

# SCOTIABANK COMMODITY PRICE INDICES

## Scotiabank's Commodity Price Index Surges in January

- A classic "commodity price boom" unfolds in base metals.
- Copper prices soar, as fabricators scramble for supplies.
- With G7 demand now picking up, a move to re-stock raw materials will continue to boost commodity prices in the coming year. The need to re-build low inventories is beginning to lift fine paper and linerboard prices in the United States, a positive development for Canadian exporters.

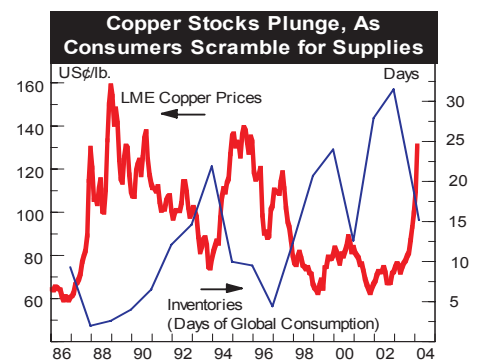
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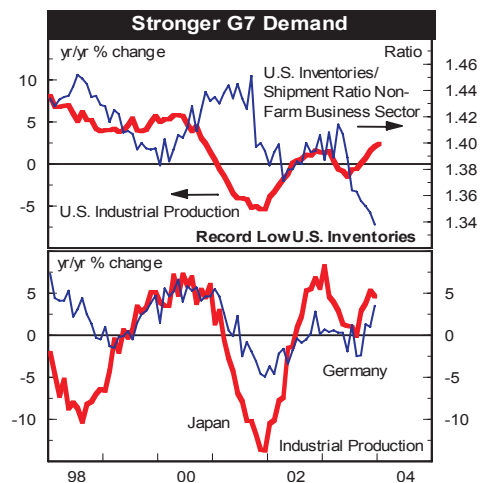
Industry and Commodity Market Research

Scotiabank's Commodity Price Index began the year on a strong note — climbing 7.4% month-over-month in January and 19.1% year-over-year. The Oil & Gas Index led the way for a second consecutive month. West Texas Intermediate crude oil (the key reference price for North America) climbed to US\$34.25 per barrel in January (5% above a year earlier) and remains robust at US\$36 in mid-February — underpinned by OPEC's decision to cut output at the February 10 meeting in Algiers.

The Metal and Mineral Index also posted another strong gain in January and is already well above the previous cyclical high of 1999. With base metal prices still zooming ahead in February, this sub-index will reach the much higher 1995 cyclical peak this month. Global copper markets have tightened dramatically, with smelters buying metal on the LME to cover contractual commitments, in view of recent mine disruptions, constraining copper concentrate supplies. A moderate improvement in industrial activity in the United States, Japan and Germany (+3% yr/yr overall in late 2003), the start of some raw material re-stocking by U.S. fabricators and ongoing strength in China's demand are boosting prices. (Of note is the 7% annualized gain in Japan's fourth-quarter GDP — the result of strong exports to China and a business investment pick-up). The Forest Products Index also rallied back in January, as U.S. dealers bid up lumber and oriented strandboard prices ahead of an expected robust spring building season, and



Inventories: LME, Comex & Shanghai Metal Exchange; year-end data and mid-February 2004. LME stocks have dropped by one-quarter from December 31, 2003.



Data to December 2003-January 2004.

February 20, 2004

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the Agricultural Index recorded a modest gain on strength in canola prices.

## Metals and Minerals

The **Metal and Mineral Index** spurted ahead in January, alongside widespread gains in base and precious metal prices. **LME copper** prices have climbed from just under US\$1 per pound in December to US\$1.10 in January and surged to US\$1.35 in mid-February (+77% yr/yr and the highest level since August 1995). **Prices have recently been spurred — not just by investment fund interest, but rather a genuine scramble by fabricators for available supplies. Chinese buying (largely for physical use) caused the February 18 spike to US\$1.35, though prices have since eased back to US\$1.31.**

**Copper markets moved into deficit last year (i.e. global consumption exceeded refined metal supplies) and the imbalance will widen in 2004.** This is reflected in the recent plunge in visible stocks on the LME, Comex and Shanghai Metal Exchange, with LME inventories dropping by an extraordinary 26% from late December to mid-February. Market conditions are even tighter than exchange stocks indicate, with significant LME volumes already sold (off warrant) and a large portion of available LME inventories concentrated in the warehouse in New Orleans, an area with logistical bottlenecks and high transportation costs to China.

In view of the decline in exchange stocks (caused partly by mining difficulties at Grasberg, Indonesia), a major Chilean company will release its 200,000 tonne copper stockpile (taken off the market in late 2002 during weak market conditions). However, this inventory has already been sold and will be released over 24 months. The re-start of mine capacity at a large U.S. company will also be less than expected.

