



## COPPER

### Theme for 2007

#### After a good workout, it's time to catch some breath

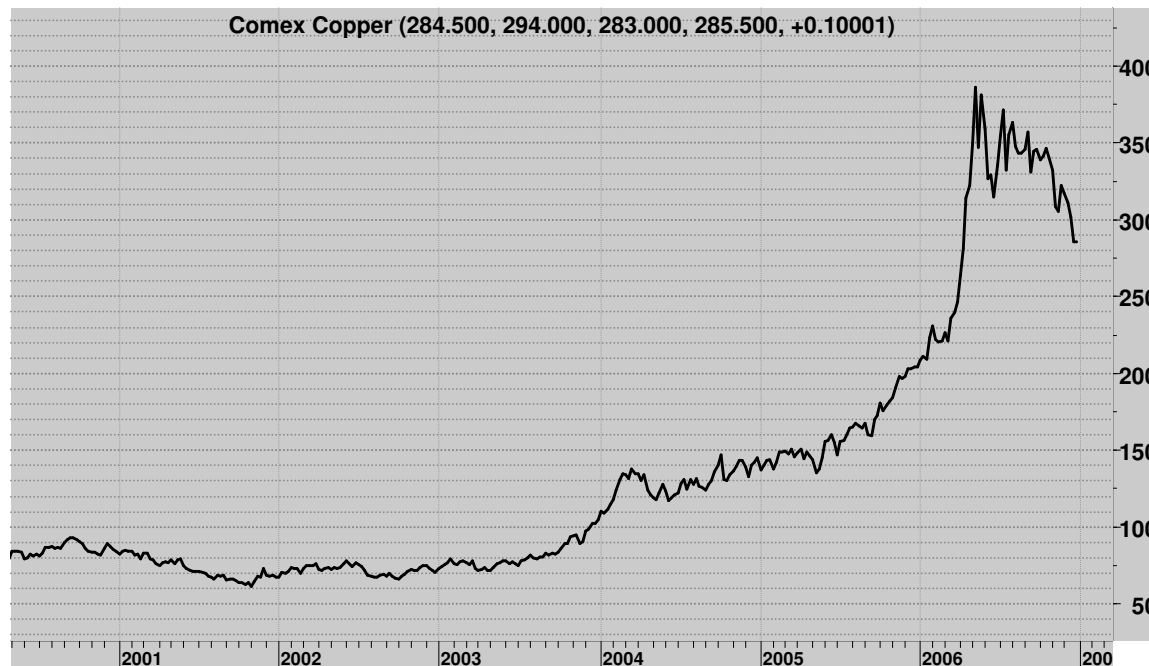
**Avinash Raheja**

*Sr. Vice President*

*January 3, 2007*

#### Flashback

The year gone by has been an eventful year for copper. Copper started the year 2006 with a flash, opening the year at \$2.04 and scaling a high of \$4.04 in May but gravity took over in the latter part of the year, bringing it down to end the year at \$ 2.86. Even after a fall of near 30% from its peak, Copper has ended the year with a net appreciation of 40%. This was the FIFTH CONSECUTIVE year that Copper posted net gains and translates into a CAGR of 33.40% for a period of five years! Now, doesn't this sound like some star hedge fund manager's performance? Until mid 2006, Copper was not only one of the best performing metals, it was among the best performing investments in the world. At its peak in 2006, it was neck and neck in performance with India's benchmark BSE Sensex stocks Index! The Indian stock market has been among the best performing emerging markets in the recent 3-4 years. Can we imagine Copper (just one single commodity) giving it a run for its money! While Sensex had moved up 365% (approx) in the period between May 2003 (the bottom for Sensex) and May 2006, Copper had scaled up 465% (approx) in the same time frame. Now how often do we see that? Little wonder, Copper came tumbling down. Not that we're suggesting any correlation between the two, but it certainly gives us a perspective.





The primary factor for Copper's bull run has been the rapid increase in demand emanating from China and the US housing boom. Automobiles and Telecom sectors of Asia have been other demand side factors while from the supply side, Chile had its role to play. Inventories of copper in LME warehouses kept sliding from early 2002 right into mid 2005, between which period, inventories were down an astonishing 98%.

However, in the second half of 2006, the story took a twist. China, the fastest growing consumer of copper began to show signs of weakening demand. Chinese consumption of the metal is estimated to have dropped by 7% to 3.40 mt in 2006. Imports have been worse with estimates of 2006 being a 40% drop from the figures for 2005.

Inventories of the metal have started building up and are now up 600% from the lows we saw in 2005 on the LME data. Chinese inventories have also been showing a likewise rising trend.



## Indicators to watch for Copper in 2007

### 1. China

China, the growth engine for economic growth around the world is already showing some signs of fatigue. The Chinese authorities have been trying their best to bring about a soft-landing and cool down the economy since 2005. While their measures of curbing credit and hiking rates has not worked as well as they would have expected, it is now showing signs of lag effects working their way through. The markets have been working on 9.5-10.0% GDP growth projection for China and even the most conservative find it difficult to see it cool down to below 9.00%. We would not like to go with that optimism. For an economy that has been growing at near double-digit growth rates for so many years, it is but natural to expect nature's way of calling it to rest. There will be market and structural imbalances that will bring about a correction in growth.



