

Commodities Quarterly

Summer lull – but prepare for autumn recovery

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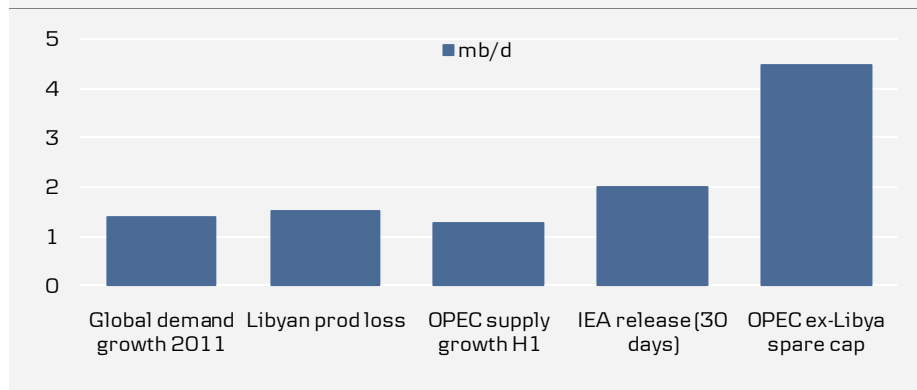
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Wheat prices have come down – more than we expected in fact – and we now see upside into 2012. Corn and soybeans pricing offer good levels for consumers.

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The current soft patch and waning investor interest in commodities in our view offer attractive levels to buy oil and metals for 2012 delivery. Dollar strength from Q4 onwards could add to costs for EUR-based consumers.

Response to Libyan war: IEA vs. OPEC



Source: IEA, Danske Markets. Note: global demand forecast is based on Danske Markets projections.

Key points

- Commodities have experienced two major sell-offs in the past quarter driven largely by plunging oil prices on unwinding of speculative positions and IEA releasing strategic reserves.
- We look for a price rebound in H2 as the current soft patch proves temporary and the euro gains on ECB hikes. Heading into 2012, we continue to project some limited upside to prices of most raw materials despite dollar strength.
- We have lowered our oil price forecasts somewhat but leave our end-2012 projections unchanged at USD120/bbl. We now see average oil prices at USD111 this year and USD117 in 2012.
- Most of our metals forecasts have been left unchanged but we have lowered our aluminium projections a little to reflect a somewhat lower profile for oil prices and hence energy costs.
- The drop in wheat has been larger than we projected and we have lowered our forecast profile as a result and now see some upside going into 2012.

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Short view: Commodities sold off as MENA risk premium drops

Commodities have suffered in recent months as deteriorating data has put pressure on the fundamental outlook and Greek debt concerns have resurfaced and weighed on the euro. Two major sell-offs have been witnessed: first, in early May, as demand destruction and unwinding of speculative long positions in oil dragged the whole commodity complex lower, and then again in mid-June after the IEA said it would release part of its strategic oil reserves to alleviate supply fears due to the failure of OPEC to replace lost Libyan production.

Indeed, the June OPEC meeting failed to reach a consensus on production going forward as Saudi Arabia, which has significant spare capacity in production, did not manage to convince other member countries – notably the Iranian presidency – that output quotas should be raised. The IEA lost patience with the cartel and fears that another spike in oil prices could be imminent led the OECD organisation to take an extraordinary step of attempting to stabilise the market by mobilising its strategic oil stocks. By proving that it is ready to intervene in the oil market if price pressures become intolerable for global growth, the IEA's reaction has effectively removed part of the geopolitical risk premium on oil that has been in place since MENA unrest broke out earlier this year. This is good news for the world economy.

This outright clash between oil consumers and producers is likely to define oil markets in the months to come. The crucial question now is whether Saudi Arabia will in fact step up supplies as we believe and hence help to alleviate a tighter market balance as we are looking for demand to fight back in H2. In Focus: OPEC we take an in-depth look at the cartel's history and argue that current obstacles will be overcome by members.

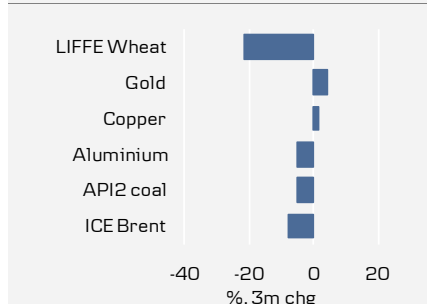
Overall, we believe that markets will soon wake up to the fact that the current slowdown is temporary and that relative rates are set to move in favour of the single currency for a few more months. This should lead to a rebound in commodity prices in H2 after the recent sell-offs. Heading into 2012, we continue to project some limited upside to prices of most raw materials defying dollar strength as demand picks up again.

With our economists projecting a global soft patch to be on the market agenda for another few months and our rate strategists looking for another three rate hikes from the ECB before new year, the headwinds for commodities are clearly mounting in the near term. However, our economists also stress that a rebound in production could be on the cards for Q4 as inventories currently being run down will have to be rebuilt and post-earthquake reconstruction in Japan should eventually give a boost to activity. Also, our Asia economist highlights that while a few Chinese rate hikes may still be in store, the prospects for a soft landing in China are increasing. This should be good news for commodities towards the end of H2. See also Macro: Soft patch to prove temporary.

Still, from a currency point of view, there may be less room for optimism for commodities beyond Q3: as 2012 approaches, the market could start to focus increasingly on upcoming Fed tightening. This should support the dollar due to the movement in relative interest rates and would in itself weigh on dollar-denominated commodities and could thus counteract some of the strength otherwise brought about by our forecast for an improving economic outlook. See FX: ECB hikes point to EUR upside for details.

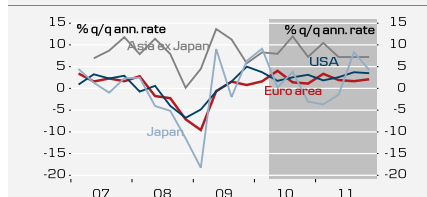
Longer term, we still believe that the dynamics of a commodities super-cycle will be in place, see Focus: Super-cycle or bubble? This means that despite business-cycle and currency fluctuations, prices of many raw materials will probably see sustained upward pressure for another five to 10 years.

Quarterly changes



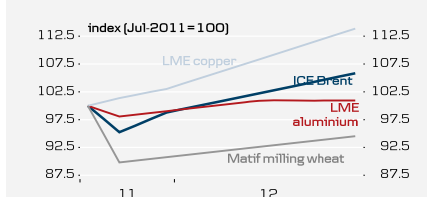
Source: Bloomberg, Danske Markets.

Composition of global growth



Source: EcoWin, Danske Markets.

Commodity-price forecasts



Source: EcoWin, Danske Markets.

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Macro: Soft patch to prove temporary

As our economists pointed out in the latest edition of *Global Scenarios*, the global recovery has entered a soft patch due to strong headwinds from higher oil prices, the Japanese earthquake and policy tightening in Asia earlier this year. This is causing another global growth scare at present and had helped to spur a sell-off in commodities as demand prospects have waned. However, as headwinds fade, we expect the global recovery to revive in H2 and continue into 2012, which should dampen the growth fears again. The recovery will continue to be moderate and be fragile in the advanced countries, though.

The US economy in particular has been affected by higher oil prices in early 2011 and we have revised down our growth forecast to 2.6% this year from 3.1% previously. This is slightly below consensus. As an export-led economy, the euro area is less affected by the rise in oil prices. Following a strong start to 2011, we have revised up GDP growth this year to 2.2% from 2.0% previously. The recovery should slow somewhat over the rest of 2011, though. China has moved in line with expectations and slowed from the peak in growth in Q1. Following the soft patch we expect the economy to pick up speed in late 2011 as lower inflation underpins consumption.

The inflation scare that we have previously warned about has faded quickly and growth fears now dominate. Headline inflation should fall sharply in H2 and into 2012 and ensure that central banks do not need to hike interest rates too aggressively. The debt crisis in the euro area could however continue to weigh on risk sentiment for a long time and the US economy is at risk of a downgrade. This will continue to add uncertainty to the economic outlook. We do not expect the Fed to embark on QE3 and we still expect the first hike in mid-2012. The ECB is expected to deliver another three rate hikes before pausing. In China, monetary policy will be tightened a bit further before going on hold during Q3.

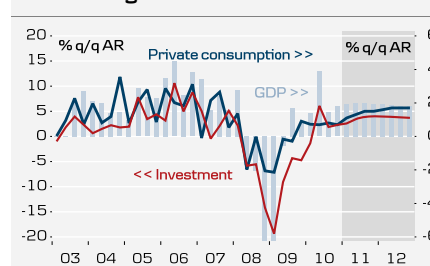
Overall, the worldwide growth scare and seasonal demand weakness are likely to hold back commodity prices over the summer. Still, we are looking for commodity prices to rise as data starts to surprise on the upside and it becomes clear that China is heading for a soft landing later this year as inflation now appears to be under control if another food price spike is avoided. The growth picture also still looks healthy for 2012 and should help to sustain demand for raw materials.

US ISM vs. GDP



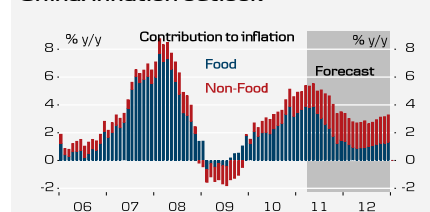
Source: EcoWin, Danske Markets.

Euroland: growth outlook



Source: EcoWin, Danske Markets.

China: inflation outlook



Source: EcoWin, Danske Markets.

G3 growth outlook



Source: EcoWin, Danske Markets.

FX: ECB hikes point to EUR upside

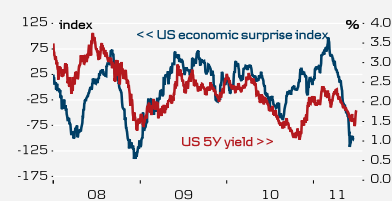
As highlighted by our FX strategists in the latest *FX Forecast Update*, relative rates remain the dominating driver on the currency market and a key theme underpinning our forecasts – not least for EUR/USD. The euro has gained strongly on the Euroland-US monetary divergence during H1 – albeit recently the Greek debt crisis has weighed on the single currency. We expect support from European monetary tightening to stay in place over the coming months and probably also quarters.

From very aggressive pricing a few months ago, the money market is now pricing little tightening from the ECB beyond the expected July rate hike. And while weaker global macro data and declining European leading indicators do bring into question the degree of tightening on the 12-month horizon, we still see a strong case for both a July and October hike, and probably also a final hike in early 2012. This in turn suggests potential for a significant re-pricing on the money market once global economic data, as expected, begins to improve. This, combined with a high probability that the EU has agreed on additional financial aid for Greece provided further austerity measures are implemented, should secure further euro upside. We see EUR/USD reaching 1.48 in three months and 1.46 in six months.

Higher US yields is a risk to our forecast for a higher EUR/USD though. Euroland bond yields have fallen since early April, but US yields have fallen more. This has led to a further widening of the EUR-USD rate spread and supported EUR/USD in an environment of weaker risk sentiment. Economic data is expected to improve over the coming months, however, which could lead to a sharp rebound in US yields. US economic surprise indicators are already showing tentative signs of a rebound – usually a good indicator for the bond market. Our main scenario is that EUR rates will rise in tandem with US rates, but the potential for a sharp spread narrowing is a key downside risk to our EUR/USD forecast.

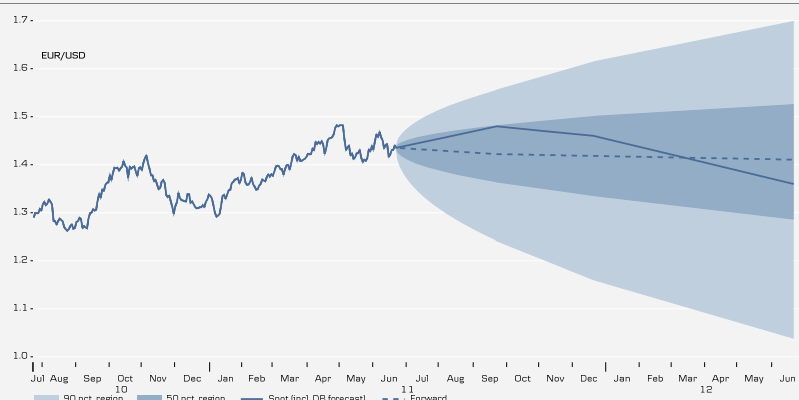
A key implication for commodities is that near-term dollar weakness could materialise – not least if market focus shifts away from Greece – and this should support dollar-denominated commodity prices in Q3. However, heading into Q4, the dollar could start to become a headwind instead.

US rates and economic surprises



Source: EcoWin, Danske Markets.

EUR/USD: Danske forecast vs. forward



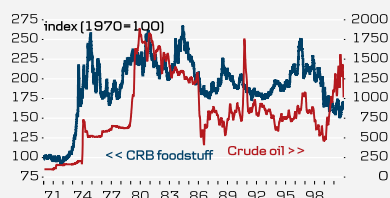
Source: Bloomberg, EcoWin, Danske Markets.

Focus: Commodities super-cycle revisited

In *Commodities 2011: Five themes to drive the markets this year*, we highlighted that a commodities super-cycle looked set to resume. Indeed, we noted the marked divergence between the nature of commodity prices in the 1970-2000 period compared with the most recent decade: in the former, prices had a tendency to be mean-reverting (i.e. return to the historical average) whereas in the latter period, there has been more trend-like behaviour. This suggests that there might have been a structural break or change in the dynamics of commodity prices around 2000. This trend has largely continued this year with the MENA crisis driving oil prices higher (albeit with significant sell-offs lately) and food price indices reaching new record highs (although pausing for breath very recently).

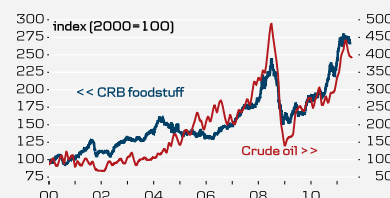
We believe good arguments exist for a super-cycle being in place notwithstanding price fluctuations driven by business cycle and dollar moves. The question is whether current prices are being driven by fundamentals, or whether a bubble is forming.

Oil and food prices: 1970-1999



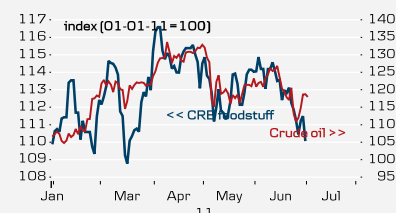
Source: EcoWin, Danske Markets.

Oil and food prices: 2000-2011



Source: EcoWin, Danske Markets.

Oil and food prices: 2011-

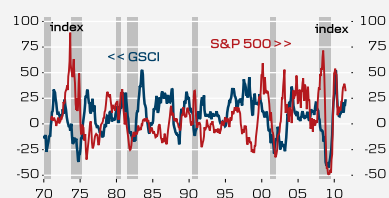


Source: EcoWin, Danske Markets.

Bubble component...?

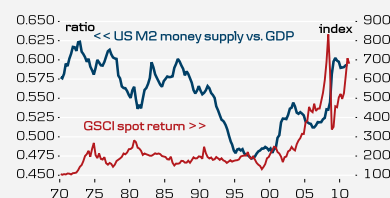
The fact that interest rates are at or close to historical lows and that provision of liquidity by central banks has been extensive since the credit crisis broke out, suggests that excess liquidity might potentially have led to a search for yield and driven a range of asset prices, including those of commodities, higher in recent years. Indeed, since the early 2000s, investors have started to view commodities as a separate asset class with potentially important portfolio diversification benefits due their historically low correlation with equities. In an environment with interest rates close to zero and quantitative easing by major central banks, there is indeed a risk that prices may have been driven higher without backing by fundamentals.

Commodities and stocks



Source: EcoWin, Danske Markets.

Commodities and money-to-GDP



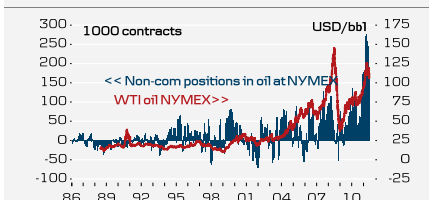
Source: EcoWin, Danske Markets.

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However, on Taylor rule measures, US interest rates have been bounded by the zero limit, as the rule actually suggests that policy rates ought to have been negative in the face of very low core inflation and an elevated unemployment rate. Two rounds of quantitative easing in the US have alleviated this by extensive liquidity provision via Fed asset purchases.

