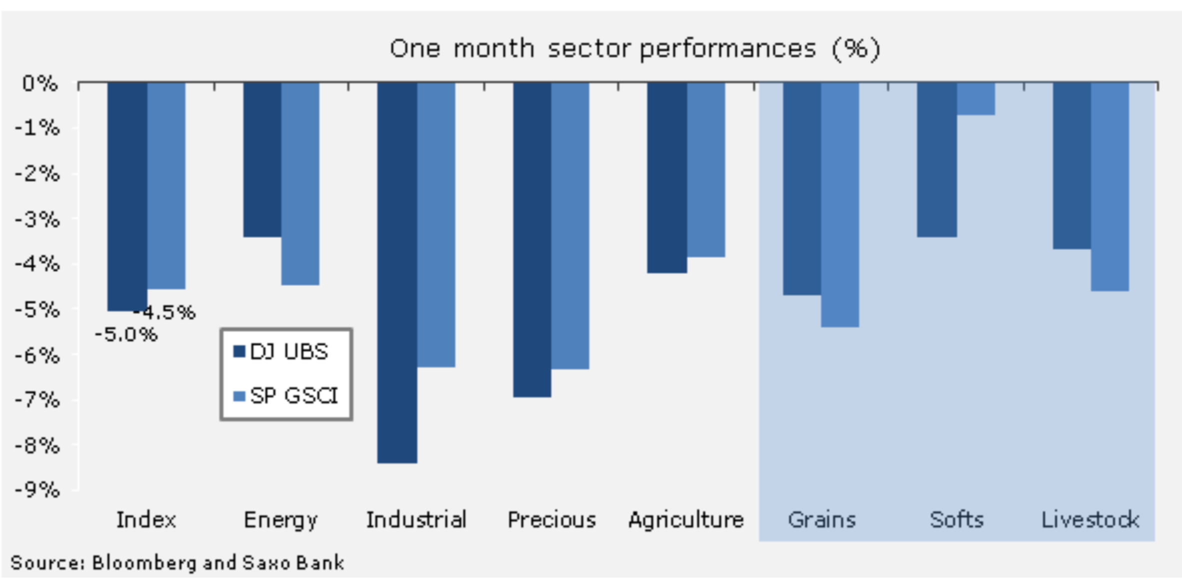
Brutal February hurts commodities.

After a solid January, most of the major commodities went into reverse during February, triggered by individual events within the different sectors but also some general macro. Political events also played their part. The USD returned to form and ended a two-month decline, rising by more than 3 percent against an index of major currencies thereby eroding commodity prices due its adverse relation. The rise was triggered by the continued buying against the JPY, but also a weaker EUR due to the outcome of the Italian election. The lack of a clear winner triggered higher borrowing costs for non-core Euro area countries, such as Spain and Italy, and it rekindled worries about a return of the debt crisis.

Elsewhere, China showed willingness to tighten liquidity to put a break on galloping property prices, which ultimately could lead to higher inflation and, at the same time, see its manufacturing activity expand at a slower pace than expected. This leaves China's new government with limited room to manoeuvre as it takes over the leadership later this month. In the US, growth continues at a moderate pace after some headwind was created by tax hikes at the beginning of the year, seasonal high gasoline prices and automatic spending cuts beginning from March 1.

