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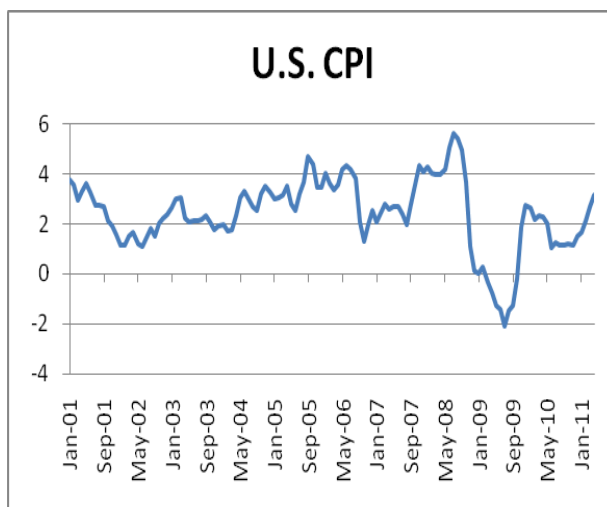
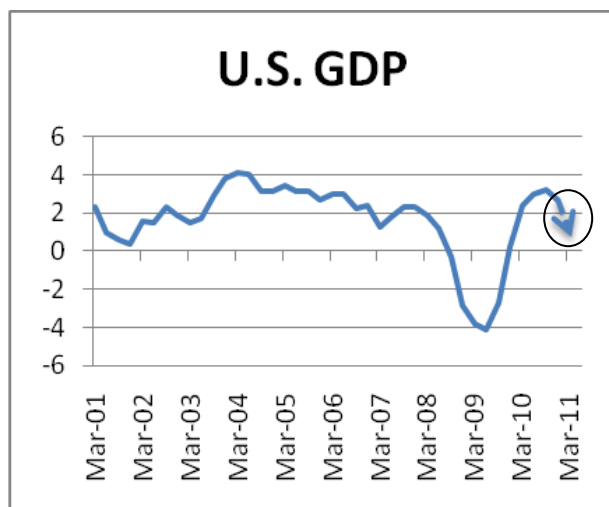
### Dilemma of U.S. Central Bank

The head of the United States central bank is asking the nation’s politicians to not play politics with the US debt ceiling. In a speech of 14th June, Federal Reserve chairman Ben Bernanke said the government debt ceiling should not be used as a bargaining chip to force budget cuts and warned that if the debt limit is not raised, then the creditworthiness of the US government could be at risk. US president Barack Obama wants to raise \$14.3 trillion US debt cap, but the Republicans want to see spending cuts in return. After hitting the limit on debt ceiling of \$14.3 (almost 100% of their GDP), the US still wants to raise it. This shows the kind of problems the US economy is facing right now. The speech by Ben Bernanke and US president Barack Obama indicating that it is very difficult to get their debt limit raised and the end of additional quantitative easing programme or QE2 will make things even more difficult for the US central bank.

### Why QE3 Will Not Be Introduced Immediately?

The levels that commodities prices touched in the first quarter of 2011 were mainly because of easy monetary policy and stimulus packages. We don’t think acute demand-supply mismatch was the reason for the bullish trend in commodities. Now, in a scenario where the US economy is seen slowing down marginally does not present a strong case for QE3, surge in the consumer price index (CPI) and core consumer prices index will prevent the Federal Reserve from thinking about QE3 and in the minutes of the last FOMC meeting it was mentioned that there would need to be a significant change in the economic outlook before another programme of asset purchase.

The underlying meaning behind this statement is that only if the economic outlook deteriorates significantly or if there is a chance of a double dip recession, only then such a measure will be required. Last but not the least, we feel it is very difficult to get away with programmes similar to QE2 in the Senate as previous programmes have proved ineffective in generating more jobs and preventing the fall in housing prices. We feel that without QE3, commodity prices are going to fall on their own weight.