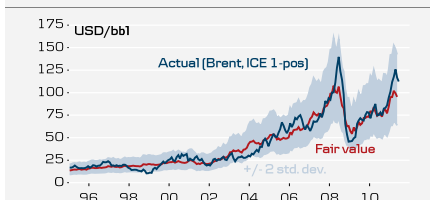
Whether monetary policy has been excessively loose for an unwarranted length of time remains an unsettled issue. Notably, while there is clearly a high correlation between e.g. oil prices and non-commercial (i.e. speculative) positioning in the black gold, statistical tests are unable to detect a significant causal effect of speculative flows on prices over longer periods of time. Indeed, in our view, there is good support from supply and demand factors for the levels at which most raw materials are trading at present. Indeed, our fair value models suggest that there is a tendency for commodity prices to return to the fundamentally justified levels over time whenever deviations occur.

Speculative positioning in oil



Source: EcoWin, Danske Markets.

Fair value model for oil

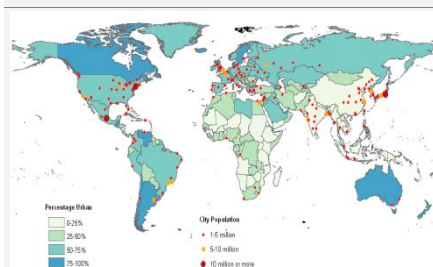


Source: EcoWin, Danske Markets.

Or super-cycle dynamics?

A range of arguments can be lined up supporting the existence of a super-cycle across the energy, metals and agricultural sectors. On the demand side, one of the key arguments is the increase in demand for natural resources due to a rising world population. Industrialisation is also heightening the need for raw materials. At the same time, ways of living are changing in many emerging markets due to a rising degree of urbanisation. This is notably raising demand for meat as many people change their diets which further accelerates the need for grains for feeding both humans and animals.

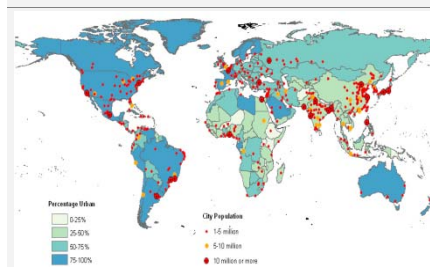
City populations: 1975



Source: UN.

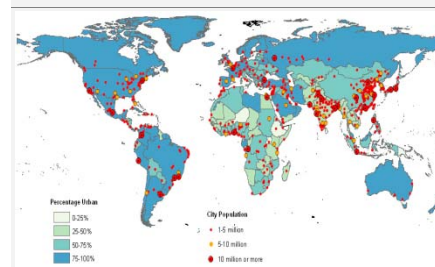
Note: Degree of blue indicates the degree of urbanisation. Red areas indicate the size of city populations.

2009



Source: UN.

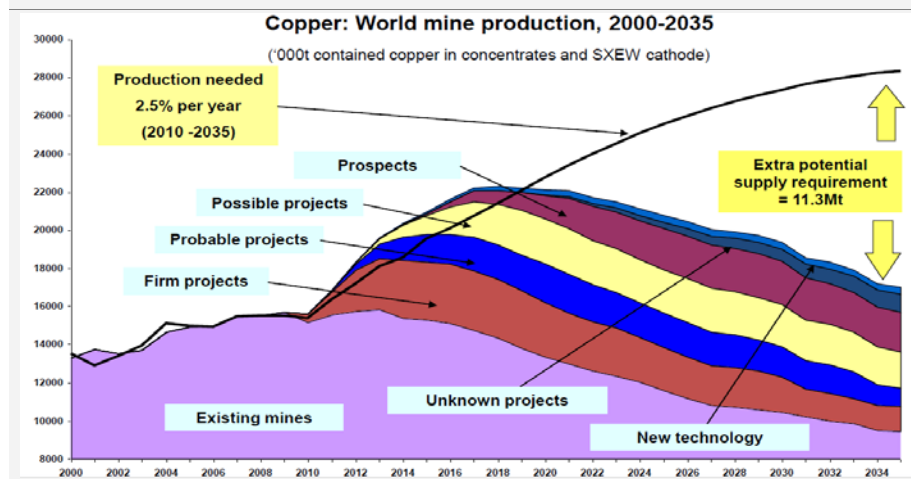
UN projections for 2035



Source: UN.

On the supply side, challenges are also mounting. Many existing oil fields are in decline outside the OPEC area and renewable sources of energy are still not realistic alternatives in many settings. New oil fields are available but drilling on deepwater is not without complications and more costly than previously. In the metals industry, many mines are struggling to expand production and due to falling ore grades – not least for copper – some are finding it difficult to keep output from outright declines.

Copper is harder to get out of the ground

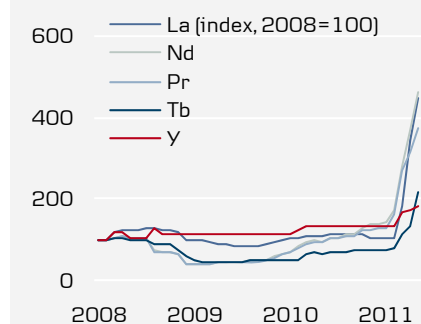


The effects of a changing climate – notably the more frequent occurrence of extreme weather phenomena – are an additional source of output uncertainty, not least for agricultural markets. The United Nations projects that agricultural productivity in countries in a wide range around the Equator will be markedly reduced by 2080. Notably, the negatively affected areas include a range of key crop-growing regions in both North and South America, Africa and Asia.

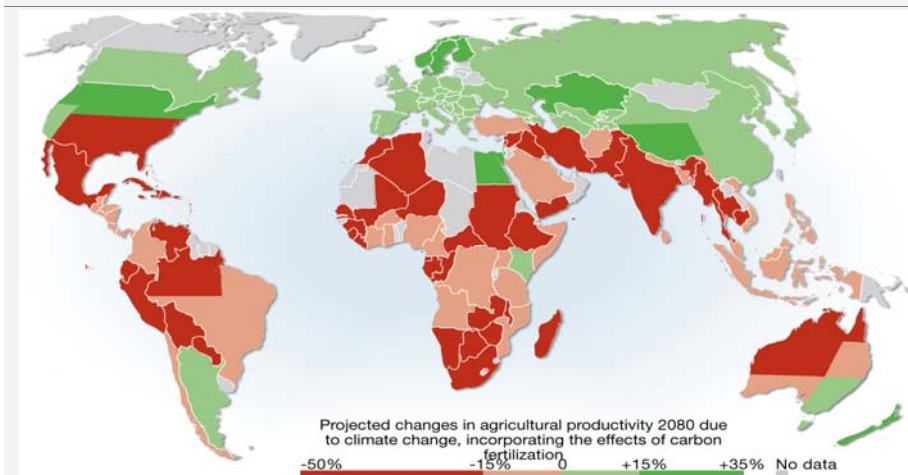
The fight over rare earth metals and minerals – i.e. a range of metals that are less abundant than the main ones traded at the LME but key in a range of high-tech and green-tech products – highlights the importance for consumers of being able to secure supplies. During the autumn of 2011, China greatly reduced the export quotas for rare earths, causing a steep rise in prices of the metals. Indeed, China has emerged as more or less the sole producer of these types of minerals as the country has relatively easy access to mining them. The US and Russia also have good supplies but production is less cost-effective and has thus been scaled back recently. However, the necessity of rare earth in everything from wind turbines over war missiles to smartphones underlines that diversification of materials is key for the global supply chain and to avoid sudden price spikes.

However, we should not forget that technological innovations can happen quickly and alleviate current supply concerns. A prime example is the revolution in shale gas markets where hydraulic fracturing and horizontal drilling have induced a surge in recoverable gas reserves. So far, the gas glut mainly exists in the US, but other countries are set to follow, and with liquefaction of gas becoming a cost-effective opportunity (liquefied natural gas, LNG), dependence on pipelines for transportation is greatly reduced. As a result, markets are now much less regional than used to be the case.

Prices of some rare earth metals



Climate change already affecting agricultural productivity



Source: UNEP.

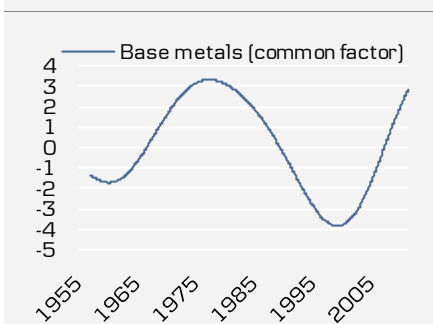
Note: degree of red indicates degree of negative effects on agricultural productivity by 2080 from climate change whereas green indicates positive effects.

Statistical view on a super-cycle for commodities

In order to study the existence of a commodities super-cycle, we use a set of statistical techniques to analyse a range of commodity price series. We define a super-cycle as a phenomenon that evolves over a long time span and is broad-based, i.e. involves a whole range of commodities. To identify such a concept in commodities we do the following:

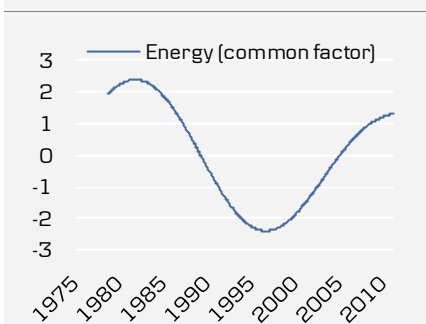
1. Calculate deflated prices of different commodities (i.e. correct for developments in US CPI to obtain real – rather than nominal – prices).
2. Smooth the resulting price series to even out e.g. business-cycle fluctuations (in statistical terms: band-pass filtering using the asymmetric Christiano-Fitzgerald (2003) procedure).
3. Search for a common factor among the series (in statistical terms: principal components analysis among a set of *real* commodity prices, i.e. extract first principal component).

Base metals super-cycle



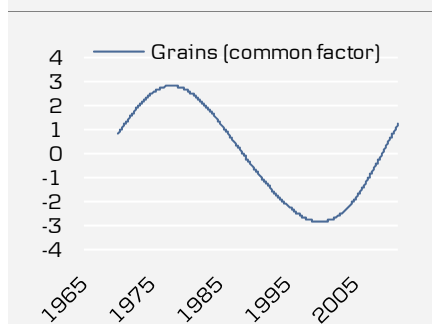
Source: Eviews, Danske Markets.

Energy super-cycle



Source: Eviews, Danske Markets.

Grains super-cycle

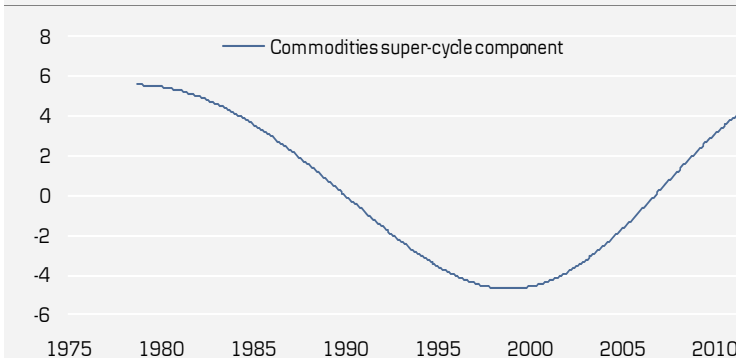


Source: Eviews, Danske Markets.

Following this procedure first for energy, metals and agricultural products separately, and then for all of these combined we obtain a range of interesting results. For metals, the last super-cycle was initiated around 1960 and ended in the early 1980s after which a period of sustained downward pressure on prices followed, likely due to technological advances in many sectors; the most recent super-cycle appears to have begun around 2000. The IMF has conducted similar analyses for industrial metals in its World Economic Outlook, see *October 2010* and *April 2011*, and looking at data as far back as the 1850s finds evidence of three so-called super-cycles with an average length of around 20 years.

Our results for metals are much alike and the additional results we obtain for energy and grains paint a similar picture as that for metals. Hence, unsurprisingly, when the three groups of commodities are combined, the cycle obtained is similar to the ones seen for the individual sectors. On the whole, we are currently approximately 10 years into a commodities super-cycle. Based on IMF estimates, we might expect this cycle to last some 20 years before being reversed. This suggests that we could see another 5-10 years of underlying upward price pressure for energy and raw materials.

Super-cycle component – all commodities (energy, metals, grains combined)



Source: Eviews, Danske Markets.

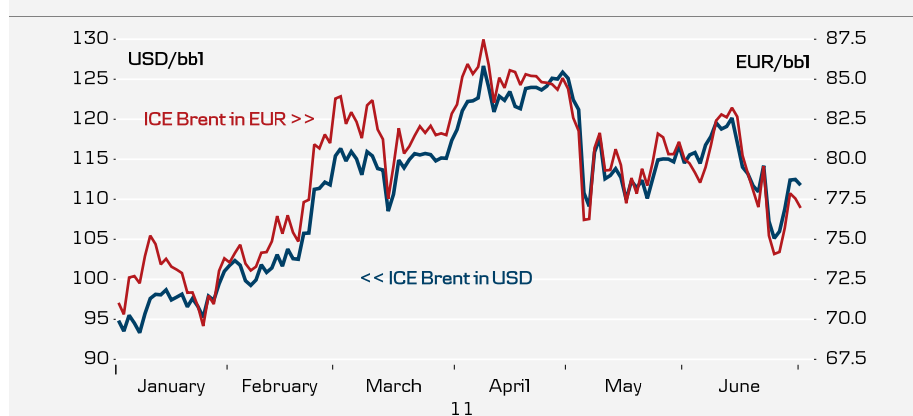
It is important to keep in mind however that business cycle fluctuations will nevertheless continue to play a key role for monthly/quarterly price movements as will risk appetite on a daily basis. But over the longer term, super-cycle dynamics will most likely guide prices in our view.

Of course, an extrapolation of the current trend is not straightforward as higher prices should eventually induce either a supply and/or demand response. Indeed, substitution effects could set in – e.g. consumers may replace expensive copper with cheaper aluminium to the extent that it is technically feasible. Also, research and development into new sources of supply might eventually pay off, and technological progress can come about quickly and reduce production costs. But, leading up to 2020, we believe consumers should be wary of expecting significant price declines for prolonged periods of time and that producers may struggle to increase output volumes.

Oil: IEA and OPEC clash over supplies

The past three months have seen energy products and notably oil being sold off extensively. Fuel oil prices have held up reasonably well, however, whereas WTI oil has dropped markedly – much more so than Brent crude. Two major sell-offs have been witnessed in the past quarter: in early May – see *Commodities Forecast Update* – and mid June. In between, some price strength for oil was seen – not least after OPEC failed to agree on raising production – but the IEA's decision to release 60 million barrels from its reserves spurred another round of plunging oil prices. The highs and lows of the past three months underline the volatility seen lately: prices have fluctuated between USD105 (late June) to USD126.6 (early April).

Crude oil in USD and EUR



Source: EcoWin, Danske Markets.

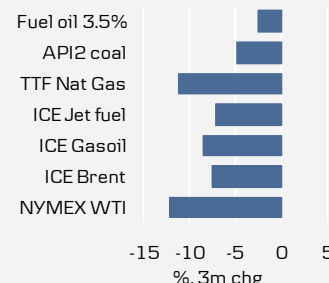
Clash between IEA and OPEC over supplies

On the whole, the oil market has been characterised by a clash between the IEA and OPEC on opinion over the responsibility for the rise in oil prices this year. The IEA first hinted that it may be necessary for the OECD countries to release some of the strategic oil reserves in its March Oil Market Report: “The IEA maintains a watching brief in both the unfolding Libyan and Japanese situations and can mobilise its 1.56 billion barrels of government strategic stocks in short order if market liquidity looks badly strained”. It did indeed start to look worrying for the global economy when oil moved above USD120 again in mid June – close to the levels seen in April, which was partly responsible for the current soft patch in world growth.

The June OPEC meeting did little to comfort the market as Saudi Arabia, Kuwait and the UAE did not succeed in convincing other member countries that production quotas should be increased. A conflict is clearly emerging between countries with spare capacity in production and those with little room to produce more than they currently do. The hawks among oil ministers (preferring no increase in quotas) happen to be the ones with little additional production capacity. Indeed, many of these countries anticipate that increasing supplies will weigh on prices and hence depress their oil revenue. In contrast, countries with spare capacity might be able to increase oil income by adjusting the quantity side of the equation as higher output should offset the impact of this weighing on prices. However, OPEC has been in crises before and we believe there will be reconciliation at the next meeting scheduled for 14 December; see *Focus: OPEC* for details.

