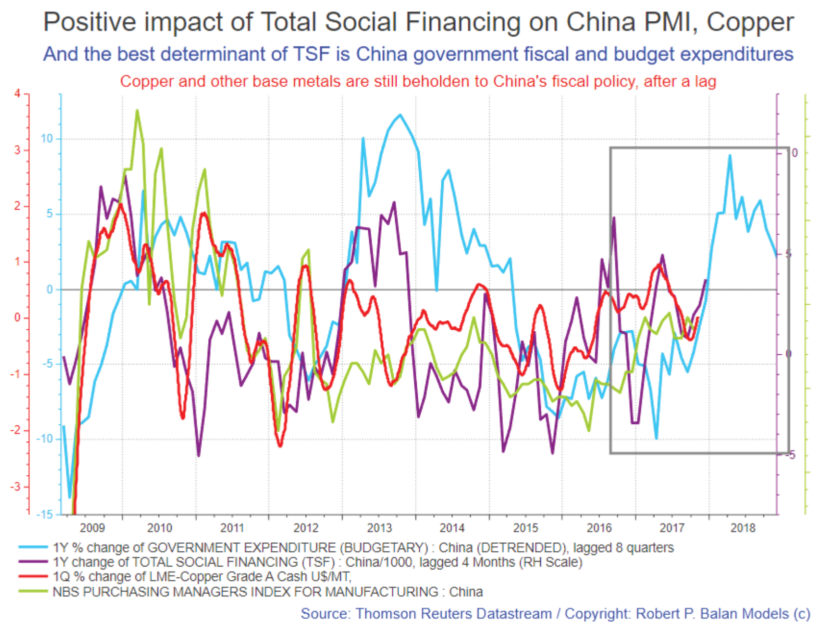
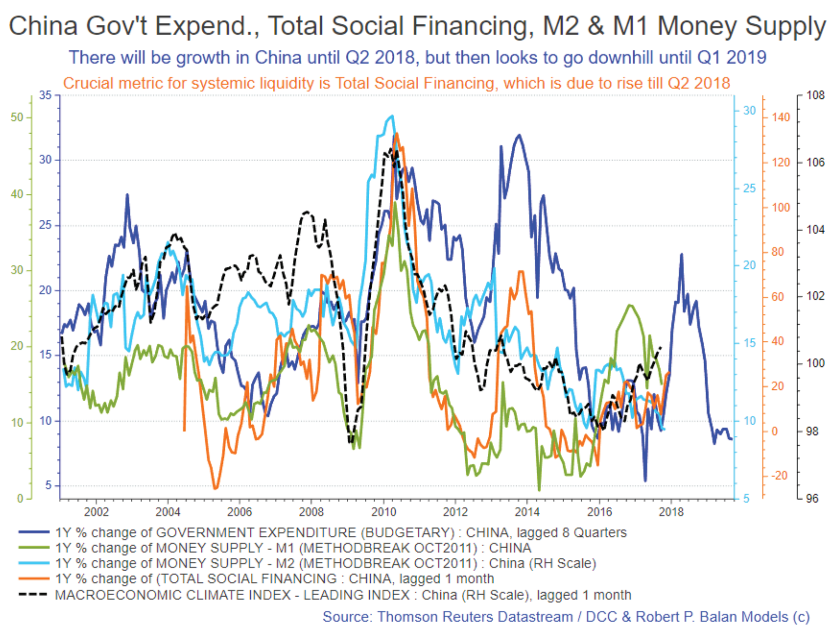
23 / Base Metals Outlook Reaffirmed: getting long on base metals and China is optimal in Q3 2017

In a report dated March 2, 2017 ("Base Metals slow further in Q2 2017, but may pick up pace by mid-Q3 until Q2 2018") we highlighted our short-term concerns about base metals: *"An unexpected surge in LME copper stocks partly offset supply-side concerns due to the strikes in Chile. Slowing Chinese demand growth as reflationary policies take a pause, will also prevent a sharp rally in copper prices in the short term, as policy actions taken by Beijing to slow the property market, have also recently taken a toll on copper and base metal prices. However, we expect conditions to be more favourable to base metals by Q3 this year, and that benevolent period could extend to Q2 2018."* **The second quarter has come and gone, and base metal prices did correct as expected, and now at mid-Q3, it is time to revisit the outlook for base metals and China.** That assessment had been proven to be on track.





Steady improvement in economic numbers coming out of China, impressive activity coming from the industrial sector in the United States, the eurozone and stable PMI in China have lifted industrial commodities prices from their troughs in May. These resource materials thereafter underwent a brief correction (as we expected) as China`s money supply briefly declined as a lagged response to previous changes in fiscal and budget expenditures. But China fiscal expensditures expanded thereafter, and so the prices of many resource materials have also been trending higher since late July ***(see 1st graph on this page)***. It's a good time to be bullish on base metals, and indeed, China, again.