While copper concentrate supplies should recover in the second half of 2004, as new mine capability is phased in, the pick-up in global demand will likely keep the supply/demand balance snug. **Copper prices are headed irregularly higher.**

**Spot uranium prices also advanced from US\$14.18 per pound in December to US\$15.00 in January and have strengthened further to US\$16.20 in mid-February — very close to the mid-1996 peak of US\$16.50.** Razor thin spot market supplies, with some buyers having difficulty filling orders, and a contract dispute — cutting off significant Russian supplies of UF<sub>6</sub> (natural uranium hexafluoride) to U.S. utilities — have boosted prices. Saskatchewan is the world's largest supplier of primary uranium from mines.

**Zinc prices have also firmed up, after lagging other base metals last year.** LME prices increased from US\$0.44 per pound in December to US\$0.46 in January and surged to US\$0.52 in mid-February (+46% yr/yr) on signs that stubbornly high LME stocks, which continued to build in early 2004, might finally be moving down. Recent prices yield 35-40% profit margins over average Western World break-even costs of US\$0.37 (including depreciation). In 2003, Canada accounted for 8% of world mine output and was the fourth largest producer, after China, Australia and Peru.

Current prices over US\$0.50 are probably ahead of improving fundamentals. However, investment funds are bidding up zinc prices expecting that the global supply/demand balance will shift from last year's surplus into a deficit. Western World zinc demand should pick up modestly by 1.5-2% in 2004, with an expected 2% rebound in U.S. car and light truck assemblies (after last year's 1.5% decline), pointing to a better U.S. market for galvanized steel. Robust demand in China

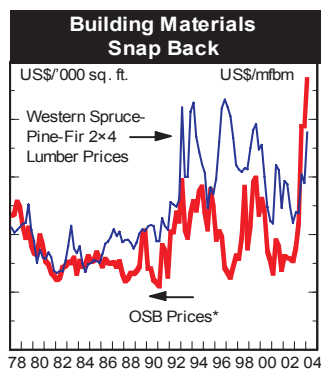
should pull up overall world consumption to 3.5% in 2004, though China's demand growth may slow from 16% in 2003 to 9-10% this year.

Until recently, the potential for high and rising exports of refined zinc from China to the West had restrained zinc prices. However, rapid growth in internal demand actually reduced China's exports from 430,000 tonnes in 2002 to about 380,000 tonnes in 2003 and a further drop is expected in 2004. Power shortages and a reduction in government VAT rebates on exports may further constrain China's smelter output and exports of slab zinc this year. Equally important, tight global supplies of zinc concentrates will constrain world smelter output in 2004, with China's smelters competing for feed with Western World smelters (on the basis of offered prices and treatment charges). Limited concentrate supplies partly reflect last year's temporary closure of the Pillara mine in Australia and production challenges at Antamina in Peru.

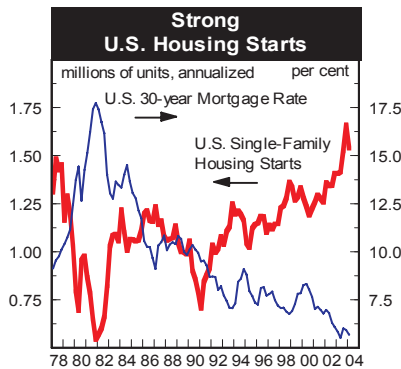
## Forest Products

The **Forest Products Index** picked up in January alongside a strong rally in building materials prices and largely unchanged pulp, paper and paperboard prices. **Oriented strandboard (a popular panel board used in residential roofing and flooring systems) soared by US\$95 per thousand sq. ft. from December to January** (climbing from US\$249 to US\$344 in the bellwether U.S. North Central region). Prices have jumped further to US\$470 in mid-February — approaching the US\$485 peak, when prices surged last autumn. **Western Spruce-Pine-Fir 2x4 lumber prices** also rose from US\$291 per mfbm in December to US\$327 in January and US\$378 in mid-February — well above year-earlier levels of only US\$253.

U.S. dealers have been replenishing their inventories of lumber and OSB, expecting another good year for U.S. home building. Demand for OSB and lumber has been particularly brisk in California. While U.S. housing starts edged down from an annualized 2.067 million units in December to 1.903 million in January — as severe winter weather in the U.S. Northeast and Midwest curtailed construction — a large order backlog for new homes, strong consumer interest in "luxury" homes and mortgage rates at generational lows should keep building activity strong through the third quarter. In the semiannual Monetary



\*OSB U.S. North Central region, 7/16" basis.



Latest data January-February 2004.

