



Scotiabank Commodity Price Index

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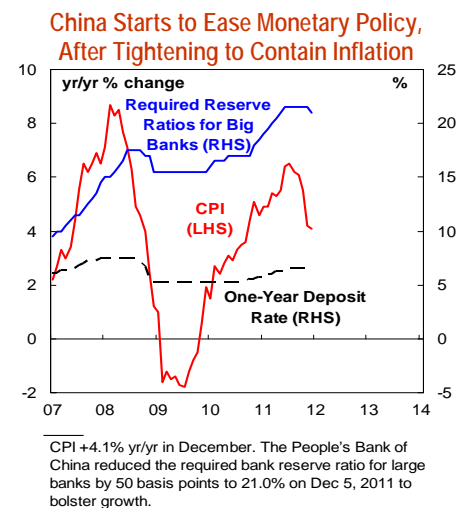
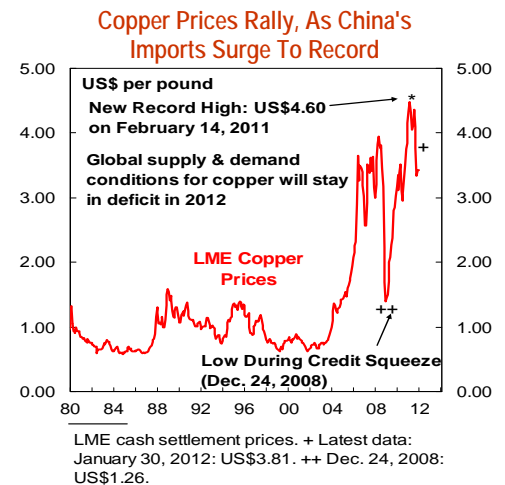
Scotiabank's Commodity Price Index Retreats in December

- *Natural Gas prices fall to a decade low, triggering U.S. 'dry' gas curtailment.*
- *However, copper prices rally back strongly, as Chinese imports surge to a record high and hedge funds switch to a net long position in copper, after shorting the market since last September. Anticipation of pro-growth policies in China lift sentiment.*
- *The Fed's ultra-low interest rate policy and hints of QE3 boost gold.*

Scotiabank's Commodity Price Index declined 1.3% m/m in December, ending 2011 down 0.1% from a year ago. After strengthening in early 2011, the All Items Index dropped 10.3% from the near-term peak last April, prior to the advent of financial market concern over excessive debt in weaker Eurozone countries.

However, sentiment has improved in early 2012, with some investment & hedge funds shifting from short to long positions in base metals. U.S. economic indicators have edged up (with stronger U.S. auto sales & assemblies and orders for manufacturers), lifting prices for industrial raw materials such as steel and base metal premia in the U.S. Midwest (the 'industrial heartland'). While China has to date only moderately eased monetary policy, hedge funds are beginning to anticipate a return to pro-growth policies and are now more inclined to believe in a 'soft-landing'. China's industrial activity — up 12.8% yr/yr in December — posted a small gain from November's 12.4% advance. Finally, the Fed's announcement that economic conditions will likely warrant keeping the Fed funds rate at ultra-low levels until at least late 2014 gave a boost to gold and industrial metal prices in mid-January, notwithstanding bouts of concern over Eurozone debt.

In December, the Metal & Mineral Index fell by 1.6% m/m, but remained 2.9% above a year ago. However, base metal prices have rallied strongly in January, with copper the 'star performer'. After inching up to US\$3.43 per pound in December, LME copper climbed as high as US\$3.91 on January 27 — yielding an exceptional profit margin of 65% over average world breakeven costs; prices had fallen as low as US\$3.08 in early October. Chinese imports of refined copper soared to a record in December (up 78% yr/yr). Last October, Chinese buyers purchased copper opportunistically, taking advantage of low prices and positive arbitrage between the Shanghai Futures Exchange and LME prices; these volumes arrived in China in December. Much of this metal will be used as collateral for bank financing in China, given tight credit, though we expect a more fundamentally driven pick-up in fabrication demand next spring.



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Global copper mine expansion will also likely be modest again this year at only 5%, keeping the supply & demand balance in ‘deficit’, and benefitting Canadian companies with significant copper output (First Quantum, Teck Resources, Copper Mountain ...). World mine supply has increased a mere 1% per annum for the past five years.

