

Scotiabank Commodity Price Index

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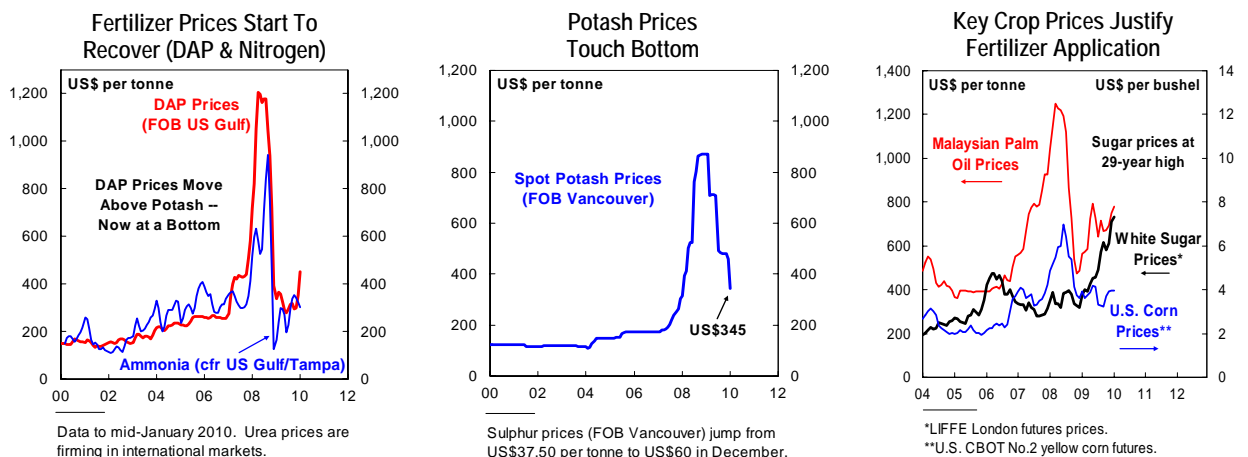
Scotiabank's Commodity Price Index Jumps in December

- *Potash prices touch bottom, spurring stepped-up buying in the United States.*
- *Base metal prices ease back in late January, as China begins to tighten monetary policy, but hold their ground fairly well.*

Scotiabank's Commodity Price Index ended 2009 on a strong note, advancing 2.9% m/m in December and up a solid 20.7% from the cyclical bottom in April. Investor interest in commodities as an 'asset class' drove commodity prices forward, a trend which continued in early 2010. The search for higher returns — given near-record low interest rates across the globe and exceptionally low U.S. Treasury yields — spurred a US\$60 bn inflow into commodity-related investments in 2009 — boosting global commodity assets under management to about US\$235 bn by late 2009 compared with a mere US\$6-10 bn in 2000. No where is this more evident than in the base metals — where fund and speculative interest has been driven by the China and 'emerging Asia' story. China continued its 'growth' story in 2009:Q4, posting a 10.7% yr/yr advance in GDP.

Strength was widespread in December. The **Metal & Minerals Index** advanced by 2.9% m/m alongside broad-based gains in base metals and strength in gold (record high of US\$1,226.56 in intra-day trading on December 4). While world supply/demand conditions for **zinc and aluminium** remain in technical 'surplus', with global production exceeding consumption, zinc and aluminium prices were bid up by G7 and Chinese investors on the coat tails of strong copper prices (underpinned by strong medium-term fundamentals for the red metal). **LME zinc prices — a metal which looms large in Canada as well as in Peru, where Scotiabank Peru is active — climbed from an already lucrative US\$0.99 in November to US\$1.08 per pound in December, spurring as high as US\$1.20 on January 7th (a 17-month high not seen since October 2007).** Current prices yield a 45% profit margin over average world break-even costs.

Spot potash prices (FOB Vancouver) edged down in December to US\$460 per tonne and dropped to about US\$345 in early January. However, prices appear to have found a bottom, with **Canpotex** reducing prices in overseas and U.S. markets, following Belarusian Potash Company's contract settlement with China at US\$350 cfr (delivered, for 1 million tonnes with an option for an additional 0.2 mt in 2010). After being well above other fertilizer prices in 2009, **potash prices are now below DAP (diammonium phosphate) at US\$450 (FOB US Gulf), given its recent rally. Fertilizer sales**



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started to pick up in the United States in December, after under-application by farmers for most of 2009. Sulphur prices (FOB Vancouver) — used in making DAP — have also jumped alongside tighter international market conditions and speculative buying in China.