Policy Report to the Congress, the Chairman of the Federal Reserve Board indicated that, with inflation low and substantial slack in the economy, the Fed can be “patient” in removing its current policy accommodation. U.S. housing starts are expected to total 1.82 million units in 2004 — only slightly below last year’s 1.85 million (the highest since 1978). Single-family starts in 2003 were at a record high of 1.5 million units.

**Pulp prices also began to climb again in February, after holding up much better than expected in January, and should rally through 2004. Global supply/demand conditions for northern bleached softwood kraft pulp (NBSK) appear to be genuinely tight, with orders from South Korea and China still strong in early 2004 (due to buying ahead of the Lunar New Year holiday), and some signs of an improvement in European paper demand. Production difficulties at some North American mills (e.g., linked to cold weather in the B.C. Interior) have also tightened NBSK supplies. NBSK producers will likely be successful in boosting prices by US\$20 to US\$600 per tonne in the United States, and by US\$30 to US\$590 in northern Europe in February — yielding moderate profit margins for B.C. Interior producers. A further weakening of the U.S. dollar against the euro since late 2003 has facilitated the European price increase, with the US\$30 gain only translating into 4 euros.**

**On an equally positive note, prospects appear good for near-term price gains for uncoated freesheet paper and linerboard in the United States — the first increases since mid-to-late 2002 — and a welcome development for Canadian exporters.**

U.S. papermakers report a marked pick-up in orders for uncoated freesheet paper from late December through February — triggering announcement of a US\$40-60 per ton price increase for cut-size copy paper, offset rolls and form bond from mid-February or March. The recent order surge likely reflects some re-stocking by paper merchants, expecting higher prices this year. Commodity-grade rolls of No. 3 offset paper had fallen to generally unprofitable levels by late 2003.

**A nascent recovery is also underway for linerboard.** U.S. box shipments rose by a strong 4% year-over-year in December 2003, limiting last year’s decline in annual shipments to only 0.1%. A moderate recovery in U.S. manufacturing and the

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February 20, 2004

Growth Trends (per cent change at annual rates)						
	Weights	One Month	Three Months	One Year	Five Years	Ten Years
<b>All Commodity Price Index</b>	<b>100</b>	<b>135.9</b>	<b>62.8</b>	<b>19.1</b>	<b>7.6</b>	<b>2.9</b>
<b>Industrials</b>	<b>83</b>	<b>163.6</b>	<b>67.9</b>	<b>22.8</b>	<b>8.4</b>	<b>3.6</b>
Forest Products	40	114.7	12.6	26.6	0.3	0.0
Metal and Minerals	27	79.3	81.6	27.8	8.3	3.1
Oil and Gas	16	359.3	146.0	15.3	24.2	10.4
<b>Agriculture</b>	<b>17</b>	<b>21.2</b>	<b>35.4</b>	<b>0.7</b>	<b>3.1</b>	<b>-0.3</b>

Index 1997 = 100					
	2004	2003			
	Jan	Dec	Nov	Oct	Jan
<b>All Commodity Price Index*</b>	<b>123.8*</b>	<b>115.3*</b>	<b>111.7</b>	<b>109.6</b>	<b>103.9</b>
<b>Industrials*</b>	<b>128.0*</b>	<b>118.1*</b>	<b>114.5</b>	<b>112.5</b>	<b>104.3</b>
Forest Products	95.7	89.8	93.9	92.9	75.6
Metal and Minerals	116.8	111.3	104.7	100.6	91.4
Oil and Gas*	224.1*	197.3*	179.5	178.9	194.3
<b>Agriculture</b>	<b>102.8</b>	<b>101.1</b>	<b>97.8</b>	<b>95.3</b>	<b>102.1</b>

\*Natural gas & propane prices are subject to revision.

need to re-stock boxes is pulling up demand. Inventories at U.S. containerboard and box plants fell to 2.425 million tons in late 2003 — down from 2.864 million a year earlier — to the lowest level since 1995.

Stronger demand has encouraged linerboard producers to announce a US\$40-50 per ton price increase for mid-February or March. Prices for 42-lb. kraft linerboard are expected to rise from today’s US\$350 to US\$400 by the second quarter, yielding moderate profit margins.

### Oil & Gas

The **Oil and Gas Index** posted a double-digit increase in January alongside widespread strength in prices for light and heavy crude oil, natural gas and propane. After falling back to US\$32 per barrel in early February, **West Texas Intermediate crude oil** (WTI) has jumped back to US\$36 mid-month. Prices have been lifted by low U.S. crude oil inventories and OPEC’s February 10 decision to rein in March production closer to the current 24.5 million b/d export quota, and to cut the formal quota again by 1 million b/d in April. The OPEC-Ten (excluding Iraq) is now producing 1.5-1.7 million b/d over the quota set back in November.