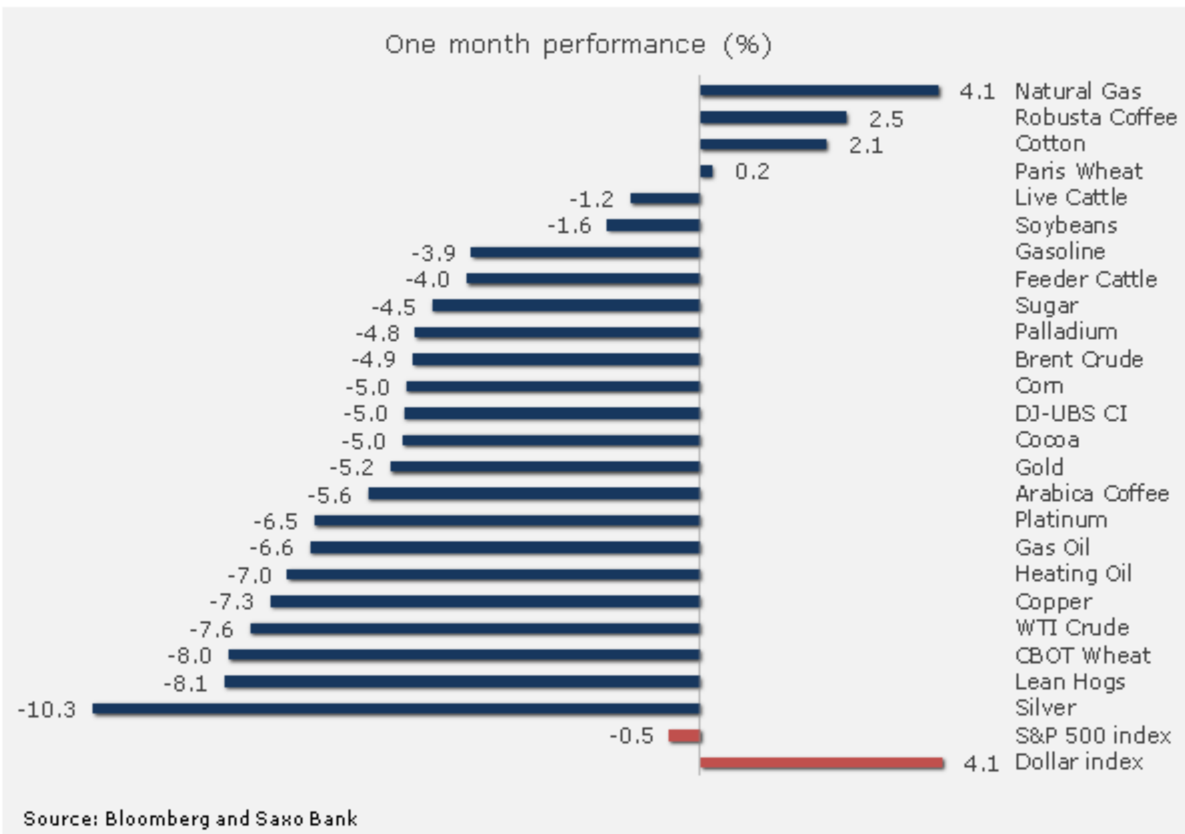
Improved growing conditions and ample supply first made an impact on soft commodities such as sugar, Arabica coffee and cocoa before also triggering weakness across the major crops, especially corn and wheat. After this, the weakness and investor selling spread to precious metals, which were already struggling after several months of weakness, so much that gold has not seen a similar bad run of monthly losses since 1997. Finally, the growth dependent commodities such as industrial metals and the energy also began to correct lower as future expectations of growth and demand had run too far ahead of current fundamentals and reality.

The two major commodity indexes both show similar losses during February despite a big difference in underlying exposure. Losses were seen across all the sectors, including the agriculture sub-sectors, in particular precious and industrial metals suffering the biggest losses.



Only three commodities managed a positive return during February. Natural gas was the strongest as it found support from colder than normal US weather and general strong demand that helped to ease the surplus inventories ahead of the new injection season, which starts in a few weeks' time. Cotton found support from increased demand for US supplies at a time when output is expected to drop as farmers switch to more profitable crops.

Silver was the worst performer, losing more than 10 percent as it got caught out by the general weakness both in precious and industrial metals. This resulted in the relative cost compared with gold falling to the lowest level since December. Interestingly, it did not, like gold, suffer any reduction in positions held through Exchange Traded Products (ETPs). In fact, net flows into ETPs has been positive for the past four months as the expected pick-up in global growth has continued to attract new investors lookng at silver with a longer investment horizon.



