Jefferies Bache Base Metals Report

Wednesday, July 24, 2013

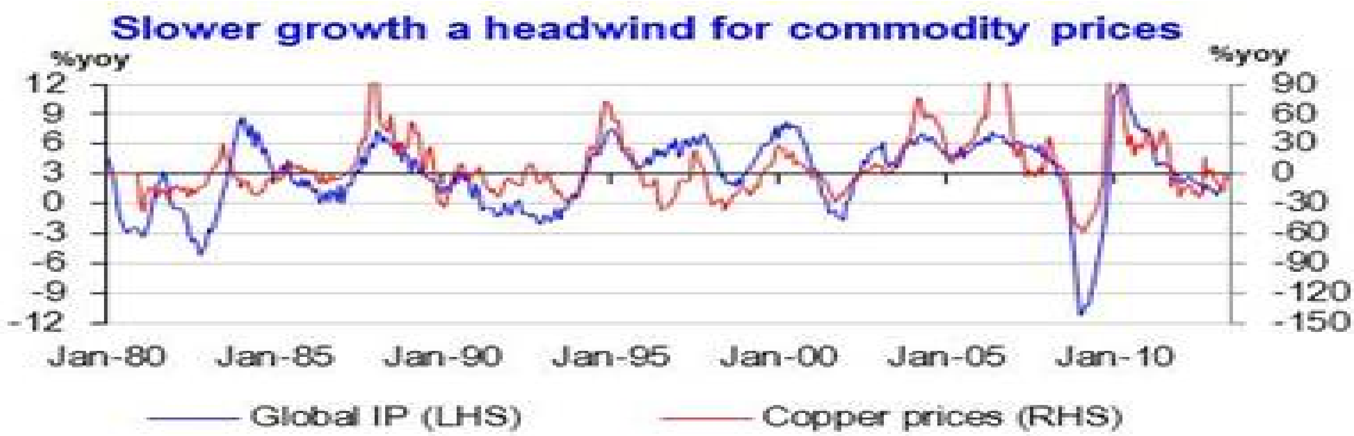
Copper Trying to Break Upwards

Copper has traded as high as $7,114 per tonne basis three months this morning on the back of short covering and some fresh CTA and dealer buying. The bulls are hoping to push prices up to the $7,180 to $7,200 area basis three months in coming days. And some are even looking for $7,250 as an upside objective. While higher prices are certainly possible in the short term, particularly given the still short nature of the copper market, the higher levels are likely to prove unsustainable from a fundamental point of view.

The macroeconomic factors do not favour a rapid rise in the consumption of copper or other base metals in the short term as the latest Chinese flash PMI indicator suggests. The HSBC Flash China Manufacturing PMI for July came in weaker than expected this morning at 47.7. Consensus was for an unchanged figure of 48.2. China accounts for around 36% of world copper consumption. This can also be seen from the chart and comments below from the chief economist of a large hedge fund which we reproduced in the weekly report on Monday.

In a note to clients on Friday the chief economist of a large hedge fund said that:

> *Most countries have now released their industrial production data for May which allows me to make an assessment of global industrial production growth. It now looks as if global IP growth was just +1.4%yoy in May, down from +1.6%yoy in April but above the nadir of +0.8%yoy seen in February. Since last summer global output growth has averaged just +1.5%yoy, a surprisingly weak period by most historical standards and below the 3% threshold that typically is needed to have rising rather than falling commodity prices. OECD industrial production growth was flat in May, a better outcome than the negative year-on-year growth rates since last summer. Non-OECD industrial production growth was +3.0%yoy in May, down from an average of +3.5%yoy since last summer.*



Sources: OECD, Reuters, London Metal Exchange

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The second reason to be longer term bearish is the rise in copper mine supplies. The International Copper Study Group (ICSG) reported last Friday that the refined copper market ran a surplus of 50,000 tonnes in April (106,000 tonnes surplus after seasonal adjustments). This marks the sixth consecutive month of surplus in this data series and for the year to date the ICSG estimates the global copper market has developed a supply surplus of 266,000 tonnes.