The cartel had been faced with a dilemma going into the February meeting — the need to signal to oil markets its intention of cutting back actual production in the second quarter (when northern hemisphere demand normally subsides), while avoiding a further near-term surge in already high prices — a development which might derail global growth. The depreciation of the U.S. dollar (particularly against the euro) has eroded the purchasing value of a barrel of crude over the past year — heightening OPEC’s determination to defend its “reference” price (a basket of seven crudes) at or slightly above the high end of a US\$22-28 target range. OPEC’s basket of crudes is also skewed towards sourer, heavier grades and the price discount off WTI (a very light, sweet grade) has widened.

From OPEC’s perspective, the agreement — worked out at the meeting — appears to be an effective one. However, to keep prices from sliding in the spring, Saudi Arabia and other OPEC members will actually have to cut shipments in March and April — with Persian Gulf tanker loadings closely monitored by traders. So far, there appears to be no reduction in March crude allocations to key OPEC customers. OPEC will meet again on March 31 to re-assess

market conditions and the need for the April quota reduction.

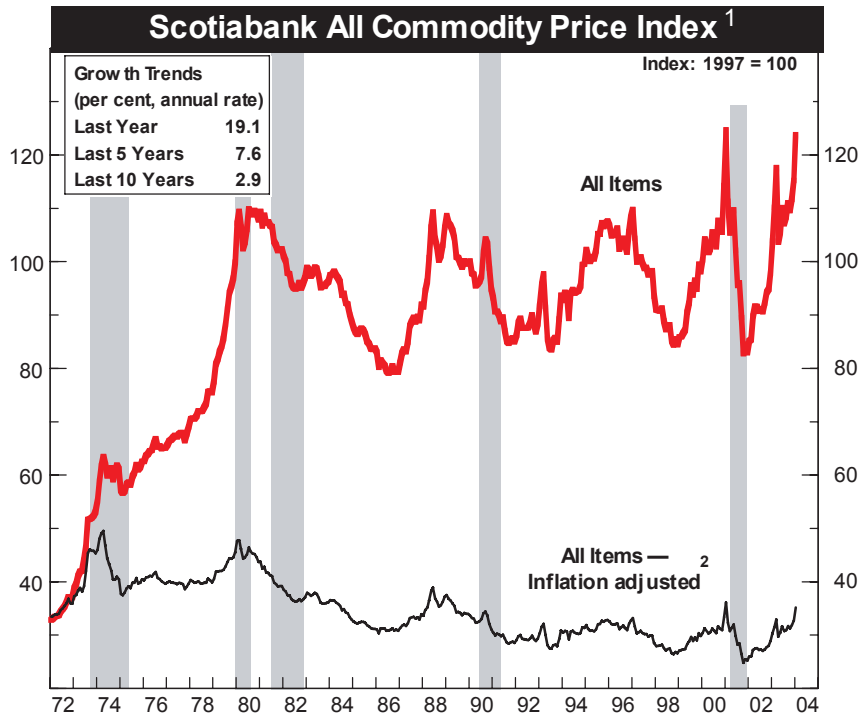
Turning to **natural gas**, estimated Canadian export prices rose by US\$0.86 per mcf in January — buoyed by strong bid prices at the turn of the year — and despite a slight decline in Nymex prices. Temperatures in the U.S. Northeast were 6.5 degrees Fahrenheit colder than normal in January — keeping both Canadian export and Nymex prices well above a year ago. With warmer weather in February, Nymex prices have eased back from January’s US\$6.27 per mmbtu to an average of US\$5.43. U.S. natural gas-in-

storage is currently at normal levels for this time of year.

**Agriculture**

The **Agricultural Index** rose in January to a level just above a year ago. While canola and hog prices led the advance, small gains were also recorded for wheat and cattle — more than offsetting a decline in barley. **Canola prices (No. 1 grade in store Vancouver)** climbed from US\$284 per tonne in December to US\$295 in January — moderately above US\$279 a year ago. However,

recent price increases for canola have been far less than for U.S. soybeans (an alternative oilseed) — encouraging Mexico to double its purchases of Canadian canola so far this crop year. China has also purchased 350,000 tonnes of canola from Canada in 2003-04, with another 100,000-150,000 tonnes on order and additional business possible due to high U.S. soybean prices and limited availability. Canadian canola crush is expected to be the second highest on record, with crushers running their plants close to full capacity.



1. A trade-weighted U.S. dollar-based index of principal Canadian exports.  
 2. Index deflated by U.S. Producer Price Index for Intermediate Goods.  
 — Shaded areas represent U.S. recession periods.