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SPECIAL REPORT

Research Strategies Solutions

APRIL 09, 2015

HAVE COMMODITIES OVERSHOT ON THE DOWNSIDE? COULD A TROUGH BE APPROACHING IN Q2 2015?

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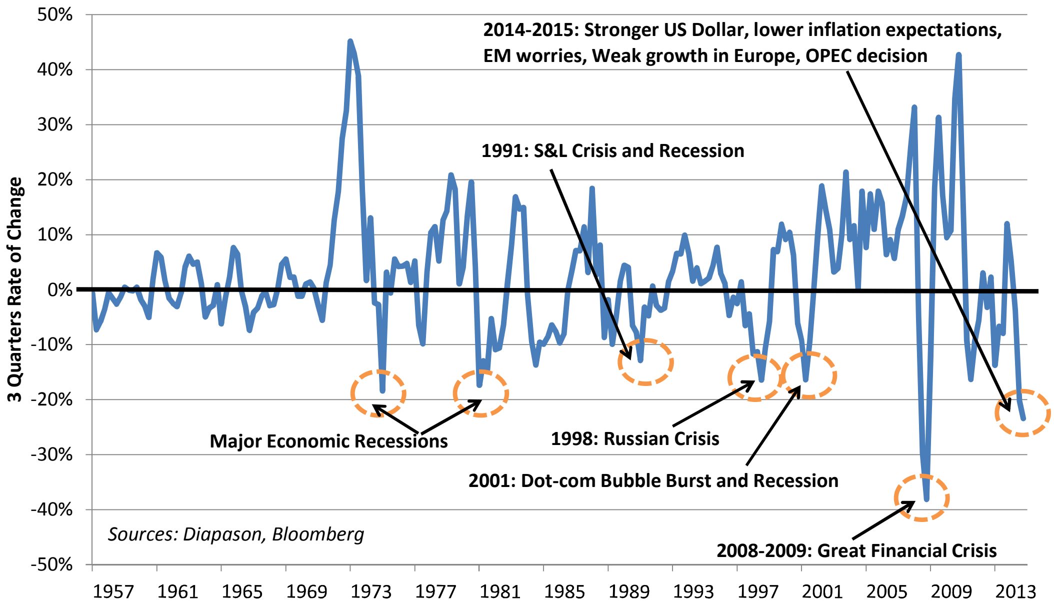
Commodity Continuous Index 3Q ROC 1957-2015



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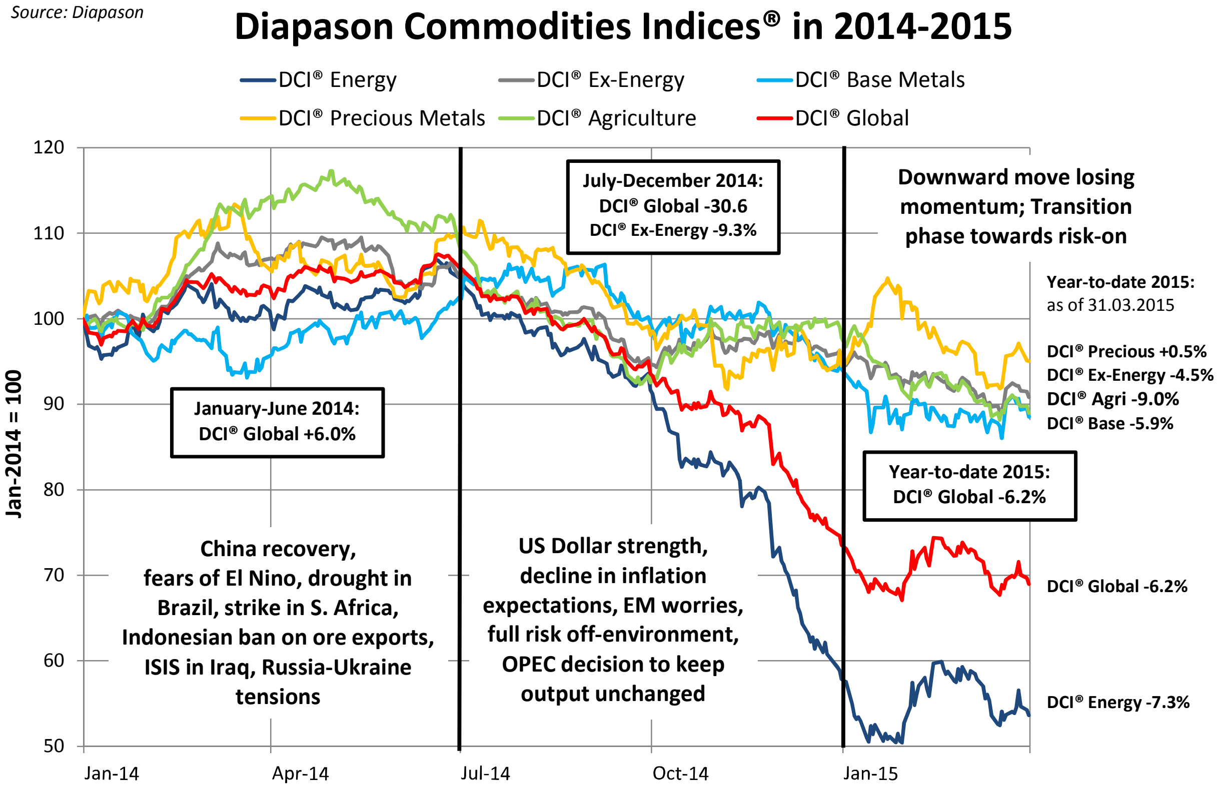
A TROUGH FOR COMMODITIES IN Q2 2015

Source: Diapason



A potential trough for Commodities in mid-Q2

Commodities have experienced their worst 3-quarter performance since 1970 with the exception of the 2009 financial crisis. Since mid-2014, commodities prices have suffered from a negative combination of deteriorating macroeconomic conditions amid weaker fundamentals. This contributed to significantly reduce the sentiment over this asset class and lead to a response of commodities producers and consumers.

Negative macro-factors

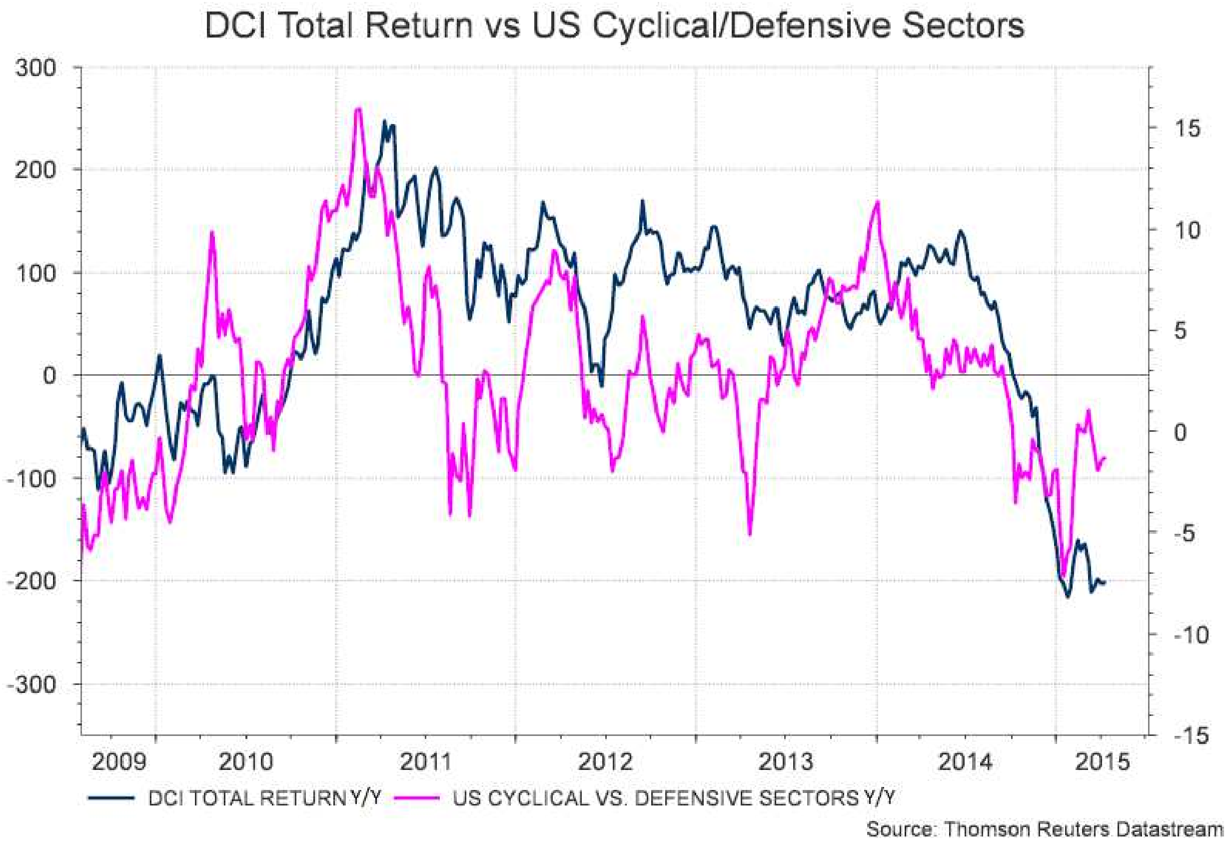
On the macro-level, commodities prices fell driven by a strong US Dollar, lower inflation expectations, concerns about growth in large emerging countries, lower long term rates and the risk-off environment. Since the end of June 2014, the US Dollar index (DXY) rose by 23% and reached by the middle of March 2015 the highest level since April 2003.

Weaker fundamentals

On top of these negative macro-factors, commodities also experienced a broad weakening in fundamentals. Following a growing oil surplus due to the return of Libyan crude oil and the US tight oil boom, OPEC decided in November 2014 to keep its crude oil production target unchanged, forcing oil prices to adjust instead. The US experienced record corn and soybean crops in 2014 amid already elevated inventories. In Europe, corn and wheat production also reached a record level last year. In the base metals sector, slower economic growth in China led to weaker demand for some base metals. The strength in the US Dollar (and growing expectations of a hike in US rates) negatively affected precious metals prices.

Extreme pessimistic sentiment: Sentiment at lower levels than in 2009

These conditions contributed to a significant deterioration in the sentiment over commodities. Commodities producers cut capex significantly; investors and investment banks are pulling out of this asset class and a growing amount of dirty laundry is coming out of the closet. Petrobras' recent corruption case is typically a scandal of cycle's trough. Shell's proposed $70 billion acquisition of BG Group also signals a new trend of consolidation among E&P companies. The positive sentiment on commodities fell to even lower levels than in 2009. The percentage of positive sentiment over commodities fell in February 2015 to the lowest level since 1991.



Money flowing out of commodities

The extreme negative sentiment has encouraged investors to pulled out money from commodities. According to Citi, cumulative investor outflows for 2014 reached $21 billion, of which $26 billion were passive index outflows, more than offsetting the $5 billion of inflows in commodity ETFs. And in fact, most of the outflows occurred during the second half of 2014. Passive index outflows reached $28.5 billion in H2 2014, more than offsetting the inflows in the first half of the year.

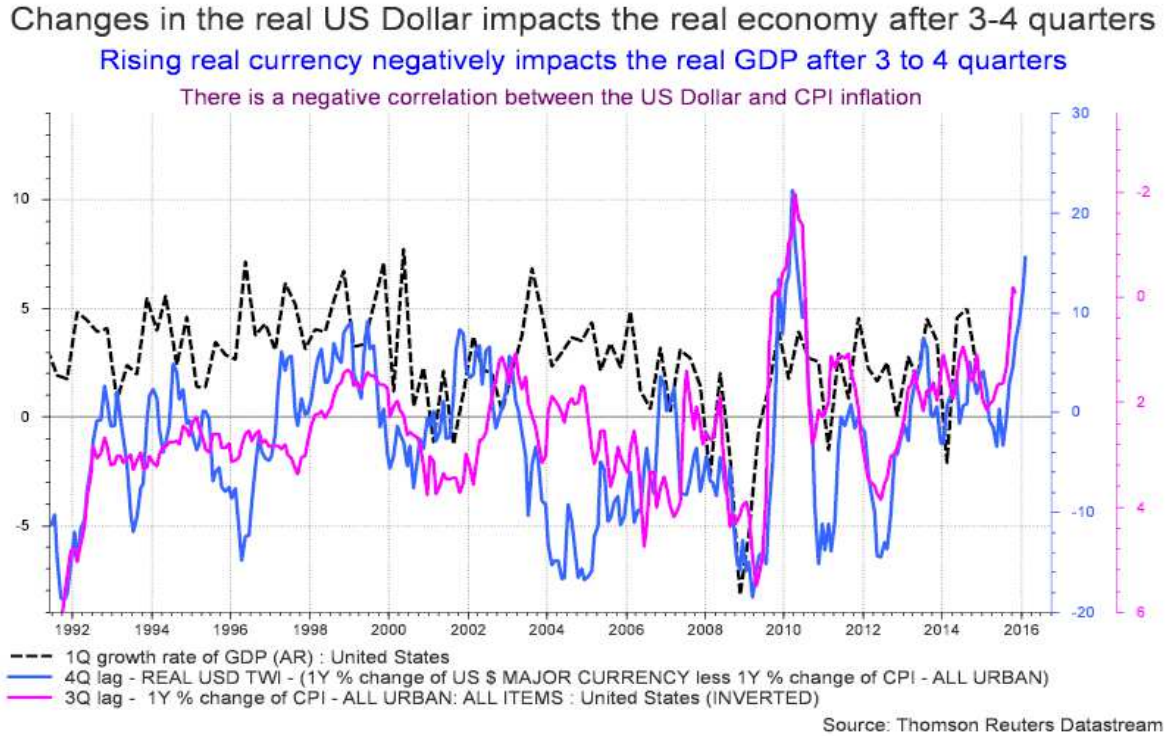
It is interesting to note the inflows in commodity ETFs. Some investors appeared to have been rotating toward more cyclical commodity exposures and to some commodities that are trading at or below their marginal cost of production. These investors are therefore seeing greater value in the energy sector than in the precious metals sector. Thus, precious metals ETPs accounted for over 70% of the decline in global commodity ETP AUM in 2014. On the other hand, investors increased their exposure of the oil markets in Q4 2014, as crude oil ETPs saw strong inflows of about $2.5 billion.

However, the downward move is now losing momentum

During the past 3 quarters (Q3 2014 to Q1 2015), the DCI® Global Index fell by 35%, driven by the energy sector: The DCI® Energy Index fell by 49%; The DCI® Agriculture Index by 18%; the DCI® Base Metals Index by 14% and the DCI® Precious Metals by 13%. This fall contrasted with the relatively good start during the first half of 2014, when worries on commodities supply pushed prices higher.

But behind the large decline in commodities, it is interesting to notice the loss of momentum. Indeed, since the beginning of the year, commodities prices started to stabilise. The DCI® Global Index fell by only 6%, compared with a decline of 31% during the previous two quarters. It is now clear that the loss of momentum is the result of adjustments in commodity fundamentals.

Physical commodity markets are adjusting, while the macro-economic conditions are gradually turning in favour of commodities. The US Dollar may soon start to weaken; inflation may pick up and the world may experience its first synchronize growth since 2010.



The US Dollar is likely to weaken during the rest of the year

A very visible, new prudence on the Fed's monetary policy's prospective change, and the relationship between the US Dollar and some key variables converge, is suggesting that the US dollar's bull phase is over — at least, for most of the rest of the year.

What the Federal Reserve's FOMC minutes told the world a few weeks ago was of course the catalyst — the key factor — that stopped the dollar on its tracks, but many broad factors that would reverse the greenback's uptrend have been building up for some time. The Fed at that time unexpectedly revised its internal projections of future growth and inflation, and their expectations as to the pace of their expected tightening. Fed policy makers also reduced their forecast for economic growth and inflation in US, which probably was directly instrumental in undercutting the erstwhile positive sentiment for the greenback.

