

November 17, 2006

## GLOBAL SLOWDOWN AHEAD: SHOULD WE EXPECT A DRASTIC CORRECTION IN RAW MATERIAL PRICES?

### Introduction

Prices of raw materials have risen substantially in recent years, well beyond the expectations of most analysts. With the current slowdown in the American economy, many people expect the demand for natural resources to decline. Already, oil prices have dropped dramatically over the past two months, and the cyclical nature of metal prices leads us to believe that they too are about to undergo a correction.

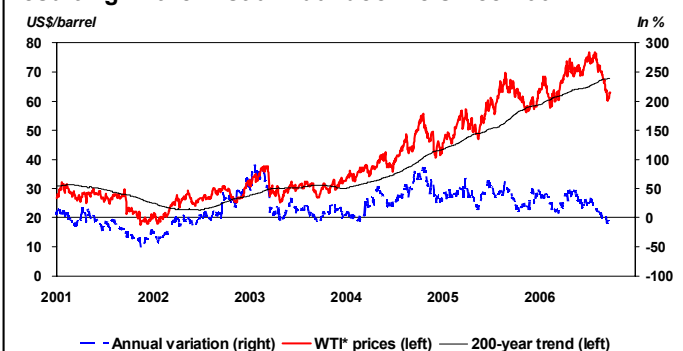
In this issue of *Economic Viewpoint*, we will not re-open the subject of the potential damage that high oil prices could have on the economy, which has been thoroughly discussed already. Instead, we will examine the idea, expressed more and more widely, that the increase in natural resource prices is not exclusively attributable to the increase in world demand, but also to a problem of supply. We will show that structural changes, relating to the growing scope of demand in Asia, as well as to gradual disinvestments in exploration over the past few decades, suggest that real prices of natural resources will not come back down to their long-term trend.

In the short term, we will not escape a correction, but the increasing size of the Chinese and Indian economies leads us to believe that the United States is no longer the only country influencing world prices. We therefore remain optimistic: the correction in raw material prices, which is likely to be short-lived, will be merely a prelude to the continuation of the upward trend observed in recent years. In these conditions, any period of softness presents an opportunity to increase portfolio positions, especially in energy, just now, and eventually in industrial metals.

### A slight correction in the short term...

Raw material prices have shown dizzying growth in recent years. From a low point of US\$18 per barrel at the beginning of 2002, oil prices have more than quadrupled, reaching a record of US\$78 per barrel on July 14, 2006. More recently, however, crude prices have faltered considerably, declining by nearly US\$20 per barrel in the space of two months. This first annual price drop since 2004 is due in part to less vigorous demand, but more importantly, to the dissipation of several tensions affecting oil supply (Graph 1). These include the end of the conflict between Hezbollah and Israel, the nuclear program in Iran, fewer serious weather events in the Gulf of Mexico and, in particular, exceptionally high oil inventories in the United States.

**Graph 1**  
**Oil prices have dropped sharply lately, resulting in the first annual decline since 2004**



Sources: Datastream and Desjardins, Economic Studies

Overall, metal prices have not risen at the same pace as those of oil, but they have nearly tripled since 2002, and some of them, especially copper prices, have increased

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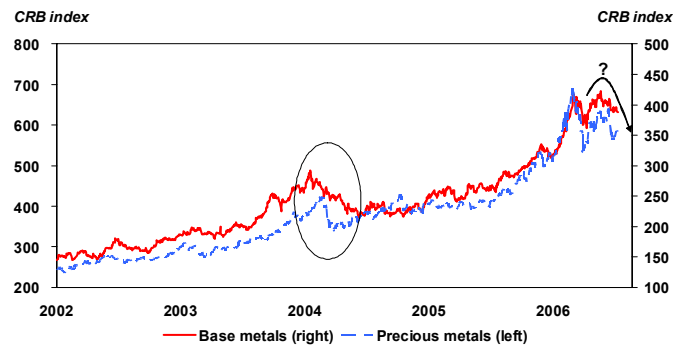
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at a practically exponential rate since the end of 2005. In recent months, precious metal prices have followed oil's lead and have lost the gains achieved in the spring of 2006, but base metals are continuing to defy the law of gravity (Graph 2). However, recent developments suggest that the winds may be about to shift.

