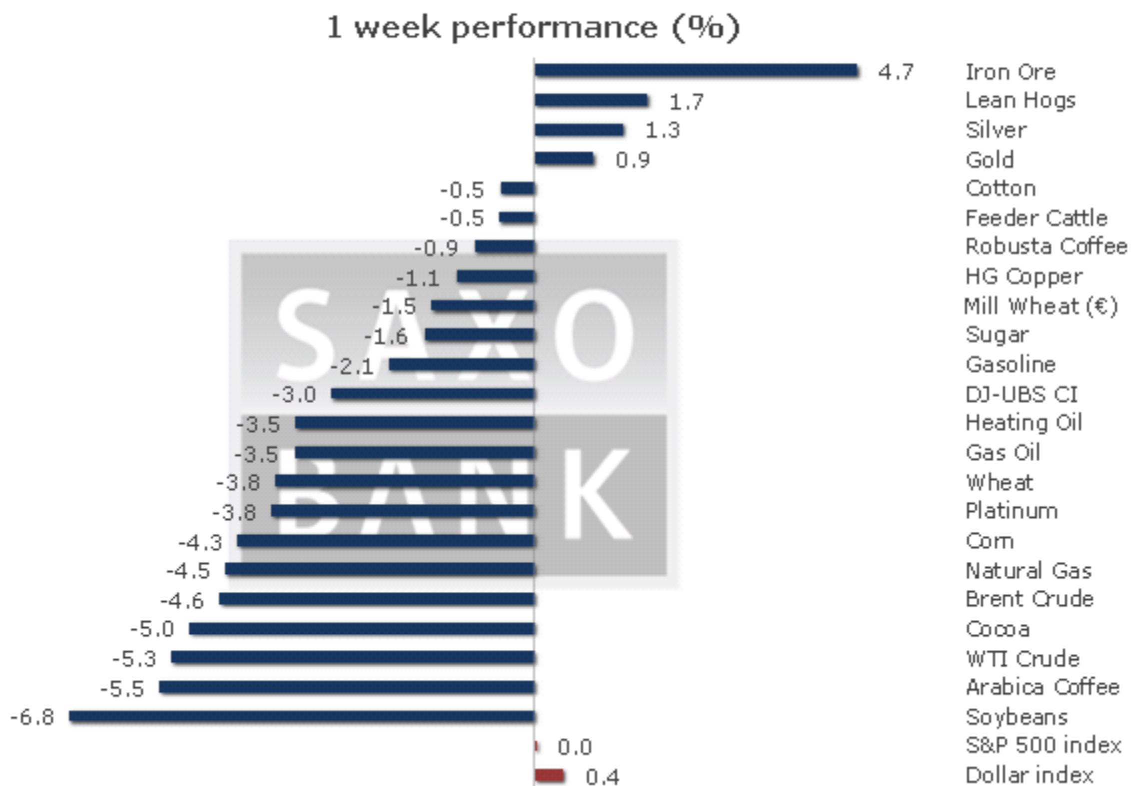
Commodities lower despite QE3

Commodities were generally lower over the past week, despite another round of stimulus from the US Federal Reserve and the Bank of Japan. This initial reaction, at least for now, must come as a great relief to central bankers, who in the past have stood accused of fuelling the rise of raw material and food costs via quantitative easing. The dollar, which had been sold ahead of the announcement, also recovered some of its poise following weak economic data from China and the Eurozone.

Looking at the table below, we see just a few commodities managing a positive performance following the announcement of QE3, with iron ore sticking out as its dramatic recovery from the recent slump continues. The broad-based DJ-UBS commodity index is down three percent, having fallen more than what it rose in the week leading up to QE3, with the energy sector in particular (-4.4 percent) and agriculture (-4.6 percent) pulling it lower. The best performer during the week were precious metals (+1 percent) while industrial metals succumbed to some profit taking which stills leaves the sector the best performer over the last month.



Oil price succumbs to selling as QE meets reality

The unleashing of QEInfinity, as it is now popularly being called, by the US Federal Reserve triggered a renewed push higher for crude oil. But just like HC Andersen's fairy-tale "The Emperor's New Clothes" it did not take long before someone realised that things did not stack up and that QE alone was not going to carry oil prices higher, considering the still weak outlook for economic activity. The dislocation from fundamentals only lasted until Monday, when a huge sell order late in the day triggered what can best be described as a flash crash with Brent crude dropping by four dollars in seconds.