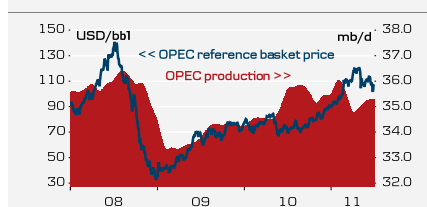
Notably, the fear of further unrest in the MENA region has led a range of OPEC countries to increase government expenditures with a range of social initiatives being taken recently. This is putting state finances under pressure and in many cases requires

Quarterly changes



Source: Bloomberg, Danske Markets.

OPEC production and price



Source: EcoWin, Danske Markets.

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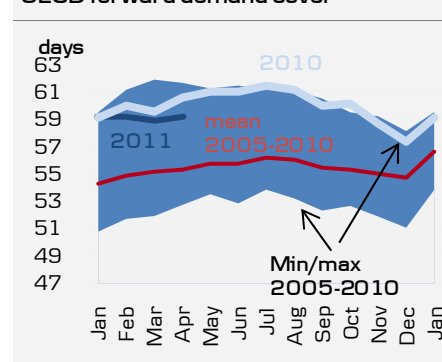
higher oil prices to balance budgets. Hence, many OPEC countries now need elevated oil prices to keep deficits at bay. This of course heightens their targeted price level, all else being equal. Notably, the Centre for Global Energy Studies (CGES) estimates that the Saudis now need USD91 to balance state budgets whereas last year the corresponding figure was only USD74.

IEA invokes on “quantitative easing” for oil

In mid June the IEA announced the release of 60m bbl of oil with 2 mb/d over the next month. This immediately spurred a sell-off in oil – not least for Brent. The impact has been minor for WTI, which has been less affected by MENA unrest than Brent since regional US inventories are the main driver of WTI (US stocks are booming still) and Brent is more affected by a lack of OPEC oil. IEA cited the loss of 132m bbl due to Libyan unrest (Libya used to produce close to 1.4 mb/d) as the main reason. The agency also stressed that even if some OPEC members start to raise production, they have been somewhat slow to do so and also there may be quality problems, i.e. heavy Saudi oil vs light Libyan. A strategic reserve release could alleviate this issue.

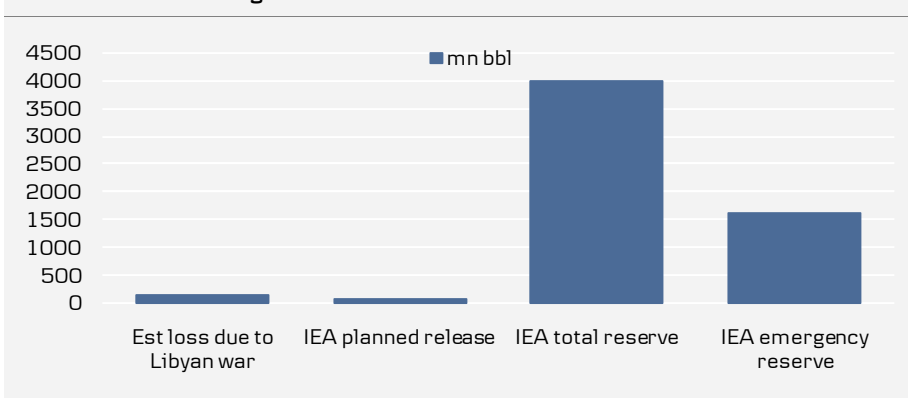
The IEA has previously said that the oil market would tighten markedly in H2 unless OPEC action came about; indeed the IEA sees an increase in global demand of 1.3 mb/d this year with a 0.5 mb/d rise in H2. It seems that the failure of OPEC to commit to an increase in supplies at the early June meeting has fuelled IEA worries further. The timing of the release is slightly puzzling, however, as there have been increasing signs that Saudi shipments have increased lately. However, the IEA seems to have lost its patience with OPEC and fears that the global economy would struggle even more to recover from the softening growth outlook at present.

OECD forward demand cover



Source: IEA, Danske Markets.

IEA release and strategic reserves

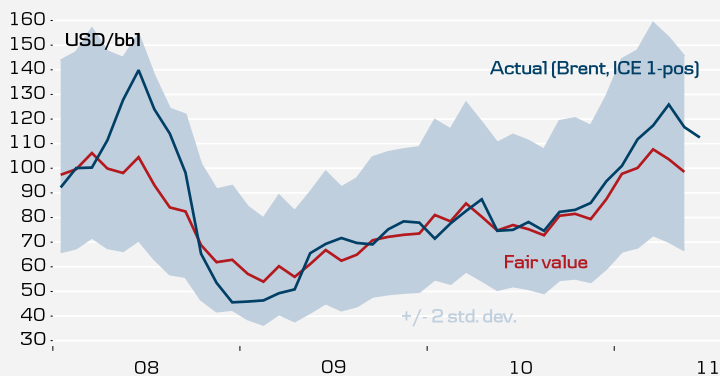


Source: IEA, Danske Markets.

This is only the third time in its history that the IEA has released reserves: previous incidents include the 1991 Persian Gulf War and Hurricane Katrina in 2005 – indeed this only happens in rather special circumstances. Crucially, the fact that the IEA has shown that the agency is ready to use the reserve to ease effects of MENA unrest should remove part of the risk premium that has been in place since turmoil broke out earlier this year. Previously, we estimated the risk premium that could be justified by geopolitical uncertainty to be around USD10 per barrel. In our view, the IEA release has depressed this risk premium to around USD5. The IEA may be able to continue to release from its 700 m bbl reserve as the current release amounts to less than 10%, but it is rather likely that the release will be a one-off, provided OPEC ups supplies as we still consider likely.

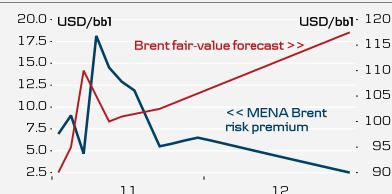
Our model for Brent crude oil suggests that the recent decline in industrial production coupled with a stronger dollar has led fair value to decline to USD100 per barrel after peaking at USD110 in March. With a MENA risk premium of around USD5 at present that leaves USD105 as a reasonable level for oil.

Brent crude oil fair value



Source: EcoWin, Danske Markets.

Fair value vs risk premium



Source: EcoWin, Danske Markets.

Demand: look for H2 rebound

As discussed in *Macro: Recovery hits a soft patch*, our economists see global growth accelerating again in Q3 as the impact of high oil prices and the Japanese earthquake fade. Due to a strong start to the year, our GDP growth forecasts for Euroland have been revised higher whereas those for the US have been taken lower as the oil-price shock has had larger negative effects than previously projected.

However, the implications of this for world oil demand this year are limited; we remain slightly more downbeat on activity than the IMF (upon which the IEA bases its demand estimates). We see global growth at 4.2% this year whereas the IMF is looking for 4.4%. As a result, we are slightly less optimistic on oil demand than the IEA and see consumption growth at 1.1 mb/d this year whereas the IEA is looking for 1.3 mb/d. The main risk to our outlook is if political will to fight the debt crisis were to vanish.

Global oil demand with forecasts, mb/d

(mb/d)				IEA	Danske
	2008	2009	2010	2011	2011
OECD	47.6	45.6	46.1	45.9	45.8
non-OECD	38.9	39.7	41.9	43.4	43.3
Total	86.4	85.3	88.0	89.3	89.1

Source: IEA, Danske Markets.

Danske vs IMF GDP forecasts

% y/y	2011				2012			
	Danske Bank	Conse nsus	IMF	OECD	Danske Bank	Conse nsus	IMF	OECD
USA	2.6	2.7	2.8	2.2	3.1	3.1	2.9	3.1
Euroland	2.2	1.9	1.6	1.7	1.9	1.7	1.8	2.0
China	9.4	9.5	9.6	9.7	9.1	-	9.5	9.7
Global	4.2		4.4		4.5		4.5	
Asia (excl. Japan and China)	6.0				6.2			
Change from March forecast								
USA	-0.5				-0.3			
Euroland	0.2				0.1			
China	0.0				0.1			

Source: IMF, OECD, Bloomberg, Danske Markets.

Supply: OPEC falls short of call on its crude

OECD supply is set to remain broadly stable this year as new production expansions in some regions are offset by, e.g. falling North Sea production. Outside of the OECD and excluding OPEC, supply could rise slightly this year. But the fact that OPEC output is at best unchanged in 2011 from last year even if we are correct and Saudi Arabia increases supplies, will, in our view, leave total global production to come in at a mere 88.7 mb/d. The IEA release amounts to only 0.67 mb/d in Q3 (60 mn bbl) and is thus far from making up for the loss due to Libya.

However, if Libya's Gaddafi is ousted and a reasonably stable rebel leadership is established, Libya could come back to the markets relatively quickly and potentially within one month's time produce 1 mb/d again. Should this happen it would increase OPEC supplies significantly and could ensure a more balanced market and thus weigh on oil prices.

Supply forecasts: Danske Markets and IEA, mb/d

				IEA	Danske
	2008	2009	2010	2011	2011
OECD	18.8	18.8	18.9	18.9	18.9
non-OECD	28.4	29.2	29.9	30.3	30.3
OPEC Crude	31.6	29.1	29.5	n.a.	29.5
OPEC NGL	4.5	4.9	5.3	5.9	5.9
Misc	3.5	3.7	3.9	n.a.	4.2
Total	86.8	85.7	87.5	n.a.	88.7

Source: IEA, Danske Markets

Market balance: tightness set to remain in place

On balance, we see a stock draw of 0.6 mb/d for 2011 as a whole, slightly tighter than last year. Together with a MENA risk premium that could stay in the price for a while this is adding to upward price pressure, which we believe will become more pronounced again in H2. Preliminary estimates for 2012 suggest an inventory draw of a similar size, i.e. 0.5 mb/d and thus we maintain our call for oil to trade consistently around USD120 at the end of next year.

Market balance and price outlook

	2008	2009	2010	2011	2012
Stock change, mb/d	0.4	0.4	-0.5	-0.6	-0.5
Prices Brent (USD/bbl)	99	70	81	111	117

Source: IEA, Danske Markets.

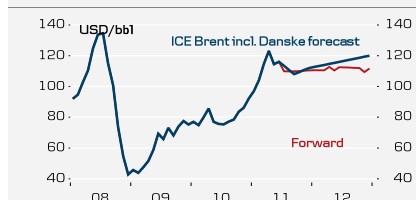
Price outlook: oil to edge higher in Q3

We have revised lower the interval in which we see oil trading in the coming months after the IEA's announcement of a release of oil stocks: this should take prices down to a USD105-115 interval (vs previous call of 110-120) as this new supply of oil will buy the market time until the Saudis up supplies as we expect will happen in H2.

Indeed, the release should help the world to recover from the current soft patch and alleviate inflationary pressure somewhat. But it will be vital to watch any Saudi comments on the IEA move: it could change their reaction function if they disagree with OPEC on the tightness in the market (less oil to be supplied than otherwise). Iran has stated that the IEA is interfering with an already balanced market. However, there have been some indications that the IEA might have coordinated its response with the Saudis.

We have lowered our Brent price profile somewhat and now see prices averaging USD111 this year (previously 114), edging higher to USD117 in 2012 (previously 119).

Danske forecast vs forward



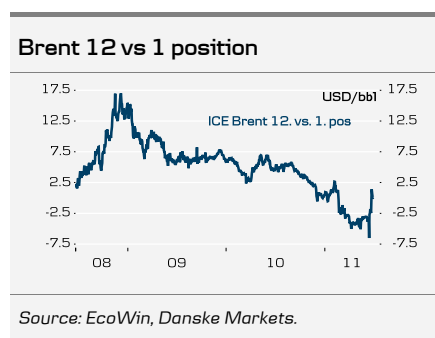
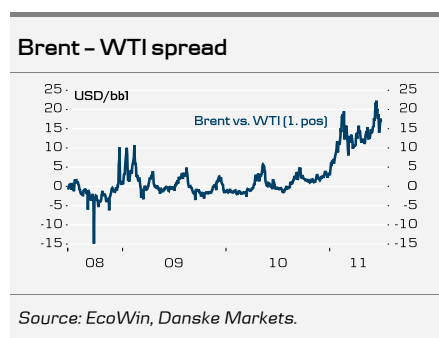
Source: EcoWin, Bloomberg, Danske Markets.

Brent curve now almost flat

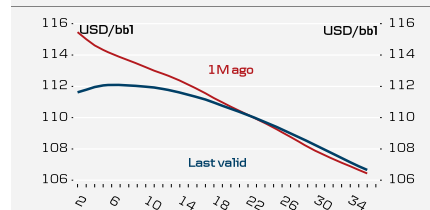
The spread between Brent and WTI crude widened to a record USD22 per barrel following a the failure of OPEC to commit to output increases in early June but has since declined to now stand around USD13. Indeed, the IEA release takes some pressure off the Brent market although 50% of the oil to be released will come from US inventories whereas one third will be released in Europe; the remainder will be made available in the Pacific region.

While the oil forward curve flattened markedly around New Year and has seen a one- vs 12-month backwardation since late February, there has been a shift recently towards a small contango. This discourages futures investment in oil and has probably been part of the reason – coupled with a less rosy outlook for demand and larger supplies – why speculators have shed long positions in the black gold recently. Indeed, this is confirmed by both CFTC data for US exchanges and by new data on Brent trading released by ICE.

From a consumer-hedging point of view, the loss of backwardation in oil also makes it somewhat less attractive to hedge 2012 exposure. However, the level shift in oil that we project more than makes up for this, i.e. our forecast remains well above the current forward curve.

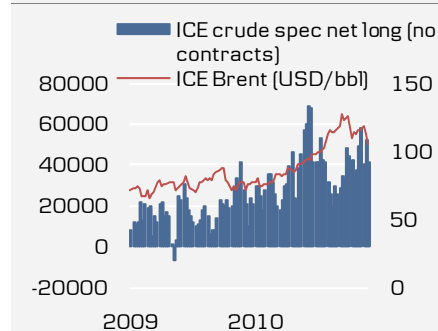


ICE Brent forward curve



Source: EcoWin, Danske Markets.

Non-commercial oil positioning at ICE



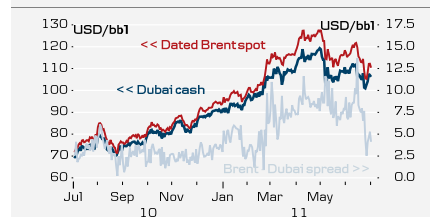
Source: Bloomberg, Danske Markets.

IEA takes some upward pressure off light-heavy spreads

Light-heavy spreads have continued to widen in Q2 as a whole but recently fuel-oil crack discounts have declined while the cracks of lighter products such as gasoil have been largely stable. The relative increase in the price of residual fuels towards the end of June has likely been driven by market expectations of heavier Saudi crude coming onto the market being taken back after the IEA said it would lease a good deal of light crude and lighter refined products. This has probably helped to alleviate upward pressure on light cracks. The IEA has said that the crude/refined products split will be one of approximately 70/30. Of the refined products, diesel and gasoline will account for more than two thirds of the release. The average barrel of crude will give a 10/70/20 split in liquefied petroleum gases/light and middle distillates/residual oil and hence the release is close to this but more tilted towards light products than the usual heavy OPEC barrel.

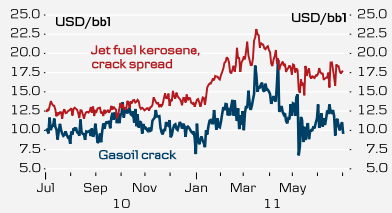
The IEA release could thus over the summer dampen the widening in light-heavy spreads that we are currently projecting. However, when the effect of the IEA release dies out, the oil market will be left to rely on heavy sour Saudi crude for the marginal supply and this should, coupled with a pick-up in industrial demand and hence consumption of lighter oil products, push light cracks higher yet again. Notably, the gasoil crack spread could rise towards USD15 per barrel in 2012 as a result.

Brent-Dubai crude spread



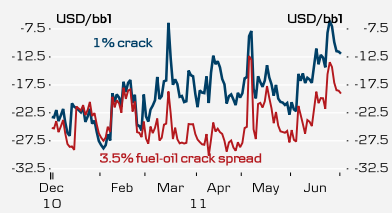
Source: EcoWin, Danske Markets.

Light crack spreads



Source: EcoWin, Danske Markets.

Heavy crack spreads



Source: EcoWin, Danske Markets.

