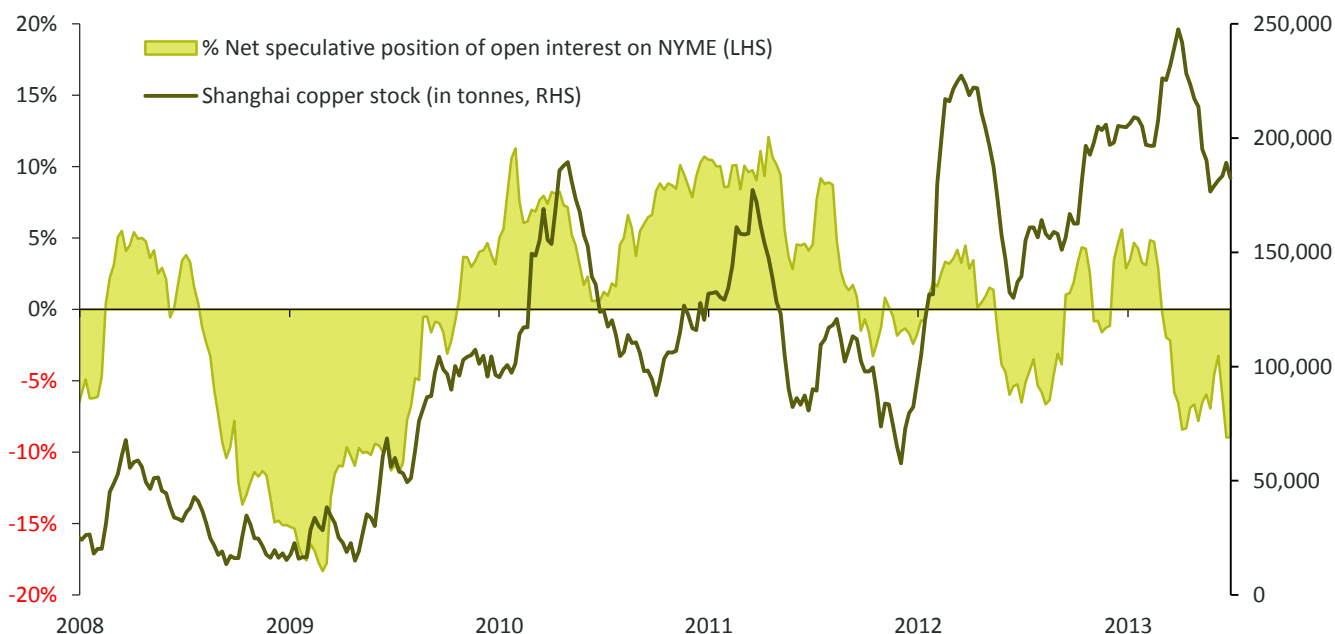


Summary

- The end of cheap credit in China may focus overleveraged base metal producers on cutting costs. The wind-down of copper stocks may have further to go.
- The directional downturn in copper is led by weakening fundamentals. Without policy stimulus, increasing speculative short positions may feed negative sentiment on copper.
- Investors may consider a short leveraged position on copper: buying Boost Copper 3xShort Daily ETP (3HCS)

Copper's weakening fundamentals are driving investors to take short positions



Source: Boost ETP Research, Bloomberg. Data as at 28 June 2013

Tensions in Shanghai's interbank lending market signals an end to easy credit in China. Overleveraged industrial producers will focus on cost control, driving the reduction in stock levels of base metals, including copper. At this stage in this cycle, the falling stock levels in copper are more a result of oversupply than they are due to falling demand. Against a fundamentally weakening outlook for China's industrial activity, copper stock levels remain high, potentially fuelling short positioning by speculators. As a result, investors may consider a short leveraged position in copper using the Boost Copper 3x Short Daily ETP (3HCS).

Spiking SHIBOR (China's version of LIBOR) in the last two weeks are reinforcing investors worries of China's credit fuelled industrial expansion. As loans are being reigned in, base metal producers and traders are likely to feel the squeeze, putting pressure on them to turnover inventories faster and stockpile less. There is growing pressure among copper producers to cut back production. In spite of the marked reduction of copper stockpiling in Shanghai warehouses since April (see chart), the current stock levels of 182,000 tonnes remain 54% above the 5 year historic average. This period has been dominated by very strong GDP y-o-y growth of 9-10%. Against a backdrop of Chinese output currently growing at 7.7% and manufacturing sentiment weakening, copper output is set to slow

down, adding further pressure to reduce stock. Reflecting the weakening Chinese fundamentals is the reversal in prices of industrial commodities, which along with precious metals, have been in steady decline since the fall of 2011.

In 2009, investors were bearish on copper until the price recovered back to ~6000 USD/MT on the LME that August. With the West in a deep recession and fiscal stimulus implementation by the Chinese government still in its early days, stocks of copper were low. Due to demand fallout, the low stock levels in turn served as a bearish signal for investors, driving them to build-up significant short copper positions on the NYME. When copper prices started to recover on the back of destocking by producers and gradual implementation of China's public infrastructure stimulus program, investors turned bullish on copper throughout 2010 and most of 2011 (see chart).

As the Chinese economic cycle is now entering a slowdown, it is the oversupply, more so than a demand fallout, which has instigated a renewed build-up in short positions in copper. Copper prices have been falling on the back of this. However, what makes the price slump of copper since 2011 different to 2008 is its magnitude and speed. In 2008, in the space of just 6 months, the copper price crashed by 66%. In 2011, when copper peaked to over 10,000 USD/MT, copper fell by 27% and recovered by 4% the following year. Given that this year copper is again down 15% (to 27 June), the two and half year performance of copper translates into a decline of 30%. As the downturn is more gradual and far less extreme in comparison to 2008, it is likely that the weakness in copper this time around is underpinned by weakening fundamentals rather than by aggressive bearish speculative positions held by hedge funds and active investors.

A less speculative driven downturn in copper is also reflected in the extent to which investors have built up short positions. As the chart shows, with the number of net speculative short positions relative to open interest in copper on the NYME recently rising to 9%, negative sentiment in copper appears to be growing. The last time investors were this bearish was in July 2009, after copper rose steadily for 7 months, having emerged from its multi-year low of 2800 USD/MT in December

2008. At that time, the bottoming of copper prices created extreme speculative bearish positioning. With about 18% of open interest in copper representing speculative net shorts, the extent of bearishness built into copper prices then was twice as much as it is today. However, as the weakening fundamentals underpinning China's investment-led growth are laid bare by the PBOC's hardening stance towards excessive credit growth, hedge funds and active investors may turn more bearish, feeding the negative sentiment; As this may sustain copper's directional downtrend further, it offers investors an opportunity to short copper. Investors may consider buying the Boost Copper 3x Short Daily ETP (3HCS).

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