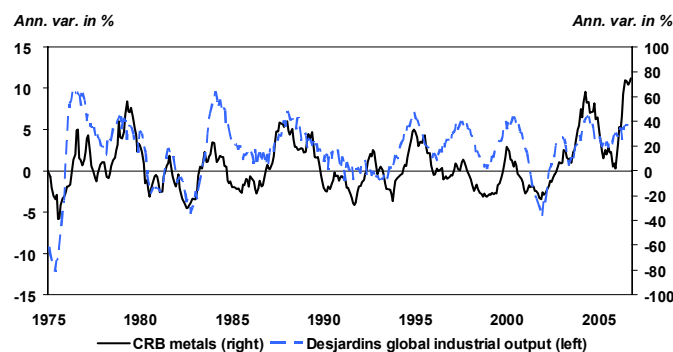
**Graph 2**  
The correction in metal prices:  
a repeat of 2004, or something more drastic?



Sources: Commodity Research Bureau and Desjardins, Economic Studies

We must remember that raw material prices move in cycles (Graph 3). Due to the rigidity of supply in the short term, an increase in economic activity tends to exert upward pressure on prices. Higher prices encourage producers of natural resources to increase their investment spending, but the adjustments are very gradual. Meanwhile, the industrialized economies enter the expansion phase of their economic cycle. Economic growth is then slower, demand declines just when the supply is at its maximum, and raw material prices suffer a downward correction.

**Graph 3**  
Metal prices are very cyclical

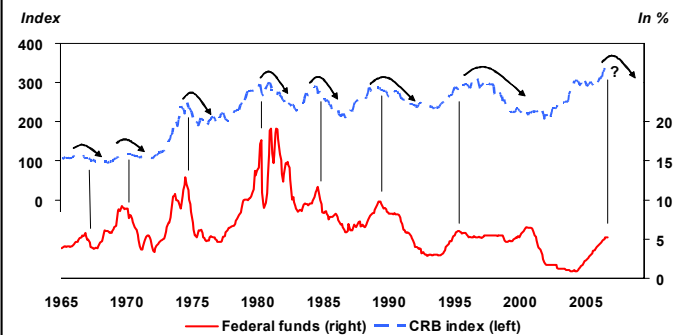


Sources: Commodity Research Bureau and Desjardins, Economic Studies

Historically, this has nearly always coincided with the end of the U.S. Federal Reserve's monetary tightening

policy (Graph 4). Now, with the slowdown in the American economy already apparent<sup>1</sup>, there is every reason to believe that the Fed has probably finished raising its key rates, and therefore a period of weakness lies in store for raw material prices.

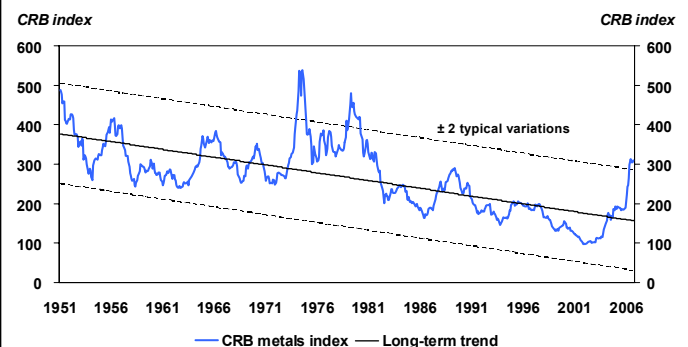
**Graph 4**  
A pause by the Fed generally coincides with a decline in raw material prices



Sources: Commodity Research Bureau, American Federal Reserve and Desjardins, Economic Studies

Furthermore, from a long-term perspective, recent trends in raw material prices, which are looking more and more like a bubble, seem unsustainable. In the past, real prices have fluctuated around a general downward trend, and the few episodes of strong growth have always been followed by corrections that pushed prices back in line with the long-term trend (Graph 5). The current situation should not be any different.