OPEC break-up?

"We were unable to reach an agreement...this is one of the worst meetings we have ever had."

This comment was made by the Saudi Arabian oil minister, al Naimi, after OPEC failed to reach agreement on production quotas at the Vienna meeting on 8 June. The market uncertainty that initially followed the meeting pushed oil (Brent) briefly above USD120/bbl.

Ahead of the meeting, many analysts argued that it would result in the first production increase in more than four years. The ‘signals’ from Saudi Arabia pointed in that direction and after years of Saudi dominance, the market had become accustomed to Saudi Arabia setting the agenda in OPEC. Considering that oil demand according to OPEC itself is set to rise an impressive 2.1 mb/d in Q3 11, a production increase was to be expected to secure a stable oil market.

Even though the meeting on 8 June showed a strong disagreement among the OPEC members, we argue that it is far too early to dismiss OPEC as an important factor in the oil market going forward. If oil prices, contrary to our main forecast, should slide below USD90/bbl (Brent) – i.e. if the global economy weakens further – we believe that OPEC will convene on a common production policy and even new production cuts cannot be ruled out. The experience from 2008/09 when production and quotas were slashed aggressively shows that OPEC is stronger in times of headwind than in times of high oil prices as is the case today.

Dramatic prelude to June OPEC meeting

The first obvious question to ask is why the OPEC watchers did not foresee the dramatic outcome of the latest OPEC meeting.

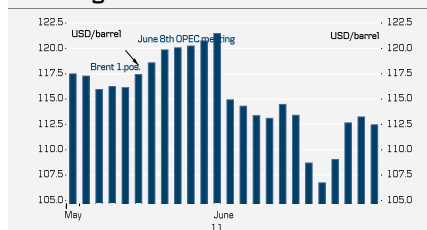
Perhaps the market should have paid more attention to the prelude to the meeting. In May, the Iranian president, Mahmoud Ahmadinejad, fired his oil minister and appointed himself as the country's caretaker oil minister. Iran holds the OPEC rotating presidency for the first time since 1975, and it would appear that the Iranian president had planned to use the Vienna OPEC meeting and strong media presence as a platform to get his often rather controversial political message out to the world. But, in the end, Iran's supreme leader, Ayatollah Ali Khamenei, banned Ahmadinejad from going to Vienna, underlining the current power struggle taking place in Iran between the president and the supreme leader.

Instead, the OPEC presidency was taken over by Mohammad Aliabadi – a complete unknown in the oil community. Before being appointed to the presidency, Aliabadi was occupied with preparing Iranian athletes for the 2012 Olympics and before that he ran a brick company. However, now – orchestrated by Ahmadinejad – he found himself about to oversee one of the most politically tense OPEC meetings in recent history.

The OPEC meeting also took place in the midst of the Jasmine revolutions and ‘Arab Awakenings’ that have swept across Northern Africa and the Middle East over the past six months. The attending countries had already seen several dictators toppled and a UN-imposed no-fly zone in Libya. The latter was initially endorsed by the Arab League and actively supported by countries like Qatar.

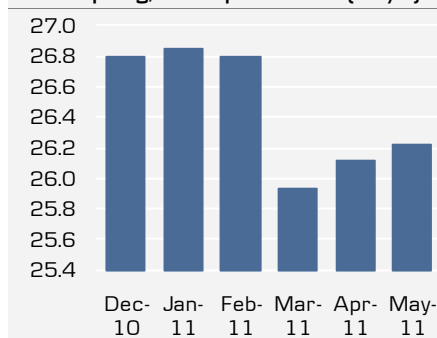
The public protests across the region were, in many OPEC countries, met with an up-scaling of social programmes and public spending, putting a severe strain on public budgets. Hence, a ‘high oil price today’ had become even more of a ‘first priority’ compared with more theoretical and probably also political considerations regarding the medium- to long-term effects on oil demand and the global economy from high oil prices.

Oil pushed above USD120 after OPEC meeting



Source: Reuters Ecowin

Dramatic fall in OPEC-11 production
in the spring, OPEC production (mb/d)



Source: Bloomberg

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Oil production in Libya has virtually come to a halt in the spring as a consequence of the civil war, and close to 1.4 mb/d of high quality oil has been taken off the market. In particular, refiners in Southern Europe are experiencing difficulties in getting hold of replacement oil for the lost Libyan output. The loss of Libyan oil has resulted in numerous calls to OPEC from, among others, the International Energy Agency (IEA) and US law makers to step up production.

In addition, the deployment of Saudi forces to Bahrain in the spring was certainly not something Iran was in favour of. The Bahrain ruler is Sunni as the Saudis, but the protesters were mainly Shi'ite, which is the main religion in Iran.

The hawks won the battle this time

We will probably never know the full extent of what actually happened behind the closed doors of the OPEC meeting in the midst of all these internal and external conflicts. However, it is clear that OPEC is now more divided than the cartel has been for decades. But division within OPEC is nothing new. The cartel has been split into 'hawks' and 'doves' for many years, but the June meeting brought the disagreement out wide into the open.

The 'doves' are headed by Saudi Arabia and supported primarily by the Gulf States, Kuwait and the United Arab Emirates (UAE). They argue that a stable oil price is to the benefit of the cartel in the long run. In particular, in the current situation with Libyan oil off the market and a significant jump in the 'call on OPEC' expected in Q3, an extension of the quotas and higher production is a necessity for a stable oil market.

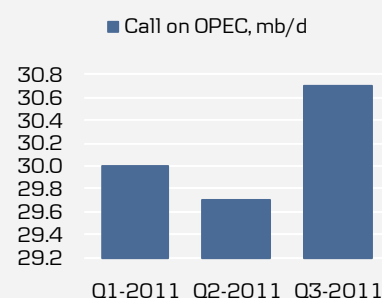
When the OPEC meeting kicked off in June, it was obvious to the 'dove' camp that the economic outlook had weakened and the European debt crisis was threatening to derail global growth. In that respect, the situation was, in its view, comparable to 2008, when oil prices initially jumped to close to USD150/bbl, thereby adding to the forthcoming global recession that half a year later pushed oil to the low 30s.

However, it was also clear to this group that despite the weaker economic outlook, the global oil market would be dangerously tight in the last part of 2011 and 2012 if the cartel did not open the taps further.

But the 'hawk' camp dominated by Iran, Venezuela and supported by Iraq, Algeria and in fact Libya saw the world in a completely different way and apparently decided to stand firm this time. From its point of view, the global economy is already so weak that higher oil production would jeopardise the stability of the oil market. Furthermore, the hawks would certainly not like to send the signal that OPEC gives in to pressure from the IEA and the US. The outside pressure might in fact have been outright counterproductive, as no 'hawk' wanted to be seen helping the West while Northern Africa and the Middle East were on the brink of a revolution.

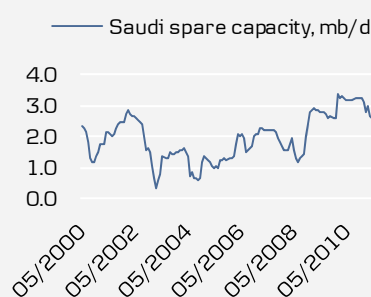
When scrutinising OPEC actions, it is important to remember that Saudi Arabia, Kuwait and UAE hold the majority (77%) of the current OPEC spare capacity. Hence, they would reap the benefits from higher production, whereas the 'hawk' countries are already producing at full capacity and hence they would only feel the pain from lower prices in the event of production being increased.

Jump in 'call on OPEC' in Q3



Source: IEA

Saudi Arabian spare capacity



Source: Bloomberg

Saudi Arabia sitting with majority of spare capacity favours higher oil production

	Production, mb/d	Quota, mb/d	Production above quota, %	Spare capacity, mb/d
Algeria	1.28	1.20	6.02	0.06
Angola	1.57	1.52	3.38	0.23
Ecuador	0.50	0.43	13.20	0.00
Iran	3.60	3.34	7.33	0.11
Kuwait	2.44	2.22	8.93	0.10
Libya	0.10	1.47	-1369.00	0.00
Nigeria	2.32	1.67	27.89	0.21
Qatar	0.81	0.73	9.75	0.21
Saudi Arabia	9.00	8.05	10.54	3.04
UAE	2.42	2.22	8.14	0.27
Venezuela	2.46	1.99	19.27	0.18
OPEC-11	26.50	24.85	6.25	
Iraq	2.68	na	na	

Source: International Energy Agency

Saudi Arabia is still in charge

For the past couple of years, Saudi Arabia has been the de facto leader and swing producer of OPEC. Saudi Arabia expanded oil production dramatically in the first half of 2008 to mitigate the pre-recession spike in oil prices and subsequently slashed oil production by more than 1.7 mb/d after the Lehman collapse.

Saudi Arabia was also quick to promise the market more oil when the Libyan oil was cut off early this year and over the past couple of months Saudi oil production has been rising as well. But Saudi Arabia has not been able – as promised – to make up for the shortfall of Libyan oil.

However, going forward, we believe that Saudi Arabia will be committed to show the market that it is still ‘in charge’ of the oil market and, as discussed above, we expect more Saudi oil to hit the market in Q3.

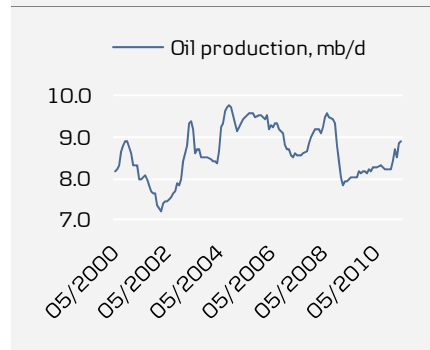
But the late response of Saudi Arabia to the Libyan crisis and the subsequent jump in prices has weakened the supremacy of Saudi Arabia. The market is wondering if the Saudis are in fact able to expand production and, probably more importantly, to supply the right light and sweet oil that can replace the highly valued Libyan oil.

The release of the IEA strategic oil stocks has furthermore complicated the situation for the Saudis. It might be seen as evidence that not least the US has lost its confidence in the ability of the Saudis to secure a stable oil market. But it might also indicate that the US and the IEA have decided to challenge OPEC and Saudi Arabia in respect of who defines the level of oil prices that are fair for producers and consumers as OPEC often puts it.

But lately we have also seen media reports hinting that the Saudis had in fact sanctioned the IEA release. One could argue that the IEA release has put the power back in the hands of Saudi Arabia: it can now go back to the hawks and say, “see what happens if we tighten the rope too much?” In that respect, note the lack of critical comments from Saudi Arabia in relation to the IEA move.

However, there is certainly also a probability that the Saudis will scale back on planned oil production on the back of the IEA release, showing the West that it is the ‘producer of last resort’ – not the IEA.

Saudi Arabia – the swing producer of OPEC



Source: Bloomberg

All in all, we think one should be careful not to underestimate Saudi Arabia's role in the oil market and in OPEC in particular going forward. Al Naimi may have called the 8 June meeting the worst meeting ever, but Saudi Arabia is still in charge. The output response from the kingdom in the second part of 2011 is still one of the most important factors in forecasting the oil price going forward.

OPEC will also survive this crisis

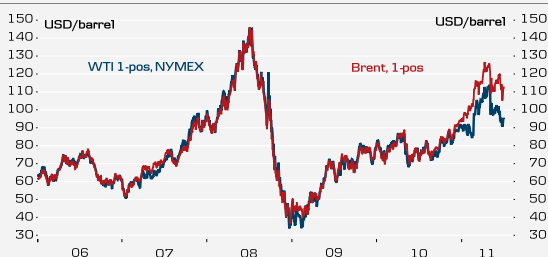
We argue above that one should not underestimate the power of Saudi Arabia despite the latest IEA oil release and OPEC disagreement, and we also think that it is far too early to bury the OPEC cartel. The cartel has faced several crises in its 50-year history. It survived an eight-year-long war between Iran and Iraq, it survived two Gulf wars, numerous political and religious conflicts – and it will probably also survive this one.

The cartel has shown remarkable strength in times of crisis. Few believed OPEC would be able to push oil prices significantly higher in December 2008 as the global economy was on the brink of a depression. But quotas were slashed a stunning 4.2 mb/d and OPEC members cut production accordingly.

The 2008/09 production cuts showed that the cartel is very powerful in times of crisis and at keeping a floor below prices. However, from a consumer point of view, the latest experience and the spike in oil prices in Q2 08 shows that the cartel is less powerful or just less inclined to keep a lid on prices. The promise to keep oil prices at a fair level for producers and consumers might be skewed to the upside – OPEC is, after all, a cartel.

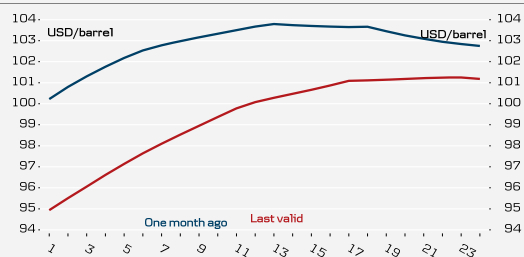
Energy charts

Crude oil prices



Source: Ecwin

WTI futures curve



Source: Ecwin

Natural Gas, Henry Hub, 1-pos



Source: Ecwin

Fuel Oil, 3.5% CIF NWE



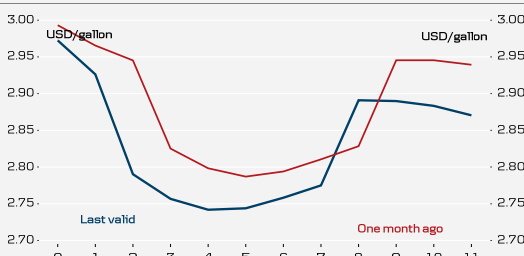
Source: Ecwin

Gasoline RBOB, 1-pos NYMEX



Source: Ecwin

RBOB gasoline futures curve



Source: Ecwin

Heating oil, 1-pos NYMEX



Source: Ecwin

Coal, 1-pos, API2



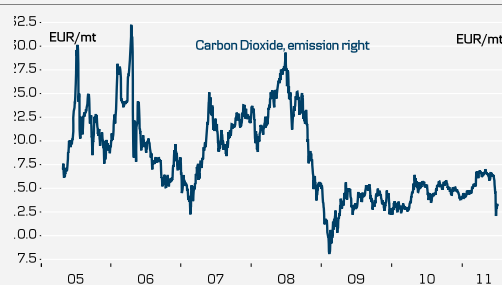
Source: Ecwin

Electricity price, Nordpool, 1-pos, quarterly



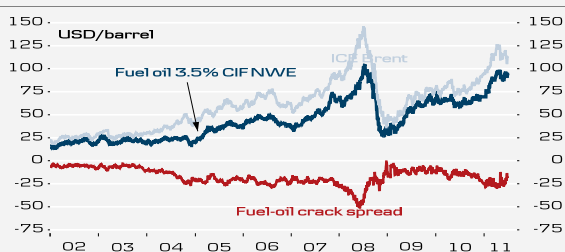
Source: Ecowin

Emission rights, CO₂, ICE ECX



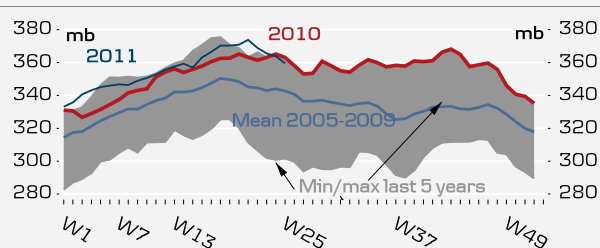
Source: Ecowin

Bunker fuel oil and crack spread



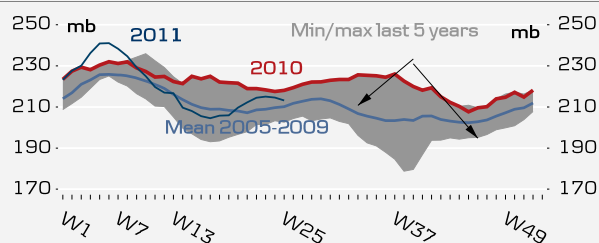
Source: Ecowin

Total crude oil stock, EIA



Source: Ecowin

Gasoline stock, EIA



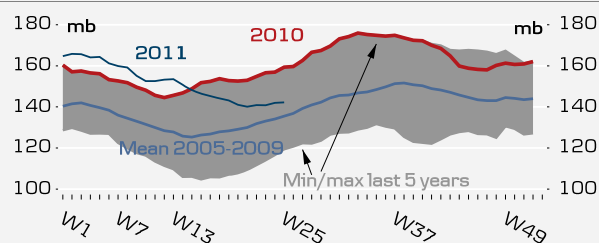
Source: Ecowin

Gasoline crack spread, NYMEX 1-pos



Source: Ecowin

Distillate stock, EIA



Source: Ecowin

Heating oil crack, NYMEX 1-pos



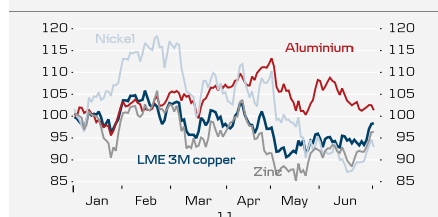
Source: Ecowin

Base metals: Set for a bumpy ride

The past quarter has seen base metals lose footing with notably nickel tumbling more than 15% over the past three months. Copper has been sold off more extensively than aluminium as the Q1 price surge in the red metal was deemed excessive. In contrast to the significant moves seen in non-ferrous metals, both iron ore and steel prices have been largely flat during the spring. To a large degree, the Q2 moves have been the mirror image of what was seen in Q1 where all base metals but steel gained 5-10% on the quarter.