Over the following days the correction continued, and by Wednesday it accelerated once again, when previous support at the 200 day moving average - an important level used by technical traders - gave way. In the end Brent crude fell by 9 percent to a six-week low at 107.10 before finding support, with the news flow also supporting the move. Saudi Arabia once again stepped in with some verbal intervention in order to talk the price of Brent crude back down to the 100 dollar level. Both the Saudis and the International Energy Agency see the market as being well supplied, which does not justify recent high prices, and any extra demand will be met by increased production.

On the economic data front, the Euro gave back some of its recent strong gains versus the dollar, as data showed that Eurozone manufacturing contracted for the 13th consecutive month in August. In China the HSBC flash PMI index stabilized but remained weak below the 50 mark, which points to contraction, and it points towards an even weaker growth number for Q3 than the 7.6 percent witnessed in Q2.

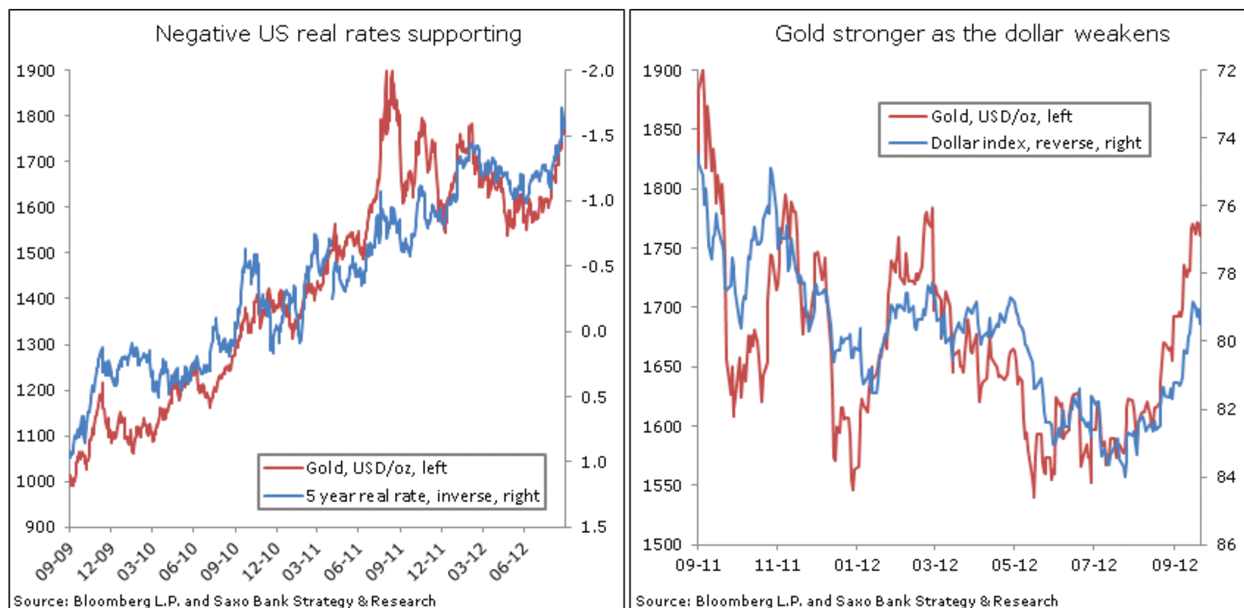
Geopolitics related to Iran have taken a backseat for now but worries about Libya's weak security situation following the attack on the US consulate in Benghazi means that foreign oil workers may hesitate returning to the country thereby putting output at risk. Supply side worries with a price negative impact adds to the confusion as the potential release of oil from strategic reserves still lingers. This is particularly so in the US, where persistently high gasoline prices are

a worry for President Obama as we hit the business end of the US presidential election campaign.

With the 200 day moving average at 111.80 USD/barrel on Brent crude (first month cont.) broken, I will be looking for a new trading range to be established between that and support at 107.00. Hedge funds and other leveraged accounts have been forced out of recently established long positions and are probably not that desperate to get back in unless we see a snap recovery back above 111.80. For now though the risk seems skewed to the downside due to the risk of additional position reduction, potentially down to 103.72 being the 50 percent retracement of the June to September rally.