The Fed's lower economic forecasts were vindicated in large part by the unexpected deterioration of US employment data in March.

In effect, the Fed's revised policy statement suggests a later implementation of a policy change and a significantly shallower trajectory of the new expected path of policy tightening. In particular, the Fed's expectations of how high rates will go by year's end for 2015 (0.625% from 1.125%), 2016 (1.875% from 2.5%) and 2017 (3.125% from 3.625%) fell by almost half compared to where they were in December last year.

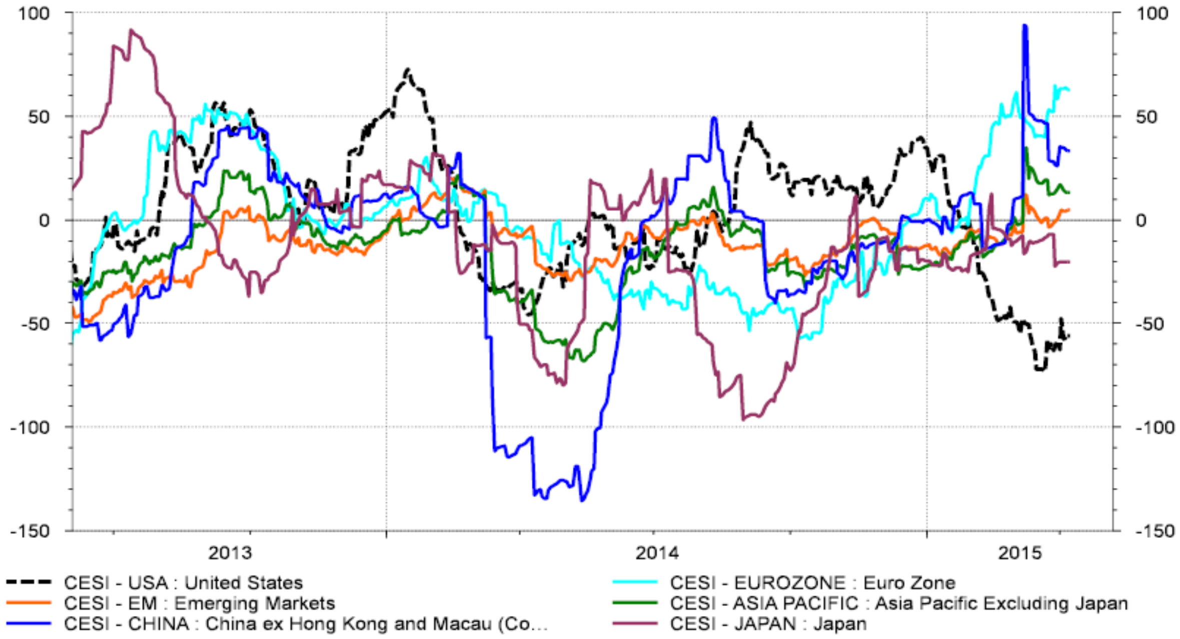
The negative impact of the strong US Dollar is also under scrutiny at the Fed

We suspect that the Fed turned "prudent" insofar as the timing of tightening was concerned because of the risk of igniting further US Dollar gains with higher policy rates. That would have been the given situation, what with most central banks easing at this time in order to forestall further deterioration of their economies. Left uncommented by the Fed is "a race to the bottom" that is taking place among central banks which are compelled to weaken their currency in order to be competitive in the global trading arena.

That would have left the US as the sole, policy-tightening counter-party for the rest of the world (ROW), which strengthens the Dollar further, and which then would leave US exporters out on a limb, and would lose more market share. It is also true that the rapid rise in the US Dollar's valuation has significantly tightened monetary conditions in the US. In a sense, the USD gains since the middle of last year had already done the policy tightening desired by the Fed — the 15% revaluation of the real (deflated) USD TWI since July last year has been estimated by Natixis as equivalent to a 175 bp hike by the central bank.

CITI ECO SURPRISE INDEX - US, Eurozone, EM, EM Asia, Japan, China

US CESI collapses as the Eurozone and ROW set the stage for an economic take-off



Source: Thomson Reuters Datastream

The US Dollar weakens as US growth "exceptionalism" wanes

It is manifest therefore that policy rates in the US can not rise that much, that soon, and so the basis for the sharp recent appreciation of the US Dollar, mainly the so-called US growth exceptionalism and prospective policy rate increases, have been illusions. It is necessary to rethink investors' stance on the dollar, and adjust the US Dollar's valuation to the new reality.

We are likely seeing such a re-evaluation, and so the Dollar's (DXY) losses so far of about 3.0% (from the March 13, 2015 top) may increase further as those investors who are still in denial accept the greenback's de-rating. Once sentiment has turned around, the underlying fundamentals that would curb further USD appreciation should kick-in, probably with vengeance, considering the overbought condition of the greenback relative to new realities in differences of expectations of growth prospects between the US and the ROW.

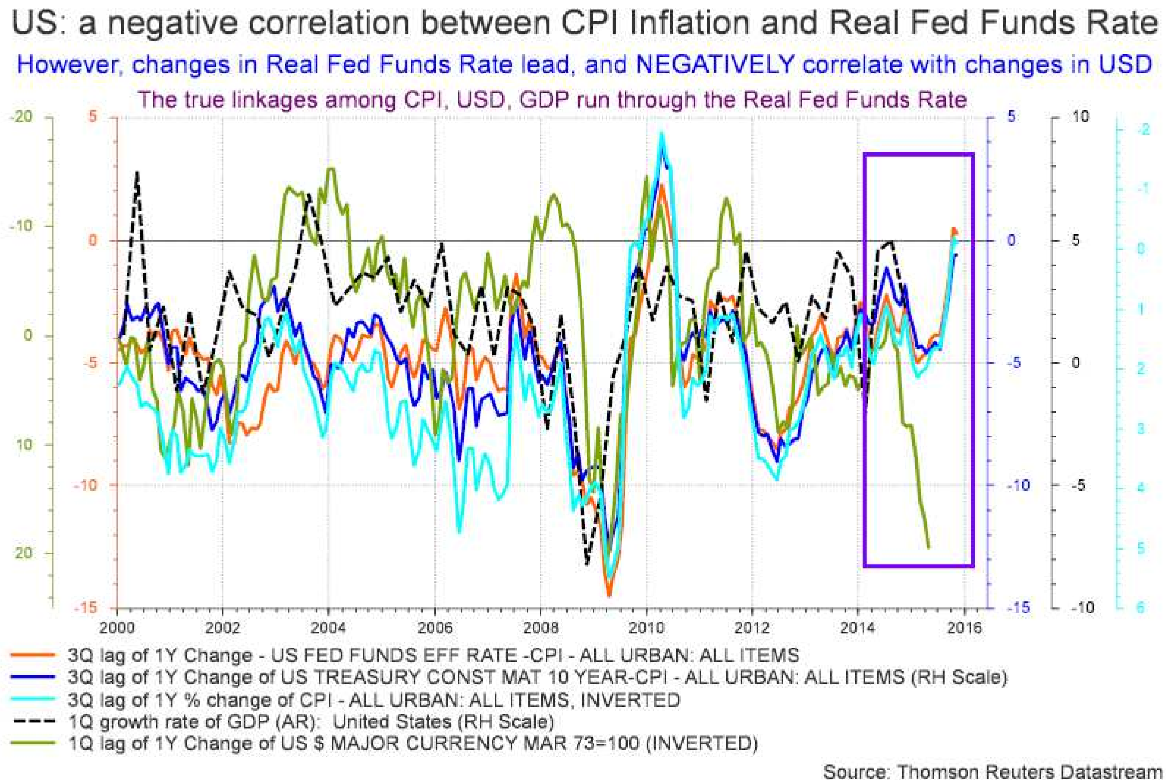
What count most in the new evaluation are not the growth differentials today (which have long been "baked-in" into the USD's exchange rate) but expectations of growth differentials in the near- and medium-term.

The so-called exceptionalism of the US economy has come and gone

The US Dollar amazing rally in the past five quarters has been based primarily on the notion that economic growth in the US will outstrip other developed economies by far in the near-future. This is very far from true. It is easy to disabuse the notion that the US is an economic Rock of Gibraltar amidst a sea of floundering economies. That might have been true during Q3 2014 when US GDP growth hit 5.00%, the strongest since Q3 2003. But economic data in the US have deteriorated markedly since January.

The US growth weakness during Q1 may extend towards the usual mid-year seasonal trough, so we may then have the first two quarters of growth this year which will not measure up to the rhetoric that has helped push the US Dollar Trade-Weighted Index almost 23 percent since June 2014. Latest real-time analysis from the Atlanta Fed's GDP Now model forecast suggests that Q1 growth may be at, or close to 0%.

This is in contrast with the more positive outlook from other developed countries and other major regions, whose economies started getting traction after aggressively easing during the second half of last year, following the lull in US monetary policy adjustments. To sum it up, it is the turn of the ROW to benefit from similar steps that the US policy makers have taken earlier. Last week alone, we have seen PMI data surprises for both the eurozone (e.g. Spain) and China (NBS), while the ISM report underlined manufacturing weakness in the US, as the new durable goods orders' report continues a 6-month decline.



The US Dollar's advantages disappear as inflation and global growth rise

Real rates: one of the most significant movers of USD valuation

Among the most significant prime movers of the US Dollar are real interest rates, and it does not matter much if we take the real Fed Funds Rate, or the real 10-year benchmark rate as reference. But the important matters in this relationship are the changes in real rates, not their nominal levels, which do not provide any timing element as to future changes or turns are concerned. Changes in the real rates lead the changes of the US Dollar by 3 quarters on average, and the relationships of the changes between the two are NEGATIVE (please see chart above).

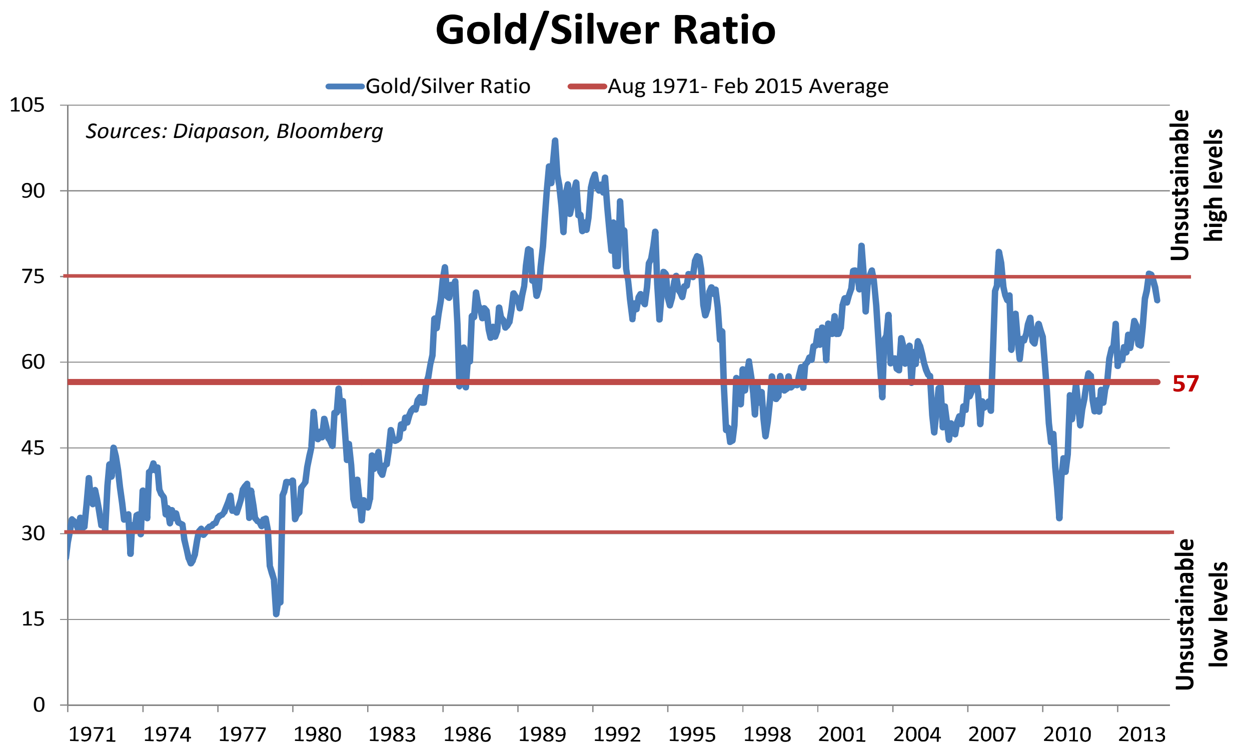
Simply put, when the yoy change in real rates turn higher, the yoy changes in the US Dollar go lower (please see chart above) after a lag. The lead the changes in real rates have over the changes in the USD is what provides its usefulness, <u>but due care has to be taken to accommodate the lags in the correlation. The lags are substantial – there is no such thing as an efficient economy.</u> As inflation rises, along with global growth, the advantages of the US Dollar will continue to wane, which we believe will be the case for the rest of the year.

GDP growth is positively correlated with real rates, but with a lag

There is another correlation that is pertinent here: the relationship between changes in real rates and changes in GDP is positive, although with a significant lag as well (see chart above). Again, we have to eschew expectations of a so-called "efficient economy" making instantaneous adjustments. Note that the sharp decline in CPI had been an important factor in bringing this about. CPI inflation is negatively correlated with real rates by definition (with the CPI being the subtrahend), and so the rate of inflation is likewise negatively correlated with GDP growth.

It is therefore easy to infer from these linkages that a strong Dollar negatively impacts GDP growth, and vice versa. Indeed that is illustrated by the USD chart above which shows that the recent episode of USD strength will likely depress US GDP growth over the next two quarters.

The claim that a stronger currency is indicative of better future prospects of the country owning that currency, relative to the prospects of another country whose currency is comparatively weaker than that of the first, is plain wrong. The stark reality is that the actual impact of the comparison works the other way around – the stronger the currency is, the worse off the country. More direct to the point: the currency makes the economy, not the other way around. The transmission mechanism runs through the impact the currency has on net exports — net trade is a direct component of the US GDP — the stronger the currency, the less export potential the country has.



The Gold/Silver ratio may reverse from the new Fed's stance

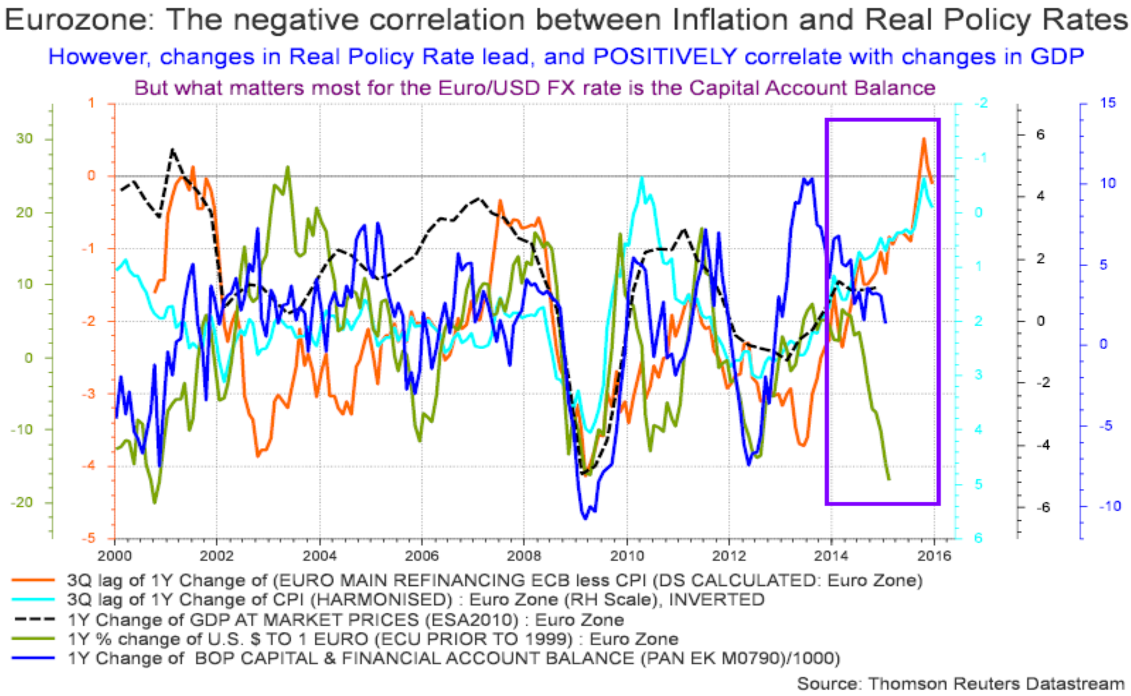
The precious metals sector continued to be particularly attractive. Contrasting with other commodity sectors, precious metals did not make a new low during the recent US Dollar rally. Furthermore, the Fed's modified stance on policy tightening two weeks ago is providing a catalyst for precious metals to bounce off recent lows. The DCI® Precious Metals Index rose by 4%, following the US Fed's new summary of economic projections on March 18th. The US Dollar may continue to weaken in the near future.

