Volume 3 - Issue #4 April ~ 2012

CRITICAL STRATEGIC METALS

Your monthly guide to the latest information on the world's strategic metals

U.S. Prepares For Major Supply Disruptions

In continuation of the China vs. the-rest-of-the-world rare earth saga, the US, EU and Japan recently filed separate but coordinated complaints with the World Trade Organization (WTO) on the grounds that China was fortifying its stocks of those rare earth metals that were critical for the manufacture of technology products such as mobile phones, camera lenses, hybrid cars and weapons. The complaint also includes non-rare earth metals tungsten and molybdenum.

While announcing the move, President Barack Obama said, "We've got to take control of our energy future and we cannot let that energy industry take root in some other country because they were allowed to break the rules."

Barack Obama signs surprising Executive Order on March 16th

US administration officials have been complaining that while China has access to large stocks at cheaper rates, the US is being forced to manage with small stocks at high prices. US officials claim that WTO forbids such unfair trade practices and since China is a member of the WTO, it must function within the WTO rules and regulations. In the absence of a resolution being found within 60 days, the dispute may be placed before a WTO panel for a ruling. Sanctions against China are a possible outcome of the process.

In spite of China's repeated claims that restrictions on its export quotas since 2009 have been driven by environmental concerns and the need to conserve scarce resources, nobody has really been buying that argument. Chinese foreign ministry spokesman, Liu Weimin said at a briefing, "We think the policy is in line with WTO rules."

He said that allegations of trade monopoly against China were groundless. It is a well-known fact that while China owns about 30% of the global rare earth deposits, it produces 97% of the global production. Liu said that sustaining that kind of production without damaging the environment is impossible. He added, "Despite such huge environmental pressure China has been taking measures to maintain rare earth exports. China will continue to supply rare earths to the international market."

A major cause of friction between China and the US is the $295 billion trade deficit recorded last year. In fact, Obama issued an executive order in February this year to create a panel that would investigate unfair trade practices by various nations, including China. During a visit to the US in February, Chinese Vice President Xi Jinping requested the US to respect Chinese interests.

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Co-incidentally, the rare earth complaint has come at a time of leadership transitions in both nations. While Obama will stand for re-election in November, Jinping is expected to take over the presidential reins in China in a power handover process within the communist party later this year.

Among other voices in both nations, China's Xinhua News Agency said that the move by the US was rash and unfair and could damage trade ties. On the other hand, in the US, possible Republican presidential nominee Mike Romney said that Obama was not being tough enough on China. Vijay Vaitheeswaran, The Economist's China business editor said, "The rhetoric over rare earths is overheated. There is no need for provoking a trade war over China's stance on rare earths because simple economics and market forces will solve this problem."

Analysts have pointed out that although the US has substantial rare earth deposits in Alaska and California, the nation appears to lack the political will to tap its own resources. However other countries have moved ahead and are seeking to become self sufficient in their rare earth supply. As Vaitheeswaran pointed out, "Restricted supply and higher prices have already spurred the development of big mines in Australia."

Karel De Gucht, EU Trade Commissioner said that China's restrictive policies gave the country a lot of advantage and its policies must be modified. The recent complaint follows the EU's earlier challenge to China on nine other raw materials that included magnesium, silicon carbide and zinc. The WTO had ruled that export restrictions on these materials defied WTO rules. Since February, China has been increasing its supply.

In another development, on March 16, Obama signed an Executive Order (EO), titled "National Defense Resources Preparedness." While the president claims the EO is a necessity to protect the country's interest, analysts and bloggers have been creating quite a ruckus at the high handedness of the EO. Put simply, the EO empowers the president to control all civil energy supplies, which include oil and natural gas; limit and control all civil transportation, which clearly is almost 97% dependent on oil; and even re-enable a draft if the country's military and non-military demands should require it.

Section 103C of the EO authorizes the president "in the event of a potential threat to the security of the United States, to take actions necessary to ensure the availability of adequate resources and production capability, including services and critical technology, for national defense requirements."

The EO makes it clear that it covers "all forms of energy including petroleum, gas (both natural and manufactured), electricity, solid fuels (including all forms of coal, coke, coal chemicals, coal liquification, and coal gasification), solar, wind, other types of renewable energy, atomic energy, and the production, conservation, use, control, and distribution (including pipelines) of all of these forms of energy."