Gold and silver consolidating before the next move

Following the announcement of QE3, two of the expected main beneficiaries of such a stimulus injection, gold and silver, actually spent the week consolidating. This made good sense considering how far the two metals had already rallied ahead of the event. As it turned out, support around 1760 on gold and 34 on silver was established. With the euro climbing back above 1.3000 against the dollar, they both finished the week on a strong note with both looking poised to push higher over the coming weeks.

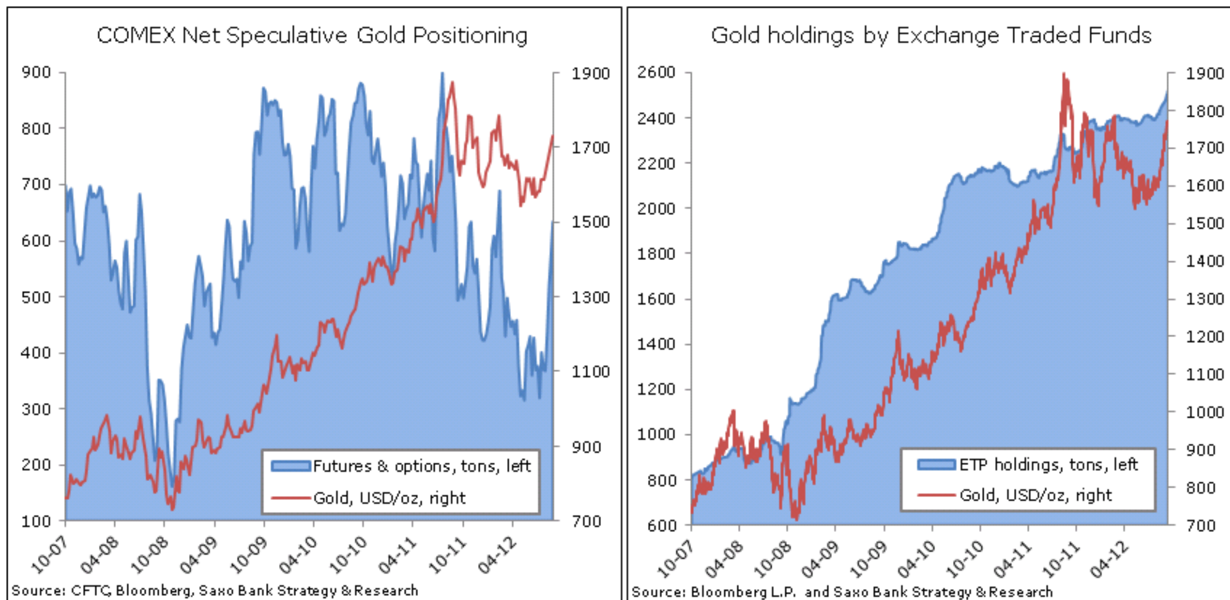


Negative real rates and weaker dollar supports

One of the supporting side effects of the additional and open-ended stimulus announced by the US Federal Reserve has been a rise in the future inflation expectations, which again has seen real US rates move further into negative territory, thereby supporting a non-coupon or dividend paying asset like precious metals. The weaker dollar over the last month as seen above has also been offering support.

Strong investment flow outweigh lower physical demand

As we have mentioned in previous updates, one of the missing parts that was required in order to see gold move higher was the return of hedge funds and other leveraged investors. Holdings in Exchange Traded Funds have continued to reach new record highs, with some 92 metric tons having been added over the last month to a current total of 2,524 metric tons according to calculations made by Bloomberg. It was not until gold broke out of its month long range that hedge funds finally engaged and as the graph below shows once they get involved they mean business. In just one month, the non-commercial net long position of gold futures and options on COMEX has risen by 267 metric tons to 634 metric tons. This is still 30 percent below the record set one year ago when gold peaked at 1,921.