The **Oil & Gas Index** posted a 2.8% m/m advance in December, as stronger natural gas export prices and a big gain in propane prices more than offset temporary slippage in light and medium/heavy crude oil. The **Forest Products Index** also firmed up in December (+2.8% m/m), led by a pick-up in U.S. building material prices and a rebound in newsprint. **NBSK pulp** prices climbed by US\$20 to US\$850 per tonne in the U.S. market in January; in a surprise development, Canfor has announced another US\$30 for February amid low world inventories and rain-related wood shortages in the U.S. South. Finally, the **Agricultural Index** rose by 3.5% m/m alongside a significant increase in Atlantic Coast lobster prices (the highest-valued East Coast fishery), some improvement in livestock prices and slight gains in wheat and canola.

Metals & Minerals

Metals & Minerals led industrial commodity prices up in December, as significant gains in base metals, gold and sulphur more than countered slight declines in silver, cobalt, potash and uranium. **LME copper prices** rose from an already lucrative US\$3.03 per pound to US\$3.17 in December and now stand at US\$3.36 (yielding an exceptional 62% profit margin over full breakeven costs).

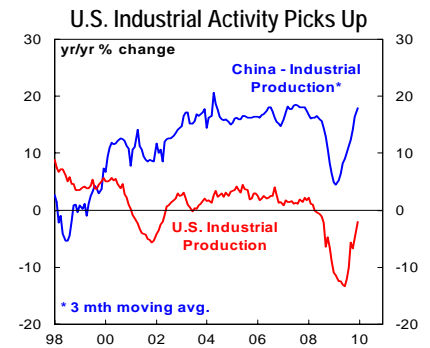
China has started to tighten monetary policy, lifting its three-month and one-year bill rates slightly in the past two weeks, draining liquidity and raising bank reserve requirements by 50 basis points to slow torrid credit expansion and prevent inflation from heating up and asset ‘bubbles’ from forming. Nevertheless, **China’s GDP should still advance by 9.5% in 2010** (up from 8.7% in 2009, though a deceleration from the strong 10.7% gain in the fourth quarter). While news of China’s tightening has pulled down copper and other base metal prices in late January from near-term highs earlier in the month, prices remain quite high and should be underpinned in 2010:H1 by some rebound in U.S. industrial activity and raw material restocking across the G7. However, we expect prices to be more volatile in 2010, with another pullback possible when the Fed starts to lift the Fed funds rate (expected by mid-2010), before climbing again in 2011. **We have revised up our forecasts for base metal prices, with copper averaging US\$3.00 in 2010 and US\$3.50 in 2011.**

Both aluminium and zinc prices have recently increased in sympathy with copper, with prices reflecting investor interest in metals as ‘assets’ over the medium-term rather than current supply/demand conditions. **Despite record aluminium inventories on the LME and Shanghai Futures Exchange in December, LME aluminium prices** posted an even bigger percentage gain than copper last month, in a bid to catch up with the red metal, climbing from US\$0.88 per pound to US\$0.99 in December and as high as US\$1.05 on January 11th. Two factors have been supportive — roughly 60-75% of LME aluminium stocks are held in warehouse financing deals established in early 2009, effectively holding them off the market, and smelter costs in China for the top ten percentile of producers are very high at US\$0.99 per pound.

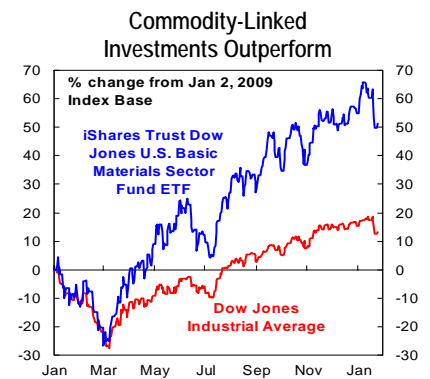
In the case of **zinc**, investors appear to be discounting tighter supply/demand conditions within several years, with the global balance shifting from surplus to deficit in 2011 and supplies becoming genuinely tight by 2013. This anticipates the following developments: 1) **increasingly short supplies of zinc concentrates relative to smelter requirements, especially in China.** The following zinc mines (among others) will deplete in the 2011-15 period — Galmoy (Eire) in 2010, Brunswick (Canada) in 2012, El Mochito (Guatemala) in 2012, Jaguar in 2012, Snow Lake and Trout Lake (Canada) in 2013, Iscaycruz (Peru) in 2013-14, Cassandra (Greece) in 2014, Lisheen (Eire) in 2014 and Century (Australia) in 2014-15. This accounts for recent interest by smelters in acquiring mines (Nyrstar’s bid for CBH Resources in Australia), driving asset prices higher; and 2) **significant expansion of zinc smelter capacity in China this year (over 1 mt).** Of these arguments, the first is likely the more cogent. Not all of the smelter expansion in China will be required to meet demand growth and stocks of refined metal are already high in China.

