

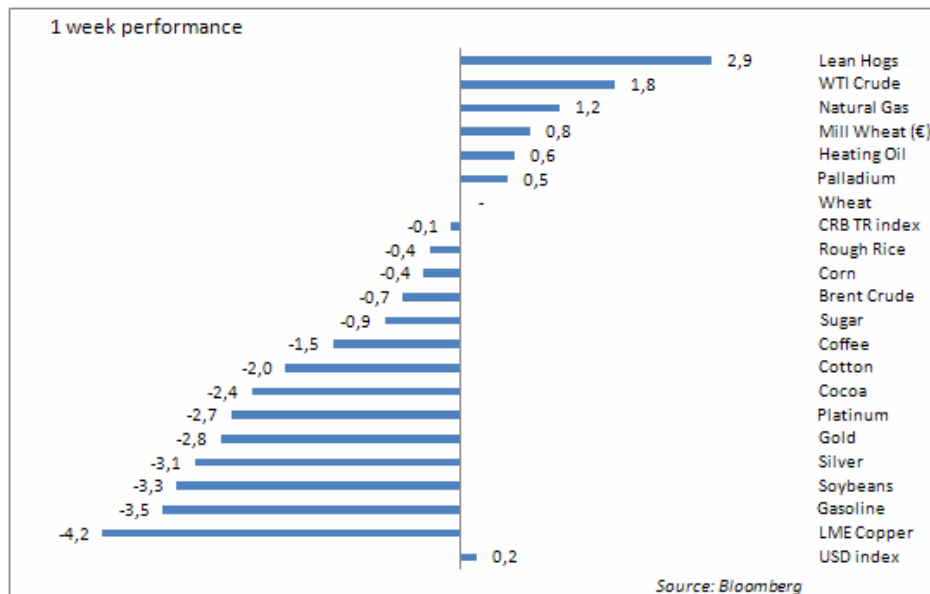
Crunch time for Europe and commodities

By Ole S. Hansen, Senior Commodity Strategist

The optimism that drove stocks and commodities higher last week has evaporated on increased concerns that European leaders at this weekend summit in Brussels will fail to deliver a workable solution to the Eurozone debt crisis. Several differences have emerged between Berlin and Paris and policymakers are working frantically to find common ground ahead of the weekend.

Failure to deliver workable solutions could reignite worries about an already fragile banking system and bring back talk of recession. Talking about the near-term direction of commodity markets is therefore very difficult at this stage and another commodity update will follow on Monday when we hopefully will be a bit wiser.

Our two major markets gold and crude oil continue to be range bound with both testing and failing at the higher end of their respective ranges this week. The selling of dollars seems to have stopped for now as attention turns to Europe. This combined with a slowing Chinese economy has removed some of the recent support for commodities.



Not a good technical week for gold

Gold traders are scratching their heads as gold continues to behave like an ordinary commodity moving up and down in line with other riskier assets. This is beginning to trouble those who bought the metal for protection from the economic uncertainties that the world is currently facing. This has, at least for now, moved the initiative for price movements to technical traders who are now looking for a deeper correction after the sharp 70 dollar sell-off earlier in the week, which followed the failure to breach resistance at 1,700 dollars.

Critical support is now located below 1,600 dollars which also coincides with the level where physical demand was observed last time round. A break below 1,583 carries the risk of deeper correction back towards 1,551 (200-day moving average) and 1,500 which is the 55 week moving average. This line has on numerous occasions supported the decade long rally and was last touched two and half years ago.



Oil rally fades ahead of resistance

WTI and Brent crude also reached but failed to breach important resistance levels indicating that a prolonged period of range trading can be expected while we wait for further clues about the future demand situation. WTI crude almost reached 90 dollars on Wednesday after a surprisingly big draw in inventories, which turned out to be driven by lower imports not consumption. It then only took a somewhat subdued U.S. Beige book for the market to drop nearly four dollars showing its still fragile state.

China slows and industrial metals tumble

Amid all the nervousness about the outcome of the European summit this coming weekend another important piece of news reached our screens this week. China, the world's second largest economy but the biggest consumer of anything from industrial metals to soybeans and cotton grew at the slowest pace since 2009. The economic slowdown among developed nations has begun to bite as weaker export demand combined with monetary tightening slowed the growth to 9.1 percent in the third quarter from a year earlier.

The copper market, which had already been shaken by recent data showing higher than expected Chinese inventory levels received another blow from the growth data resulting in a 10 percent retracement since Monday. The price of high grade copper in NY fell to 3.13 dollars per pound and a test of the 3.00 low from early October cannot be ruled out.

Chinese iron ore prices experienced the biggest decline in 15 months as they finally began to react to depressed demand and subsequent falling prices of steel. Chinese steelmakers have

been under pressure for a while as stock piles reach record levels and prices have dropped to a 10-month low. Several factors have caused this setback: demand from the railway sector has dropped as the government suspended 80 percent of new railway projects combined with the completion of many other projects also reducing demand. Tightening credit is making funding for new projects difficult which also impacts demand. The chart below shows how the price of Chinese imported iron ore fell to 147.7 dollars per metric tonne after reaching a record of 192 in February.



Sugar defying gravity

The price of sugar rose strongly earlier this week adding to the confusion surrounding a commodity which is facing its biggest supply glut in at least four years. The price of ICE NYBOT sugar for March delivery is up 12 percent year to date after rallying strongly over the past month. That makes it one of the best performing commodities in 2011 and it comes at a time where higher production is being expected from most of the major producing nations. The near term prospects for reduced supplies due to the worst flooding in half a century in Thailand, the world's second largest exporter, has been the main focus over the last couple of weeks. It could potentially delay and in the worst case damage some of the crop.

Red tape causing supply shortages

The U.S. and Europe have been facing shortages as well, not due to limited supply, but more due to red tape. In Europe production has gradually been falling over the years after the World Trade Organisation once accused Europe, then the second-biggest sugar exporter, of dumping subsidised supplies on the world market. Financial incentives have triggered a gradual reduction in production, to the point where imports are needed but punitive import duties add nearly 60 percent to the international price. Meanwhile in the U.S. trade barriers to protect U.S. farmers have caused domestic stockpiles to drop to the lowest levels in half a century after adverse weather damaged the crop this summer.

The bottlenecks above have all helped sugar rally but as prices approached overbought conditions and with the potential for Thailand's crop damage turning out to be less than feared

the market now seems to have peaked and could potentially be heading back down towards 25 dollars per pound, especially considering a world faced with a production surplus of 4 to 5 million tonnes for the 2011/12 season.



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