**Graph 5**  
Real metal prices have been following a downward trend for more than half a century

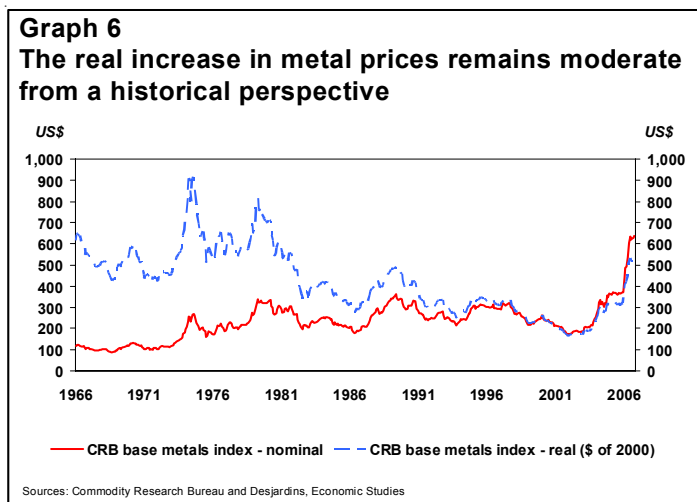


Sources: Commodity Research Bureau and Desjardins, Economic Studies

<sup>1</sup> The American real GDP growth decelerated from an annualized quarterly rate of 5.6%, in the first quarter of 2006, to 2.6% and 1.6%, respectively, during the next two quarters.

... but an upward trend over the long term

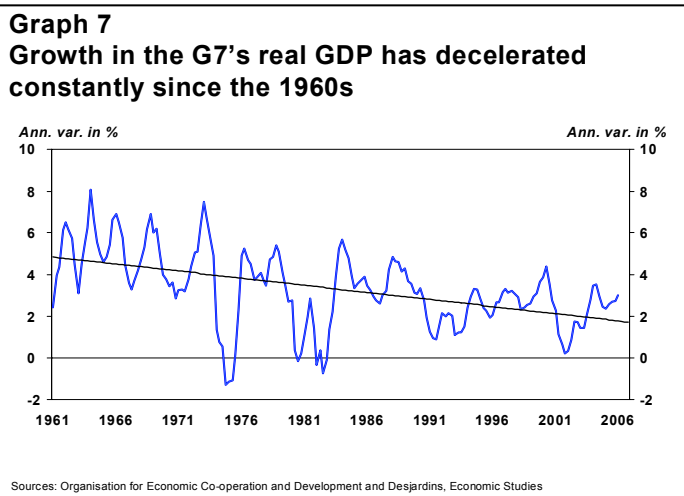
In fact, nothing is less certain. True, the price of raw materials has exploded in recent years, but if we take inflation into account, the levels recorded recently are barely higher than their historical average and are still weak compared to the heights reached during the oil crisis of the 1970s (Graph 6). Furthermore, even if a correction does occur, several forces currently at work lead us to believe that basic raw material prices will not resume their downward trend in the years to come. This is partly due to significant structural changes in terms of both demand and supply.



On the supply side, we noted massive disinvestment by resource producers during the 1990s, when expectations of a strong rebound in economic growth after several decades of deceleration in the most industrialized countries were not fulfilled (Graph 7)<sup>2</sup>. The faster pace of economic growth since the American recession of 2001 and the increase in resource prices should encourage some companies to move forward with exploration and development, but it will take several years of sustained growth in raw material prices to reverse the trend. We must bear in mind that adjustments take time, since it can take an average of eight to ten years to get a mine up and running.

Furthermore, as far as oil and minerals are concerned, new discoveries are often made in places that are difficult to reach, with unstable political and economic

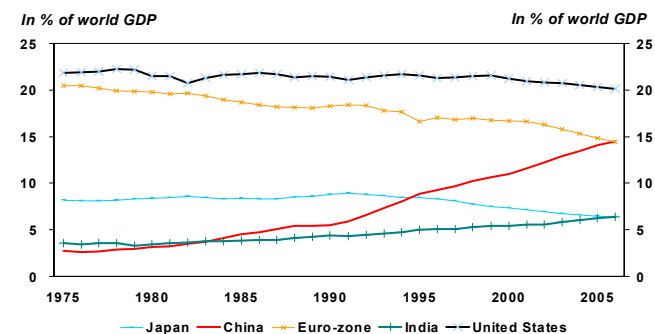
<sup>2</sup> Economic growth was particularly weak during the first half of the 1990s, and just as it was starting to rebound, the Asian crisis hit hard, strongly hurting demand for raw materials.



situations. Therefore, even though many resource companies have benefited from the global increase in raw material prices to the point where they were swimming in record profits, they have tended to favour paying dividends to shareholders, redeeming shares or acquiring competitors over investing in exploration and expanding their production. The numerous mergers and acquisitions that have occurred around the world since the beginning of the year are a good example.