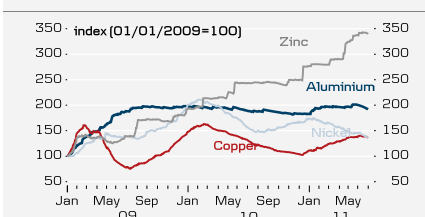
In the previous issue of *Commodities Quarterly*, we argued that elevated energy prices following the MENA unrest should hold a hand under energy-intensive metals such as e.g. aluminium. While this has to some degree proved to be true, we did not expect to see the extensive sell-off that actually played out. The combination of weaker economic data fuelling fears that demand may falter and an escalating Euroland debt crisis weighing on the single currency have proved a poisonous cocktail for metals. Although oil prices got a boost from the lack of OPEC commitment to increase production, this has done little to sustain metal prices – probably because other sources of energy such as coal have seen much more muted movements than oil, thus leaving metals cost curves little changed.

LME 3M prices



Source: Ecwin, Danske Markets.

LME metal stocks

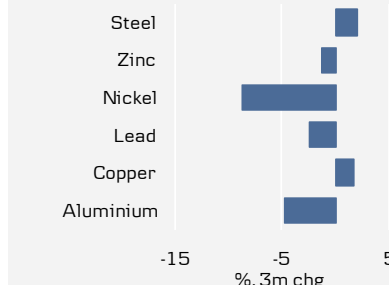


Source: Ecwin, Danske Markets.

Despite the headwinds to commodities seen in the near term, the fact that a key consumer of base metals – China – might be about to recover from its mid-cycle slowdown is clearly positive for metals such as aluminium and copper. Growth is still slowing, but it still looks like a soft landing. Q2 is poised to be a bit weaker than previously expected, but on the other hand growth could now improve as soon as Q3. Inflationary pressure is also easing, but the question remains whether the landing of the economy will be too soft to bring inflation within the People's Bank of China's comfort zone. Nonetheless, the pace of monetary tightening is expected to ease. Chinese import growth has turned negative year on year in recent months but could pick up later this year.

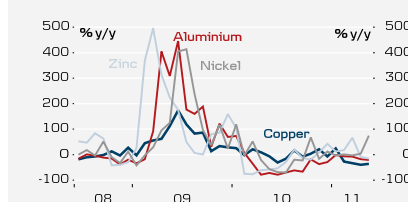
Looking at LME inventories, it is striking that stocks-to-consumption ratios have moved higher in recent months for most metals. Aluminium still looks to be the most 'loose' market with inventory cover close to 12 weeks – albeit nickel is not far behind at 10 weeks. As we have pointed out previously, copper remains the tightest market among the LME metals despite a recent stock build. Zinc inventories have continued to move higher in recent years and although stocks-to-consumption is around two weeks (similar to copper), the prospects are more rosy from a consumer point of view in the sense that production growth is set to be healthy going forward.

Quarterly changes



Source: Bloomberg, Danske Markets.

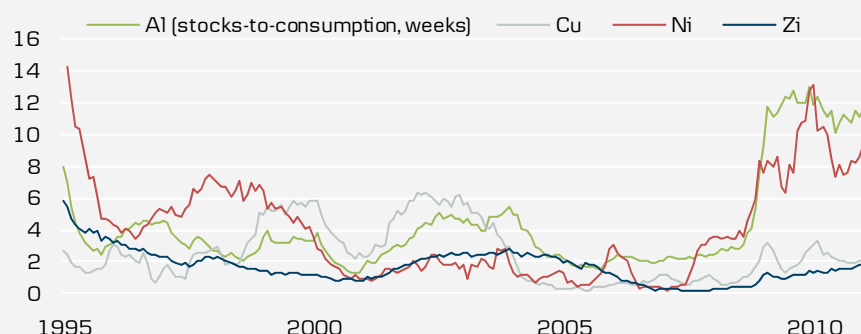
Chinese imports



Source: Ecwin, Danske Markets.

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LME stocks-to-consumption ratios

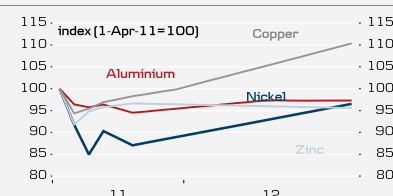


Source: WBMS, Bloomberg, Danske Markets.

On relative movements in metals, it is worth noting that substitution away from copper towards cheaper alternatives will also be an important theme looking ahead. The copper-aluminium ratio is now at historically high levels. Copper is usually the preferred metal for electrical appliances due to its conductivity. However, in the transport and construction sectors, aluminium could increasingly be viewed as offering a more cost-effective and weight-reducing substitute. However, greater volumes are often required when aluminium is to be substituted for copper, thus reducing its appeal somewhat. In addition, aluminium faces a number of regulatory obstacles for use as an electrical conductor due to the risk of fire.

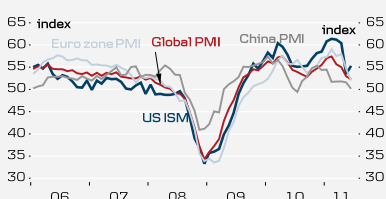
While we remain cautious on calling base metals higher in the coming months, we do see upside for H2 as a whole although this is unlikely to materialise until the end of the year. We continue to project some limited upside in 2012 – not least for copper.

Base metals: relative forecasts



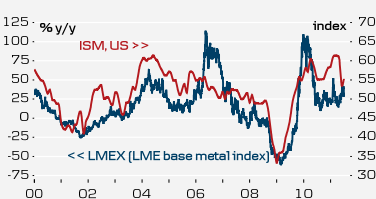
Source: Ecwin, Danske Markets.

Global manufacturing PMIs



Source: Ecwin, Danske Markets.

Cyclicality of base metals

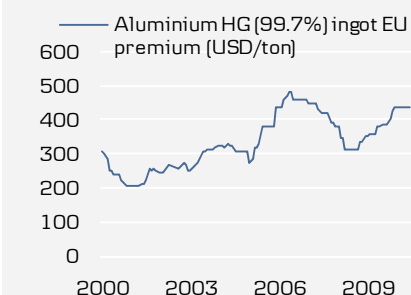


Source: Ecwin, Danske Markets.

Aluminium: weak fundamentals but physical market tight

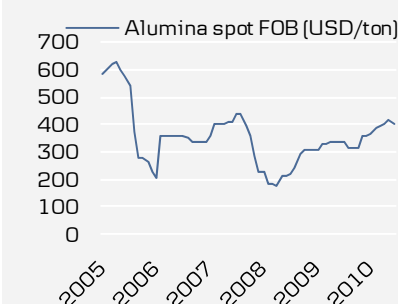
Inventories at the LME have been broadly flat in H1 and have helped prevent aluminium from selling off as extensively as, say, copper. After rising consistently throughout the past two years, physical premia for aluminium have been largely unchanged in recent months. Separately, alumina prices have eased a little of late. Energy prices have however stayed at elevated levels and ensured that the cost of producing aluminium remains relatively high.

Aluminium physical premium



Source: Bloomberg, Danske Markets.

Alumina price



Source: Bloomberg, Danske Markets.

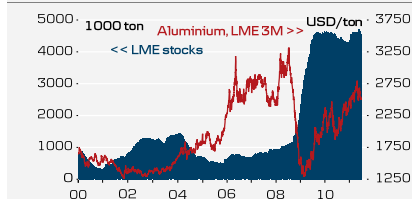
After base effects led to significant declines in consumption and production growth in 2010, year-on-year growth in aluminium has again edged higher lately. Demand for aluminium remains solid as machinery, equipment and construction orders remain strong. In contrast, car sales have weakened a bit lately. Overall, durable goods orders for metals still look reasonably healthy in the US.

Cancelled warrants for the metal have risen but CRU reports that consumers are currently facing long waiting times to get hold of aluminium because load-out rates are at a mere 1,500 MT per day per warehouse per location. This has generated a backlog of orders for metal to be delivered and has helped keep physical premia elevated. Indeed, aluminium inventories are high but not easily available to consumers.

On the supply side, output has risen in recent months. However, given the likelihood of power shortages in China during the summer, aluminium smelting capacity could be impaired. The main reason for the power cuts is high coal prices faced by power stations combined with government caps on energy prices. Power outages could however also have an impact on demand – not least producers of semi-finished aluminium goods.

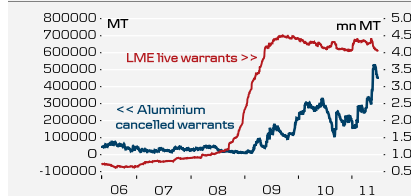
Financial deals still constitute a key risk to aluminium prices in the medium term as the attractiveness of these is set to wane as interest rates rise. However, although another round of quantitative easing now appears rather unlikely, with the Fed recently hinting that policy rates will nevertheless be kept low for an extended period, warehousing deals could remain profitable for some time yet.

Aluminium: LME price and stocks



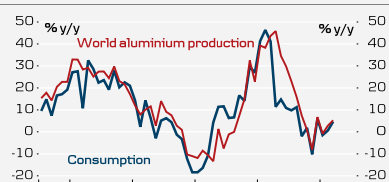
Source: Ecwin, Danske Markets.

LME warrants



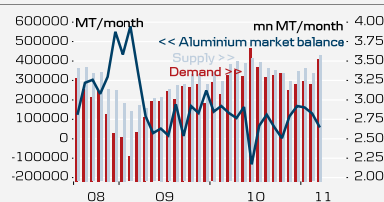
Source: Ecwin, Danske Markets.

World aluminium supply and demand



Source: Bloomberg, Ecwin, Danske Markets.

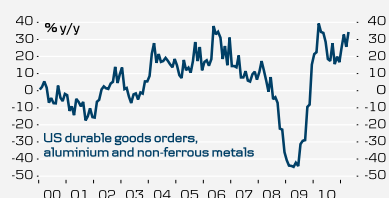
Aluminium market balance



Source: Bloomberg, Ecwin, Danske Markets.

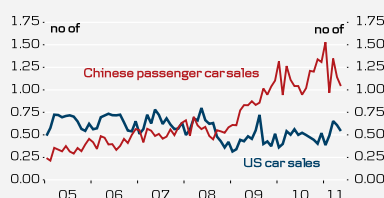
A physical exchange traded fund (ETF) for aluminium was finally launched by ETF Securities in early May after similar products for copper and nickel started trading in December. Thus far, interest in the aluminium ETF backed by physical metal has been very subdued with a mere 47 tonnes tied up in the product. High storage fees for aluminium appear to have kept investors at bay despite the attractiveness of buying aluminium spot in the current contango market.

US durable goods orders



Source: Ecwin, Danske Markets.

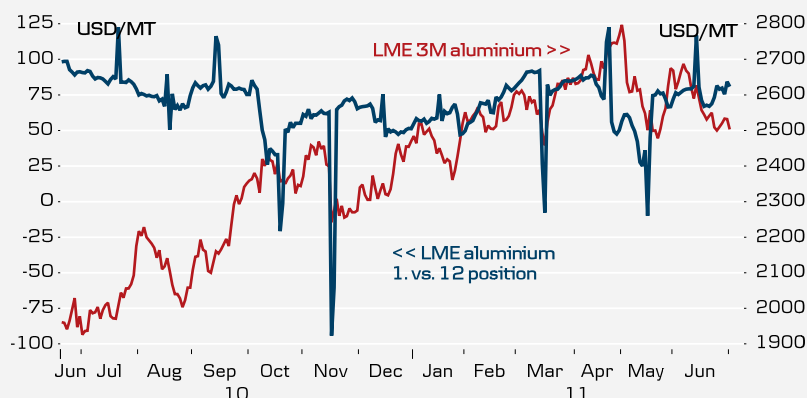
Auto sales in US vs. China



Source: Ecwin, Danske Markets.

Our indices of speculative positioning at LME suggest that some of the longs built up in early spring have now been unwound. Crucially, the attractiveness of financial deals in the light metal have been challenged somewhat recently. During May, the spot-12M spread (which has been in contango for a long time) briefly turned into backwardation. This also happened in March but was even more pronounced in November 2010.

Aluminium: 1. Vs. 12. LME future prices

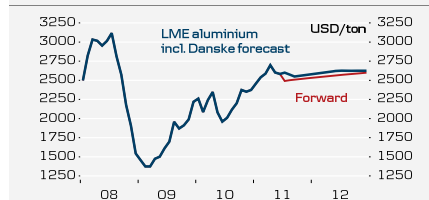


Source: Ecwin, Danske Markets.

In spite of the threat from unwinding of financial deals, we are not expecting an outright price collapse for the lightweight metal. One of the key reasons for this is that the cost curve is shifting higher still, not least due to elevated energy prices. According to Brook Hunt, almost 30% of producers would incur a deficit should prices fall below USD2,000/t. At current prices, most smelters are profitable but a small percentage of high-cost ones only break even if prices rise above USD2,700. This dynamic ensures that, if a rise in interest rates spurs a sell-off in prices, many smelters would probably halt production and hence help stabilise the market, thereby providing a floor under the price of the metal.

We now expect aluminium to average USD2,570/t this year (previously USD2,600/t) and USD2,600/t next year (previously USD2,700/t).

Aluminium forecast vs. forward

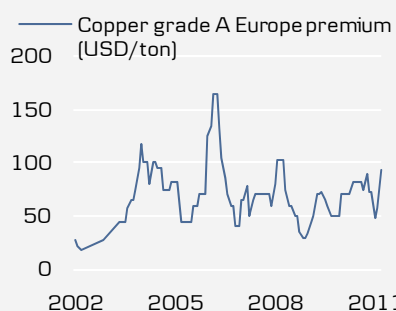


Source: Bloomberg, Ecwin, Danske Markets.

Copper: summer lull but Chinese demand set to pick up in H2

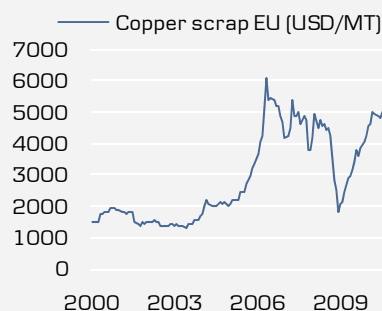
LME inventories have staged a continuous increase during most of H1 despite healthy demand which has weighed on pricing – for once, a conventional co-movement between stocks and prices has been seen in recent months. Stocks at LME are now at levels not seen since last year. In contrast, physical premia for copper have edged higher after some weakness at the start of the year. Scrap prices have eased a little however following the LME sell-off.

Copper physical premium Europe



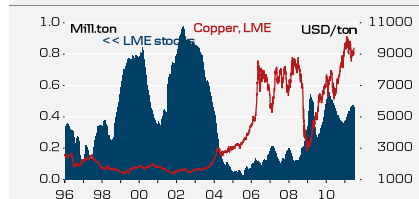
Source: Bloomberg, Danske Markets.

Copper scrap prices



Source: Bloomberg, Danske Markets.

Copper: LME price and stocks



Source: Ecwin, Danske Markets.