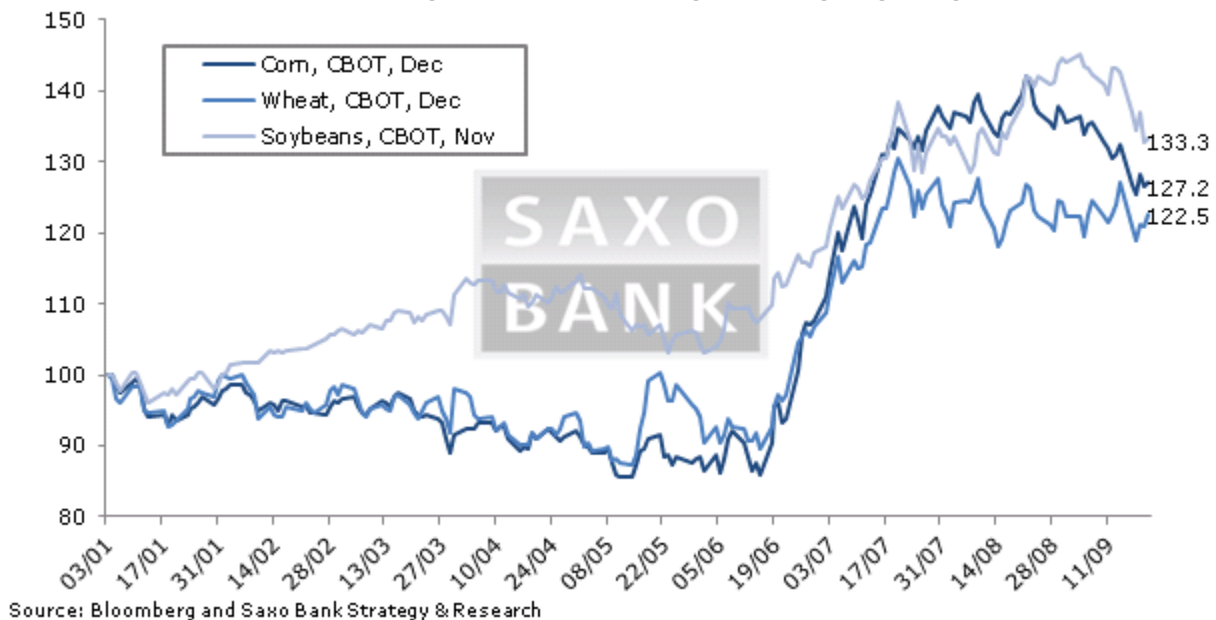
Platinum mining strikes ending but support persist

Platinum saw its biggest one-day drop since March as the nearly six-week-long strike at Lonmin's Marikana mine, which at one stage triggered a massacre of workers, came to a close after workers agreed to much improved pay conditions. While this could be the beginning a calmer situation, it does carry the risk of similar demands and disputes arising at the other major platinum mines.

Over the past six weeks, platinum recovered most of what was lost during the previous six months. The question now is how much of the 300 dollar price gain will be given back following the Lonmin settlement. Not much is our initial thought, due to several factors. The most important is its link to the other precious metals, where additional gains are expected in the coming weeks and months. Furthermore the strike and shut-down of production have left the global surplus greatly reduced and going forward, the feeling is that some risk premium needs to be priced into platinum, given its high dependency of supplies from South Africa. New demands for higher wages are likely to occur on a regular basis. This will erode profitability for mining companies, and could impact their future investment plans, thereby putting supply at risk.

Grains hit by profit taking but supply worries lingers
Following the most recent production updates from the US Department of Agriculture, grain prices have eased helped by projections that late rain during August may have improved yields on soybeans and corn. Indications have also emerged that demand destruction caused by higher prices have started to be felt. Recent export data on US produced corn showing sales dropped to one-eighth of the level seen a year earlier, and this helped trigger the biggest weekly loss in three months.

The near-term worry, however, centres around wheat, as the Russian government continues to send out conflicting signals on whether export restrictions will have to be implemented following a summer drought that has seen yields slump by 25 percent. Such a ban was last introduced in 2010 and hurt Russia's credentials as the world's third biggest exporter. Ministers have clearly been trying to avoid a repeat, but as domestic prices continue to rise and stocks dwindle, it may only be a matter of time. Should such a ban be implemented, it will add upside price pressure on European and American produced wheat, as buyers in the Middle East and North Africa will have to look elsewhere than Russia for supplies.



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