This may positively affects the overall precious metals sector. But the likely acceleration of global growth, and more specifically the prospect of future wider growth differential between the US and the rest of the world in favor of the latter, will probably be just as significant as a weakening of the US Dollar in pushing precious metals higher. Economic data in the US have deteriorated markedly since January. This is in contrast with the more positive outlook from the rest of the world (ROW), whose economies started getting traction after aggressively easing during the second half of last year, following the lull in US monetary policy adjustment. Prospective US Dollar weakness and stronger growth in the ROW are already contributing to the outperformance of the most cyclically-driven precious metals within the sector. So as the risk-off environment continues to fade, the underperformance of the most defensive precious metals will continue.

The Gold-Silver Ratio could fall back further

The gold-silver ratio is probably telling us something in this regard. The ratio is typically a "risk trade". A significant rise in the gold/silver ratio typically reflects rapidly growing credit/market risks. Following the Lehman's crash, the ratio rose sharply above 80 as gold outperformed silver, reflecting extremely difficult monetary conditions at that time. But the opposite is also true. In 2011, the QE2 program contributed to greatly ease monetary conditions, leading to a significant outperformance of silver against gold.

Since the end of Bretton Woods in August 1971 the average for the gold-silver ratio has been 57:1, or 57 ounces of silver value contained in each ounce of gold value (see above chart). That relationship closed at the end of March at around 71 which was an improvement from the 74 it was trading at prior to the Fed announcement (on March 18th). The gold-silver ratio has a long way to go to yield a significant signal of a turnaround in the precious metals sector, but what we got in the second half of March 2015 is a very good start. On a fundamental basis, silver may outperform gold on the acceleration of global growth. Silver is indeed more cyclical than gold due to its more extensive industrial use (photovoltaic, water purification, electronic components,...).



The Eurozone and the EUR will rise in H2 2015

The Eurozone growth factor fundamentals are starting to reassert

The potential (and impending) weakness in US GDP growth compares oppositely with the EUR outlook (please see chart above), which shows that fundamental broad factors which would reverse the euro's downtrend have been on a very robust uptrend for some time.

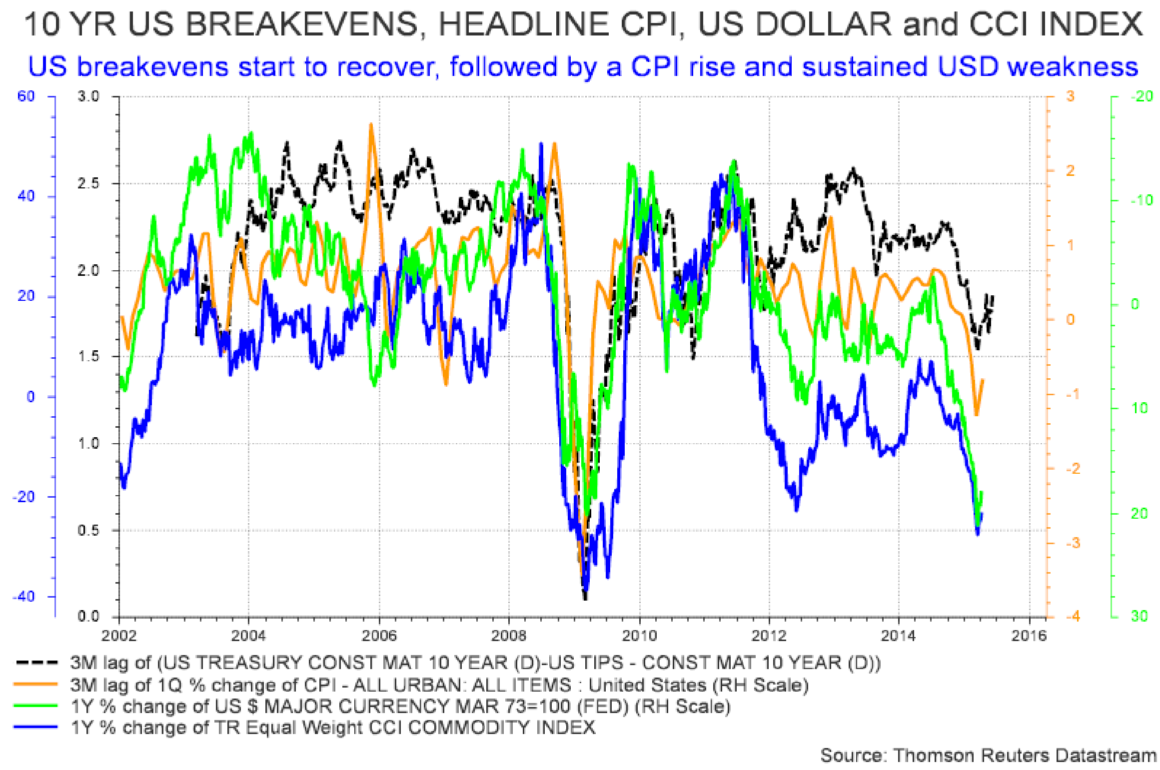
As in the US, the changes in real rates (policy rate, or the 10-year benchmark) are positively correlated with GDP growth in the common currency area after a lag. Note that the sharp decline in CPI inflation has been an important factor in bringing this about as well. So for the next two quarters at least, we expect growth in the Eurozone to continue to rise, perhaps even robustly. The sharp decline in the euro likely played a significant part in the Eurozone's expected change in fortune for the better. This of course contrasts with the negative outlook in the US during the same period, a situation where a strong US Dollar ironically played a significant part in degrading the US growth outlook.

News flow is favorable as investors bet on a Eurozone recovery

If we are to take the contrasting growth prospects as basis, then we should expect the EUR/USD exchange rate to turn around soon — its outsized recovery in the past several week tells us that the reversal has probably started. There is a wide gap between the expected growth recovery in the Eurozone and the level of the EUR/USD, which suggests to us that a significant EUR catch-up should take place over the rest of the year. That would weaken the US Dollar immensely.

Incipient growth in the Eurozone and prospects of a currency recovery also means that the area's Capital Account Balance should start improving after having deteriorated in the past five quarters. This is significant in evaluating the EUR recovery outlook as the Capital Account Balance is the single, most significant determinant of the EUR's future valuation (please see chart above). Said another way, capital inflows from European investments returning from abroad should strengthen the currency in a positive feedback loop, as growth, money supply, debt issuance and inflation factors continue to recover due to the impetus that cheap currency, low inflation and low rates have imparted on the economy in the past several quarters.

The news flow is favorable in this regard. Money is flowing-in back to Europe at a record pace. This year has seen the biggest inflows into European funds and assets ever recorded already. Business Insider said that "investors are climbing over each other to get a hold of stocks and bonds — both government and corporate — in the Eurozone". All in all, aggregate risk-on flows into European assets were huge: almost $40bn in March 2015 alone.



US and global disinflation will abate later in the year

- Around the globe, nations are all feeling the adverse effects of very high debt and the related decline in commodity prices and overall economic activity. This decline, in turn, is being felt via lower prices for both commodities and traded goods – that is, disinflation. Falling inflation effects loop back further into commodity prices by increasing real rates which in turn strengthens the US dollar, and, which in a second-round effect, depresses commodity prices even further.

- Falling prices for oil and other key industrial commodities results in the sharp drop in capital expenditures related to oil and gas, which have resulted in a sharp decline in related economic activity and employment in those sectors. That has, in turn, negatively impacted the prices of other cyclical commodity sectors like base metals. It is worthwhile to note however that not all commodity sectors were impacted to the same degree — Gold has outperformed within the commodity asset class, despite the stronger US Dollar.

- US inflation now seems increasingly influenced by global forces. The Thomson Reuters/ Commodity CRB Index has shown much higher and more predictive correlation with US inflation levels than the Fed Funds rate or unemployment levels in the last few years. The CRB is a basket of commodity futures (energy constitutes 39%) that is priced in US dollars, and rises and falls primarily as a function of global demand.

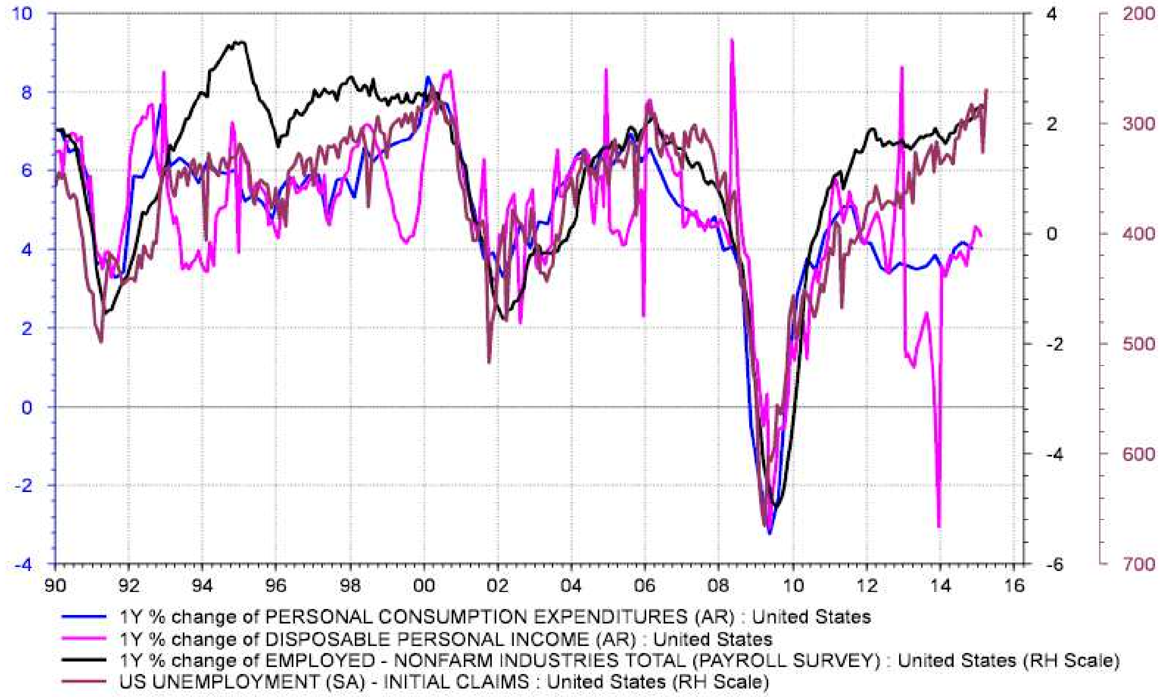
Wage/employment cost pressures will not power inflation higher this year — commodity prices will

- The historical source of inflation in the US, namely wage growth and employment costs, have been tame and will not be the prime movers of inflation this time around. That role will be taken over by commodity prices this year.

- A rise in inflation in the US will therefore be predicated on the rise in commodity prices, which we expect to see as from Q2 this year. The down trend in oil, a combination of higher supply and less demand from emerging economies, has been a disinflationary force of late. But demand is starting to stabilize, and should pick up during H2 this year. A recovery in energy prices will boost US CPI inflation in 2015. In fact, we expect that US Core CPI inflation will continue to ascend for the rest of the year. US CPI inflation is a pacesetter in the developed economies, so expect the globe to follow suit, after a lag.

- The lead US breakevens have on inflation is providing a clear signal that CPI Headline Inflation is on the way up. When inflation rises in the US, it also lays the ground work for a weaker US Dollar as real rates fall.

Consumer Spending, Disposable Personal Income, Payrolls, Initial Claims



Source: Thomson Reuters Datastream

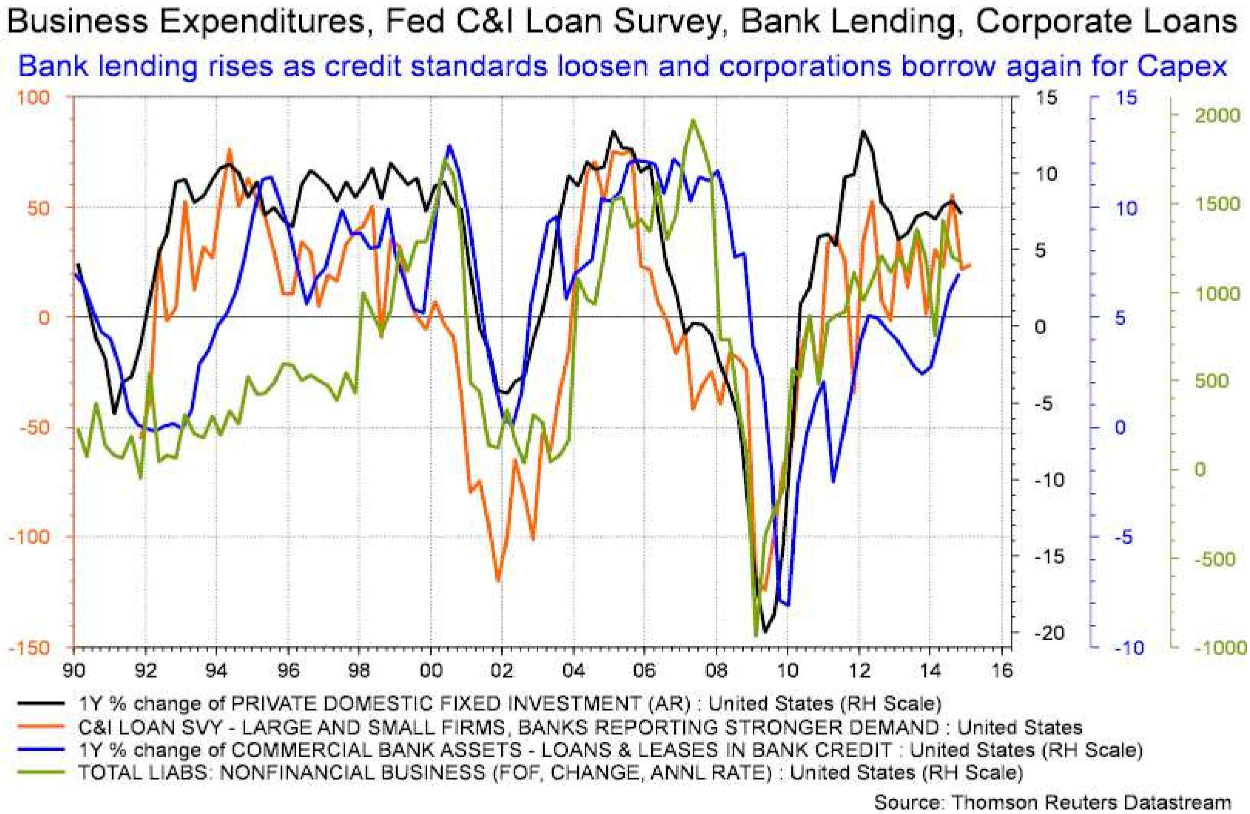
US Fundamentals show slower H1 growth, but activity picks up in H2 2015

Consumer spending is at highest level since Q2 2011

- After several years of restructuring, reduced spending growth, increased savings rates and debt-reduction, US household balance sheets are in better shape than they have been since the early to mid-1980s, based on a wide variety of metrics.
- Whether you look at debt, service-to-income, debt-to-income, consumer loan delinquency rates, cash balances as a percent of income, or household net worth, the US consumer balance sheets are, on aggregate, in the best shape they have been in several decades.
- While the above-cited household data do not provide any guarantees, there are strong reasons to believe that a greatly improved consumer balance sheet, combined with other factors will still generate consumer spending this year and beyond.
- Consumer spending in Q4 2014 was at its higher level since Q2 2011. Advance data suggests that it may have declined in Q1 2015, but with Consumer confidence continuing to rise, spending should be a factor in the H2 US growth recovery.
- One important factor to consider is that the average age of household consumer durables in the US is the highest since 1962. This suggests that there is still considerable pent-up demand. Although durable good orders declined after surging in early Q3 2014, we expect a re-emergence of spending on durables later in H2 2015.