The Oil & Gas Index retreated in December (-3.6% m/m), led by natural gas. Nymex near-by futures plunged as low as US\$2.32 per mmbtu on January 19 — a level not seen since 2002 — before recovering slightly to US\$2.67 later in the month. Prices have fallen below levels needed to generate a reasonable 9% return on ‘dry’ gas development (at least US\$3 for the lower-cost ‘dry’ shales and an even higher US\$5 for conventional wells). Despite low prices, gas supplies continue to grow due to intense development of lucrative, liquids-rich U.S. shales (e.g. part of the Marcellus) and significant volumes of ‘associated gas’ produced with crude oil. Abnormally warm U.S. winter temperatures have heightened expectations that U.S. gas-in-storage will exit the heating season in March at extremely high levels, placing a cap on prices until next Fall. The net result, **Chesapeake Energy (the second-largest U.S. gas producer) has announced that it will reduce its operating ‘dry’ gas rig count by 50** (mostly in the Haynesville and Barnett shales), cut gas production by as much as 1.0 bcf per day and defer ‘dry’ gas well completions — boosting prices moderately in late January. While a positive development, it may take some time before natural gas prices significantly recover.

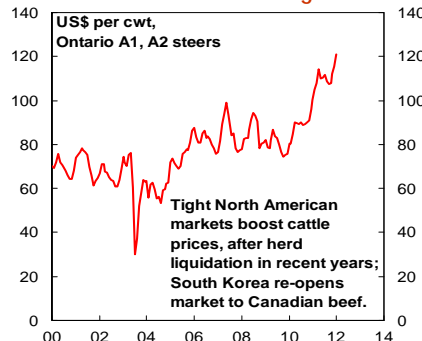
The Forest Products Index gained ground in December, rising 0.7% m/m. Stronger lumber and OSB prices more than offset a further drop in NBSK pulp prices to US\$890 per tonne and a slight decline in SC-A paper prices. **Western Spruce-Pine Fir 2x4 lumber prices climbed from only US\$230 to US\$248 per mfbm in December, ending the year at a profitable US\$261** — buoyed by a slight improvement in fourth-quarter U.S. housing starts to 657,000 units annualized, holiday mill curtailments and expectations of a pick-up in Chinese buying in early 2012, now occurring. (B.C. producers report that they are now selling higher-grade lumber to China — a new ‘C’ grade between a high-end No.3 and a low-end No.2.) However, mill prices remain below the US\$285 of late 2010, at a time of rapidly expanding sales to China and a surge of optimism over a possible recovery in U.S. housing. B.C. lumber mills expect steady sales to China in 2012.

U.S. housing starts did edge up in 2011 to 607,000 units and should inch ahead again in 2012 to 680,000, though a large overhang of foreclosures is slowing the improvement. **In view of Fed concern over a still weak U.S. housing market, it would not be surprising if the Fed were to announce an ‘asset purchase program’ or QE3 to include mortgage-backed securities later in 2012, to boost liquidity.** The Administration might also unveil a mortgage-refinance program, which in my view might be more effective in boosting the housing market, as interest rates are already low and not a constraint. The Softwood Lumber Agreement between Canada and the United States has been extended for two years through October 2015.

The Agricultural Index also edged ahead in December, rising 0.8% m/m. Stronger cattle, barley and Atlantic Coast lobster prices (the highest-valued fish & seafood export from Canada) more than offset a slight decline in wheat and hog prices.

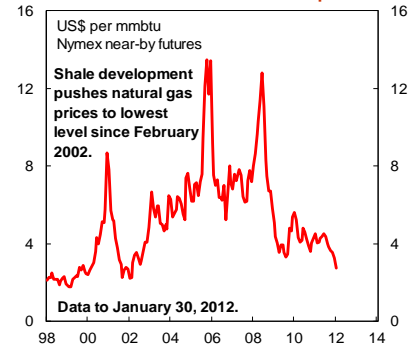
Cattle prices in Ontario (A1A2 steers) climbed to a record high of US\$115.53 per cwt — up 20% yr/yr. Multi-year herd liquidation in Canada and the United States through mid-2011 has cut marketings, boosting prices. In the United States, high corn prices — squeezing profit margins — and severe drought in the southern ranch states accelerated selling of feeder calves and cattle at lighter weights in 2011. In Texas, 9% of the entire beef herd was liquidated. In addition, U.S. beef exports returned to pre-mad cow levels and set monthly records in

Cattle Prices Climb To Record High



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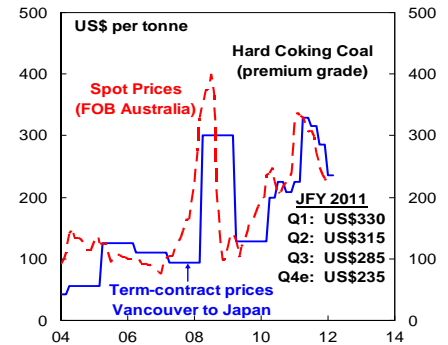
Natural Gas Prices Drop