On the demand side of the equation, the structural change reflects the rapid industrialization of the Asian economies. In the last century, the oil and mining industries tended to base their growth forecasts on the economic activity of the United States, the world's largest player. It is now clear that the contribution to global economic growth resulting from the phenomenal advance of the Asian economies, in particular China and India, has been underestimated in recent years. This is partly due to the fact that although China's economic growth has remained relatively stable, at nearly 10% over the past 15 years, its contribution to the world's GDP has been practically exponential. After doubling its weight from 1975 to 1990, its importance to the planet nearly tripled during the next 15 years, growing from 5.5% of world GDP in 1991 to 14.6% in 2006 (Graph 8). China is now ahead of the Euro zone and stands in second place behind the United States. India's progress has not been as rapid, but if its weight is added to that of China, the combined China-India block is estimated to account for 20.9% of world GDP in 2006, a larger proportion than that of the United States, which has fallen from a height of 22.3% in 1978 to 20.1% in 2006.

**Graph 8**  
China's weight in the global economy has grown practically exponentially since 1990

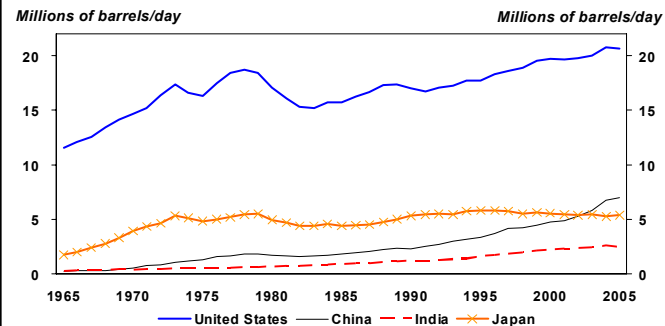


Sources: The World Bank and Desjardins, Economic Studies

With its growing economic weight, Chinese demand will be influencing the raw materials market for some time to come. One must understand that China is just getting started in its consumption of both oil and metals (Table 1). As far as oil is concerned, Chinese consumption already far exceeds local production, and the volume of oil imports is continuing to grow by double digits from one quarter to the next. Consequently, China, whose nearly 17% increase in oil consumption accounted for more than a third of the global increase in 2004, has outstripped Japan as the second highest consumer of crude (Graph 9). Moreover, access to credit, the development of the road network and the marketing of low-cost automobiles mean that the growing number of cars—still relatively small compared to the size of the population—is expected to explode in the next few years.

The same story applies to metals. True, China's demand for basic materials has slowed somewhat due to the government's efforts to prevent overheating in certain

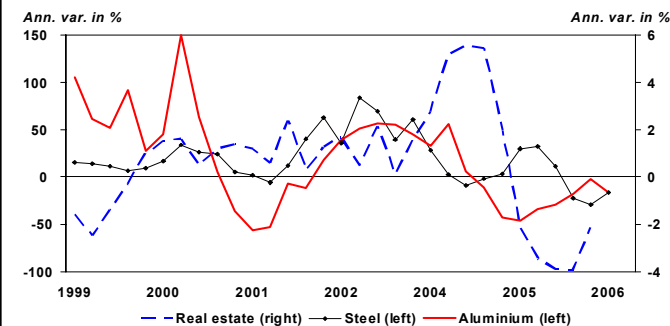
**Graph 9**  
China is the world's second largest consumer of oil



Sources: British Petroleum and Desjardins, Economic Studies

economic sectors deemed to be at risk, such as real estate; but the industrialization of the country is just getting started, and demand will continue to make itself felt for many years to come (Graph 10).