Employment hit a speed bump in March, but should rise further with growth in H2 2015

- There had been marked improvement in employment in the past several quarters, although the jobs data for March 2015 has disappointed. Average hourly earnings has been weak in Q1 2015, following the growth data lower. Wage growth continues to improve, nonetheless, although at a pace that was slower than historical norms.
- Although the payroll and unemployment data are close to maximum historical levels, there still remains a slack which many economists believe can lead to further gains in employment. That should give consumption growth another leg up if that happens.



Business Expenditures start to recover, but are still at depressed level relative to historical norm

There are several reasons to believe that the business expenditure cycle will accelerate appreciably in 2015 and beyond:

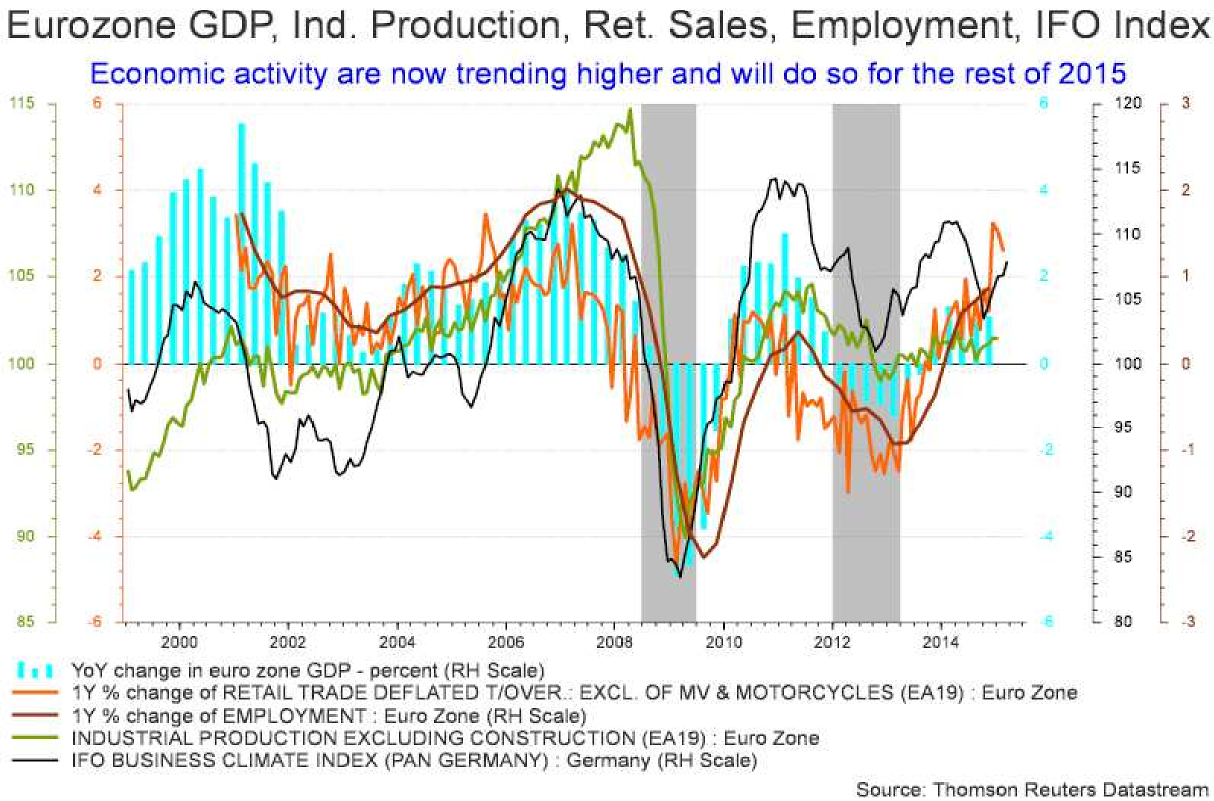
- First, the age of US capital stock is at an all-time high, meaning that there is considerable pent-up demand to replace equipment, software and the like.
- Second, capital expenditures have started to rebound, but is still only at levels associated with previous economic cycle troughs. This suggests that CapEx must accelerate significantly in order to be able to cope with a normalization of consumer demand.
- Capital expenditures started to take off in the second half of 2013, and various independent surveys have concluded that US capital expenditures will accelerate significantly in 2015 and beyond (Citibank Survey).

Credit Conditions are now significantly easier: bank lending and corporate loans pick up pace

Bank Credit

To the extent that consumers and businesses are disposed to accelerate their level of expenditures, financial institutions appear to be well-primed to facilitate this growth.

- With capital ratios at multi-decade highs and loan delinquency rates at multi-year lows, banks are poised to meet increased demand from consumers and businesses for credit.
- Indeed, US banks have been loosening lending standards in virtually all credit categories, including consumer loans, credit cards and small business loans.
- Total US bank credit is already growing at high single-digit rates, and appears poised to grow significantly further if consumer and business demand accelerate, as expected.
- In fact, US corporates are hoarding more than $4 trillion of cash, waiting for opportunities to unleash that record spending power.



Eurozone fundamentals: Economic recovery ahead

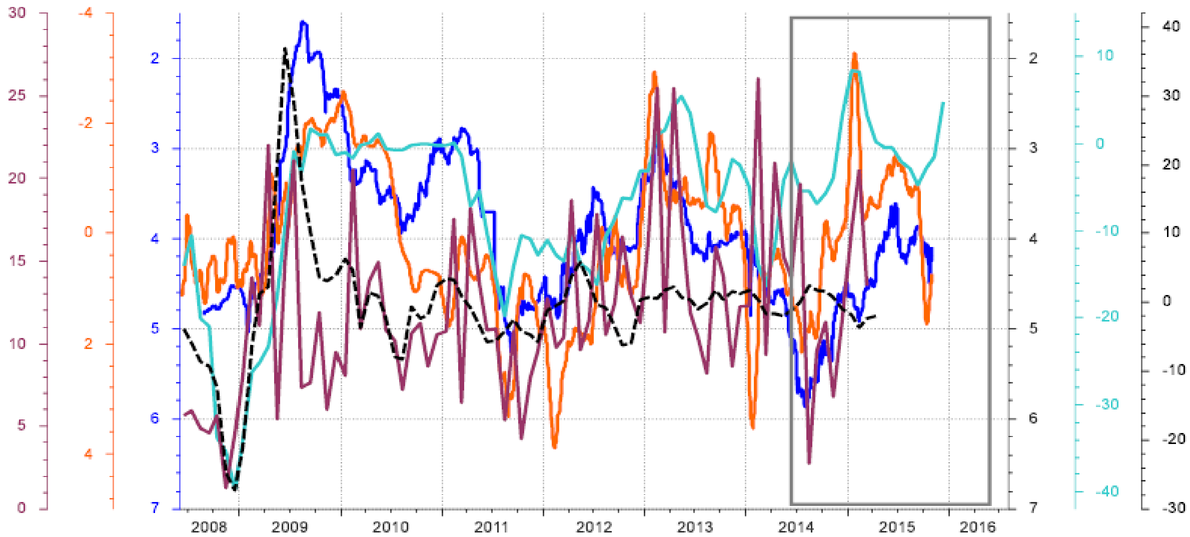
- There are now a bundle of signs of a significant recovery in Europe. The stronger Dollar and weaker Euro will reallocate growth away from the US and EM and toward Europe and Japan, with H2 2015 adjustments going mainly to the former which is at an early stage of a growth mini-renaissance.
- Economic data over the past quarter confirms that the recovery is gaining momentum. Consumer demand in particular has been surprising consistently to the upside, with private consumption stronger than expected in Q4 2014. As a consequence, retail sales have been growing at a pace not reached since early 2007, before the financial crisis began.
- Business confidence has also continued to improve across the board, with composite PMIs above the 50 threshold in February for all "big-four" countries for the first time since April 2014 and the aggregate index at its highest level since last July, led by the services sector.
- We expect growth of 0.65% q/q in Q1, which would be the strongest print since Q1 2011.
- There has been a significant rise in household purchasing power, which is now translating, at least in part, into higher spending. Private consumption may grow 1.6% in H1 2015 and 1.4% by year-end (versus 1.3% and 1.2%, respectively, in market expectations), a pace not achieved since 2007.
- We expect HICP inflation to rise 0.25% in H1 2015 and 1.25% by year-end.

Finally a more favourable environment for Europe

- The favorable impact of lower energy prices aside, the euro area also benefits from a significant improvement in monetary and financial conditions, primary as a consequence of a QE program that is essentially open-ended. The ECB QE's signalling effect has been substantial, resulting in outsized decline in yields and narrowing of risk spreads. More importantly, inflation expectations have risen, improving market sentiment, which has been fearful of the Eurozone's erstwhile apparent slide into a deflationary trap.
- The private sector is reporting the best growth in four years. And inflation has started an upslope trend in Germany, as PMI improves for the area (e.g., Spain) These are particularly good news for employment, and for the EUR.

Growth factors in China: CNY, Interest Rates, Social Financing, NBS PMI

Changes in the CNY continue to lead changes in rates, financing levels, and the PMI



1Q change of CHINESE YUAN TO US DOLLAR*10 (In USD terms), lagged 3 quarters (RH Scale)
CNY 3 YEAR IRS QTR INT 5M SHIBOR (3yr SWAP RATES), lagged 6 Months (LH Scale) (INVERTED)
(SOCIAL FINANCING : China ex Hong Kong and Macau (Country)/1000)
1Y change of CHINA REPO 1 WEEK, lagged 6 Months (LH Scale) (INVERTED
2Q % change of NBS PURCHASING MANAGERS INDEX FOR MANUFACTURING : China ex Hong Kong and Macau (Country)

Source: Thomson Reuters Datastream

Asia and China fundamentals may surprise to the upside in H2 2015

- Asian central banks including the PBoC have revised down CPI projections on lower-than-expected inflation but GDP growth forecasts have not been upgraded. Lower oil prices have led to a significant drop in inflation but the impact of lower oil prices is yet to reflect in China's GDP projections, as well as in most Asian countries.

- In our view, the impact of lower energy prices will be visible much later — in H2 2015. Better G5 growth, lower oil prices; and larger monetary and fiscal easing will provide a boost to Asia GDP in H2 2015. We forecast Asia-Pacific GDP growth at 6.6% in H2 2015, well above the 5.4% in H1 2015. Robust Asia-Pacific growth will contribute immensely to a higher global GDP growth in H2 2015, in our opinion.

Possible devaluation of the Yuan

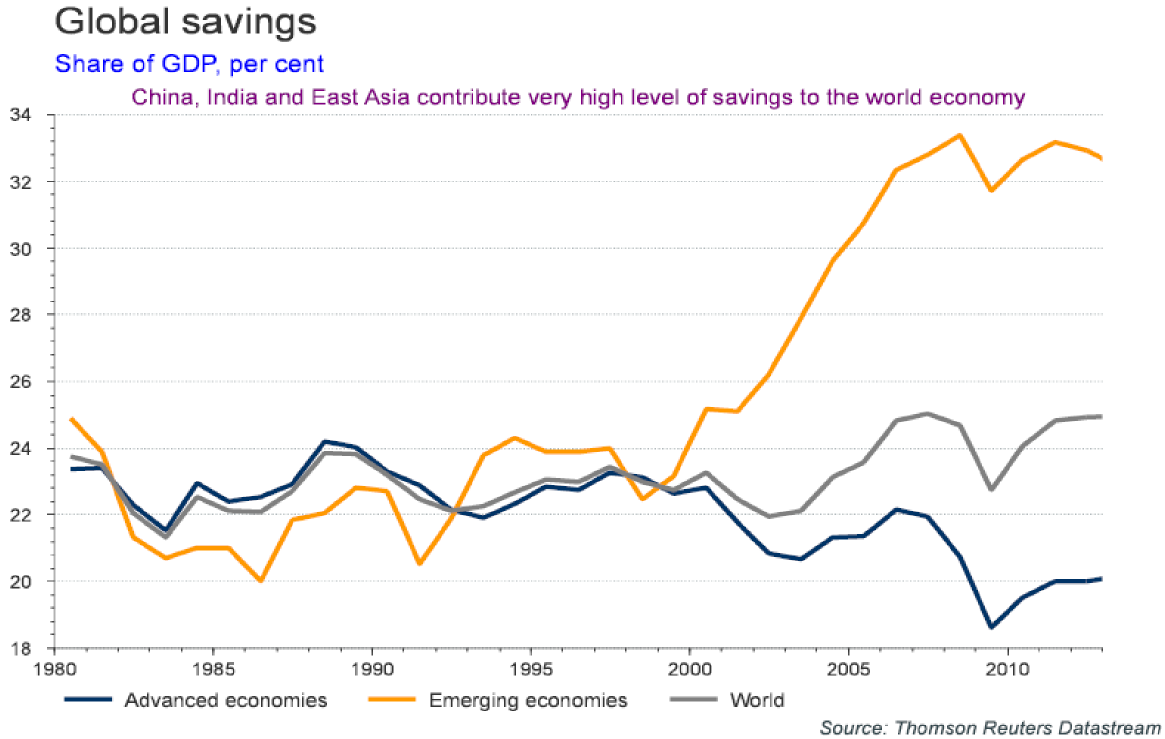
- The possibility of a CNY devaluation and/or band widening is drawing investors', as well as our, attention. Fundamentally, there is a good argument for a significant depreciation of the CNY against the USD, given CNY overvaluation, downside risks to China growth, and the PBoC's currently significantly tight monetary stance.

- The exchange rate of CNY is of high importance to our macro approach to China (please see chart above), as it is a strong determinant of subsequent short-term rates (e.g. Shibor and repo), which in turn leads developments in Total Social Financing volumes, which in turn cascades into bank lending, industrial production and to some extent, the housing market. The exchange rate has a positive correlation with short-term rates in China, with about a 3-month lag.

Bad news is good news

- Global investors' concerns about China tail risks (debt and housing market) are likely to ease from the currently elevated levels as monetary policy makers announce and draw up plans to ease financial conditions further. Henceforth, we expect targeted monetary easing, as well as active industrial and credit policies, to have more focused effects. We expect a 25bp policy rate cut and two more 50bp Required Reserve Ratio (RRR) before the end of Q2 2015.

- Lack of improvement in real estate investment and falling inflation continue to be key themes for investors in China. But with more aggressive easing plans in the pipeline, those issues will likely recede in H2 2015.



The Private Sector will resume its role as growth driver

Due to the "deleveraging process" that took place in the past five years, the private sector (households and corporations) has purged a significant amount of risky investments that it previously held. The largesse from the central banks hastened the deleveraging process by providing wherewithal for the private sector to shore up balances.

As a result, the aggregate balance sheets of consumers and businesses across the globe (more so in EM economies), and their liquidity position in particular, expressed in extremely high savings ratios — are the most favorable they have been in the past three decades. But its consequence manifests in low, even negative bond yields in many developed economies, and its accompanying effects of low inflation and a strong US Dollar as safe-haven.