Global consumption was strong in H1 notwithstanding weakness in Asian buying following the February price surge. Notably, Chinese imports of refined copper have declined recently but it is interesting to note that scrap imports have similarly risen in a sign that buyers are turning to cheaper alternatives when five-digit prices for the red metal are seen at the LME. This has been the key driver of a marked decline in consumption growth recently. Still, German demand for copper continues to be firm on healthy activity in the export sector and in the Middle East: the recent increases in government spending in e.g. Saudi Arabia could fuel copper demand due to infrastructure spending. Japanese demand has been hit less than feared by the earthquake but consumption could be hit in coming months by planned power outages. We expect that copper demand will bounce back towards the end of H2 as the global economy sees an activity rebound.

US durable goods orders



Source: Ecwin, Danske Markets.

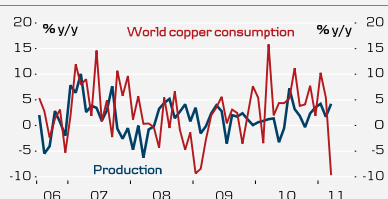
Chinese house prices



Source: Ecwin, Danske Markets.

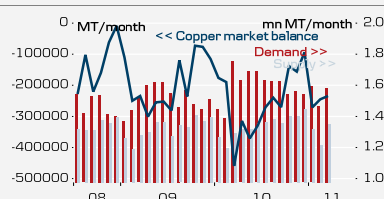
In contrast, copper production is still stalling: notably Codelco is struggling with strikes in Chile, downward revisions to output from the Esperanza mine and a temporary shutdown of the OK Tedi mine. CRU reports that Chinese refined copper production has risen lately sourced from an increase in domestic ore supply, scrap imports and concentrate stocks. Uncertainty regarding the outlook for mine supply remains key for copper prices but for now there are few signs that a significant pick-up in output is on the cards. Some market observers are however highlighting that supplies from Africa and China may be on the rise. We look for broadly flat mine production this year. But, treatment and refining charges (TC/RC) remain elevated, suggesting that refiners have become somewhat less eager to dump prices in order to attract ore for processing.

World copper demand and supply



Source: Bloomberg, Ecwin, Danske Markets.

Copper market balance

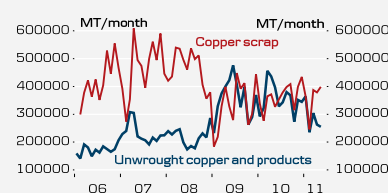


Source: Bloomberg, Ecwin, Danske Markets.

It is well known that many existing mines are struggling with falling ore grades as most mines are beyond their peak in terms of production and that there is a pronounced lack of new ore deposits to develop. At the same time, rising costs – both due to elevated energy prices and a shortage of skilled labour in the sector – are putting miners under pressure. However, currently producing mines are seeing costs well below current spot prices. Notably, Brook Hunt estimates that it would take a decline in the LME price to below USD7,000/t before the first producers were squeezed out. This is unlikely to happen any time soon and miners will probably have to continue to fight to merely keep production levels at the status quo. However, we should keep in mind that prices above marginal costs may eventually lead to a ramp-up in production to the extent that this is technologically feasible and cost effective.

In financial markets, the copper forward curve has merely seen a level shift in the past three months, i.e. from the USD9,500/t level to now trade around USD9,000/t with the curve fairly flat, albeit with a mild backwardation beyond 1Y. Our indices of positioning at the LME suggest that speculators have retained long positions in copper recently but COMEX data suggests otherwise. Indeed, there have been indications that commodities as a whole have lost some of their appeal among investors recently; having been an investor favourite for a while, it is likely that copper may have seen some longs being shed lately.

Chinese imports of copper products



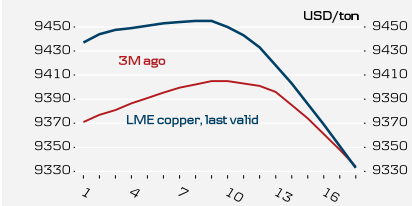
Source: Ecwin, Danske Markets.

Speculative positioning in copper



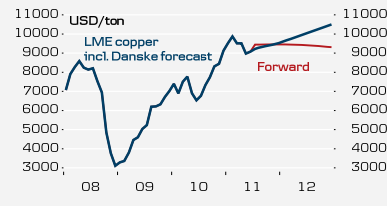
Source: EcoWin, Danske Markets.

Copper forward curve



Source: Ecwin, Danske Markets.

Copper forecast vs. forward

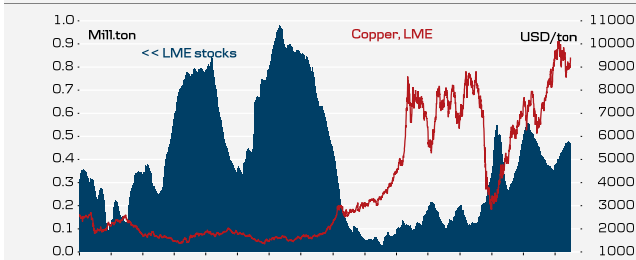


Source: Ecwin, Danske Markets.

We still expect copper to average USD9,400/t in 2011 (unchanged) and USD10,125/t in 2012 (unchanged).

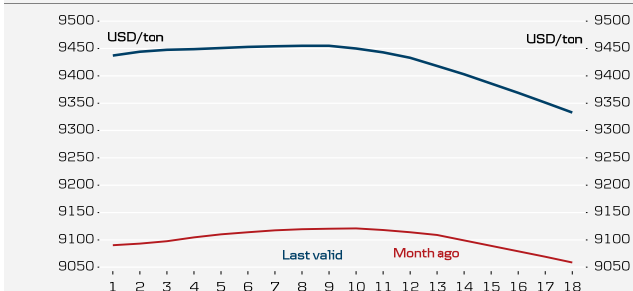
Base metals charts

Copper, LME



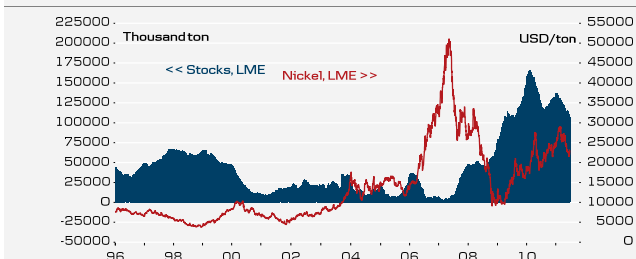
Source: Ecwin

Copper forward curve, LME

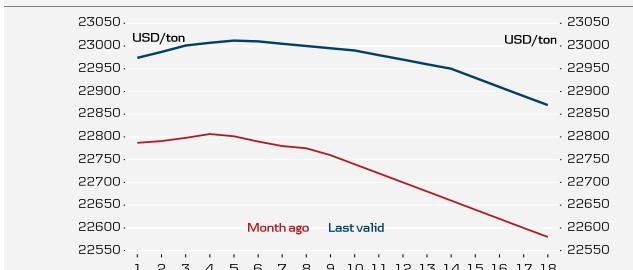


Source: Ecwin

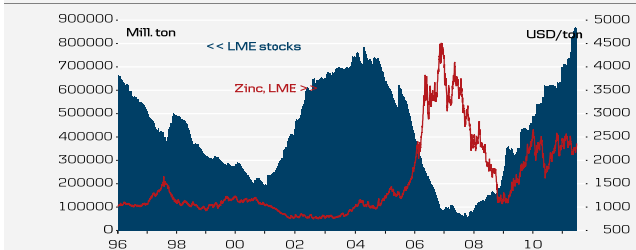
Nickel, LME



Nickel forward curve, LME



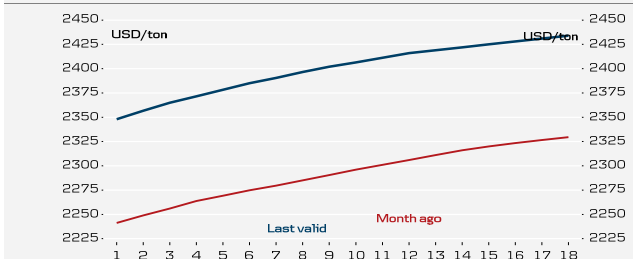
Zinc



Source: Ecwin

Source: Ecwin

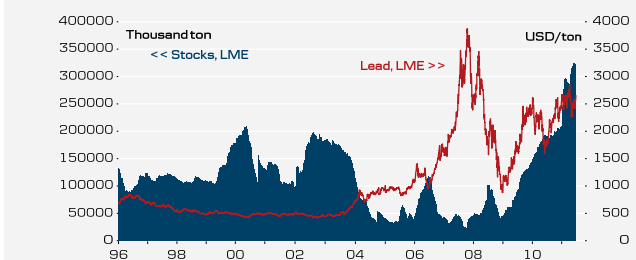
Zinc forward curve, LME



Source: Ecwin

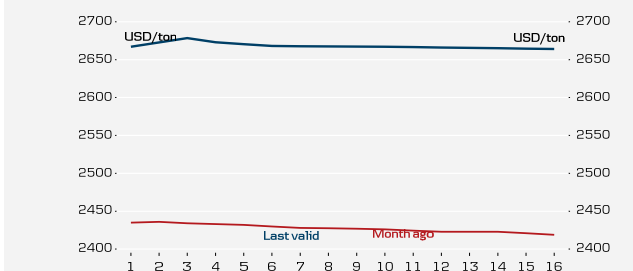
Source: Ecwin

Lead, LME



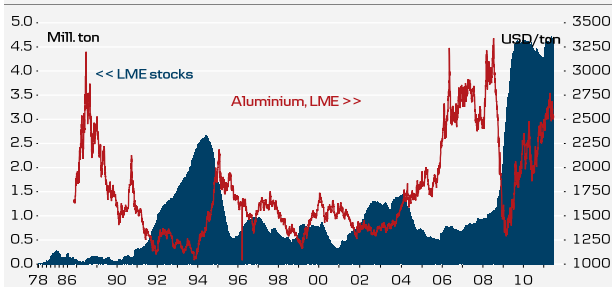
Source: Ecwin

Lead forward curve, LME



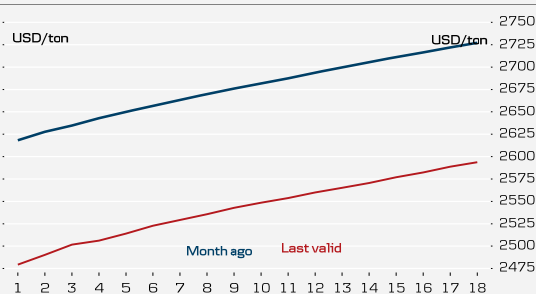
Source: Ecwin

Aluminium, LME



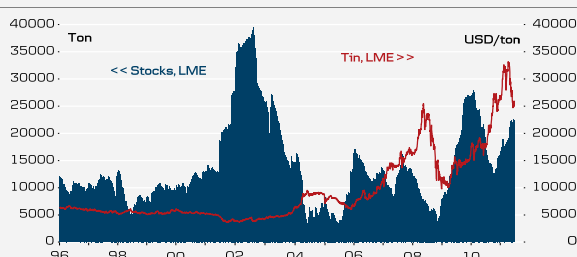
Source: Ecwin

Aluminium forward curve, LME



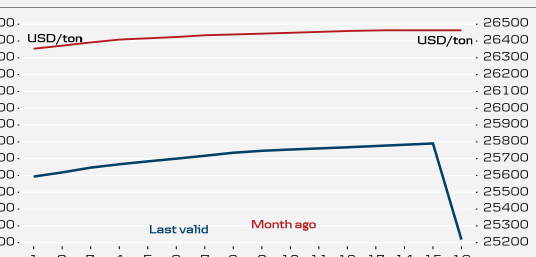
Source: Ecwin

Tin, LME



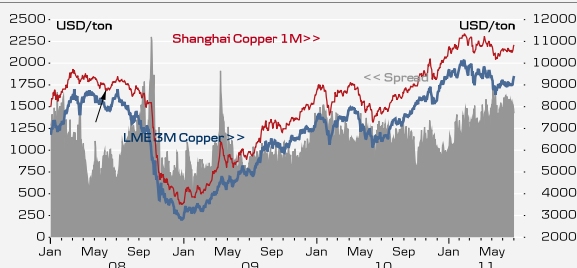
Source: Ecwin

Tin forward curve, LME



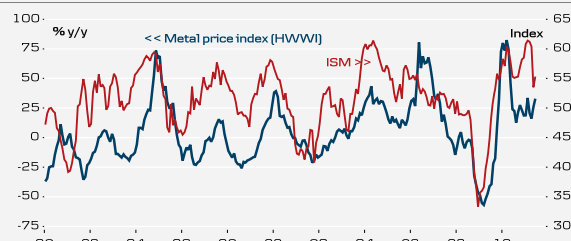
Source: Ecwin

Spread between Shanghai and LME



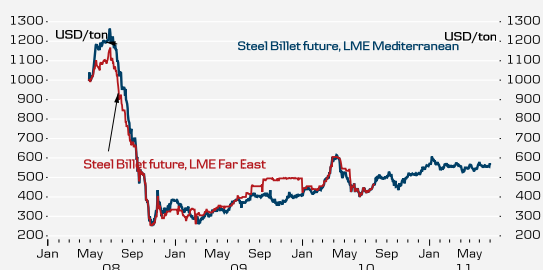
Source: Ecwin

Metal price index and the ISM



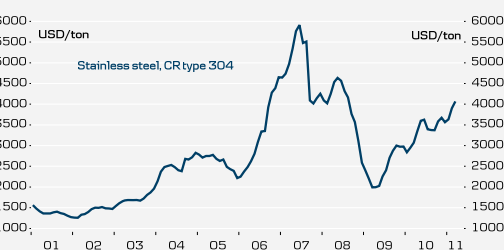
Source: Ecwin

Steel Billets, LME



Source: Ecwin

Stainless steel

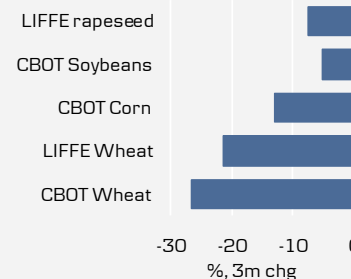


Source: Ecwin

Grains: Pausing for breath

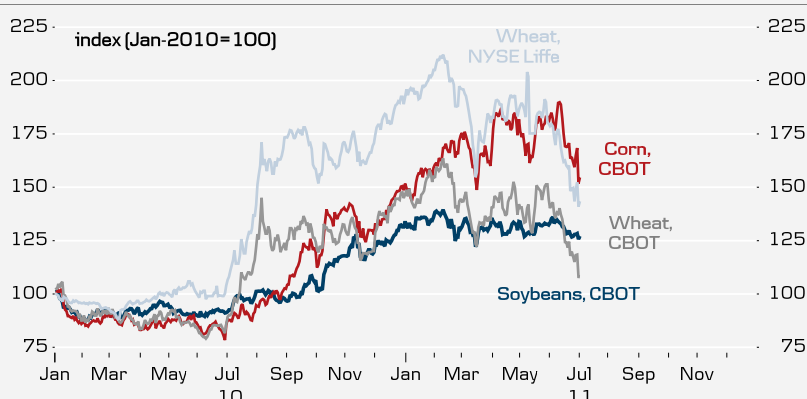
After a significant rally in grains prices during April and May, June saw a marked reversal of previous price rises after an improvement in weather conditions accelerated plantings and crop progress. Wheat prices have declined sharply with both CBOT and LIFFE prices down more than 20% over the past quarter. In contrast, sugar and cocoa prices have held up well, posting gains over the past month.

Quarterly changes



Source: Bloomberg, Danske Markets.

Grains prices



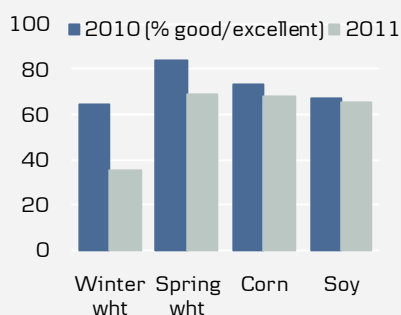
Source: EcoWin, Danske Markets.

Weather improvements in sight

Crop progress in the US has so far evolved slightly less favourably than was the case last year but recent weather improvements and notably the waning adverse effects of the La Nina weather phenomenon have helped to accelerate growth. For winter wheat less than 40% of plants are in good or excellent condition, which compares with more than 60% at the same time last season. However, we should not forget that last year droughts in the Black-Sea region kick-started the surge in grains prices during July-August and initially US crops were little affected. So far, corn has actually progressed surprisingly well notwithstanding very wet weather during the key planting period in May.