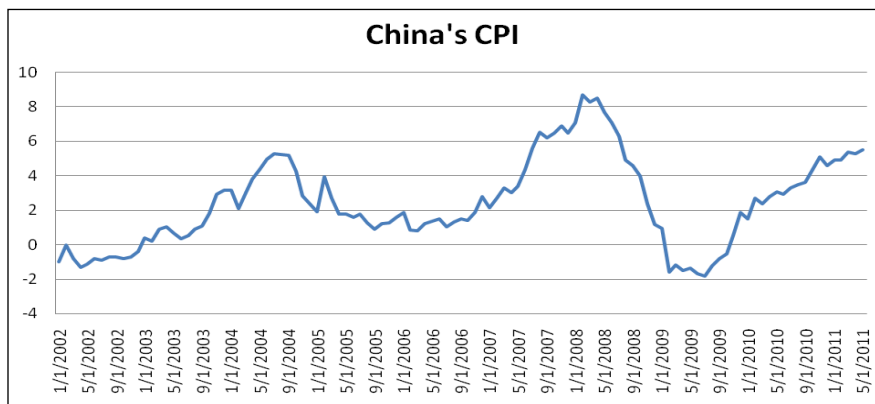
Source: Reuters, NB Research

In the recent FOMC meeting the staff revised down its projection for the rate of increase in real gross domestic product over the first half of 2011. The effects from the disaster in Japan were also anticipated to temporarily hold down real GDP growth in the near term. The Fed said that it had revised down its projection of 2011 growth to 3.1% to 3.3%, from its January estimate of 3.4% to 3.9%. The 2012 estimate moved to 3.5% to 4.2% from 3.5% to 4.4%, while the 2013 projection was between 3.5% and 4.3%, versus the 3.7% to 4.6% range central bankers expected at the start of the year. Long run, the Fed expects the economy to grow from 2.5% to 2.8%. Growth in GDP continues to remain sluggish where as inflation is seen picking up, may put brakes on another asset purchase programmes.

**China: A Dragon without Wings for a while**

China, the second largest economy of the world, is still facing a stiff task in managing growth with price stability. It is getting into a stale-mate situation where it is not ready to forgo its development stance nor can it allow its stubborn inflation to just keep on rising.

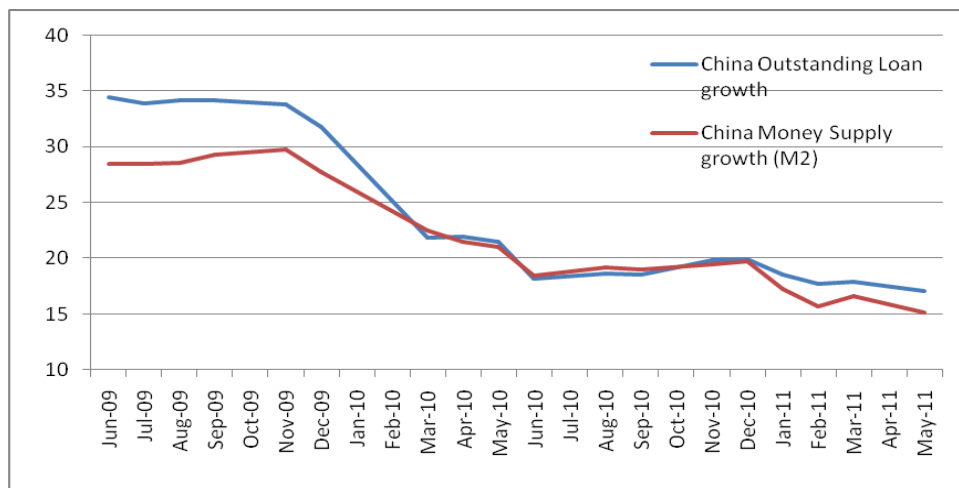
But one of them has to make way for the other, and we believe that the former would be compromised by the Chinese officials in times to come. Curbing soaring prices has become a priority for China. In May, the consumer price index (CPI), a measure of inflation, reached 5.5% year-on-year, a 34-month high, according to the National Bureau of Statistics.



Source: Reuters, NB Research

In response to rising inflation, the People’s Bank of China, which was left with no other option but to continue with its monetary tightening stance, on 14th June 2011, soon after the Chinese CPI data, raised RRR by 50 basis points.