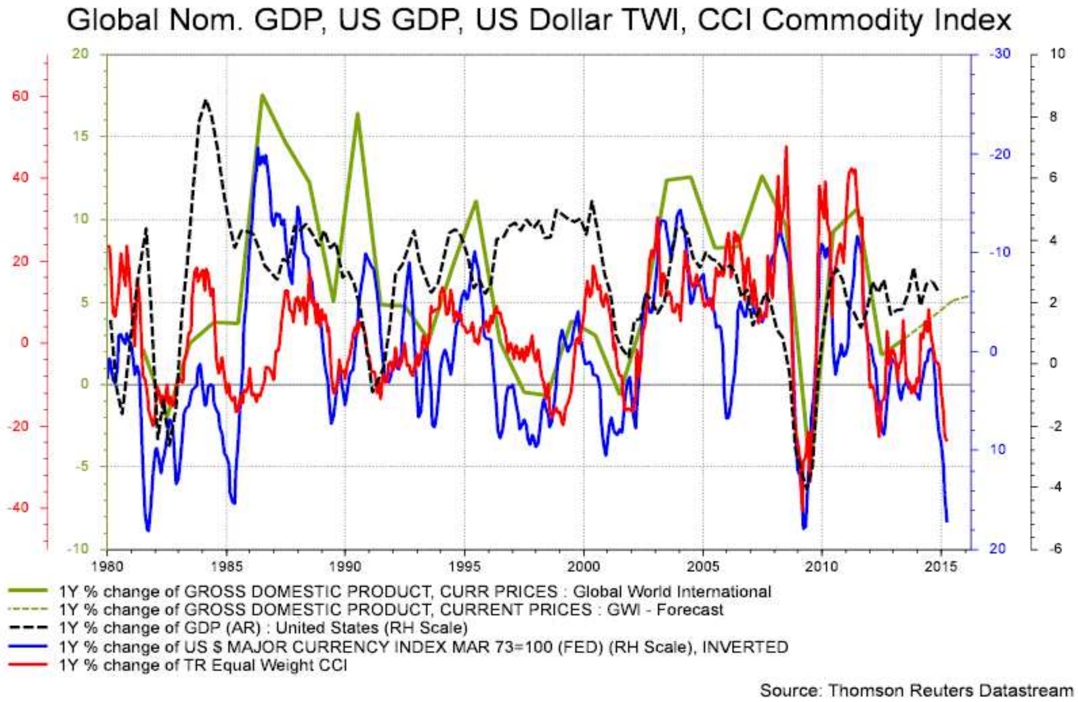
Nonetheless, as risk-aversion wears off, financial entities in the developed world will seek to optimize the return of those humongous liquidity positions. <u>This is what will drive risky asset prices going forward.</u>

Which asset or assets will dominate in the near-future?

Financial balance sheet accounting, which mechanically takes away an imbalance at one end and puts it back-in at the other end, will determine the near-term asset class dominance structure. If debts are made easier, then assets are made much worse, and vice versa. <u>If risky assets will become more dominant as we expect, then less-risky or even safe assets will decline in significance. Investment in riskier assets is the initial step in rebuilding portfolios.</u>

There are three strands of events that will determine the performance of the economy and asset classes going forward, and the manner and pace these financial portfolios are rebuilt:

- When and how quickly the private sector will put the hoarded/saved incomes back to work.
- How quickly and how long will it take the central bank to take back or neutralize the huge amount of safe-and-liquid-store-of-value instruments that they have created.
- What kind of fiscal response the governments will take to alleviate the condition of excess savings over investment. The normal response in the past has been for governments to borrow some of the excess savings and invest the proceeds of that borrowing in demand-boosting investment. For the US, that would be tackling the country's many pressing infrastructure needs. The US may also have to modify some provisions of its corporate tax laws to entice the repatriation of capital hoarded abroad.



Factors that enhance or impede initiatives from the Private Sector

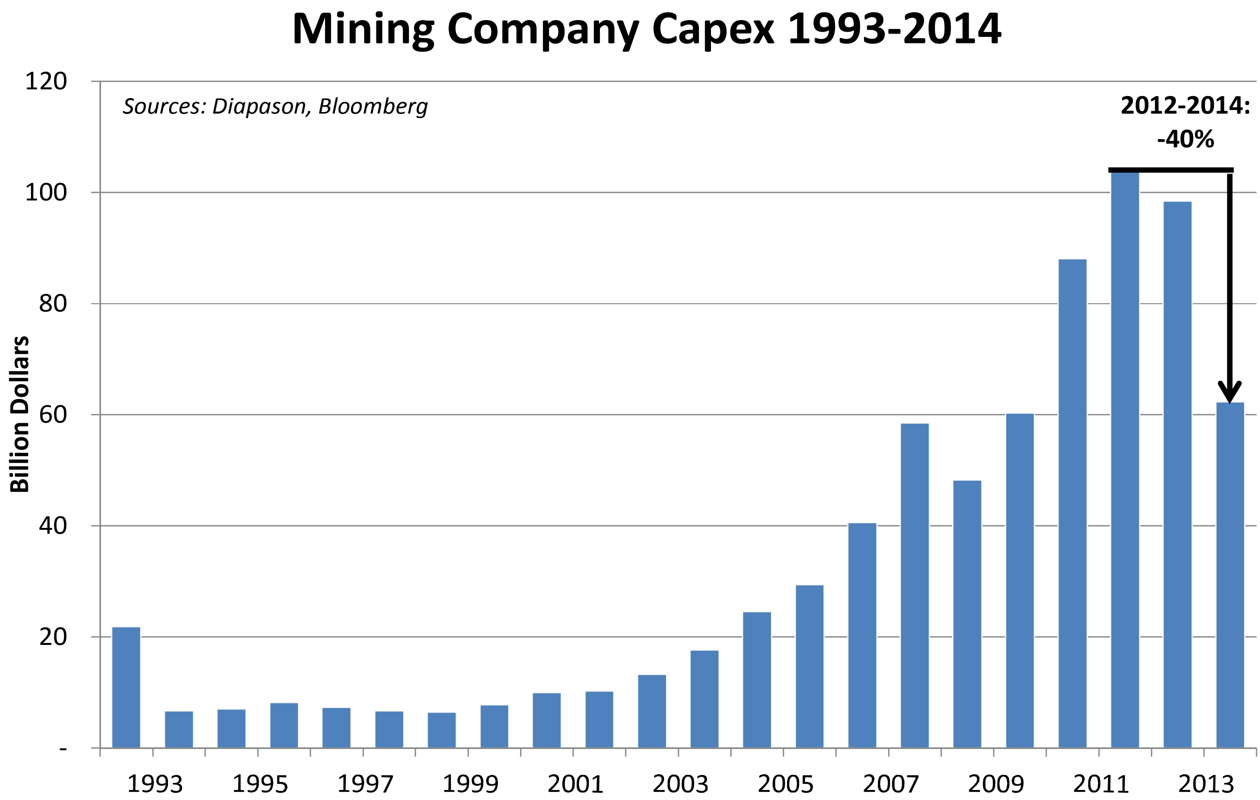
- Past, and on-going episodes (e.g., ECB in the Eurozone) of central bank Quantitative Easing remain, and will be, a feature of the financial landscape for a significant period. The resolution of the tremendous amount of overhanging aggregate global bank reserves will be the most important economic activity and market driver for the next decade and beyond.
- US monetary policy is effectively put on hold for a while as the Federal Reserve assesses the cumulative impact of the strong US Dollar in the past 5 quarters on the domestic and the global economy, and as it monitors the outlook for US growth, and wage employment costs (for inflation pressures).
- A more sustained easing of financial conditions in China, and additional stimulus measures in Japan will add fuel to the upwards impetus for all asset classes.

Global growth, ex-US should significantly improve in H2 2015

- Eurozone and China, especially the former, are due for a significant recovery as the positive impact of low rates for long, easier financial conditions, relatively weak currencies and low inflation exert salubrious effects on their economies. Global growth, ex-US, should accelerate as from Q2 2015.

The US Dollar will continue to weaken for the rest of the year

- The US Dollar should weaken as global growth improves in H2, even as US growth recovers from very weak H1 activity as a consequence of severe weather at the end of last year. US growth may level out in Q2, and should resume its ascent by Q3 2015.
- The hiatus from the Fed's monetary tightening process (the Fed's prudent stance validated by the disappointing March data) should likewise put a pause in the US Dollar's uptrend, as does the improvements in the growth prospects of the Eurozone and China and some parts of the EM. Rising market sentiment ex-US should further help undercut the US Dollar as the investment climate improves in other regions of the world.
- A weaker US Dollar and a prospective pick up in global trade as growth improves, will help lift energy and commodity prices, which in turn should put a floor on global inflation. A trough in global disinflation will, in a feedback loop, improve commodity prices in turn.
- Commodities have been pinned by the strong dollar, and has been underperforming global growth as a consequence (see chart above). A weaker US Dollar should enable commodities to catch up with global growth.



FUNDAMENTALS: Market mechanisms at work

The large decline in commodity prices is triggering response from consumers and producers. Adjustments by physical participants have contributed to stop the downward momentum on commodity prices. The DCI® Global Index even rose by almost 7% during February, the first monthly gain since June 2014. In February, all commodity sectors stabilized with the exception of the precious metals sector, which fell by almost 5%. Throughout the quarter the situation is mixed but the stabilization of commodities prices is clear.

Adjustments from commodity producers…

Supply and demand has started to adjust. Commodity producers have cut capex, leading to slower output growth. The adjustments mechanisms are even more rapid than usual in the oil market thanks to the tight oil boom. The elevated decline rate and the high cost to drill wells should lead in the second half of this year to a significant slow down in US crude oil production growth, while conventional crude oil supply would have taken maybe a year or two before adjusting to the new conditions.

In the mining sector, adjustments from mining companies already started in 2013 when metals prices fell to low levels. Between the early 2011 and the end of 2013, the DCI® Base Metals Index fell by 35%. This prompted mining companies to reduce capex by 40% between 2012 and 2014. Aluminium producers are cutting the most expensive smelting capacities. In March, Alcoa announced it would look at cutting or selling as much as 500’000 tons of annual smelting capacity, accounting for 14% of its total capacity. Since 2007, Alcoa reduced its smelting capacity by 1.3 million tons.

…and from commodity consumers

Demand is also responding to the low commodities prices. US oil demand has recovered. According to the US EIA, US petroleum products implied demand was up by 4.3% y/y in Q1 2015, fuelled by low prices and the further rise in US jobs’ creation. Aluminium demand from the transportation sector continues to grow rapidly at the expense of steel. In January 2015, global zinc slab consumption also reached 1.3 million ton, a new record high, while demand tends to decline seasonally because of the Chinese Lunar New Year.

	Marginal Cost of Production 2014	Price on 07.04.2015
Platinum $/ounce	$1'400	**$1'167**
Gold $/ounce	$1'100	**$1'209**
Silver $/ounce	$15.0	**$16.8**
Nickel $/mt	$18'450	**$12'675**
Copper $/mt *	$4'894	**$6'019**
Aluminium $/mt	$2'300	**$1'784**
Zinc $/mt	$1'525	**$2'137**
Soybeans $/bsh	$10.8	**$9.8**
Wheat $/bsh	$8.0	**$5.2**
Corn $/bsh	$4.3	**$3.8**
Coffee (Arabica) $/lb	$1.2	**$1.4**
Crude Oil (Brent) $/bbl	$92.0	**$57.9**
US Natural Gas $/Mcf	$5.4	**$2.7**

Source: Diapason

Marginal costs are defined as the 90th percentile of the cost curve

**Copper prices fell below the marginal cost of production in 2009 but had since then a large "scarcity" premium over the marginal cost of production as miners have struggled to lift production*

Prices fell close to cost of production

As we have seen, the decline in commodity prices fell by a significant amount these past 3 quarters. Producers are responding to the low commodity price structure by reducing capex. In fact, it is interesting to see that prices for some commodities have fallen below the marginal cost of production.

Delay or cancellation of marginal projects

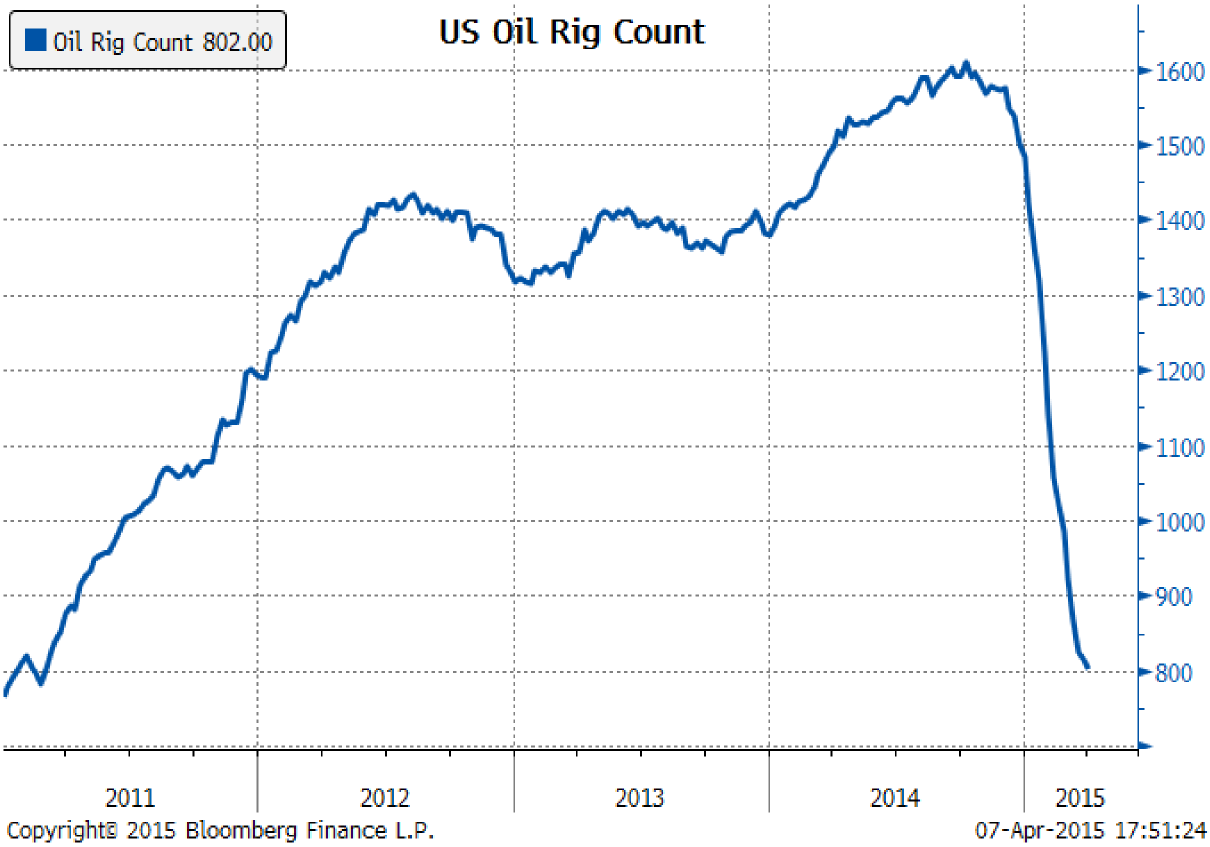
In the above table, we can see in green commodity prices as of April 7th, 2015, which are below the marginal cost of production (defined as the 90th percentile of the cost curve) of 2014. For example, greenfield oil sands projects in Canada require a barrel between $90 and $100 to break-even. Current oil prices have triggered a wave of delay or cancellation of new oil projects.

In early April, TransCanada announced a two-year delay plans to finish a new crude oil pipeline to transport oil from Alberta to Quebec to 2020. While the growing amount of trains used to transport crude oil may have explained part of this decision, the fact that a lower amount of crude oil output should come on stream in the coming years in this high cost region have played a role in this decision. Canada is not an isolated case. According to a senior executive at Saudi Aramco, the steep fall in oil prices may force the industry to cancel about $1 trillion of planned projects in the next couple of years.

