



Financial markets & gold

We maintain our bearish outlook for gold. Although Fed funds futures have priced in a normalisation of US policy at various points since 2009, we believe the first step will now more likely than not take place this month. Moreover, a tightening cycle in US monetary policy is regarded as long overdue based on the Taylor rule, with a strong likelihood of further steps in the new year.

While a 25 bps hike in December may have little impact for precious metals given the strength of market expectation, we also expect three more rate hikes in 2016. If realised this would be a meaningful departure from the currently priced expectation and consequently, more negative for precious metals. We reference the impact to gold prices of the rise in market expectations of a December hike from 30% in October to more than 70% currently, Figure 6.

By the same token, a disappointment of the market expectation for the first rise in nominal US rates since 2006 would be positive for gold as we believe it would have to be accompanied by either a systemic risk event, a sudden and dramatic deterioration in growth prospects, or else the shock that market participants have miscalculated in some other way.

Industrial metals: Supply rebalancing gains momentum

The barriers to exit in many metals markets are high. These barriers range from the need to cover high fixed cost bases, take-or-pay supply contracts; pressure and incentives from governments to maintain employment and balance current accounts to a struggle for survival. 2015 did however mark the start of the supply curtailments in response to low and falling prices. There are some differences between the oil and the metals markets however. In the case of oil, demand was reasonably robust, and the oversupply was driven by a supply glut. In metals, the industry still has to adjust to structurally lower Chinese demand while long gestation projects continue to add tonnes to the market.

We think the critical mass in this adjustment process will come in the latter half of 2016 for oil, but not so for the industrial metals. In the industrial metal complex, it was only toward the end of 2015 that any significant capacity cuts have been announced. Glencore has taken the industry lead in the base metals, with cuts of 500kt in mined zinc (c.3.5% of the market) and copper (c.2% of the market). In aluminium Alcoa announced cuts of 500kt (1% of global supply), but we think more cuts from China is needed to be truly effective. More recently, Chinese smelters (copper ~200kt, zinc ~500kt and nickel ~120kt) announced a raft of cuts. These are partly in response to cuts by the miners in our view however. The magnitude of these cuts is not sufficient to support prices, except for potentially the Nickel market. In comparing the supply response during the global financial crisis, it was only when the cuts exceeded 10% of the market that prices started to find a floor. We see supply cuts gathering momentum in 2016, but the market will be wary of producers reversing their decision at the first sign of a price recovery. The adjustment process this time round will be much slower than during the GFC, and we only expect a price stabilisation in 2017, when the markets should start to look more balanced.

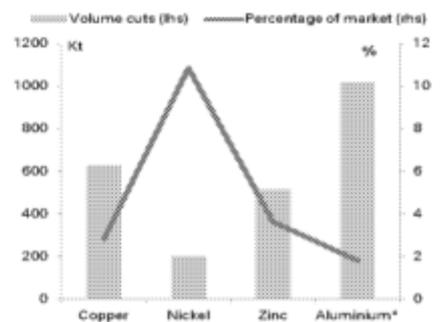
The demand outlook for oil remains healthier than that of the industrial metals. This statement deserves some clarification. In absolute terms the demand growth in many metals is likely to be higher than that of oil; however the rate of growth in many metals is likely to be half the rate seen over the past five years. Oil demand is likely to be only marginally lower over the next five years due to the more price elastic response and the fact that oil demand growth is much less sensitive to the Chinese economic slowdown. The net result is that although we forecast metal demand growth to remain positive, producer and indeed market expectations are still too high in our view. The slowdown in

Figure 6: Gold downside to result from US Fed normalisation



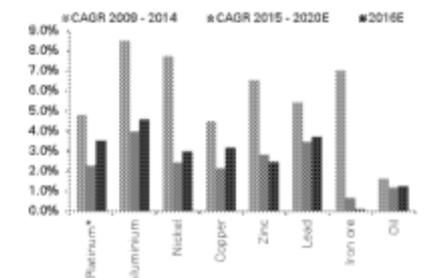
Sources: Bloomberg Finance LP, Deutsche Bank Research

Figure 7: Base metal production cuts as a percentage of the market



Note: *excluding Chinese capacity cuts as net additions for outweigh closures
Source: Deutsche Bank Research, Company Reports

Figure 8: Metal and oil demand growth forecasts



Note: *excludes investment demand
Source: Deutsche Bank Research, Wood Mackenzie