However, the ICSG doesn’t allow for unreported stock change in China and thus its calculation of Chinese demand falling 7% YoY has probably been skewed by destocking this year in China and restocking over the same period of 2012. Some analysts estimate that Chinese copper demand has risen 7% year on year and year to date.

Excluding China, the ICSG says copper demand has fallen by 1.6% YoY YTD. But in bearish contrast, the ICSG estimates that global copper mine output has risen by around 9% YoY in the first four months of 2013. Concentrate production increased by 11% and solvent extraction-electro-winning (SX-EW) by 2.4%.

The average world mine capacity utilization rate for the first four months of 2013 increased to around 82% from around 78% in the same period of 2012. World refined production is estimated to have increased by around 6% in the first four months of 2013 compared with refined production in the same period of 2012: primary production was up by around 5%, and secondary production (from scrap) increased by 11%.

Aluminium May Try To Break Higher

Aluminium may try to break higher on the back of copper. If the market can decisively push through the $1,855 to $1,860 level basis three months then it could head on to the next upside target of $1,900 to $1,910 per tonne basis three months. The market continues to watch the Congressional hearings with both interest and a little bewilderment because no one is sure what can or will result from the hearings.

Yesterday, Reuters reported that:

> *Brewer MillerCoors LLC urged U.S. lawmakers and regulators to boost oversight of the London Metal Exchange (LME) and Wall Street banks' ownership of warehousing firms, saying inflated aluminum prices have cost buyers billions of dollars. The Chicago-based brewer, speaking on behalf of the some of the world's biggest drinks firms, blamed a lack of regulation in the United States and Britain for creating an "economic anomaly" in metals markets that has pushed prices higher, even as supplies have grown. "U.S. bank holding companies have effective control of the LME, and they have created a bottleneck which limits the supply of aluminum," Tim Weiner, global risk manager for the brewer, said in a statement to the U.S. Senate banking committee ahead of a scheduled hearing on Tuesday. "Aluminum prices ... have remained inflated relative to the massive oversupply and record production," he said.*
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> *The hearing will be the first by Senators to discuss banks' ownership of physical operations from metals warehousing to power plants. Weiner's comments, the first public testimony from aluminum users on the issue, will likely increase pressure on regulators to delve into the lucrative and controversial industry. The U.S. Commodity Futures Trading Commission (CFTC) has already started preparations for a possible investigation of the metals warehousing business*

Metal Bulletin did a piece on Monday on the many possible consequences, mainly unintended, of the implementation of the London Metal Exchange's new warehousing proposals. The LME is proposing that warehouse companies in its network will be required to deliver out more metal than they draw in at storage locations where large outbound queues have developed.

Metal Bulletin outlined six possible scenarios that could play out. They are:

Premiums, then prices, will collapse.

Some market participants claim warehouses have been saving the base metals markets from disaster since 2008. They have done so, according to these participants, by providing long-term homes for unwanted metal, disguising the surplus of material and creating mechanisms - such as rent deals and delivery incentives for producers - for users to profit despite poor demand.

Warehouses are already unwinding efforts to secure metal and have, in some cases, stopped paying incentives to producers to deliver directly into sheds. If warehouses are unable to accept more deliveries, the market will be flooded with unwanted metal and, with fewer incentives available, producers will be forced to compete aggressively for business by cutting premiums and prices.

Bearish users will see this coming and will start to unwind their long positions. If there is a mass rush for the exit, prices could collapse overnight.

LME trader view: "One way or another, a flood of aluminium will hit the market. Aluminium could be $300-400 lower and premiums could vanish."

Warehouse view: "Material has to go somewhere, and if there's no market premiums will be under pressure; I could see aluminium premiums in Europe at $90 by early next year. If demand thins and there's lots of metal available, prices will be under pressure."