In spite of all the criticism, it cannot be denied that this appears to be the first time that a concrete policy has been tabled should an energy crisis occur. For example, it's a well-known fact that if Iran ever feels threatened by Israel or the West, the first step Tehran would take would be to block the Strait of Hormuz and cut off 40% of the world's seaborne oil supply, which is about 20% of the total global supply and create a supply gap of about 20% in the US. Naturally, the results would be catastrophic for the US.

The EO does not mention rare earth metals as part of its scope but the possible effects of an oil-supply interruption are clear from the analysis of the EO. The similarity of the oil and the rare earth supply situation cannot be ignored. Should China feel threatened in any way, Beijing could very well cut off supply of rare earth metals to the western world thereby triggering a chain of catastrophic events in the global markets.

Section 303 of the EO permits the government to "enable rapid transition of emerging technologies," which implies important technologies that have now been kept out of the market will be pushed into the market early if required. The same section states that the National Defense Stockpile could take control of strategic materials "if such transfers are in the public interest." The provisions of the EO certainly imply that the president is well aware of the situations that could arise should the WTO complaint disfavor China.

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Institutional Investors Continue Gold & Silver Buying Spree

The global silver market was pretty shaken up in 2011 when silver bullion prices dropped from a high $49 to $32 and then again from $43 to $28. Investors around the world have been reacting differently to the price upheavals which triggered the most paranoia in October 2011. However, about 50% of investors have turned the fall into an opportunity and are aggressively buying the lower-priced silver. Considering the uncertain financial future, the decision to hold silver bullion instead of fiat currency certainly appears to be a wise one.

Silver prices are expected to remain volatile in 2012 as well. Analysts expect the market to mirror last year's performance with sharp rises and falls and in fact, Barclays Capital has predicted that silver will be the most unpredictable of the precious metals. Although price predictions vary from $32/oz to $52/oz, the consensus seems to be in the mid-$30s. Analysts have also pointed out that traditional supply and demand rules are unlikely to drive prices. Instead, the only factors that would affect the silver market are market sentiment and investor behaviour.

For example, China's mega-sized demand for silver is well-known, but given that the country's trade deficit has been at its highest in more than two decades, fears of a slowdown are high. A weak Chinese economy means a lower silver demand.

Egon von Greyerz, founder and managing partner at Matterhorn Asset Management, said that silver was not for the faint hearted this year. His advice to investors, "My view is people should hold more gold than silver, but from a profit potential point of view, silver looks very much like it's going to have a bigger move." He said that while silver corrected more easily than gold, the correction seen in February is rather mild. He believes that when silver turns, it will run positive very quickly.

Speaking about gold, he said that there is a major demand for physical gold that is growing rapidly. He is confident that institutional money will enter the gold market aggressively and transform the market. During an interview last week, he said, "We are seeing the low this week or we could be under pressure for another week. But thereafter, in April, if I look at the technical picture, gold looks fantastic. The next move will be a major move in both gold and silver."

He said that the paper market is artificially manipulated and is not relevant to the physical gold market in the long-term. However, physical gold is what people should invest in now and protect themselves from the volatile 2012 markets. He added "The institutional investors are going to go heavily into gold and that will totally change the market. As we know there isn't enough physical gold around to satisfy an increase in demand, so that can only be satisfied by a higher price."

Also speaking about gold, Caesar Bryan of Gabelli & Company said, "Well, there's been a bit of a transfer from the paper players, those involved on the COMEX and in the futures market who have been liquidating. On the other hand, the physical buyers, including central banks, are stepping in to accumulate gold." He added, "The central banks have been accumulating a great deal of physical gold at these lower levels. So there's a bit of a tug of war going on between the futures market and the physical market."

Among other opinions, Anne-Laure Tremblay, precious-metals strategist with BNP Paribas said, "Beyond the short term, we remain positive on gold's outlook as the fundamentals are still solid." The bank stated, "An improving macroeconomic outlook and high risk appetite should see silver outperform gold for most of H2'12 and 2013 although silver, like gold, remains vulnerable to waves of liquidation. As a result, the gold/silver ratio should decline to the low 40s by H2'13."

BNP Paribas had forecast gold and silver prices in February and they stand by those predictions in March as well. The bank expects gold to sell at $1,850/oz in 2012 and $2,225/oz in 2013. Silver is expected to sell at $37.50 in 2012 and at $51 in 2013.