Lower investment on existing projects is increasing supply risks

Low or even negative operating margins are forcing commodity producers to cut cost as much as possible on existing assets. This reduction of investment could also affect commodity supply.

For example, farmers are reducing the use of fertilizer and equipment, putting at risk yields. In the oil industry, investments are typically made to mitigate the natural decline rate of mature oil fields by injecting water or natural gas. The announced reductions in investment could therefore lead to a higher decline rate at existing oil fields. Mature oil regions such as the North Sea or Western Siberia are especially exposed to this risk. In base metals, lower investment in brownfields project may also lead to a higher decline in production from existing mines.



ENERGY: The Oil price recovery is near

Oil companies are adjusting to the low oil price environment

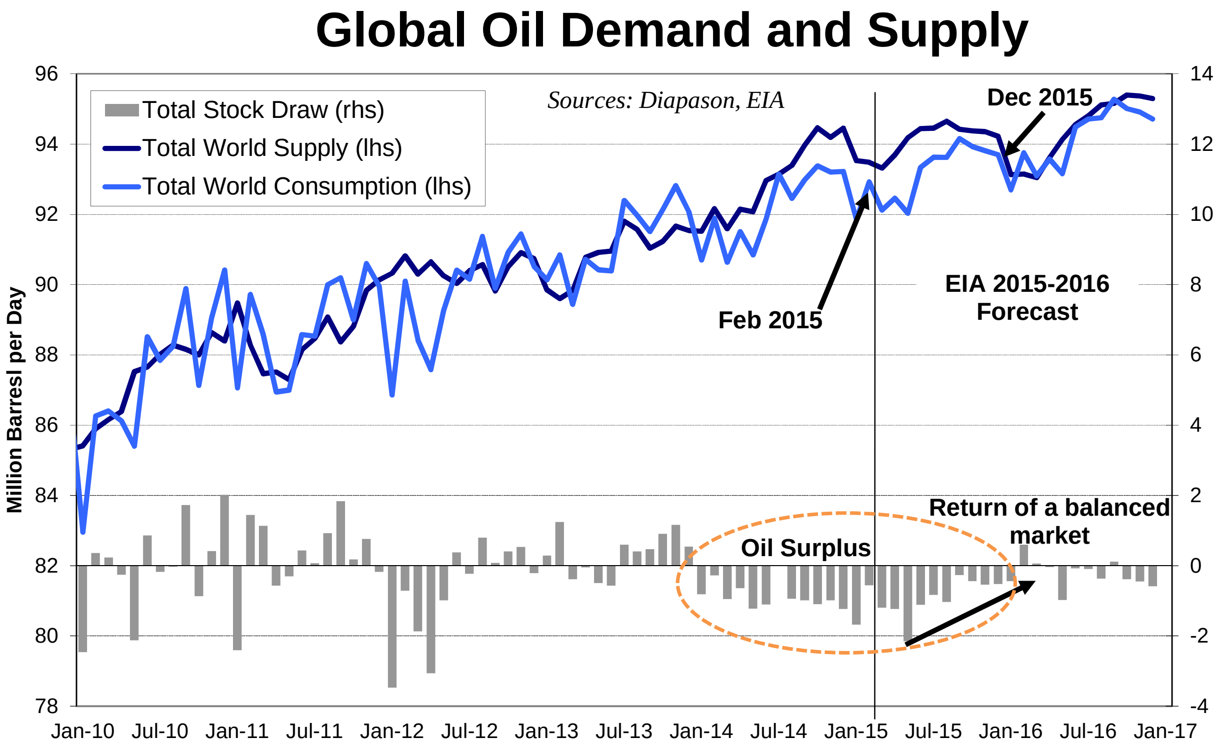
Adjustments are most visible where the price action was the strongest. The 60% decline in oil prices between June 2014 and January 2015 has indeed triggered a wave of large cuts in expenditures in the oil industry. The combined layoffs announced by the top three oil services companies (Halliburton, Schlumberger and Weatherford) were 23'400, accounting for almost half of the expected layoffs caused by the decline in oil prices (about 50'000 workers).

RBC Capital markets also estimated a cut in capital spending by 20% ($86 billion) for 2015, driven by exploration & production companies (-31% y/y or -$52 billion). Another reflection of the rapid response by the US oil industry is the significant decline in the number of US oil rigs. Monthly U.S. crude oil production fell in January for the first time in over a year, while the 50% cut in the number of oil rigs since last fall is beginning to restrain production growth in the lower 48 states. The decrease in oil rigs in use occurred in all the tight oil regions. The most impressive decline in the number of rigs was in the Permian Basin, in West Texas, where it fell since early December 2014 by 283 to 285, accounting for 36.6% of total US oil rigs decrease. These cuts resulted in the cancellation or delayed oil projects, reducing the medium-term supply growth outlook.

Short-term downside risks ahead before a sustained recovery

However, oil prices face some important downside risks on the short run as crude oil inventories could rise further in the coming weeks due to the combination of the oil surplus and the refining maintenance season. Global demand for crude oil by refiners typically hit a seasonal low in April as refiners perform work ahead of the summer, when oil demand peaks seasonally.

Lower crude oil demand and the surplus could contribute to rapidly rising crude oil inventories. The possible lack of available storage capacity in the coming weeks is a major risks for the oil market. This also fits with the scenario that the risk-off environment is not yet over.



Supply is adjusting more rapidly than in the past

Nonetheless, adjustments in oil supply are likely to take effect in the second half of the year as oil companies are cutting spending. The fact that US tight oil wells have a high decline rate (up to 60% at the end of the first year) also suggests a more rapid than usual adjustments of supply to the low oil prices environment.

The US government expects domestic crude oil production to peak only in May 2015 to 9.4 million b/d and then decline by about 150'000 b/d until December 2015. US crude oil production could reach 9.2 million b/d in December 2015, down by 100'000 b/d y/y, a significantly slower growth than in December 2014 of 1.4 million b/d y/y. In 2014, US production of crude oil rose by 1.2 million y/y, the most important rise since at least 1900 when data started. In 2015, US crude oil production is expected to rise by only around 0.6 million b/d y/y. This would therefore mark a major change from the previous year and reflect the capacity of the supply-side to respond rapidly to unsustainable low oil prices.

Demand is accelerating from OECD countries…

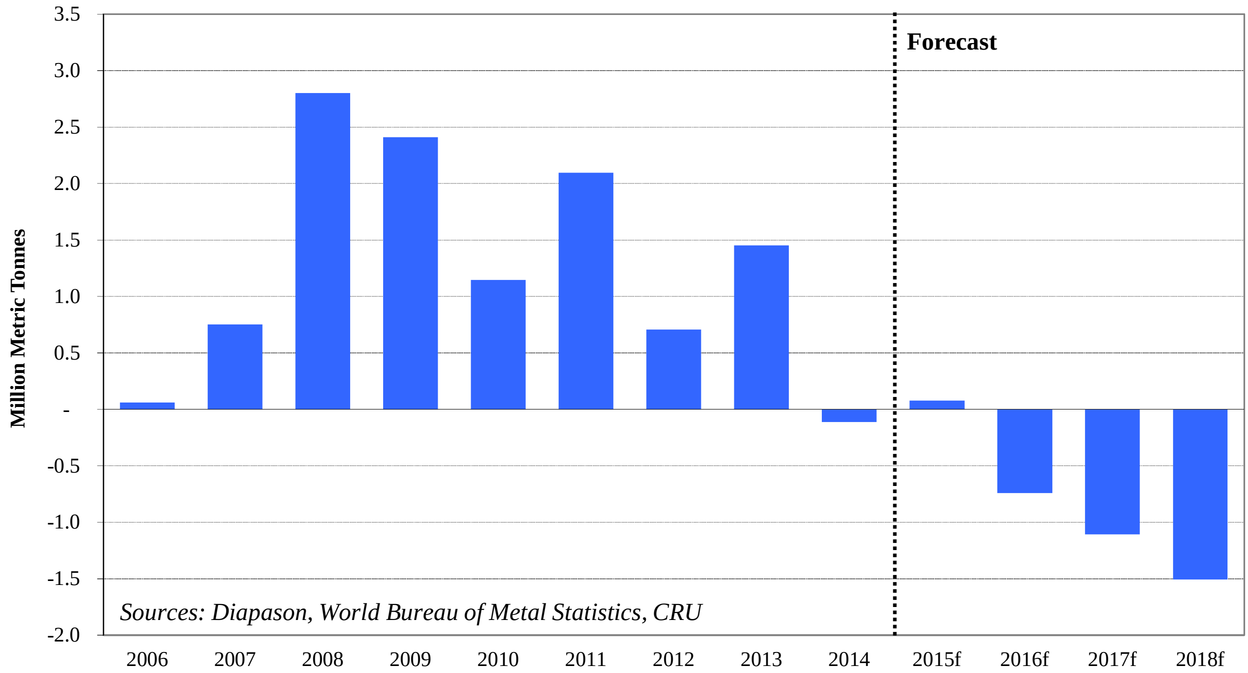
Moreover, demand for oil is growing at a faster pace, encouraged by low prices. In Q1 2015, US gasoline demand reached 8.8 million b/d (+4.3% y/y), the highest level for this period of the year since 2011. Strong demand for petroleum products in the US is fuelled by low fuel prices and the expansion of the labor market. US employees on non-farm payrolls reached 141.1 million in February 2015, a new record high and up by 2% from the previous peak made in January 2008. And demand could rise further driven by the rest of the world.

Europe has been a drag on global oil demand these past few years due to the anemic economic activity — European oil demand fell by 2.1 million b/d between 2007 and 2014. But the expected improving economic conditions in Europe should contribute to a much weaker decline in European oil demand this year (-100'000 b/d y/y vs an average of –240'000 y/y on average during the previous 5 years).

…and non-OECD countries

But non-OECD countries and especially Asia are likely to contribute to the bulk in global oil demand growth this year. On top of lower oil prices, the improving economic situation in China and in other neighboring non-OECD countries should boost demand growth. Asian crude oil demand ex-Japan should rise by 0.6 million b/d y/y this year, similar to the previous 2 years before accelerating to +0.7 million b/d y/y in 2016, accounting for about 67% of global oil demand growth. The acceleration of demand, while supply growth is slowing down should contribute to bring the oil market back to equilibrium at the end of this year.

Primary Aluminium Global Balance



BASE METALS: Aluminium and zinc to lead the way

The fall in oil prices has naturally had a negative impact on base metals prices as it lowers their cost of production. For example, power costs typically account for 40% of total costs to produce aluminium. The decline in oil prices had therefore an especially important impact on aluminium prices.

However, aluminium and zinc are likely to be the best performers within the base metals sector this year. Indeed, amid low and declining inventories, the zinc and the aluminium markets are in a structural deficit. Low prices these past 3-4 years have contributed to lower investments in new mines or smelting capacity, while demand growth is expected to continue to expand. The transportation sector is using more and more aluminium and contributed to bringing the aluminium market into deficit, as suggested by the significant decline in aluminium inventories at major exchanges which have fallen by 27% since the end of April 2014 to 4.2 million metric tons, the lowest level since May 2009.

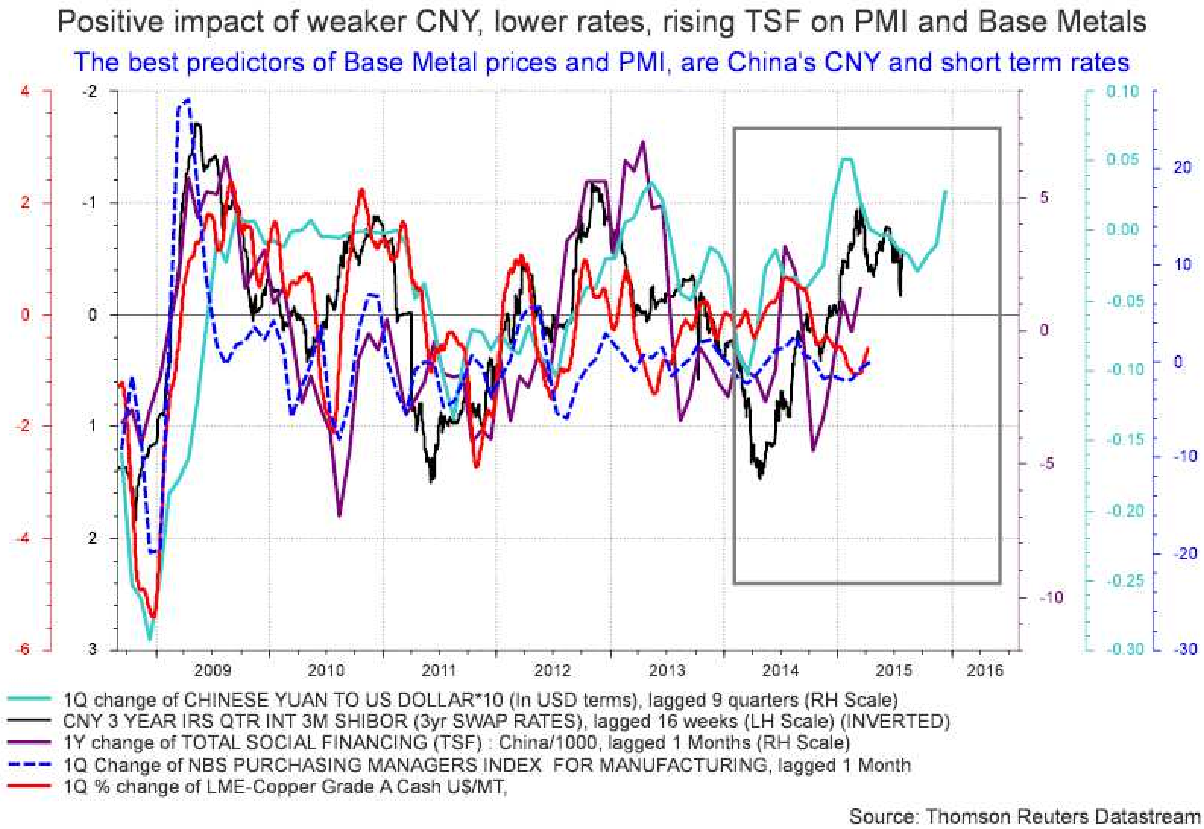
Aluminium idle capacity may return to the market

However, although aluminium prices remain below the marginal cost of production estimated at $2300 per metric ton (before the 60% decline in oil prices), about 2.4 million metric tons of idle smelting capacity, accounting for 5% of global aluminium production last year, could restart in reaction to higher aluminium prices, capping the upside price potential in the short run. The recovery in oil prices is therefore required to see a more sustained upward move in aluminium prices as it would also lift the breakeven price for producers.

Major zinc mines to close this year

Zinc inventories at the LME have started to decline earlier than aluminium, and since December 2012 have fallen by 49% to 631’000 metric tons the lowest level since December 2010. Zinc inventories could decline further in the coming years as some major zinc mines are expected to shutdown.

This year alone, MMG’s Century mine in Australia, the world’s 3rd largest zinc mine with a capacity of 500’000 metric tons per year and Vedanta’s Lisheen mine in Ireland with a capacity of 167’000 metric tons (the world’s 7th largest zinc mine), are expected to close in the second half of 2015. This followed several major closures in the past two years. Thus, despite prices being above the marginal cost of production estimated at $1525 per metric ton, zinc mined supply growth is likely to lag demand growth, leading to a growing deficit in the coming 3 years.



Copper is another animal

Contrasting with other base metals, the copper market is expected to move into a surplus this year as last year's delayed supply should come on-stream on top of already planned expansions and new mines. But like in 2014, the surplus is likely to be smaller than initially expected due to possible supply disruptions and stronger demand from China.