Analyst view: "I think a rush for the exit is unlikely on the basis that we can see it's going to take a while for queues to unwind. Never say 'never', but it's not the mostly likely outcome."

Likelihood: 4.5/5. The queues drove premiums up; reducing them will drive premiums and prices back down.

Shorts will be penalized.

The new rules may force some warehouses to limit or suspend inflow due to long outbound queues. This could prevent users from delivering into certain warehouses, meaning short-position holders could be blocked from delivering material against their short position.

Shorts could be left having to roll their positions forward until the warehouse will accept delivery, paying for private rent and the cost of rolling while they wait.

Another option would be for shorts to find another warehouse or location that can take their material, but they would have to pay the freight costs to get it there, and every day they wait they risk being severely squeezed as spreads narrow.

Analyst view: "There is a risk that on-exchange shorts may be denied ability to deliver onto the LME in settlement. If you assume default is not an option, the backwardation blows out due to the shorts. There is, in principle, a clear risk it could happen."

Physical trader view: "If you're running a good enough book you're not going to get that caught. If you haven't kept an eye on which warehouses can take your metal you deserve to get stuffed."

Likelihood: 3.5/5. The unwary exist.

Private stocks will prevail:

The new rules could force the release of hundreds of thousands of tonnes of LME-bonded aluminium, which will be difficult to place. Material leaving warehouses will have to compete with fresh production if it is offered to industrial consumers, so it is more likely to be put into private warehouses.

No data is published on private stocks, so inventory levels will become unclear.

The change may also reduce liquidity, leaving some users more vulnerable to position-related squeezes if large players opt to play the spreads.

Analyst view: "The released stocks will go off warrant. Some [analysts] suggest liquidity will be reduced and users will be more vulnerable to position-related squeezes. In principle it is a risk, but it is far from a foregone conclusion."

LME trader view: "I think the off-warrant game is over too."

Likelihood: 3/5: If the contango and cost of finance remain where they are...

Queues get worse.

Market participants may cancel warrants to ensure scheduled delivery date positions, if they think queues are likely to shorten. This could have the reverse effect, because cancelled warrants are the reason for the queues.

Material leaving Detroit or Vlissingen is moved into nearby warehouses and shorter queues emerge where there were none before. This would create a more even distribution of stocks, but more widespread queues throughout the warehouse system. And Detroit and Vlissingen remain clogged at around the 100-day mark.

Outbound queues will end up longer than ever.

Physical trader view: "Those bright boys at Glencore and Trafigura are working out what to do next. As a trader I see enormous queues developing and premiums for guaranteed non-queue metal as warehouses seek material ahead of the deadline."

LME View: If the industry believes the new proposal to be effective in allowing a greater speed of access to LME metal, the market could see an increase in cancellations to obtain a scheduled delivery-date position. This could result in queue lengths being exacerbated in the short- to medium-term; although, in the longer term, the effect of the new requirements would be to reduce queues to or below the 100-day Affected Warehouse threshold.

Likelihood: 4/5. It always gets worse before it gets better.

Backwardations create a two-tier system.

If short-position holders have to pay to roll forward because they cannot deliver onto the LME, spreads will narrow, sparking backwardations that will keep LME prices from falling even as long positions are liquidated.

This would artificially hold up nearby LME prices, while consumers, well aware of the surplus of metal following the collapse of rent deals, will refuse to pay that price in an oversupplied physical market.

The physical market will trade at a discount to the LME, creating a two-tier system comprising a real supply and demand based physical market and an artificial futures market with no connection to actual metal consumption.

LME trader view: "It's possible you'll see squeezes and possible you'll see a backwardation. When the iron curtain came down and Russian aluminium became available, the price shot up as people covered their shorts."

Physical trader view: "I think there's been a two-tier market for a long time."

Likelihood: 2/5. Mr Li won't have it!