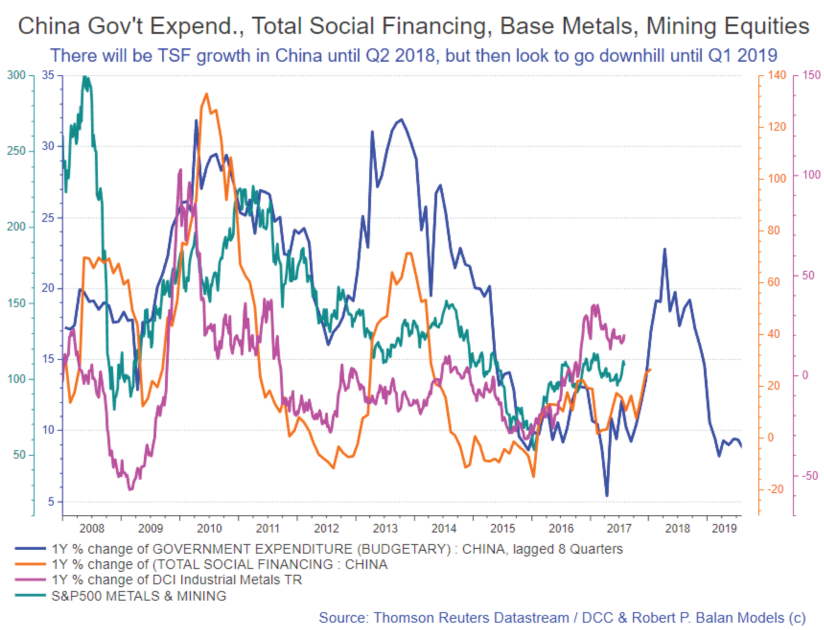
Money supply, along with Total Social Financing, are the primary transmission of fiscal and budget expenditures to the real economy in China. These two Chinese micro variables exert a large influence on the price of base metals *(see 1st graph on this page)*. The lagged effect of a even a short-term change in Chinese fiscal policy had negative reverberations in systemic liquidity during Q2 – hence, the slowing of TSF and money supply have negative impact the global prices of base metals. But the negative impact is gone, as we will show in additional details provided below.

The recent Q2 sell-off in the commodity pits was not a harbinger of slower global growth as some investors supposed – our expectation is that base metals will likely lead the commodities in a reflation wave in H2 2017 that will have have support from improving growth dynamics in China *(see 2nd graph on this page)*. This should do wonders on the demand side -- we see sustained global economic expansion and relatively healthy demand from China providing stable support. Chinese demand growth should slow only gradually even as the country rebalances its economy toward consumption. The primary risk to this supportive backdrop is an escalation of trade tensions between the U.S. and China (which we do not expect, in the immediate future at least).

Reflationary policies launched since late 2015 continues to provide a floor to the Chinese economy in 2017, and that may well extend into Q2 2018. Nonetheless, the fiscal and monetary impulses from those factor will wane sometime by the middle of next year. China's manufacturing sector, fixed-asset investment and the property sector should remain strong over the next three quarters at least, which will support the demand for base metals. The government of President Xi Jinjiang has been re-directing policy stimulus to support consumer- and services-led growth, but also continues to invest in the country's electricity grid, which accounts for about a third of China's copper demand. So, expect base metals demand in China to be sustained at a moderating pace, but a significant source of global demand for base metals nonetheless.

As far as we can see, the transmission mechanism between the Chinese economy and prices of raw materials is the Total Social Financing. TSF is a liquidity measurement tool invented by China in 2011 to serve as economic barometer that sums up total fundraising by Chinese non-state entities, including individuals and non-financial corporates. **It has become a better indicator of monetary policy than traditional measures of money supply *(see 2nd graph on previous page and 1st graph on this page)***. On the other hand, TSF is being influenced to a large degree by the Federal fiscal and budgetary policies over the preceding 8 quarters. In that respect, base metal prices have become beholden to the lagged impact of China's government expenditures and budgetary allocations.

Meanwhile, a more accommodative approach by the Federal Reserve, alongside a weaker dollar, have been a potently positive combination for the commodities markets. We have already seen the prices of many industrial commodities move sharply to the upside over



recent weeks. Steel rebar prices are highest level, since early 2013, in China – the world`s biggest consumer of that item. Zinc and lead prices have been pacing the resource material market as well – zinc at its highest level since late 2007 (when the US recession started). The price of copper broke out to the upside and is trading at over $6600 per metric ton which is the highest price since mid-2015 ***(see 2nd graph on this page)*****. The commodities market is currently in broad uptake as global growth continues to take hold, the Federal Reserve and other central banks have notched down their rhetoric regarding tighter policy, and the US Dollar as a consequence had been trending lower, and may weaken further a little bit more. In fact it was the "dovish" July FOMC statement which lit a bullish fuse for commodities prices.**

The policy gridlock in Washington DC has contributed to the weakness of the US Dollar. The Trump administration is not at all concerned with the weakening dollar (both Mr. Trump and his Treasury secretary have stated, on multiple occasions, they would like to see a weaker dollar), so there is no risk in sight of an official intervention to arrest the currency's slide. **Moreover, it seems like every time there is a news flow which is negative to the Trump administration, the dollar plunges further.** The US Dollar will likely be under pressure for a while, as we do not envisage an immediate end to the governance travails of The Donald.

Base metals, as part of the Commodities asset class, should therefore continue to perform well until mid-year 2018, following a favourable environment provided by the previous decline in long terms rates, and decline in loans (which also helped weaken the US Dollar , *see graph on this page*). Industrial metals have generally outperformed other commodity sub-sectors this year, as zinc, lead and copper hit new highs almost every week. **There is also another big reason for the rally: production has been falling from last year's levels. The so-called "stock glut" from the 2012-2013 period is largely gone.** In fact, there has been the transition of many of the sectors' components from surplus to deficit, some of them extremely so **(*see graph on this page)*** . **From here, we expect the supply situation or the market balance of the individual metals to continue driving the price gains as years of neglect on the investment side (due to multi-years of low prices) have left a gap between immediately available supply and the increasing global demand for raw materials. We do not expect the supply deficit to go away anytime soon. This is a good foundation for firmer future base metal prices.**