Of the 32 commodities covered in the Scotiabank Commodity Price Index, **lead** was the strongest performing commodity in 2009. **Strong battery demand for ‘E-Bikes’ in China** (electrically driven bicycles) contributed substantially to this stellar performance.

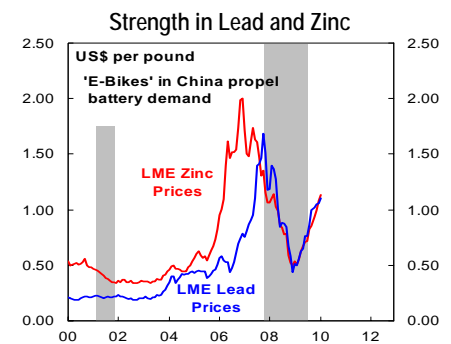
Turning to fertilizers, following the BPC one-year contract settlement with Chinese buyers (CNAMPGC and Sinofert), **Canpotex has reduced its overseas spot potash prices to US\$385 (cfr or delivered) for the standard grade** (business into Taiwan has been done at this level) and US\$400 cfr for granular product.



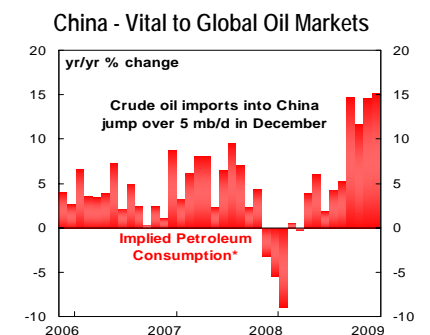
China's Industrial Production: +18.5% yr/yr in December. U.S. Industrial Production: -2.0% yr/yr in December, but up 4.7% since June.



Data to January 25, 2010.
Since March 9, 2009 low in equity prices:
The ETF +102%; DJIA +56%.



Data to January 25, 2010.
Shaded areas indicate U.S. recession periods.



* China's implied petroleum consumption equals crude oil refinery runs plus net imports of petroleum products. Data to December 2009.

Potash Corporation has also reduced prices into the United States to US\$390 (FOB warehouse in the U.S. Midwest) until the end of February, after which prices are scheduled to rise to US\$420. Fertilizer shipments have recently picked up in the United States for all three major nutrients — potash, phosphates (DAP) and nitrogen (urea). U.S. farmers under-applied fertilizers in 2009, with shipments of potash declining by 40%, phosphates by 30% and nitrogen by 10% in response to uncertain economic conditions and crop prices in early 2009. While nitrogen application is necessary to get a reasonable corn crop and was still applied in the U.S. Midwest last year, relatively high prices for potash discouraged application, as farmers waited for prices to fall alongside the plunge in other fertilizers. Though India has asked for an even lower potash price for its 2010 contract, the BPC settlement with China is generally recognized as the bottom. **Potash prices are now well below the price of DAP, which has surged in both U.S. and overseas markets. Urea prices (FOB Yuzhnyy) — the international bellwether — rose further in mid-January to US\$269 per tonne.**

Current crop prices in the United States and abroad support fertilizer application. The three crops using the most potash per hectare planted are corn, sugar cane

and palm oil. International **sugar prices** have recently been at a 29-year high (pushed up by a decline in India's output, linked to a poor monsoon and a shift by farmers from sugar cane to other crops), underpinning a high level of sugar planting in Brazil. **Crude palm oil (CPO)** prices in Malaysia and Indonesia (used as cooking oil in China & India and as a biofuel feedstock) have also rallied significantly from their late-2008 low, with replanting in Malaysia over a three-year crop cycle likely spurring fertilizer use. **U.S. corn prices** are probably the least supportive, having fallen back sharply from US\$4.23 per bushel on January 8th, following the USDA's surprise upward revision of the U.S. corn crop to a new record high. However, at US\$3.65, corn prices are still well above the US\$2.47 average of 2000-07 and the 'economics' of applying fertilizer remains positive, particularly after last Fall's nutrient-depleting record crop. We view 2010 as a transition year for potash, with dealers restocking modestly given the reduced 'risk' of holding inventories, on the way to stronger market conditions in 2011.