**Graph 10**  
The slowdown in the real estate sector has led to a decline in metal imports...



Sources: Statistics Bureau of China and Desjardins, Economic Studies

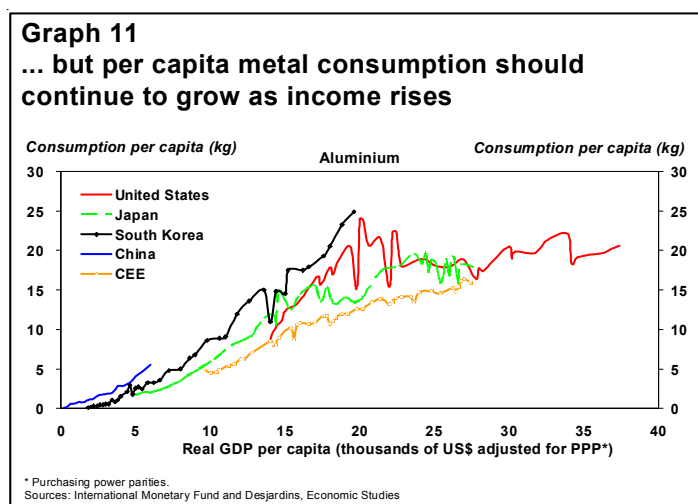
**Table 1**

**Raw material consumption per capita**

	Aluminium (kg)	Copper (kg)	Steel (kg)	Oil (barrels)
United States	20.6	7.7	411.5	25.3
Euro zone	15.9	9.5	366.4	13.5
Japan	17.8	9.6	602.1	15.3
South Korea	24.9	17.7	981.7	17.4
China	5.5	2.8	209.2	2.0
Brazil	4.1	1.8	100.9	3.6

Source: International Monetary Fund, British Petroleum and Desjardins, Economic Studies

This is mainly reflected in the relationship between income and consumption of raw materials. Normally, we note that consumption tends to increase until such time as income reaches approximately US\$25,000 per capita. This was the case in the United States and in Japan, where the post-industrialization of the economy has caused metal consumption to reach a ceiling (Graph 11). China, on the other hand, where per capita income is still very low, promises to keep prices up at around today's high levels, especially since, like other Asian economies such as South Korea, China is more metal intensive.



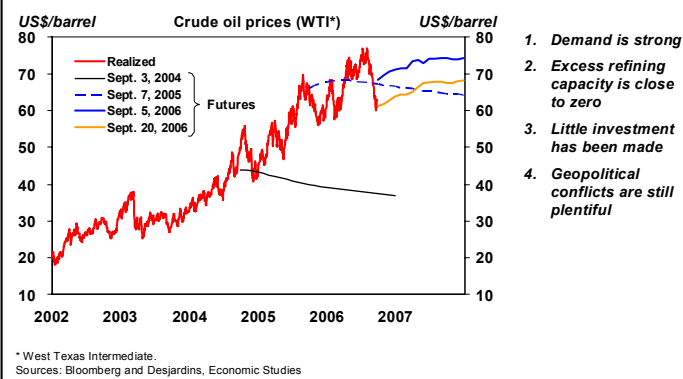
## Conclusion

In the short term, it seems clear that raw material prices are headed for a period of weakness. The correction in oil prices appears well advanced, however, and we anticipate a rebound soon. In fact, the futures market shows that crude prices are more likely to rise than to fall (Graph 12). One reason is that excess refining capacity is getting increasingly slim, and any disruption in supply and transportation will result in price increases. Base metal prices are still surprisingly strong, but as the American economy slows down, they should follow oil's lead and experience a correction soon. However, due to the shift of economic growth from the United States to Asia, the world economy should remain strong from a historical perspective, which should allow raw material prices to decline to a more moderate degree than in previous ends of cycles.

In the longer term, many resource companies will be encouraged to increase their production. Still, the ongoing industrialization of China and India, combined with an economic recovery in the United States, will likely cause

demand to increase faster than supply over the next few years. In these circumstances, we estimate that resource prices may resume their upward trend around the end of 2007.

**Graph 12**  
 Upside risks remain



We therefore remain optimistic. Given the correction in oil prices, this strikes us as a good time to replenish portfolios with energy stocks. It is still too early to build up positions on basic materials, but we recommend taking advantage of periods of weakness to increase long positions. The positive impact of a potential rebound in raw material prices (both energy-related and non-energy-related) on the loony leads us to favour the Canadian market. Based on this outlook, it is likely that, after a decline at the beginning of 2007, the Toronto Stock Exchange will experience some good years of growth.

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