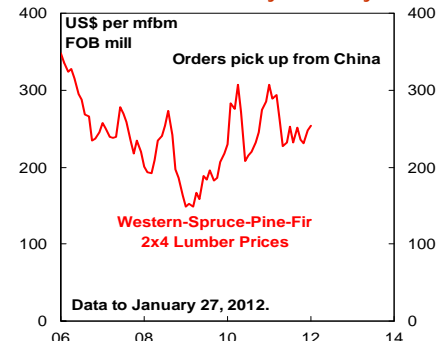
Soft Aluminium Prices



Hard Coking Coal Prices To Asia



Lumber Prices Rally Modestly



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late 2011, tightening supplies. South Korea has just re-opened its market again to Canadian beef. While the herd is now being rebuilt on both sides of the border, it will take some time to significantly boost supplies, pointing to even higher cattle prices in 2012. U.S. cattle numbers may not return to 2009 levels until 2015.

Oil & Gas

WTI oil prices advanced slightly in December to US\$98.58 per barrel and have averaged US\$100.38 to date in January — a substantial jump from the US\$75.67 near-term low on October 4, 2011 during a bout of extreme ‘risk aversion’ linked to Eurozone challenges. **Spot Brent (a better world benchmark than WTI) remains elevated at US\$111.12 in late January. Saudi Arabia reportedly views US\$100 oil as satisfactory.**

A wide ‘geopolitical risk premium’ has resurfaced in world oil prices in recent months — largely related to tightening sanctions against Iran to curb its alleged nuclear explosives program. On January 23, the EU enacted new sanctions on Iran, placing an embargo on imports of Iranian crude, effective July 1. Companies registered in the EU will also not be permitted to ship Iranian oil to other regions. The sanctions were delayed until mid-year to give EU refineries time to find alternative supplies (600,000 b/d) and to limit the fallout of potentially higher prices on the fragile economies of some members (e.g. Greece).

Iran has reacted by threatening to either close the Strait of Hormuz, through which about one-third of world exports flow, or impose its own embargo on the EU ahead of time. Weapons inspectors from the International Atomic Energy Agency are currently visiting Iran to examine its nuclear program and engage in dialogue with Iran. However, it appears likely that this issue will continue to elevate oil prices for some time. Tightening banking sanctions are gradually making it more difficult to pay for Iranian crude via the Central Bank. Iran is OPEC’s second-largest producer, with output of 3.55 mb/d.

Metals & Minerals

Gold prices (London PM Fix) slipped from US\$1,739 per ounce in November to US\$1,652 in December (as low as US\$1,546 on the 29th). **However, prices rebounded as high as US\$1,739 on January 27 in the wake of the Fed’s policy statement, setting out a likely very accommodative, reflationary monetary policy through late 2014.** Hints at the possibility of QE3 are also very price supportive for gold. The Fed is particularly concerned that it may take some time to reduce today’s high unemployment rate of 8.5% to more normal levels. In view of recent developments, the ‘Bull Run’ in gold appears intact and the price forecast has been revised up to an average of US\$1,750 for 2012.

While the **base metal complex** has rallied strongly in January, conditions in recent months have been mixed. **LME aluminium prices** fell below average world cash costs in December amid more-than-ample smelter capacity relative to demand. However, prices have lifted off cash costs in January, alongside permanent smelter shutdowns by ALCOA, the possibility of smelter cuts by Norway’s big producer and a general improvement in sentiment for base metals. Despite recent developments, aluminium prices are expected to remain on a low plane for much of this year. **China is developing a new aluminium industry in the Northern and Western Provinces such as Xinjiang based on the availability of ample steam coal for power generation (an extraordinary development).** New smelters in Xinjiang have cash costs which are about 5% below the world average and are quite competitive — unlike many high-cost smelters in central and eastern China. **China continues to aim for aluminium self-sufficiency — thwarting industry hopes that China will emerge as a significant net importer (a development likely to boost prices by mid-decade).**

The **contract price of premium-grade hard coking coal from Western Canada to Japan and other Asian markets** eased from US\$285 per tonne to about US\$235 in calendar year 2012:Q1 (see chart). This is in line with lower fourth-quarter spot prices from Australia to China, averaging US\$238. Spot prices (FOB Australia) fell further to US\$219.60 in early January (prior to the Chinese New Year holiday). Lower prices reflect a recovery in Australian coal shipments — after severe flooding in early 2011. An inventory correction in China’s construction-grade steel also got underway last Fall due to over-production in the summer and concern over a downturn in private-sector property construction. China’s massive ‘social housing’ program should boost rebar demand as 2012 unfolds.