Signs continue to point to more than a 30% price increase for **premium-grade hard coking coal from Western Canada to Asia**, when annual contract negotiations are concluded for FY2010. Spot prices for Australian hard coking coal rose by another US\$15-20 in December to US\$200 per tonne (cif), well above the 2009 contract price to Asia.

Oil & Gas

WTI oil prices lost ground in December, falling to US\$74.52 per barrel from US\$78.15 in November. Prices rallied back to a high of US\$83.18 on January 6, as a severe cold front across much of the United States, Britain, China, South Korea and India boosted heating oil demand. However, prices remain volatile and have pulled back to around US\$75, as warmer weather returned to the United States and demand remained sluggish (-1.8% yr/yr). On a more positive note, the large U.S. inventory overhang of oil & products is now largely gone, with overall stocks only +0.5% above a year earlier and crude oil declining -2.2% yr/yr. Concern over President Obama's proposed restrictions on U.S. commercial bank 'proprietary' trading in financial & commodity markets is taking a toll.

Market concern over the impact on China's oil demand from tighter monetary policy is also weighing on the market, though this concern is likely overdone. Apparent oil demand in China — the world's second-largest oil market — rose 15.1% yr/yr in December, with strong demand for diesel fuel and record refinery runs. Crude oil imports climbed over 5 mb/d for the first time (5.2 mb/d), boosted partly by commercial stockpiling.

Nymex natural gas prices rallied from US\$4.63 per mmbtu in November to US\$5.36 in December, touching as high as US\$6.01 during the cold spell in early January. However, we continue to think that prices will be constrained by the development of new, low-cost U.S. shales. U.S. 'industrial' demand recovered slightly in October, hopefully the start of a trend linked to a recovery in manufacturing.

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Growth Trends

(per cent change at annual rates)

	Weights	One Month	Three Months	One Year	Five Years	Ten Years
All Commodity Price Index	100	41.0	74.7	7.2	5.2	6.0
Industrials	83	39.7	82.5	8.6	5.2	6.3
Forest Products	40	39.6	57.1	-0.1	-1.9	-0.6
Metal and Minerals	27	40.1	39.1	3.9	13.3	10.5
Oil and Gas	16	39.3	212.0	24.4	3.0	10.0
Agriculture	17	50.5	30.6	-1.3	5.1	4.0

Index 1997 = 100

	2009		2008		
	Dec	Nov	Sept	Dec	
All Commodity Price Index*	175.8 *	170.8 *	162.8	152.9	163.9
Industrials*	184.5 *	179.4 *	170.4	158.7	169.9
Forest Products	93.1	90.5	85.7	83.1	93.2
Metal and Minerals	251.1	244.1	238.2	231.2	241.6
Oil and Gas*	296.4 *	288.4 *	264.1	223.0	238.2
Agriculture	132.4	128.0	124.8	123.9	134.1

*Natural gas and propane prices are subject to revision.

Forest Products

Western Spruce-Pine-Fir 2x4 lumber prices firmed up from US\$207 per mfbm in November to US\$218 in December and **have surged to a profitable US\$250 as of January 22**. U.S. distributors are replenishing low lumber inventories ahead of the spring building season in the face of mill curtailments and tight log decks at sawmills on the B.C. Coast and in Oregon and Washington. Log prices got so low last spring and summer that many logging crews were laid off in the Western United States and ‘Timber Investment Management Organizations’ and REITs have reined in harvests, expecting better log prices once the U.S. housing market recovers. U.S. housing starts remained subdued in December at an annualized 557,000 units, though permits picked up. Interestingly, a relatively strong Toronto construction market is providing some offset for hard-pressed Canadian lumber producers; Canadian lumber consumption now accounts for 20% of the U.S./Canadian total, up from 10% previously.

Agriculture

Spot canola prices (FOB Vancouver) edged up from C\$423 per tonne in November to C\$426 in December and are still fairly lucrative at C\$402 in mid-January. However, there is some concern that canola prices could be dampened by last year’s record U.S. soybean harvest, more competition for U.S. soybeans from an improved crop in Brazil & Argentina and China’s import restrictions on canola from Canada and Australia (over an alleged blackleg risk).

Scotiabank All Commodity Price Index ¹



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.