Banks will sell warehouse assets and independents will triumph Under the US Bank Holding Act rules, bank-holding companies cannot own non-banking assets for more than ten years. Restrictions on the amount of metal that warehouses can take in and keep in will affect their rent returns, which could prompt banks to speed up the sale of their assets.

Warehousing will go back to basics and the system will be mainly controlled by independent warehousing firms.

This will be the final straw for incentives and rent deals.

LME trader view: "It's been a fantastic game for the banks but it's over. I'd be willing to bet that the warehouses aren't bought by other banks. Warehouses will become independent again and then they don't have access to the kind of money the banks do. I think anyone who cancelled sheds because they couldn't compete with the banks will be looking to relist."

Physical trader view: Who is going to want to buy the warehouses? The good independents will now see an advantage and will always take metal in."

Likelihood: 1/5. The rise of the independents has been predicted since banks and trading companies took the warehouses over. But power does not deconsolidate and the small rarely triumph.

CFTC Puts Warehouses on Notice of Possible Probe

Reuters reported that:

The U.S. commodities market regulator has put Wall Street banks and other big traders on notice for a possible investigation of their metals warehousing businesses following years of complaints about inflated prices. The U.S. Commodity Futures Trading Commission (CFTC) last week sent a letter to firms ordering them to preserve emails, documents and instant messages from the past three years, two sources who received the letters told Reuters. The notice amounted to a "warning shot" ahead of what is probably a formal CFTC probe, one of the sources said.

If there is an investigation, it would be the first such probe by any regulator into the lucrative and controversial industry, which since 2010 has become dominated by banks including Goldman Sachs Group Inc and JPMorgan Chase & Co and global merchant traders like Glencore Xstrata Plc and Trafigura AG. The letter from the CFTC's enforcement division did not refer to an investigation, but the do-not-destroy order *touched on some of the most sensitive issues in a controversy that has plagued the London Metal Exchange for years.*

The CFTC explicitly said that the firms should retain communication related to incentives or premiums given to metal producers in exchange for storing metal; daily loading rates; high load-out requests; delivery policies and procedures and complaints about load out requests. While the recipients of the letter say they now expect a wide-ranging probe, it is not clear how or when that could take place.

The CFTC opens dozens of investigations a year, yet only a handful ever result in action and some are never made public. It almost never discusses open inquiries. In the past three years, a mountain of aluminum and other metals has accumulated in the global warehouses that are part of the LME network.

After years of complaints from end-users such as Novelis, the world's biggest maker of flat-rolled aluminum, and customers like Coca-Cola Co, which use the metal for aluminum cans, regulators are now taking a deeper look into the industry as political pressure to rein in Wall Street's powers intensify. A possible probe comes amid intensifying scrutiny of Wall Street's role in raw material markets from owning oil tankers, power plants and metals warehousing. The Federal Reserve is weighing whether to allow banks to continue owning physical assets.

"The CFTC has a role to play in protecting American manufacturers and consumers from having the price of their gas, canned food and beverages, or electricity driven up by Wall Street speculators," said Senator Sherrod Brown, a Democrat from Ohio. "The CFTC should use the full force of its power to address this abuse." The U.S. Senate banking committee will hold its first hearing on the matter on Tuesday, asking whether "Too Big to Fail" banks should be allowed to operate freely in loosely regulated physical commodity markets and own physical commodity assets from power plants to oil tankers.

Chinese Macroeconomic News

Reuters reported this morning that:

China's manufacturing engine lost further momentum in July and the job market weakened, a survey showed on Wednesday, complicating a transition to consumer-driven growth and boding ill for so many leveraged to the world's second-largest economy.

The knock-on effects are already being felt farther afield - from a slowdown in Japanese export growth despite a weaker yen to Apple Inc lamenting a rare drop in Chinese demand for its premium brand of gadgets. "China's slowdown is starting to become more dangerous," warned Yasuo Yamamoto, a senior economist at Mizuho Research Institute in Tokyo.