It was very surprising to see China raising reverse requirements while some of the markets were still open, rather than the close on Friday or during a holiday, as is usual. Such sudden announcements clearly indicate that the economy is still not out of the monetary tightening stance. Hence, such moves by China may result in less credit off-take for its industries, thus affecting the aggregate growth of the economy. As shown in the graph, the broad measure of money supply (M2) and outstanding loan growth in China has slowed down considerably over the months and doesn’t seem to grow in the near term.



Source: Reuters, NB Research

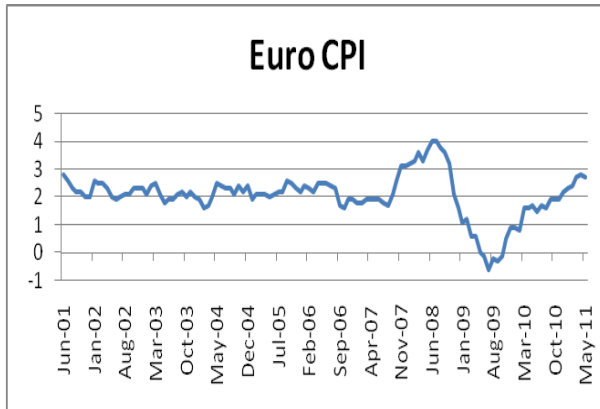
Three factors that have paved the way for China’s rapid economic growth with relatively low inflation over the past three decades are comparatively cheap labour, government-controlled prices of natural resources including gas, water and electricity, and the ignored environmental cost. All these factors have contributed to the relatively low cost of production. But, the cost of all the three factors has been rising of late. China which is the world’s largest consumer of the so called “hot commodities” is likely to witness a slowdown and will have negative consequences on the prices of commodities. If Chinese slowdown persists for more than a quarter, then it could have a disastrous impact on the prices of commodities.

**Euro-Zone Debt Crisis: Sheer Nightmare for the World’s Economy**

The latest data shows that economic growth in the euro-zone remains subdued. Of course, with headline inflation well above target, this won’t stop the ECB from raising interest rates again over the coming months.

If we take a look at the Euro zone’s economy then there are more signs that growth is slowing. With rising inflation, slowing wage growth and spreading fiscal squeeze hitting disposable incomes as well as further monetary policy tightening round the corner, the consumer outlook certainly remains grim. And as the export boom continues to lose a bit of steam and the lagged effects of the euro’s strength hitting home, the uncompetitive peripheral economies will be hit rather sharply, making them ever more vulnerable to the ongoing debt concerns.

The drop in the economic sentiment indicator (ESI) from 106.2 in April to 105.5 the third fall in a row which left the index at its lowest level since October last year, is indicating a negative side of the economy. The situation in the economy is not showing any major growth indicators, demonstrating the greater need for decisive and united action by the policymakers to get a grip on the situation.



Source: Reuters, NB Research

Recently, we saw a slight drop in euro-zone inflation, which is unlikely to prompt the ECB to tone down its hawkishness. However, we still feel that interest rates are set to rise again, if commodities prices do not fall. Sluggish growth, coupled with high inflation and the ongoing debt crisis in troubled nations, will lead to a drop in the demand for commodities from the Euro Zone as a whole.

**Conclusion**

Slowing growth in the US, China, Japan and the Euro zone makes us believe that the commodity cycle for the year has peaked out and we are going to see all commodities except gold going down on their own weight, in the coming months. The end of the additional quantitative easing programme in the US and the probability of the introduction of a new quantitative easing plan is very dim. More than demand and supply, the macroeconomic environment has turned against the boom in commodities. Irrespective of tight demand and supply situation, we feel even agricultural commodities are going to remain under pressure and will go down. The ongoing crisis in the Euro zone will support gold. We see a 8-10% correction in base metals; crude oil may test the level of \$85/barrel and selling on rallies is the right strategy for commodities for the next quarter. In Agricultural commodities soft commodities such as spices are likely to suffer, oilseeds (soyabean, soyaoil, mustardseed and even cotton) are going to correct by 8-10% in coming months and we see more pain by the end of the year for the complex. And it seems in coming months we are going to see a "perfect storm" in commodities.

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