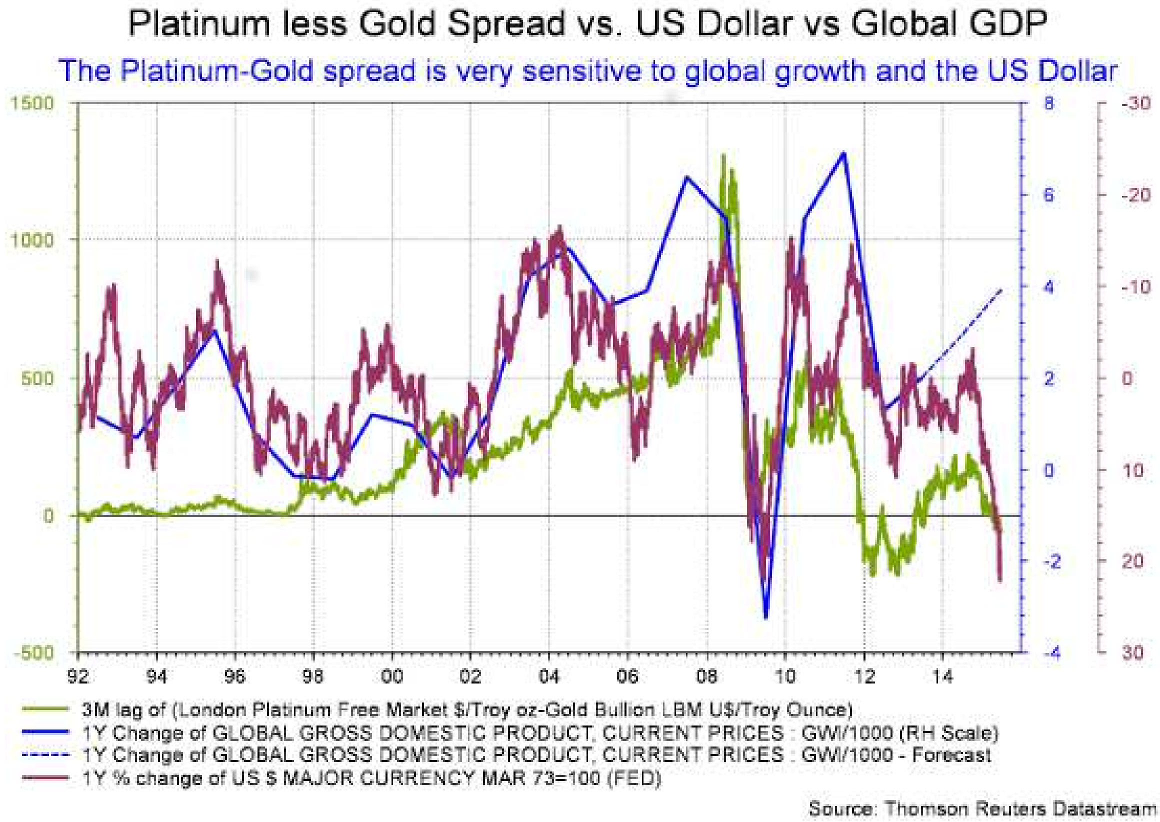
Already supply disruptions in Q1 2015 contributed to the recent good performance of the red metal. Copper supply negatively affected by the drought in Chile, which was followed by important floods. A strike at the Grasberg mine in Indonesia, the world's second largest copper mine by capacity also increased worries about mining operations. Further supply disruptions could support copper prices as it would mitigate the impact of the expected market surplus.

The Chinese government won't allow any hard landing

The strong demand growth expected not only in copper, zinc and aluminium but also in other base metals is likely to come from the acceleration of the Chinese economy. China, which accounts for more than 45% of global base metals consumption, has slipped from the limelight in the past months, as growth and activity remain flat.

The government's desire to normalize from an infrastructure-led growth to one driven by consumption, but tempered by its desire to avoid major disruptions to employment, has produced a sideways trend to GDP in the past quarters. Whether or not this trend will continue for some time really depends on what policies will be adopted for the near-term.

One thing we feel certain about: there will be no hard-landing for China. This was confirmed by the recent response of the Chinese government to weak economic data. At the end of March 2015, the Chinese government announced cuts in the minimum down payment for some second-home buyers in a response to the weaker real estate market activity. The PBoC was also active. At the end of February, it cut benchmark interest rates for the second time in 3 months. More easing from the government and the central banks are likely to occur if the economic situation deteriorates.



PRECIOUS METALS: PGMs should outperform Gold

The stronger global growth may mitigate the impact of the weaker US Dollar on gold prices, leading to the under-performance of the yellow metal against more cyclical precious metals — palladium and platinum may also outperform gold.

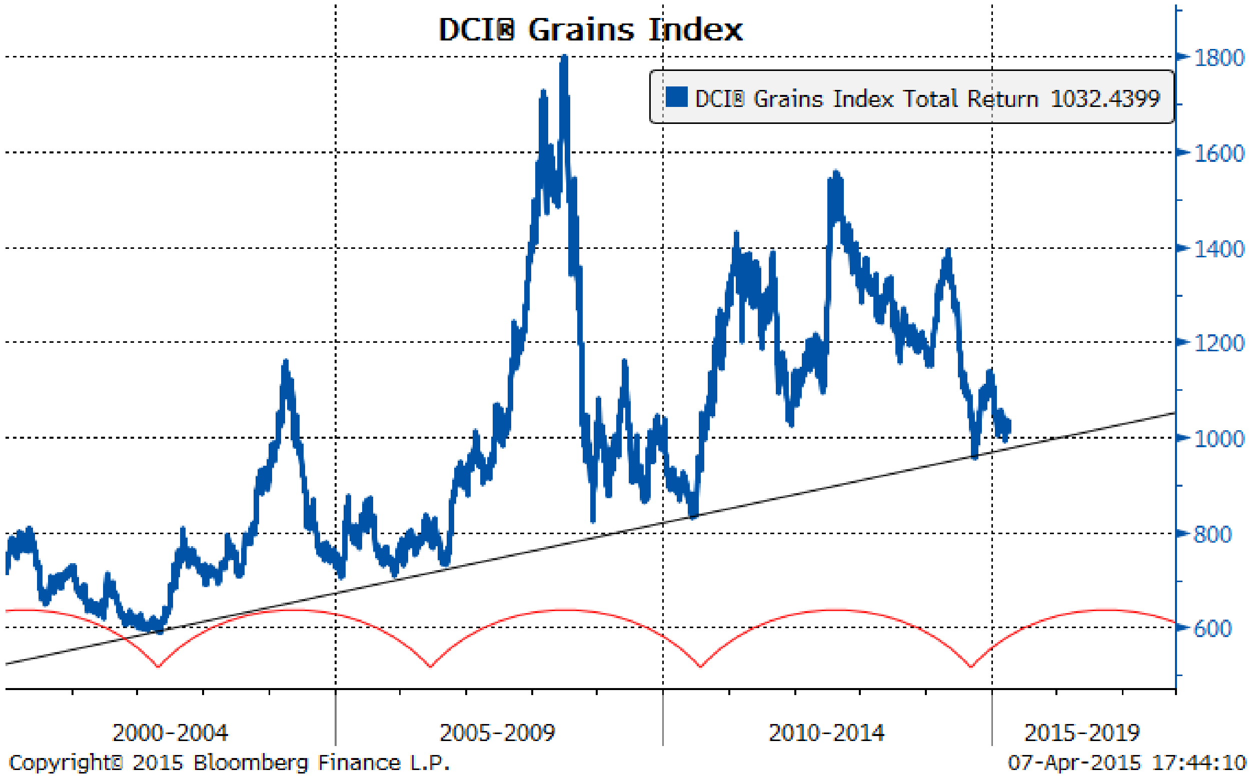
There are indeed still some issues with the platinum-gold spread. The ratio closed last week at a $43 premium for gold over platinum. This is an unnatural state for this price relationship — platinum is more than ten times rarer than gold (platinum production is 11 times smaller than gold production) and should trade at a premium to the yellow metal (see above chart). Until the ratio comes to par, or better, for platinum to move into a premium position, the outlook for the Precious Metals Group remains uncertain.

Global platinum was in deficit last year of around 700 thousand ounces according to a report issued this month by the newly formed World Platinum Investment Council (WPIC). However, above-ground stocks held by producers, comfortably made up for the short-fall. The WPIC sees reasons for higher prices on the back of robust demand and a tightening supply market, a market which — it must be said — remains in deficit, but this may not feed through into higher prices much before 2016/17 when the HSBC bank sees prices potentially exceeding $1,700/ounce.

Platinum may hence also do well within the precious metals sector. The most cyclical precious metals are therefore likely to outperform gold prices on the probable US Dollar weakness and especially with the acceleration of the rest of the world (relative to the US) and the decline of the risk-off environment. Consequently, after a first downward move the gold-silver ratio should carry-on further.

Reduced interest for interest-bearing assets

Low or negative rates should reduce the appeal for interest-bearing assets. Investors may hence look for alternatives such as gold or the US Dollar (cash). Furthermore, as commercial deposit rates approaches zero or turn negative, savers will likely start hoarding cash instead, or investing directly in physical assets such as precious metals. Gold and the US Dollar are therefore likely to be the biggest winners in this environment. This is why the correlation between the US Dollar and gold has become positive.



AGRICULTURE: Low grain prices are increasing supply risks

The price structure of agricultural commodities has fallen to low levels as the market discounted weak fundamentals. Moreover, following a pause last month, the US Dollar rally was reignited due to strong US economic data, suggesting an upcoming rise in the Fed's benchmark rate.

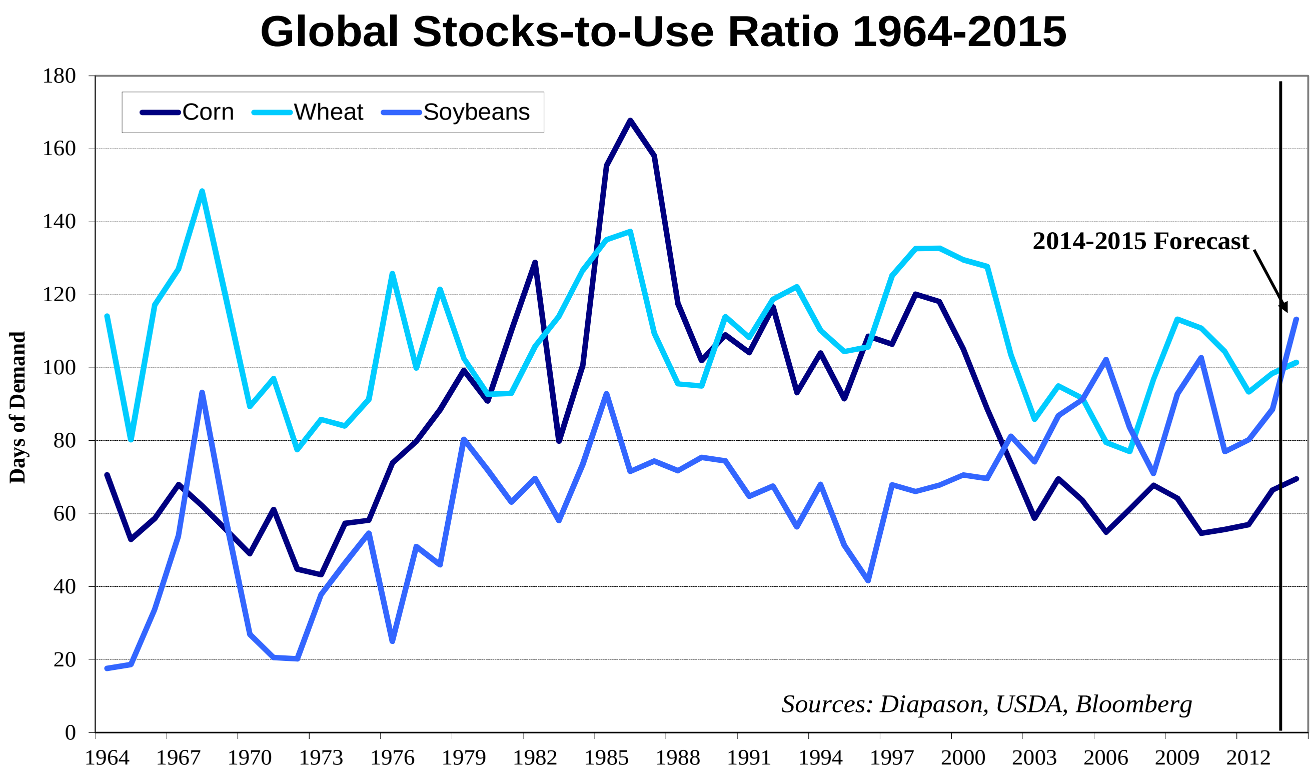
However, grain prices have fallen to low levels, approaching the lows made in 2008-2009, close to cost of production. This is encouraging farmers to reduce expenditures, which could in turn increase risks on yields. Moreover, investors should keep in mind that the agriculture sector may especially respond positively from any weaknesses in the US Dollar.

Grain prices fell below average spending

Grain prices have fallen below or closer to the average spending in the US. Average spending for soybean in the US Midwest is at $10.1 a bushel, while last week prices stood at around $9.8 a bushel. On the other hand, corn prices stood at around $3.8 per bushel, compared with an average spending to grow corn in the Midwest estimated at $4.6 per bushel, a difference of $0.8 per bushel. This could significantly reduce farmers' incomes. According to the USDA, US farm income should decline by 32% y/y in 2015 to $73.6 billion. As a consequence, US farmers are likely to spend less for their crops. This should lead to a significant reduction in expenses in fertilisers and equipment, which may put yields at risk. Deere, the provider of agriculture equipment, has forecasted a decline of 17% of net sales for 2015. Low prices have therefore increased the risks on crops.

Farmers are facing growing financial difficulties

Moreover, low margins have already contributed to reduce planting for the eight major crops in the US (corn, soybeans, wheat, cotton, rice, sorghum, barley and oats) to decline to 254.6 million acres, down 3.3 million from last spring, and the lowest since 2011. Some farmers had to breach lease contracts in order to reduce planting, leading to growing tensions between landlords and farmers — 40% of farmland is leased out in the Midwest Corn Belt and the grain-growing Plains. In Iowa, about 1% of the farmland leases could be breached this spring, reflecting growing financial difficulties for farmers. Indeed, breaking leases may lead to long legal battles and are typically the solution of last resort for famers in order to cut expenditures. Weak income has also forced some famers to turn to banks for loans to pay rent. Total non-real estate farm loans rose by more than 50% y/y in Q4 2014 to $112 billion, increasing the vulnerability of farmers to a possible rate hike this year.



A deficit would reduce the massive overhang of grains

While inventories are close or at record high levels, this year's crop could be significantly smaller than that of the previous year, as the crop is more vulnerable because of lower spending by farmers. This increases the likelihood of a deficit this season, while the surplus was already expected to be smaller than that of last year for most grains. A deficit could then contribute to reduce grain inventories, which have reached extremely high levels.

According to the International Grains Council, global wheat and coarse grains inventories at the end of the 2014/15 season could rise to 431 million tons, up 29 million tons y/y and the highest level since the mid-1980s. The stocks-to-use ratio should reach 22% - the highest in 5 years. Global soybean inventories could rise by 18 million tons to a record 300 million tons.

