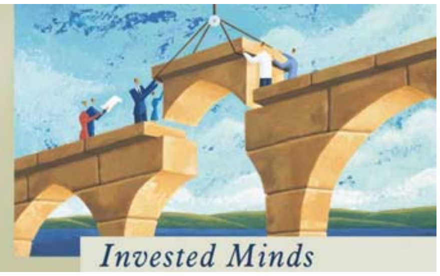
Market Insight

TAL Global Asset Management Inc.



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Energy and Commodities: Flip and Flop

Crude oil hit a 52-week high of $41.55 on May 17. Only the energy sector is bucking a quarter marked by unpredictability and uncertainty. Commodities, on the other hand, once so positive, fell heavily after indications China wanted to clamp down on its burgeoning economy.

"Nobody would have predicted that energy prices would be at $40," says Frank Settino, analyst on the TAL Global Asset Management global equity research platform covering the energy and the utilities sectors. "As we moved into the second quarter, we actually expected a weakness in the demand for crude oil."

Typically, there is less demand for oil after the winter, but there has not been this level of seasonal demand in 15 years. At the same time, U.S gasoline inventory demand coverage is at a five-year low just as driving season gears up and the demand for gasoline is strongest. Demand for gasoline in the U.S. has gone up by 3% year-over-year, well above what is usual, as evidenced by the way gasoline prices have spiked at the pumps in the U.S. and Canada.

Since OPEC, the Organization of Petroleum Exporting Countries, is producing at historically high rates and building inventories, we would expect prices to moderate. However, the risk of supply disruption in Iraq and unrest in Saudi Arabia has combined to add a significant price premium. The geopolitical risk is higher than it has been in the last 15 years, and as a result, prices are exaggerated well above what was expected. "Given the turn of recent events, I expect prices to remain high," Frank Settino says. "However, because markets are discounting higher commodity prices than they have in the past, I am neutral on the sector."

"Speculators and hedge funds have taken a very large position in oil and if they decide to unwind it to take profit, we will see a pullback in prices, as we did for metals," Settino says.

Many investors who left the commodities sector after China announced its intent to slow the economy are unlikely to return in such strength and have the same upside influence on prices. "Commodity prices have further room to fall as speculators continue to liquidate their positions," says Diana Racanelli, vice president of global equity research at TAL responsible for the coverage of the basic materials sector.

One reason for the correction in the base metals market has been concern that attempts by the Chinese government to slow their economy will reverse China's appetite for commodity imports. That fear, combined with the strength of the U.S. dollar, has led to the deep commodities sell off. Despite efforts to slow the economy, the growth of industrial production in China was 19.2% in April. It may take months of data to see if a soft landing can take effect, Racanelli says.

Recently both inventories and prices of base metals have declined. However, physical demand remains strong leading to inventory draw downs, with supply deficits still expected in nickel and copper. Aluminum, generally the most balanced of the base metals, might also end 2004 in a slight deficit position.

For the boom in commodities to be truly over, there would have to be a sharp slowdown in the economic growth of both China and the U.S., in which case fundamentals would play a bigger role. If this does happen, Japan which exports to China will also slow down. Nevertheless, we are heading into a seasonally slow period for base metals. This, combined with the fact that investors are taking a wait-and-see approach with respect to China, may lead to a further drop in commodity prices over the summer months. An increase in U.S. interest rates could provide the impetus for another drop in prices and present an opportunity to selectively buy into the sector.