp rises are unlikely as demand from the G3 economies will remain, at best, subdued. Demand from the US will continue to change as the US becomes self-sufficient in oil thanks to fracking and is allowed to export oil-something forbidden so far for strategic reasons.The price of coal has collapsed as demand weakened because of environmental reasons (thermal coal for energy production) and cyclical downturn(coking coal for smelting steel).Australia, the world's biggest coal exporter will feel the impact, but so will coal-exporting Indonesia.

China's domestic coal sector will shrink further as it is uncompetitive compared to imported coal. But then China is still producing most its energy by coal, something which will change rapidly for enviromental reasons.

Hence the price trends of hard commodities will have a diverse impact on Asian importers and exporters of metals and of oil.

Chart 1: Prices of Metals,Oil and Gold, 2013-14,blue oil, red copper,yellow gold,black iron ore



Source: Bloomberg

The view from Latin America

Chile is the most obvious case to consider as its main export is copper (but exports are diversifying now…).From 4Q.13 onwards GDP growth has been declining while inflation has accelerated, but the peso stayed relatively strong. The newly elected administration is planning an extensive fiscal initiative on education and other spending areas all of which may sit uncomfortably with falling copper exports and prices all of which constitute an important source of fiscal revenues.

Brazil will bask under the spotlight of the world cup which, however, will not disguise the mounting economic problems facing this major exporter of iron ore, soybeans, coffee and sugar. The prices of ore and sugar are falling because of expanding supply but those of soybeans may have peaked and the prices of coffee are drought driven. (Chart 2). A picture which will not help an environment of decelerating GDP growth for over one year now, accelerating inflation which will keep interest rates high (hiked 9 times so far), weakening BLR and presidential elections in October. World cup or not, BLR-denominated financial assets will stay under pressure and not necessarily helped by exports.

The case of **Argentina** is. As an exporter of wheat the outlook is poor now price-wise although China's aggressive entrance in the importation of dairy products may open new markets as it did for Australia and New Zealand. At least Argentina has sorted out the Paris Club outstanding debt "default" but the peso has stayed weak.

FACTBOX : Gold, the end of line ?

Rather than repeat the old story about gold being the safe haven during periods of crisis, it is best to consider the following factors which will keep the price of gold down. Taking a view, say from May 2013 when the Fed announced that rates will go up, the price of gold has been on a falling trend as the opportunity cost of holding gold will increase once USD rates and yields rise

The recent ECB action to introduce negative rates reinforced the view that the ECB will do what it takes to help the EU recover and stave any EUR-related crisis.

Less volatility in fixed income and equity markets-the worse for gold.

Chart 2: Prices of food, 2013-14,red corn, yellow wheat, green soybeans, blue Thai rice

Source: Bloomberg

Winners and Losers

To the extent that China is a major importer of several soft and hard commodities, the softer prices of iron ore, coal and copper are good news but against the background of slowing economy which was an important driver of these developments in the first place.

Thailand's ill-advised attempt to corner world rice prices failed, and the military government will be faced with the task of paying farmers and disposing of a mountain of rice, all of which is good news for Asian rice importers such as the Philippines and China which will see less food-driven pressures on their CPIs. Ditto for wheat and corn importers, which cover most Asia and China as well.

Indonesia's restrictions on "unprocessed" metal ore exports is a double-edged sword which can backfire despite keeping prices up for now.

Gold is most unlikely to return to favor in portfolios while the AUD, given also its wide USD interest rate differential, will continue to do well as it slowly decouples from commodity prices

A mixed picture indeed.