China has vast income disparities across its country and the last decade's growth has not brought the prosperity to rural and inland areas while inflation has been creeping upwards. This will have the potential to bring about a consumption shock and even the slightest can see a good 2% drop in their GDP growth rate. While the world has been focusing on China's need to IMPORT raw materials, it will be unwise to realize how much stuff they EXPORT. Any slowdown in the USA and other markets will only hurt Chinese growth more. Also, while they've been importing all the raw materials and we all know how much their prices have risen in recent years, it is very easy to understand it will be increasing the cost of living for the Chinese. Inflation will bring about a nasty surprise to any optimistic projections for their GDP.

## **2. Global Economic Growth**

According to the *World Economic Outlook*, Sep 2006 published by the IMF, world GDP grew at 5.3% in 2004 (the highest in a generation) then grew at 4.9% in 2005 and projections for 2006 and 2007 are 5.1% and 4.9% respectively. This will be for the first time since the early 1970s that the world will see four consecutive years of above 4% growth rate. Three out of these four years are over and we're down to the last quartile. The balance of risks is clearly poised on the downside now. It's not ruled out that the world need not stop at four and it can do five consecutive years of such sterling growth rates. But surely, a majority of the growth in demand for many commodities is behind us now. The slightest underachievement will be reason for major disappointment and we can see a domino effect in many financial markets, including commodities like Copper. While it is now difficult to envisage a slowdown in economic growth and everybody speaks of how China, India and some other Asian countries have immense potential and unsatiated demand for raw materials, we must realize that this is known to all and prices are fully factoring the upsides. It's the downside risk that hasn't been factored in. If China's GDP growth rate were to slide by 2% (from just under 10%), it will look very small on paper but we must keep the perspective that even a cascade effect on other economies resulting in a minor slide of 0.5% in their corresponding figures, will be very potential in causing economic damage. History has taught us how strong contagions can be. While the contagion has been positive in recent years, when the sentiment reverses, it will not stay isolated.

## **3. Inflation**

Inflation numbers in many economies have moved above comfort zone for central bankers. The US is seeing higher inflation, Japan has certainly moved out from deflation, China, India, Euro-zone, Asia-Pac have all been throwing up rising inflation numbers. While prices of commodities have been on an incline since 2002-03, so far we have seen that has caused no damage to global demand and economic growth. However, constantly rising prices extended over time can surely put a spoke in the wheels of global growth. Rising wages are good for some time as consumers get more money to spend, but while that is good for consumables, it has the potential to cause a dent in the Industrial and capital sector. Rising wages and commodity prices mean rising cost of production and increasing capital outlay for capital projects. What is a threat to capital projects and investments is a threat to demand for copper as well.

## **4. Expectations vs. Reality**

While in college, students are taught in economics that demand and prices are inversely proportional, in reality it is quite different. It is not the price that demand is related to – it is the 'expectation on price' that affects the demand. It is for this same logic that we see increasing demand for a commodity at the peak of a cycle and lower demand for it when prices have



reversed. Thus, a decline like the one we've already witnessed in the price of copper in H2-2006 will tend to pull back any demand and bring about a further fall in its price.

## **5. Monetary Tightening**

Central banks have stuck to hawkish views and monetarism has begun to influence global policy makers once again. While the global markets have seen incredible amounts of funds being released for the last decade or so (commencing from the Mexican Crises in the mid-90's), we're now entering an era where an increased monetary tightening can be seen from the central bankers of the world. Any tightening is going to cause collateral damage in commodities as well. This will impact Copper from two sides. First, the real sector (industry) will face lower demand owing to rising cost of funds and second, the financial sector (speculators and investment funds) will find it increasingly difficult to fund their long positions in commodities. This will be negative for the outlook on the price of copper and other base metals.

## **6. Housing Sector**

The US housing sector has been another source of fuel for the rally in copper prices in recent years. Signs of slowdown are now quite evident and the Fed chairman has introduced the word 'significant' to his outlook on the slowdown in the US housing sector. This can add the weight on copper prices and will take copper prices lower as we head into 2007. Similar slowdowns in housing sectors of other countries in Europe, Middle East, and Asia can also be expected to further curtail projections for demand of copper.

## **7. Financial Markets**

While the 2003-05 rally in Copper was driven by industrial (real sector) demand, the rally in 2005-06 was more out of investment funds rather than real industrial demand for the metal. We must realize the fact that Copper had become an investment vehicle besides being just a base metal. A lot of the buying that we saw in that phase came from the setting up of new commodity index funds across the globe and their buying into copper. Investment in funds that track commodity indexes doubled in the past year to \$110 billion as pension funds and other money managers diversified from stocks and bonds, according to American International Group Inc. With the Commodity indices now having posted a decline in recent months, we will see a slowdown in new Index funds being floated and to that extent, we will see lesser buying in most commodities including Copper.