Since taking office in March, China's new leaders have said they are prepared to tolerate tamer growth and push a restructuring of the economy toward domestic consumption, but there have been mixed messages on how much of a slowing they would tolerate. The flow of data suggests their task of changing the shape of the massive economy will only get harder.

Wednesday's flash HSBC/Markit Purchasing Managers' Index showed output, employment and new orders all declining at a faster pace in July. The overall index of business conditions fell to 47.7 from June's final reading of 48.2, a third straight month below the watershed 50 line which divides expansion from contraction, and the weakest level since August 2012.

The employment sub-index slid to 47.3 in July, the weakest since the depths of the global financial crisis in early 2009. "This print could reignite fears of a Chinese hard landing," said Annette Beacher, head of Asia-Pacific research at TD Securities in Singapore. "We expect economic growth to continue moderating towards 7 percent."

China's economy grew 7.5 percent in April-June from a year earlier, the ninth quarter of slowdown in the past 10 quarters. While top leaders have stressed in recent weeks that reform is the priority - the latest being President Xi Jinping - they were also at pains to assure investors that Beijing would not allow the economy to slip too far.

On Wednesday, the industry ministry said it was putting a priority on restructuring and reforming traditional industries such as steel, shipbuilding, cement and aluminium, once drivers of growth, but now plagued with overcapacity.

Some analysts note China is also hostage to the health of global markets. China cannot change its weak economic growth situation due to still weak external demand and overcapacity problems in the domestic market," said Wang Jian, a senior researcher with the China Society of Macroeconomics, a research body affiliated with the National Development and Reform Commission (NDRC).

"China's economic growth rate will probably fall below 7 percent in the fourth quarter this year and may fall under 6 percent in some quarter next year," Wang wrote in the China Securities Journal on Wednesday.While that's at the extreme end of market forecasts, China has become such a major importer of goods that any weakness in demand is increasingly felt worldwide.

Japan on Wednesday reported annual growth in its exports to China eased to 4.8 percent in June from 8.3 percent in May, and camera maker Canon Inc trimmed its sales targets and annual profit forecast, blaming the China slowdown.

"Chinese consumers tend to be very fond of cameras, especially high-end ones such as SLRs, but an economic slowdown has hit just as sales were recovering from last year," Chief Financial Officer Toshizo Tanaka told an earnings briefing.

In the United States, Apple reported quarterly revenues from Greater China dived 43 percent from the previous quarter, and fell 14 percent from the same time last year - an abrupt turnaround for the Silicon Valley giant which has come to count on endless growth in the world's biggest smartphone market. The country accounted for 13 percent of all Apple's April-June sales, up 10-fold in the past four years but down from nearly 19 percent in the previous quarter.

The same goes for commodity exporters. China consumes around half of the world's iron ore and coal and 30-40 percent of global production of base metals such as copper. "It adds to the concern about the outlook for demand, and brings into question just how strong Chinese commodities demand will be," said Alexandra Knight, economist at National Australia Bank.

Bloomberg news reported yesterday that:

Premier Li Keqiang’s government sees 7 percent growth as the bottom line for tolerance of an economic slowdown, Chinese news organizations reported, signalling the nation will act to support expansion if needed. Expansion below 7 percent won’t be accepted because China needs to achieve a moderately prosperous society by 2020, according to a commentary published July 21 by the official Xinhua News Agency and credited to reporter Wang Yuewei. Li said at a recent meeting with economists that 7 percent is the “bottom line” and the nation can’t allow growth below that, the Beijing News reported today.