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| Growth Trends | (per cent change) | | (Compound Annual Growth Rates) | | |
|-----------------------------------|-------------------|--------------|--------------------------------|------------|-------------|
| | One Month | Three Months | One Year | Five Years | Ten Years |
| December 2011 | | | | | |
| All Commodity Price Index* | -1.3 | -4.3 | -0.1 | 3.1 | 9.7 |
| Industrials | -1.7 | -4.9 | -0.6 | 2.3 | 10.0 |
| Forest Products | 0.7 | -3.4 | -6.2 | 1.4 | 3.0 |
| Metal and Minerals | -1.6 | -7.8 | 2.9 | 4.7 | 15.1 |
| Oil and Gas† | -3.6+ | -0.8+ | -1.4 | -0.4 | 11.7 |
| Agriculture | 0.8 | -0.5 | 2.9 | 8.7 | 7.9 |

* A trade-weighted U.S. dollar-based Index of key Canadian exports including forest products, metals & minerals, oil & gas and agricultural products, 1997=100; * see technical note on page 12; † the latest natural gas and propane prices are subject to revision.

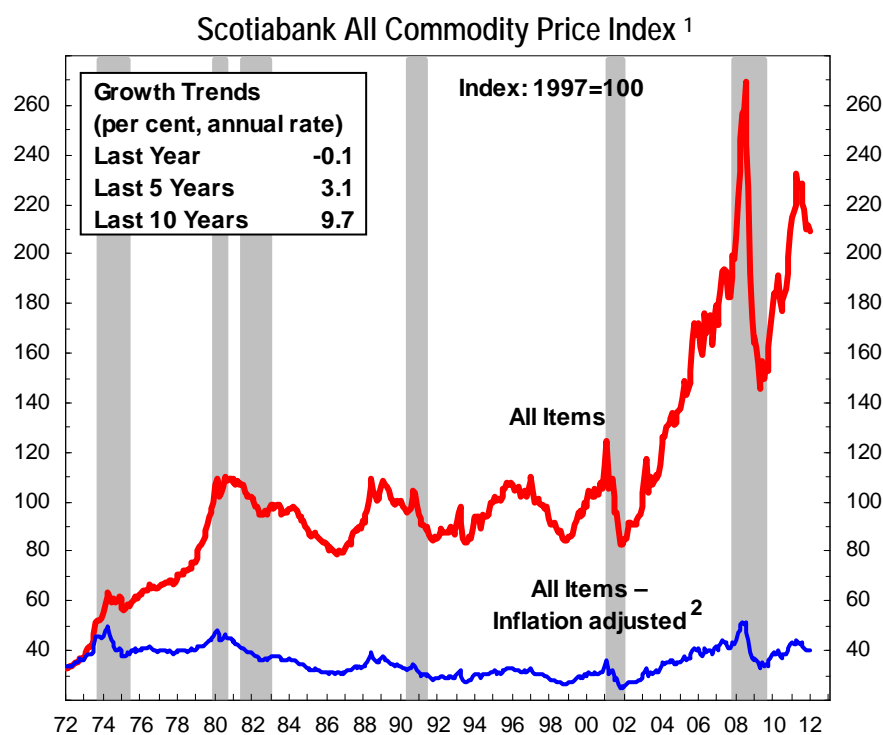
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Spot potash prices (FOB Vancouver) were unchanged in December at US\$500 per tonne (+31.9% yr/yr), as were **sulphur** prices at US\$217.50 per tonne (though the latter reflects little recent spot business at the Port of Vancouver, in view of softer international DAP demand). **Spot uranium prices** remain at a low ebb — just over US\$52 per pound in late 2011 and early 2012 — and ‘base’ prices for term contracts are US\$61.

Agriculture

The **Canadian Wheat Board’s asking export price for No. 1 grade wheat** edged down from US\$407 per tonne to US\$394 in December and US\$373 in mid-January. The U.S. Department of Agriculture projects the world wheat ending-stocks-to-use ratio at an ample 30.8 in the 2011-12 crop year, though the ratio was slightly higher at 31.1 in 2009-10.

Of great interest to Canadian farmers, the **ICE Futures Canada Exchange (the former Winnipeg Commodity Exchange)** began to trade a **milling wheat futures contract on January 22, 2012, with the earliest delivery month October 2012**. Canadian wheat farmers could shift to this contract, once the single-desk monopoly of the Canadian Wheat Board ends in August. Milling wheat futures have not traded in Winnipeg since the advent of the CWB seventy years ago.



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.