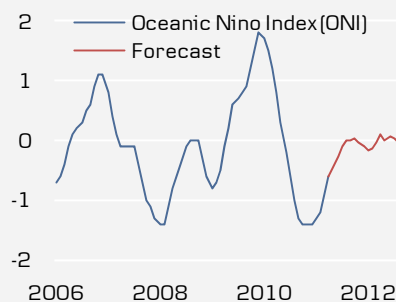
The US National Weather Service (NWS) is now saying that the El Nino/La Nina is weakening, i.e. the deviations from normal are diminishing after a peak 2009/10. correspondingly, extreme weather could be less pronounced this season and facilitate a larger-than-expected harvest.

US crop progress



Source: Bloomberg, Danske Markets.

Oceanic Niño Index



Source: US NWS; Danske Markets.

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Bearish USDA report

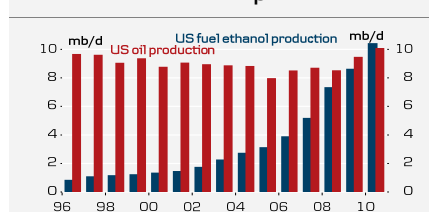
The Quarterly Stocks and Acreage report from the USDA published in late June revealed that US farmers planted slightly more corn than projected at the prospective plantings survey in March and much more than analysts had forecast. Separately, the International Grains Council said that weather conditions for crops are improving in both the US and China and hence added to the bearish sentiment in markets.

Indeed, expectations had been formed that wet weather in the US during a key point in the planting season might have induced some farmers to refrain from sowing corn. Farmers appear to have defied the weather and continued to plant corn into June; usually the seeding of corn is finished by the end of May. The fears over a lack of corn planting were proved wrong however and the quarterly inventory count for the US was well above expectations, leading the price of corn/maize to drop sharply at both CBOT and LIFFE.

USDA did, however, note that a separate survey will be conducted during the month of July of farmers Montana, Minnesota, and North and South Dakota on plantings as a good deal of acres still remains to be seeded in these areas.

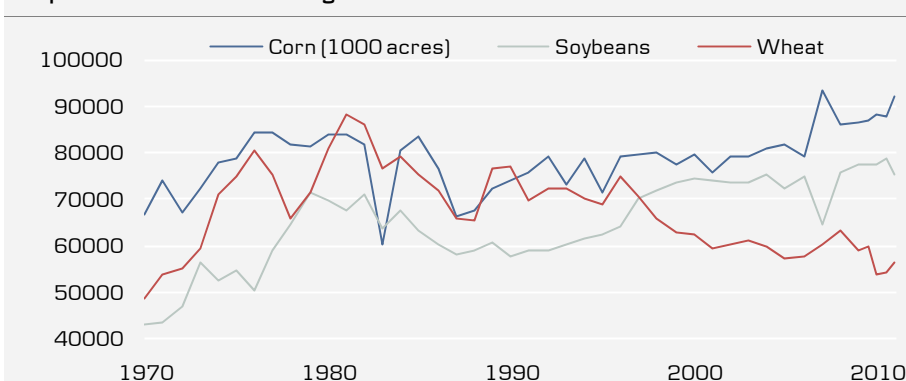
Acreage for wheat and soybean in contrast came in below forecasts but inventories for these grains were also higher than projected and thus price declines – albeit smaller than those for corn – were seen for these two grains as well. It appears that elevated oil prices and hence demand for corn for production of bio-ethanol led US farmers to devote even larger fields to corn than projected around the March report. Cotton also witnessed a surge in acres as price of the textile fiber has almost doubled during the past 12M; prices ICE cotton prices plunged after the report.

US oil and bio-ethanol production



Source: EcoWin, Danske Markets.

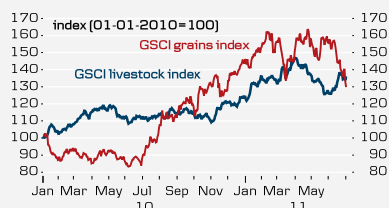
US planted acres of different grains



Source: Bloomberg, Danske Markets.

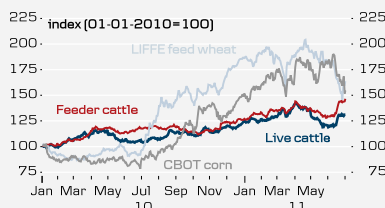
Importantly, the main reason for larger inventories in the US appears to be that livestock producers have cut back on herds as they cannot pass on higher feed costs to end consumers of meat. The rise in corn and soybean prices has greatly reduced the need for feed grains and/or livestock producers have switched to cheaper feed sources such as, e.g. lower-quality wheat.

Livestock vs. grains prices



Source: EcoWin, Danske Markets.

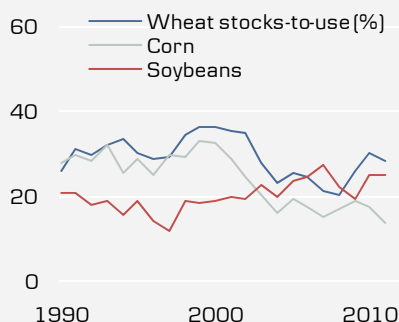
Cattle vs. corn and feed wheat prices



Source: EcoWin, Danske Markets.

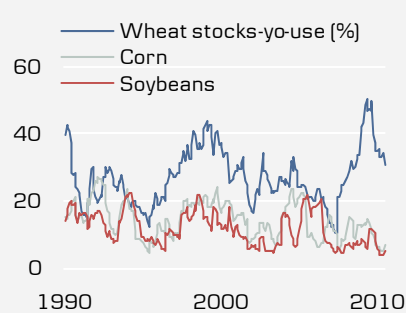
Overall, the USDA report was bearish for food prices. Although expectations for ending stocks-to-use ratios indicate increasing tightness in the grain markets both in the US and on a global scale, corn has dived towards less comfortable levels as elevated oil prices imply that corn is increasingly attractive to produce for use in the production of fuel ethanol. However, with oil prices significantly down from the highs seen earlier this year and consequently grains prices as well, this should provide inflation-targeting central banks with some breathing space, at least for now.

Global grains stocks



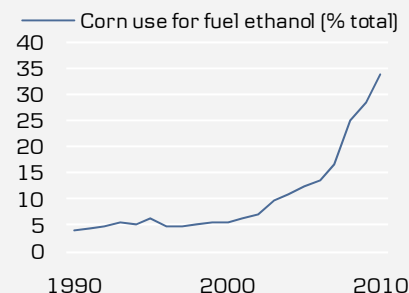
Source: Bloomberg, Danske Markets.

US grains stocks



Source: Bloomberg, Danske Markets.

Corn use for fuel ethanol production



Source: Bloomberg, Danske Markets.

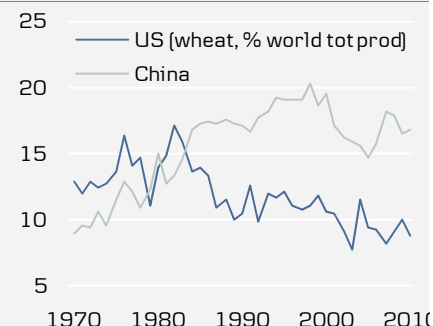
Policy makers target agricultural markets

Regulators are increasingly focused on ensuring that speculators do not fuel bubbles in food prices. While investor interest in commodities has increased markedly since the start of the millennium, it remains difficult to identify a significant long-term causal effect of speculative flows on prices. However, compared with, e.g. the oil market very little data is available for the world grains market. Data mainly exists for the US which used to be the all-important producer globally, but with other regions increasingly essential globally, a data deficit has emerged.

The French G20 presidency has proposed construction of a central database on crops, limits on export bans, international market regulation, emergency stockpiles and a plan to raise global output in a set of diverse responses to dampen food-price rises. It is likely that more concrete measures will soon be announced.

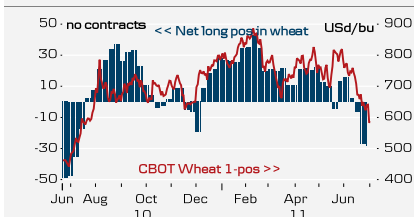
Recently, investor flows into commodities including grains have waned somewhat and non-commercial positioning has dropped – not least for wheat and soybeans. In fact, wheat positioning has turned net short again to levels not seen since spring 2010.

Distribution of wheat production



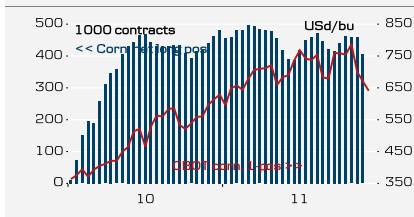
Source: Bloomberg, Danske Markets.

Wheat: speculative positioning



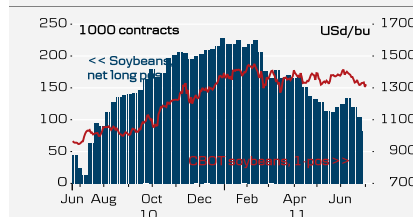
Source: EcoWin, Danske Markets.

Corn: speculative positioning



Source: EcoWin, Danske Markets.

Soybeans: speculative positioning



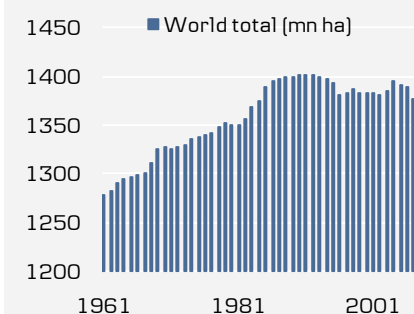
Source: EcoWin, Danske Markets.

Structural support to grains intact

As highlighted in Focus: Super-cycle restarted, there are a range of arguments as to why the prices of agricultural products may continue to see upward pressure for years to come. One of the problems facing the sector is a lack of new arable land coming into production. Indeed, total world farm land appears to have reached a plateau after rising steadily during the 1960-80s. Notably, the size of US arable land has declined markedly over the past two decades.

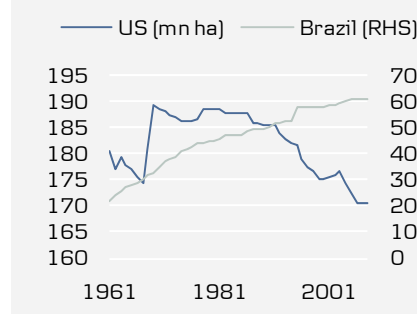
However, some regions have in fact managed to expand acres significantly. A prime example of this is the cultivation of the Brazilian savannah, the cerrado, which used to be deemed unfit for farming. Via a range of measures, farmers ensured that the acidity of the soil was reduced and that it soybeans can now actually grow in a tropical area. Whether the Brazilian revolution could happen elsewhere remains an open question, but for now there is good reason to be worried that the agricultural sector will face difficulties in steeping up food supplies as quickly as necessary.

Global arable land



Source: Bloomberg, Danske Markets.

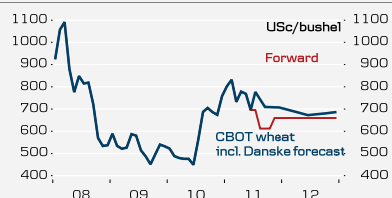
Arable land in the US and Brazil



Source: Bloomberg, Danske Markets.

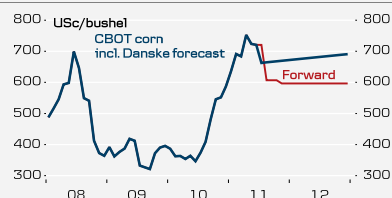
We have lowered our grains forecasts markedly after the recent respite from stock counts. We now see Matif milling wheat averaging EUR215 in 2011 (previously 235) and EUR195 next year (previously 220). We still see limited upside in corn and soybeans. Grains will nevertheless be in the hands of the weather intra-season.

Wheat: forecast vs. forward



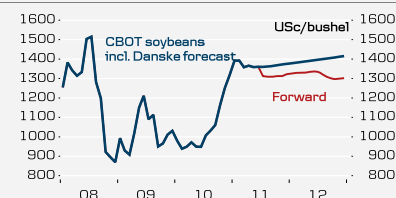
Source: Bloomberg, EcoWin, Danske Markets.

Corn: forecast vs. forward



Source: Bloomberg, EcoWin, Danske Markets.

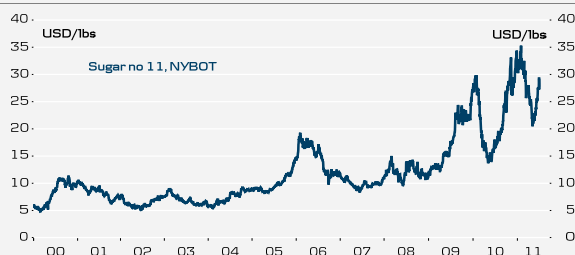
Soybeans: forecast vs. forward



Source: Bloomberg, EcoWin, Danske Markets.