> *Chinese stocks rose the most since July 11 on optimism that the government will limit the depth of a slowdown after gross domestic product rose 7.5 percent in the second quarter from a year earlier, the same pace as an official 2013 target. Li previously said the government shouldn't let growth and employment fall below lower limits that he didn't specify.*
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> *"The comments confirmed that the government's acceptable range for growth this year is between 7 percent and 7.5 percent," said Chang Jian, a Hong Kong-based economist at Barclays Plc who formerly worked for the World Bank. "As economic growth is slowing to below 7.5 percent, the government policy's focus is gradually shifting to stabilizing growth."*
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> *The Shanghai Composite Index (SHCOMP) gained 2 percent, with rail-related stocks surging on speculation that the government will ramp up construction. Other parts of the reports may add to confusion on the government's tolerance for a slowdown. The Xinhua commentary said 7.5 percent is the "lower limit" for growth this year while the Beijing News reported Li said the "lower limit" for China's GDP expansion is 7.5 percent. The articles didn't elaborate on the difference between a "lower limit" and a "bottom line."*
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> *Investors are focused on the possibility of additional support measures after exports fell last month by the most since the global financial crisis.*
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> *Analysts at Mizuho Securities Asia Ltd. and Bank of America Corp. focused on a purported transcript of Li's comments, circulating on the internet. The State Council Information Office didn't respond to a faxed question from Bloomberg News about the authenticity of the account.*
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> *Lu Ting, head of Greater China economics at Bank of America in Hong Kong, said the transcript was "important information," with Li indicating that the "floor" for growth this year was 7.5 percent, while 7 percent was the lower limit for the period through 2020. Lu said that the government may roll out a "small scale fiscal expansion" including spending on railways, social housing and environmental and information-technology infrastructure.*
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> *Shen Jianguang, chief Asia economist at Mizuho in Hong Kong, said 7.5 percent is the lower limit this year and 7 percent is the boundary starting next year. The government is already trying to support expansion with spending on railways, city infrastructure and environmental protection, Shen said.*

The Financial Times reported today that:

> *China has banned the construction of government offices for the next five years, ratcheting up an austerity campaign that has already taken a toll on the economy. The State Council, China's cabinet, and the Communist party late on Tuesday said the ban, which takes immediate effect, would also apply to the expansion of existing buildings.*
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> *"We must really use our limited funds and resources for the development of the economy and the improvement of people's lives," they said.*
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> *China's austerity campaign – unlike those in the west which have been triggered by budgetary shortfalls – is driven largely by the new leadership's determination to address what it sees as the slipping moral standards of the Communist party elite.*
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> *Xi Jinping's first move as party chief late last year was to bar lavish banquets, red-carpet receptions, wasteful travel and other trappings of corruption that have stained the public's perception of the government.Those measures have had a clear impact on the economy, leading to slower consumption growth in the first half of the year and dealing a blow to luxury goods companies around the world.*

Whether the latest ban has a similarly negative impact on the property market will depend on how it is interpreted by state-owned companies. Chinese corporate executives have felt pressure to comply with Mr Xi's earlier austerity policies even though government officials, not companies, were his targets.

Beijing has previously tried to stop local governments from building massive new offices, but only with limited success. Even in poorer parts of China, cities and villages have built monolithic offices, replicas of the US Capitol building and faux-European palaces. In one notorious case, the government of the poor Yingquan district in Anhui province spent a third of its budget on a White House replica.

Under the new ban, renovations of outdated offices will be permitted, but the approval process will be extremely strict and there will be no tolerance for "luxurious decorations".

In announcing the ban, the state council tried to anticipate the ways local governments might circumvent the rules. It said that expensive government buildings could not be built under different names such as "institutes" or "centres".

It prohibited the expansion of existing buildings under the guise of "building repairs". It also said that government and party agencies were not permitted to accept any form of corporate sponsorship or to collaborate in any other way with companies to construct buildings.

In his first public speech as Chinese premier in March, Li Keqiang said he would ban the use of public funds to build new government offices, halls or guest houses to reduce the size of the country's enormous bureaucracy. "It's very, very positive. Lots of the investment in buildings has only raised most costs down the road. The money can be saved and used for more productive things," said Shen Jianguang, an economist with Mizuho Securities.