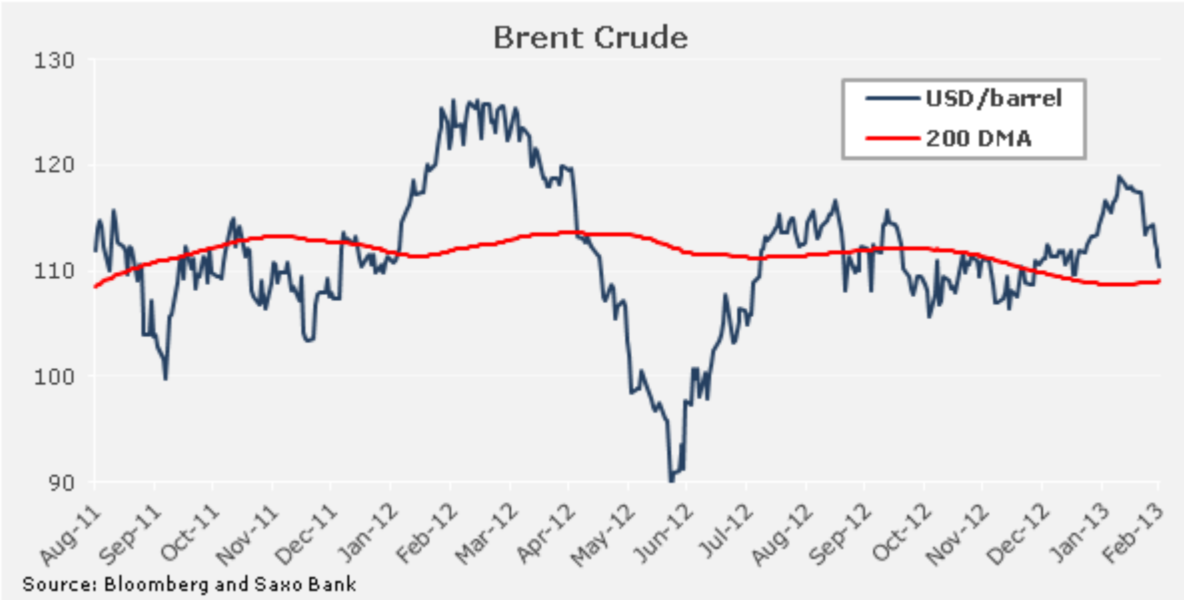
Gold struggles amid investor exodus

February was another testing month for gold as the price dropped for a fifth month in a row. Such a string of negative performances has not been seen since 1997. Money managers have been scaling back their net-long exposure for months now and recently we saw the gross short portion of this number rise to its highest level since 1999 – a time when European central banks were busy selling gold from their reserves. Despite some soothing words from Ben Bernanke , the US Federal Reserve chairman, to continued quantitative easing, gold failed to move back above resistance, currently at 1,620 USD/oz. This continued weakness is now being driven by investors in ETPs scaling back their exposure to gold. Until recently, this investor segment had been very resilient and continued to buy despite the lack of price performance. This changed during the second half of February and it led to an almost 110 metric tonne reduction in total holdings, according to Bloomberg, the biggest monthly reduction seen during the relative short history of ETPs.

The combination of a rising dollar and strong US economic data has been something that gold has not been able to respond to so far and it raises the risk that the key support levels at 1,555 USD/oz and 1,525 USD/oz could be tested once again. As mentioned above, the US economy is growing at a steady pace but several factors, such as tax hikes at the beginning of the year, a period of seasonal record high gasoline prices and additional spending cuts from March 1, may eventually provide some headwind for the economy and return some support to gold. The Italian election also carries the risk of re-igniting the focus on the political risk and debt crisis in Europe and could potentially lead to a test of the ECB's resolve. With the speculative short positioning rising, a strong driver could emerge from short covering should the market eventually find a catalyst for taking gold and silver higher.

Crude oil lower as future expectations align with current fundamentals
Both crude oils continued to retrace their January gains, with the WTI dropping to its lowest level this year as domestic production and inventory levels continue to rise. Brent crude, the global benchmark, has begun to realign forward expectations of higher prices due to an expected pick-up in growth with current fundamentals. Chinese manufacturing PMI rose less than expected, according to the latest reading. This will bring some focus to the 12th National People's Congress next week given, on the one hand, Beijing is fighting rising inflation while trying to stimulate manufacturing and consumption. With China expected to represent a big chunk of the expected growth in demand this year, any change in outlook there could have a major impact on fundamentals and prices.

The sell-off has, to a certain extent, been driven by investors needing to reduce their speculative net-long positions, which at one stage reached levels that once again, just like 2011 and 2012, proved to be unsustainable. Brent crude has now moved back down to familiar territory, which should trigger some support towards 109 USD/barrel, the 200-day moving average, while resistance can be found towards 112.50 USD/barrel.


Brent Crude
130
120
110
100
90
USD/barrel
200 DMA
Aug-11
Sep-11
Oct-11
Nov-11
Dec-11
Jan-12
Feb-12
Mar-12
Apr-12
May-12
Jun-12
Jul-12
Aug-12
Sep-12
Oct-12
Nov-12
Dec-12
Jan-13
Feb-13
Source: Bloomberg and Saxo Bank

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