## **8. Industrial Sector**

After the gigantic rally in Copper prices, it has become increasingly difficult for manufacturers of industrial and consumption goods to pass-on the prices to the end-user. As history has repeatedly taught us, business will always find a cheaper alternative/substitute when prices go up alarmingly. While substitutes are one issue, business is already working its way to find other alternatives. One glaring example that has come to our attention is that the cable industry has begun reducing the amount of copper that is used in their cables. Since conduction occurs mainly at the periphery of the conducting media, some cable manufacturers have been busy cutting copper usage by using it only on the periphery rather than using it in complete. When the industry has started resorting to such alternatives, we need to adopt a cautious outlook for the price of the underlying commodity.



## Price Outlook for Copper in 2007

We remain convinced of the Commodity Bull cycle and are of the firm opinion that commodities including copper will outperform for the next decade or so. However, we see 2007 and especially the first half of the year as a correction phase. In bull markets lasting 12-15 years, it would be reasonable to expect corrections for periods lasting even unto 2 years.

We see the price of Copper remaining under pressure for the most part of 2007. From today's level of \$ 2.76(Comex price), we should see a sharp bounce trying to test \$2.90-3.00 levels. Following the bounce, it should resume it's fall and before the end of the fist half of the year, we expect Copper to touch \$2.35-2.40. Markets do not always trade at fair value and most often tend to exceed fundamental value on either side. While, Copper prices did exceed their fair value on the upside when they scaled above \$4.00, they may do just the same on their way down and we may even see it test \$2.00.

## Long Term Outlook for Copper

The Long-term fundamentals still remain encouraging (though not as strong as they have been in the early 2000's). While supply will be higher in coming years, demand will keep growing as well. The telecom and housing sectors in Asia, Africa, S. America and Eastern Europe will keep creating demand for the metal as years go by. Copper will scale above \$4.00 once again but we do not see that happening in 2007. After we tide over 2007 and global imbalances have eased, Copper should rise like a phoenix from the ashes and far surpass it's 2005 peak. Long-term, we remain bullish on Copper like for most other commodities.

### **CommTrendz Risk Management Services Pvt. Ltd.**

202, Crystal Tower,  
Gundavali, Off Andheri-Kurla Road,  
Andheri (E)  
Mumbai, MH, INDIA 400 069.  
Tel.: (91) 22 2682 6426  
Fax: (91) 22 2683 1494  
Email : [avinash.raheja@commtrendz.com](mailto:avinash.raheja@commtrendz.com)  
[www.commtrendz.com](http://www.commtrendz.com)

---

*CommTrendz Risk Management Services Pvt Ltd is an independent research firm dedicated to the commodity futures and foreign exchange markets. For more information, contact us at +91 - 22 - 2682 3028 or [info@commtrendz.com](mailto:info@commtrendz.com)*

**DISCLAIMER:** Neither CommTrendz nor any of its employees accepts any liability whatsoever, for any loss arising from the use of this report or contents thereof. CommTrendz and its employees may from time to time have long or short positions in, and buy or sell the commodities mentioned herein. This research may not be independent from the proprietary trading and investment management interests of CommTrendz, which may conflict with your interests. CommTrendz and the author of this report reserve the right to change their views without giving prior notice. This report is meant for the exclusive use of its intended recipient(s). This report may not be redistributed or reproduced, in part or full, unless authorized in writing by CommTrendz.



## MCX Copper

Copper prices on MCX have been remarkably well correlated with Comex Copper. Liquidity on the exchange has surely increased dramatically and now MCX gives an opportunity to trade on Copper for good 14 hours a day. Our view on MCX copper remains identical to the one expressed in this report on International Copper.



### Comm-trendz Risk Management Services Pvt. Ltd.

202, Crystal Tower,  
Gundavali, Off Andheri-Kurla Road,  
Andheri (E)  
Mumbai, MH, INDIA 400 069.  
Tel.: (91) 22 2682 6426  
Fax: (91) 22 2683 1494  
Email : [avinash.raheja@comm-trendz.com](mailto:avinash.raheja@comm-trendz.com)  
[www.comm-trendz.com](http://www.comm-trendz.com)

*Comm-trendz Risk Management Services Pvt Ltd is an independent research firm dedicated to the commodity futures and foreign exchange markets. For more information, contact us at +91 - 22 - 2682 3028 or [info@comm-trendz.com](mailto:info@comm-trendz.com)*

**DISCLAIMER:** Neither Comm-trendz nor any of its employees accepts any liability whatsoever, for any loss arising from the use of this report or contents thereof. Comm-trendz and its employees may from time to time have long or short positions in, and buy or sell the commodities mentioned herein. This research may not be independent from the proprietary trading and investment management interests of Comm-trendz, which may conflict with your interests. Comm-trendz and the author of this report reserve the right to change their views without giving prior notice. This report is meant for the exclusive use of its intended recipient(s). This report may not be redistributed or reproduced, in part or full, unless authorized in writing by Comm-trendz.