Agricultural charts

Sugar



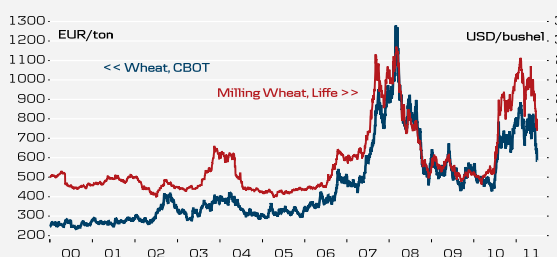
Source: Ecwin

Soybeans



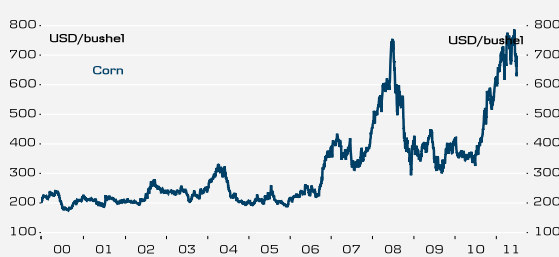
Source: Ecwin

Wheat



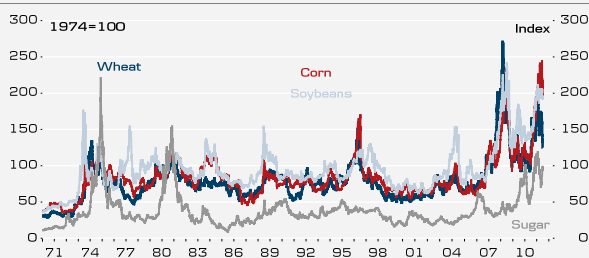
Source: Ecwin

Corn



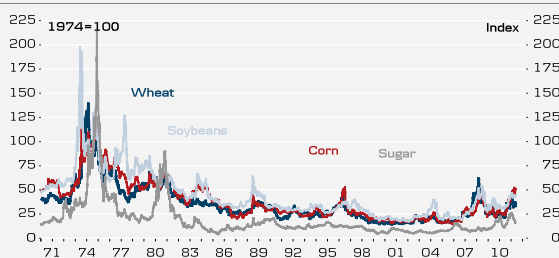
Source: Ecwin

Nominal prices



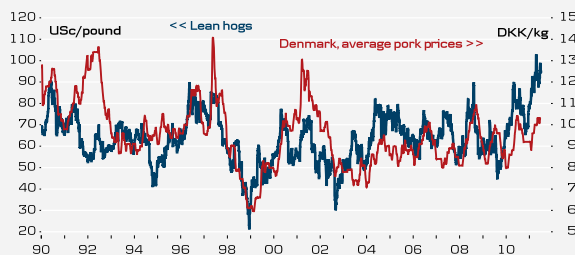
Source: Ecwin

Real prices



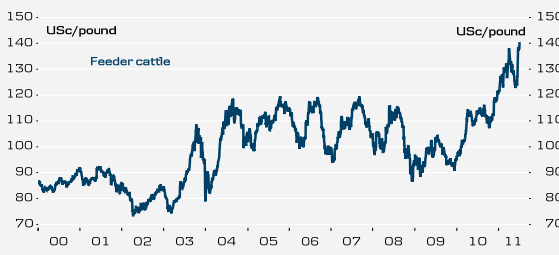
Source: Ecwin

Pig prices



Source: Ecwin

Feeder cattle



Source: Ecwin

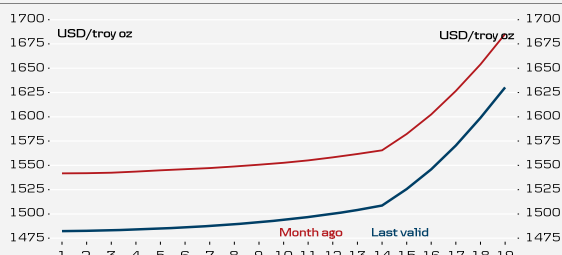
Precious metals charts

Gold, spot



Source: Ecwin

Forward curve, Gold, Nymex



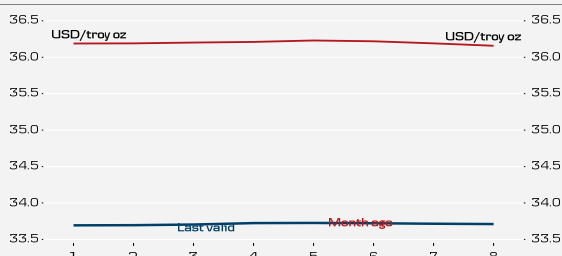
Source: Ecwin

Silver, spot



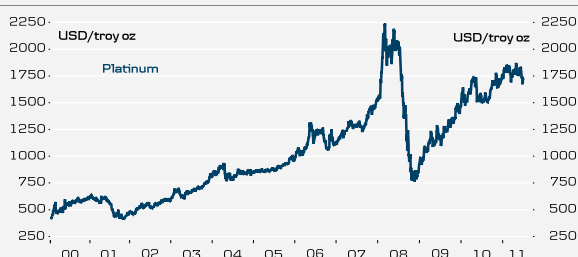
Source: Ecwin

Forward curve, Silver, COMEX



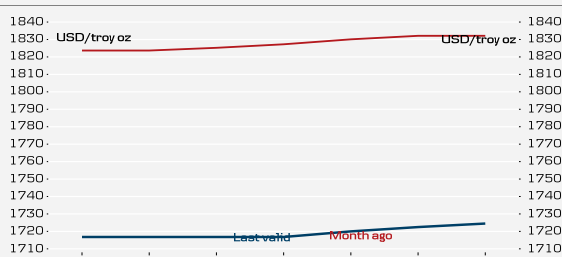
Source: Ecwin

Platinum, spot



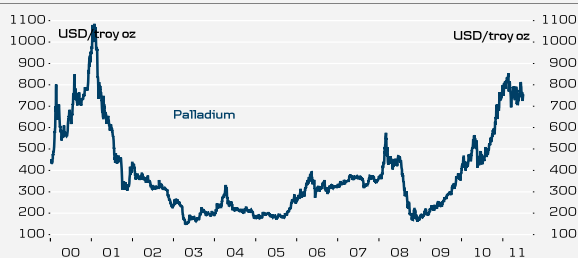
Source: Ecwin

Future curve, Platinum, Nymex



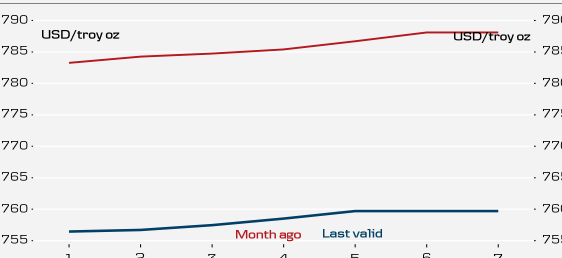
Source: Ecwin

Palladium, spot



Source: Ecwin

Future curve, Palladium, Nymex



Source: Ecwin

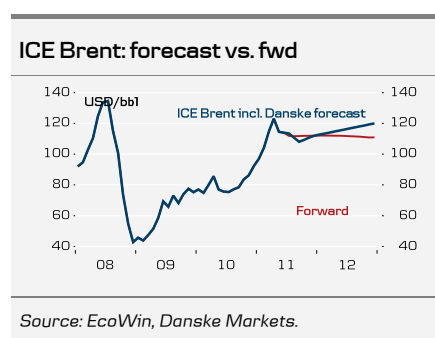
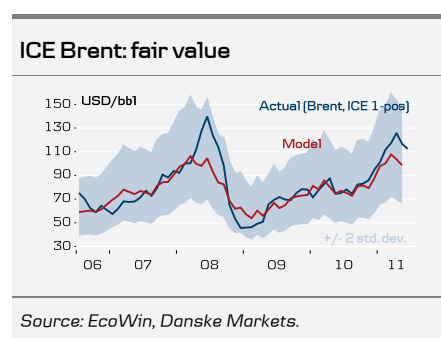
Hedging: Use summer lull to prepare for 2012 recovery

The sell-offs in commodities that have taken place in recent months and the possible summer lull in prices ahead in our view offer attractive levels for consumers to position for the likelihood of a H2 and 2012 recovery in prices. While we might still see another month or two of disappointing data releases, which could depress spot and forward prices alike, we do expect to see upside pressure on commodities from the macro side come through during the autumn.

Notably for EUR-based buyers of commodities it is worth keeping in mind that the dollar strength that our FX team expects to see materialising towards the end of the year, could make commodities priced in euro even more expensive to the extent that a higher USD does not weigh on commodity prices in dollar terms. Hence it might be preferable to fix the EUR price for 2012 to take this unknown out of the equation.

Oil: lock in expenses below USD110 for Brent

Our oil forecast remains some USD10 per barrel above the forward curve for 2012 as a whole. In itself, this points to the attractiveness of locking in expenses for next year at current price levels. In addition, we stress that risks are in our view primarily on the upside: while the IEA release has bought the market some time, if the Saudis do not increase shipments there is a significant risk that oil prices might have to rise markedly in H2. Currently the oil forward curve is rather flat but should the curve shift towards backwardation again - e.g. if we get another set of below-expectations data releases out of major regions - this could offer a good opportunity to position for 2012. We recommend clients on the consumer side to lock in oil at prices below USD110 barrel for Brent.



Oil products: use current setback to prepare for wider light-heavy spread

Regarding oil products, we have seen a tendency towards widening light-heavy spreads at the start of Q2. However, the IEA release which is concentrated around lighter products may offer an opportunity to obtain lower prices levels for e.g. jet fuel and diesel as the market has seen a narrowing of the light-heavy spread late June. We do however project that spreads will extend again during the autumn when Saudi Arabian crude is added to global markets.

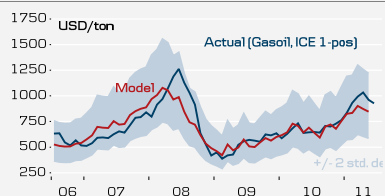
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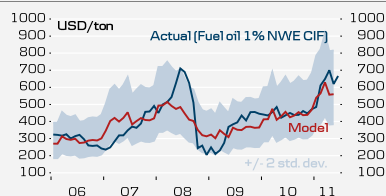
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ICE gasoil: fair value



Source: EcoWin, Danske Markets.

Fuel oil: fair value

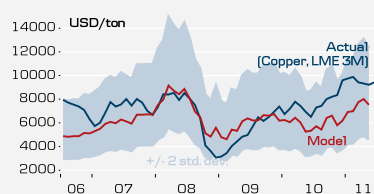


Source: EcoWin, Danske Markets.

Base metals: buy copper but sell aluminium

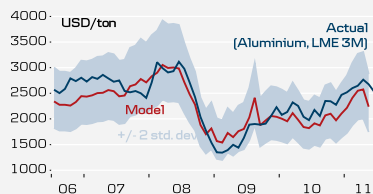
Base metals have held up reasonably well despite the recent sell-offs in oil and agriculturals. But, for copper, we still see good value in locking in prices with the current forward curve, not least in 2012, when our forecast is markedly higher than current market pricing. For aluminium, consumers should, in our view, not fear marked price rises, although higher energy costs and substitution away from copper to other metals pose a risk. Sellers of aluminium (or clients looking to hedge inventories) should consider locking in current levels and take advantage of the upward-sloping contango structure to prepare for a potential unwinding of financial deals when interest rates start to rise.

LME copper: fair value



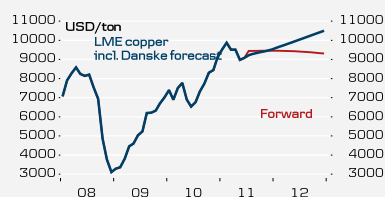
Source: EcoWin, Danske Markets.

LME aluminium: fair value



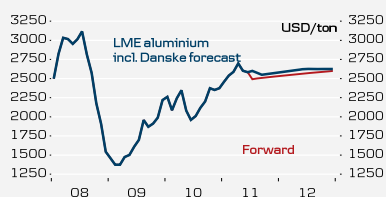
Source: EcoWin, Danske Markets.

LME copper: forecast vs. fwd



Source: EcoWin, Danske Markets.

LME aluminium: forecast vs. fwd

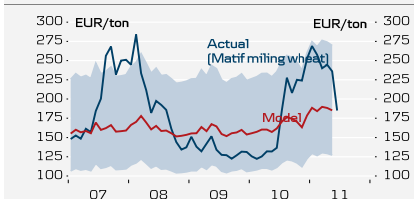


Source: EcoWin, Danske Markets.

Grains: an opportunity for consumers of corn and soy

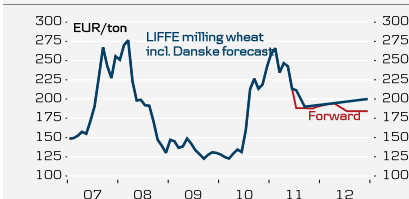
With the whole of the agricultural complex selling off significantly of late, wheat prices are now actually close to our fair-value measure which has not been the case for a very long time! Thus, in our view, it has become much less attractive to sell wheat on a forward basis than just three months ago. In contrast, this is an opportunity for consumers of not least corn and soybeans to lock in some potentially favourable levels for next-year deliveries.

Matif wheat: fair value



Source: EcoWin, Danske Markets.

Matif wheat: forecast vs. fwd



Source: EcoWin, Danske Markets.

Historical commodity prices

	04/07/2011	Month ago		Year ago		This year	
	Price	Price	%, m/m	Price	%, y/y	Start level	YTD change, %
Energy							
NYMEX WTI 1.pos.	95.3	100.3	-5.0	72.2	32.0	91.4	4.2
NYMEX Gasoline RBOB (Usc/gln), 1.pos.	297.6	299.3	-0.6	197.8	50.5	245.3	21.3
ICE Brent 1.pos.	112.1	115.9	-3.2	71.7	56.4	94.8	18.3
ICE Carbon (€/tn)	13.3	16.8	-21.3	15.7	-15.5	14.2	-7.0
Electricity Nord Pool,€, 1.month	42.8	52.5	-18.6	-	-	-	-
TTF Natural Gas (€) 1st. month	21.9	23.2	-5.8	20.7	5.8	24.2	-9.5
Natural Gas, Nymex, 1.pos.	4.3	4.7	-8.4	4.7	-8.0	4.4	-2.2
API2, steam coal, 1st month	123.2	122.7	0.4	95.4	29.1	129.5	-4.9
Base metals:							
LME 3M Prices (US\$/t)							
Aluminium	2,514	2,636	-4.63	1,936	29.87	2,469	1.82
Copper	9,505	9,101	4.44	6,412	48.25	9,602	-1.01
Lead	2,679	2,433	10.11	1,753	52.82	2,550	5.06
Nickel	23,305	22,800	2.22	18,800	23.96	24,750	-5.84
Zinck	2,382	2,258	5.49	1,780	33.82	2,454	-2.93
Precious Metals:							
Spot Prices (US\$/oz)							
Gold	1,494.4	1,542.0	-3.1	1,209.5	23.6	1,418.8	5.3
Silver	34.1	36.1	-5.8	17.8	91.9	30.9	10.2
Agriculturals:							
Front Month Prices							
CBOT Wheat (USd/bushel)	612.3	809.3	-24.3	593.3	3.2	844.8	-27.5
Matif Mill Wheat (€/t)	188.3	234.5	-19.7	140.0	34.5	252.5	-25.4
CBOT Corn (USd/bushel)	640.8	758.5	-15.5	365.5	75.3	629.0	1.9
CBOT Soybeans (USd/bushel)	1,322.3	1,386.3	-4.6	953.5	38.7	1,393.8	-5.1
NYBOT Sugar (USd/lb)	27.3	22.5	21.3	16.3	67.4	32.1	-15.2
Commodity indices							
Reuters/CRB TR	336.7	348.6	-3.4	254.5	32.3	332.8	1.2
S&P GSCI Energy TR	1,093.2	1,142.2	-4.3	873.0	25.2	1,035.6	5.6
S&P GSCI Industrial Metals TR	1,952.2	1,949.5	0.1	1,422.3	37.3	1,992.4	-2.0
S&P GSCI Agriculture TR	746.0	834.4	-10.6	514.5	45.0	826.0	-9.7
S&P GSCI Precious Metals TR	2,005.8	2,112.6	-5.1	1,555.3	29.0	1,914.8	4.8
AIG	156.9	165.9	-5.4	124.0	26.5	162.4	-3.4
Rogers commodity index TR	3,920.0	4,125.1	-5.0	2,910.8	34.7	3,896.4	0.6
Steel prices (EUR/t)							
EU domestic hot rolled coil	550.0	570.0	-3.5	610.0	-9.8	505.0	8.9
EU domestic cold rolled coil	670.0	690.0	-2.9	680.0	-1.5	605.0	10.7
EU domestic hotdip galv. coil	640.0	700.0	-8.6	690.0	-7.3	590.0	8.5

Source: Bloomberg, Danske Markets.

Commodity-price forecasts

	2011					2012				AVERAGE		
	04/07/11	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4	2010	2011	2012
Energy:												
front month												
NYMEX WTI (US\$/bbl)	95.3	95	103	98	104	108	112	115	118	81	100	113
ICE Brent (US\$/bbl)	112.1	106	116	108	112	114	116	118	120	81	111	117
Base metals:												
LME 3M (US\$/t)												
Aluminium	2,514	2,532	2,625	2,550	2,575	2,600	2,625	2,625	2,625	2,202	2,571	2,619
Copper	9,505	9,624	9,160	9,350	9,500	9,750	10,000	10,250	10,500	7,562	9,409	10,125
Zinc	2,382	2,414	2,270	2,300	2,295	2,290	2,285	2,280	2,275	2,188	2,320	2,283
Nickel	23,305	26,907	24,280	23,000	23,500	24,000	24,500	25,000	25,500	21,915	24,422	24,750
Steel	566	564	550	560	570	585	590	595	600	488	561	593
Precious Metals:												
spot (US\$/oz)												
Gold	1,494	1,388	1,510	1,500	1,475	1,450	1,425	1,400	1,375	1,226	1,468	1,413
Agriculturals:												
front month												
Matif Mill Wheat (€/t)	188	252	222	190	192	194	196	198	200	171	214	197
CBOT Wheat (US\$/bushel)	612	786	810	709	707	690	672	679	686	599	753	682
CBOT Corn (US\$/bushel)	641	672	661	666	671	676	681	686	691	441	668	684
CBOT Soybeans (US\$/bushel)	1,322	1,380	1,355	1,365	1,375	1,385	1,395	1,405	1,415	1,043	1,369	1,400

Source: Bloomberg, Danske Markets.

Oil products: price and crack spread forecasts

Oil products forecasts	2011					2012				AVERAGE		
	04/07/2011	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012
Jet fuel CIF cargo (USD/MT)	1021	977	1065	1011	1046	1065	1085	1105	1124	731	1025	1095
ULSD 10ppm CIF NWE cargo (USD/MT)	945	920	995	941	976	995	1015	1035	1054	696	958	1025
ICE gasoil (USD/MT)	924	886	975	921	956	975	995	1015	1034	694	935	1005
ICE Brent (USD/bbl)	112	106	116	108	112	114	116	118	120	81	111	117
3.5% fuel oil FOB ARA barge (USD/MT)	609	546	620	559	587	599	612	625	637	444	578	618
1.0% fuel oil FOB NWE cargo (USD/MT)	659	567	670	609	637	649	662	675	687	463	621	668
Crack spread forecasts (USD/MT)	2011					2012				AVERAGE		
	04/07/2011	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012
Jet fuel CIF cargo (USD/MT)	199	200	215	220	225	230	235	240	245	134	215	237
ULSD 10ppm CIF NWE cargo	123	143	145	150	155	160	165	170	175	99	148	167
ICE gasoil	102	109	125	130	135	140	145	150	155	97	125	147
3.5% fuel oil FOB ARA barge	-213	-231	-230	-232	-234	-236	-238	-240	-242	-153	-232	-239
1.0% fuel oil FOB NWE cargo	-163	-210	-180	-182	-184	-186	-188	-190	-192	-134	-189	-189

Source: Bloomberg, Danske Markets.

Commodities at Danske Markets

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Disclosure

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