El Nino is back but weak

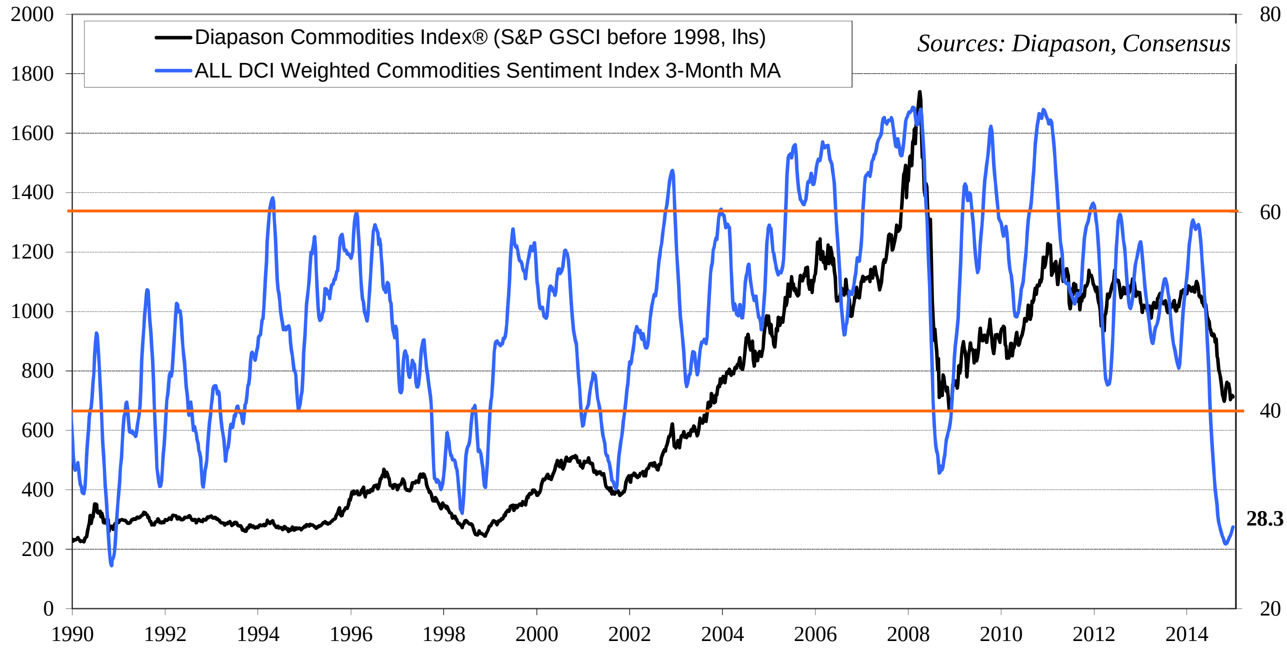
Moreover, El Nino is back. The weather phenomenon has arrived later than initially anticipated and is currently too weak to harm crops. But it could become stronger and threaten yields as it increases the probability of drier conditions in Asia and in Africa particularly in August to October. While this could push the prices of sugar, cocoa and wheat, El Nino could bring better growing conditions in the US and in Latin America, increasing the crop outlook for soybean, corn and Arabica coffee.

Grain prices are oversold

Grain prices, which are looking more oversold, may have a limited downside potential as most negative factors have already been priced-in (large harvest and inventories), while the market may have put less emphasis on supply risks.

Some consumers have also increased purchases of US grains in order to benefit from the low prices environment despite the rise of the US Dollar. Grain prices have also proved to be resilient in face of the large upward move of the US Dollar in February. On top of that, agricultural commodities prices should benefit from the stabilisation of the US Dollar in the coming months.

Diapason Commodities Index and Commodities Sentiment Index



SENTIMENT: sentiment on commodities fell to extremely low level

The positive sentiment on the commodity sector remains at extremely low level . The DCI® Weighted Commodities Sentiment Index 3-month rolling average stood last week a 28.3, slightly up from the 24-year low reached at the beginning of February 2015 (at 26.5). In the oil sector, the positive sentiment has fallen to even lower levels than in 2009.

This was due to the fact that some beliefs that the commodity super-cycle is over as the fundamental reason for the current decline in oil prices was supply-driven — while it was demand-driven in 2008. Adjustments from the supply side are traditionally taking a longer time than the one from demand, leading to the extremely low positive sentiment on the sector.

Over pessimistic investors may be surprised

But this may not be true anymore. The tight oil, which contributed to the major oil surplus, is significantly more price-elastic than conventional crude oil. US crude oil production is likely to grow by a significantly weaker amount this year due to the response of oil producers to the low oil price structure.

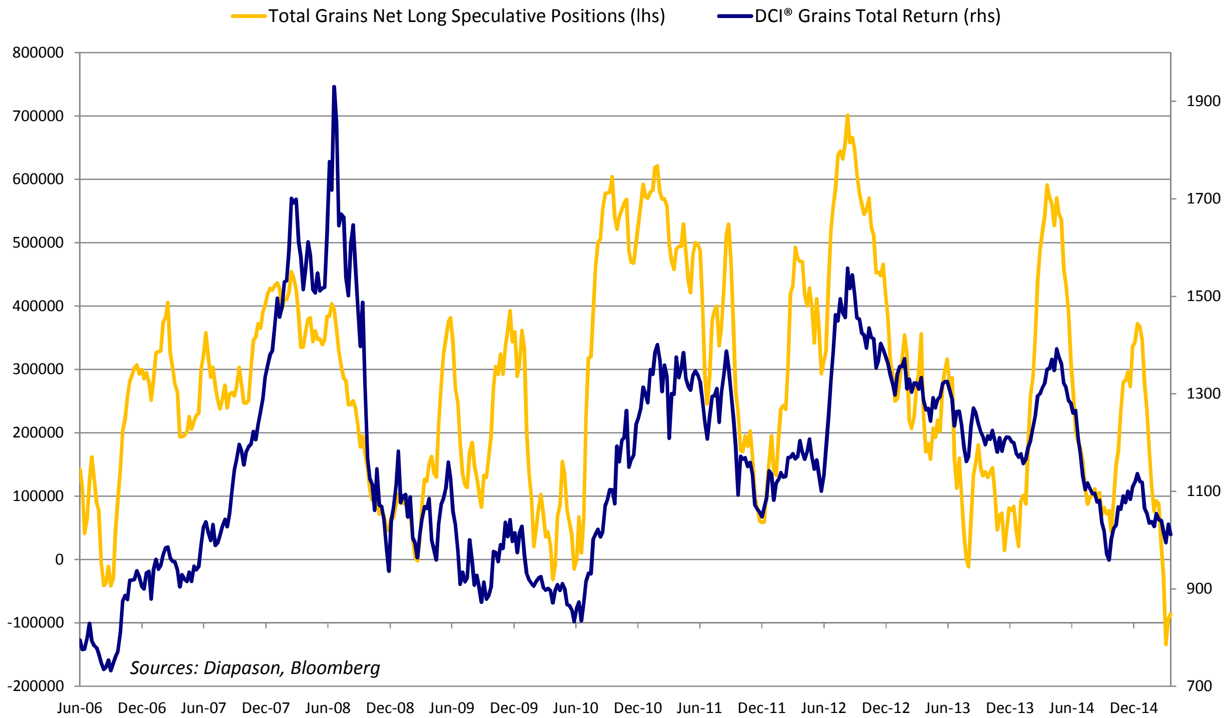
The US Government estimates that US crude oil production could decline between May and December 2015 by about 150’000 b/d, a significant change from last year, when US crude oil production grew on average by about 100’000 b/d per month. In the coming months, investors may hence be surprised to see these unusual rapid adjustments from the supply side.

Negative sentiment spreading among producers and banks

The sentiment on commodity is also negative among commodity producers. There are a number of reasons behind this depressed sentiment: fears of hard landing in China and claims that the commodity super-cycle is over arose.

These have prompted several investment banks to spread the idea that the end of the commodity secular bull cycle is a given certitude, while many structural imbalances remain. These theories quickly expanded to the media, contributing to the over-bearishness for the entire sector. On the other side of the debate, research houses such as McKinsey or Chatham House challenged these views but did not have an equivalent echo in the press.

Total Grains Net Long Speculative Positions and DCI® Grains Index



CFTC COT: Speculative positions suggest oversold conditions

Net long speculative positions on agricultural futures at record low levels

Net long speculative positions remain low for most commodities also reflecting the negative sentiment over the sector. On grains, net long speculative positions fell to the lowest level since disaggregated data started in 2006 as market participants are expecting important crops amid elevated inventories, leading to the decline in grain prices to levels close to the lows of 2009. But the sector is presenting signs of oversold conditions.

Net speculative positions on soybeans futures became negative at the end of March 2015 and reached -21'934 contracts, the lowest level since October 2006 and a significant decline from February 2014 level at 194'038 contracts. Short speculative positions have also increased sharply on soybean meal futures. During the third week of March 2015, they rose from less than 20'000 contracts in May 2014 to 45'966 contracts, the highest level since November 2011.

The grain sector is not an isolated case. Net speculative positions on soft commodities have also fallen to –20'677 the lowest level since the lowest level since June 2007. Agricultural commodities are therefore showing clear signs of oversold conditions.

Other commodities sectors are also showing some signs of oversold conditions

The amount of short speculative positions is also elevated in other commodity sectors. In the energy sector, net long speculative positions fell in October 2014 to 184'025 contracts, the lowest level since July 2012. While the amount of net long speculative positions have rebounded to 302'548 contracts, it remained down by 65% from June 2014 heights, which was close to a record high level.

Looking at specific commodities, we can clearly see some signs of oversold conditions. On WTI futures, the amount of speculative short positions (159'058 contracts) is close to record high level (at least since 2006 when data started), reflecting the negative sentiment on the commodity.

In the metals sector, the situation is not as clear. On gold and platinum futures, the amount short positions is also close to or at record levels. But other metals are telling a different story. Long speculative positions have been building in silver and copper futures and are getting closer to previous record levels.

Figure 1. Map of the Middle East and North Africa

Source: Based on U.S. State Department information.

Forgotten geopolitical risks on the rise

The nuclear deal between Iran and the P5+1 countries is far from resolving all the complex issues of the Middle East. In fact, the geopolitical risks are clearly on the rise. Some major oil exporting countries are also facing growing domestic social discontent.

The Middle East and North Africa

Saudi Arabia is under siege. Iranian proxies in Yemen and Iraq have started to take the upper hand on a domestic level and could soon start to threaten the Saudi dynasty. No wonder Saudi Arabia launched the "Operation Decisive Storm" — air attacks for now— against the Houthi rebels in Yemen. The situation in the northern part of Iraq is also destabilizing for the region as recent gains against Daesch were made directly with the help of the Iranian military forces, confirming the growing influence of Tehran over Baghdad as the US left a major vacuum when they left Iraq. The situation in North Africa is also far from stable. In Libya, persisting fights between rebel groups, which are unlikely to stop anytime soon, have started to affect oil flows, leading to rising volatility of crude oil exports. Libyan crude oil production indeed fell to 341'000 b/d in February 2015, down from 900'000 b/d in October 2014.

Africa and Latin America

Further south the political situation is also becoming unstable. The recent election of General Mohammadu Buhari in Nigeria, which is increasing political risks in the region. Indeed, the election of the northerner candidate may help against the Boko Haram insurrection. But the population in the south and especially in the Niger Delta, the main oil producing region, are worried about the election of this northerner. Militant groups once again take actions again the oil infrastructure, the main source of income for the federal government. Militants in the Niger Delta were the main reason behind the decline in Nigerian crude oil production from 2.1 million b/d to 1.7 million b/d between the end of 2010 and mid-2013.

Finally, Venezuela is facing growing social discontent due to high inflation, goods shortages and political repression. This country, which produces 2.3 million b/d of crude oil, may face further social unrest. In turn, this could threaten the political stability and could cause unplanned supply disruptions like in 2002-2003 when social protest led to a halt of crude oil production of 2 million b/d for several weeks.

Conclusion

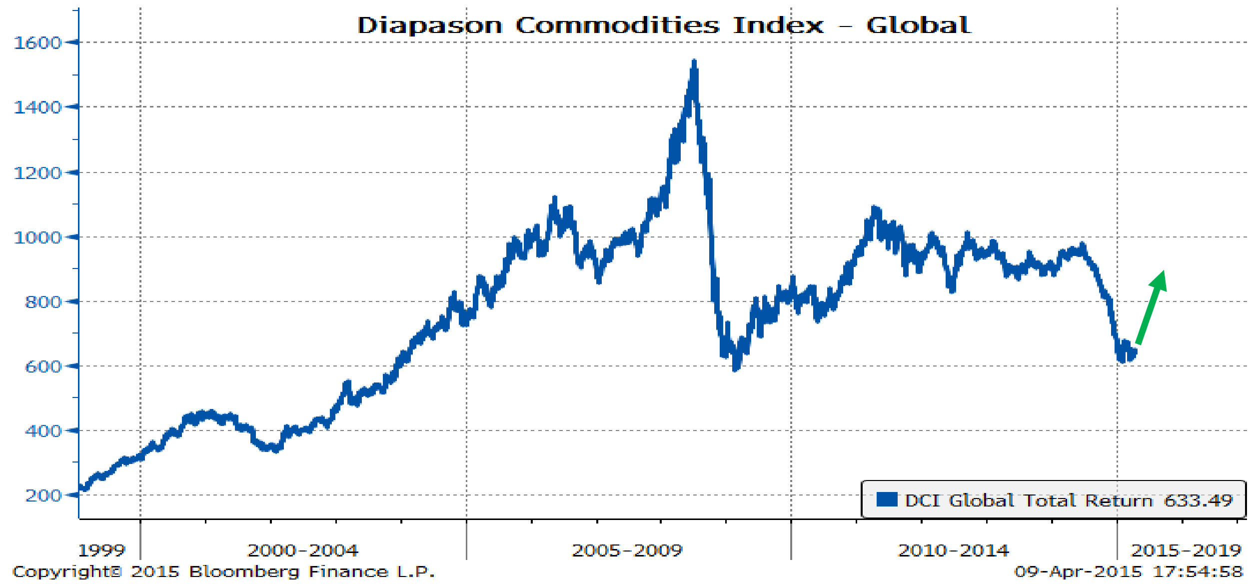
Commodities have suffered greatly during the previous 3 quarters. The asset-class experienced its second worst performance over a period of 9 months, since 1970. Furthermore, this followed declining prices in the previous 3 years. Commodities prices have therefore been falling for the past consecutive 4 years and may appear to continue for a fifth year year (year-to-date the DCI Global Index is down by 0.2%). However, since World War 2, there has never been a consecutive 5-year decline in commodity prices not event after the peak of 1980.

Several factors contributed to the recent decline in commodities prices. The stronger US Dollar, lower inflation expectations, worries on large emerging countries and speficific fundamental drivers — specifically, those of the energy sector. The OPEC decision to keep its production target unchanged in the face of sharply declining demand and prices, was a sea-change, paradigmic shift for the oil industry. The weather also added headwinds to the asset class, in what had become a trifecta of woes. The US and Europe grew record crops due to very benign planting conditions. Moreover, slower economic activity in China negatively affected base metals demand growth. Precious metals were also impacted for the worse by the strength in the US Dollar and expectations of a rate hike in the US, which has been dominating market sentiment since the middle of last year.

However, the sharp decline in commodity prices has triggered inevitable reactions from commodities producers. Markets mechanisms, which tend to balance the price undershoot, are starting to respond to the low commodities prices structure. Producers are cutting investment, reducing the supply growth outlook or increasing the risk of weaker production, as what we are now seeing in the agriculture sector. These adjustments will help stabilize commodity supply/demand balances in due time. We believe that the adjustments are starting to bear fruit — there are more and more signs of transition towards a stable price structure, so we expect the near-term to be a more favourable period for commodities.

On top of improving commodity fundamentals, the macro-economic conditions are turning gradually in the favour of commodities. Indeed, the US Dollar has likely turned around, a development that is key to a commodity market revival. Inflation is expected to accelerate in the coming months, as Europe and China and the US in H2 2015, may experience stronger economic growth, leading to a global synchronised growth. The acceleration of Asia and China should have an especially important impact on base metals and energy commodities.

This forthcoming risk-on environment should be very favourable for commodities and would mark a major change from the risk-off sentiment that has characterized the previous 3 quarters. Cyclical commodity sectors are likely to benefit the most from this forthcoming situation. These are the commodities which also suffered the most during the past 3 quarters, and offer the best value when the market environment becomes more positive in Q2 2015, as we expect. These conditions should contribute to a 25% to 30% upward move in commodity prices by the end of the year. Furthermore, downside potential is limited as some major commodities prices are close to the marginal cost of production. Consequently many commodities seem to offer interesting risk-reward position at current levels and it appears to be interesting to build long positions.



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