

# 2011 Economic and Financial Outlook

## **PRESTIGE ECONOMICS**

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# LETTER FROM THE CHIEF ECONOMIST AND PRESIDENT

Dear Readers and Clients,

This year was marked by significant volatility amidst improving economic conditions. Rough and tumble as it was, we made it. In general, we are optimistic about 2011 – and we are not alone. Growth levels everywhere are poised to exceed pre-recession levels, as the world is transitions to genuine economic expansion. Nevertheless, this year's peek inside the Pandora's Box of sovereign and municipal debt, as well as the Fed's conversion of its balance sheet into growth's sacrificial lamb, are serious causes for concern. In general, we expect the world will breathe a bit easier, employment will improve slightly, and financial markets will trend higher in 2011. Some economic fig leaves meant to obscure long-term concerns, however, shrank in 2010, and could become smaller still in 2011. There are clearly secular problems that need to be addressed at home and abroad.

This year was also exciting for Prestige Economics. In 2010, we attended OPEC and IEF meetings, spoke at the AFP annual convention, and were featured by numerous media outlets including the Wall Street Journal and the CNBC special "Beyond the Barrel." For Prestige Economics, 2011 will be our third year of operation. When I first conceived of Prestige Economics as a research, advisory, and consulting firm, I knew we would have something truly unique to offer our clients. We are Consensus contributors with a deep understanding of financial markets, as well as experienced management consultants with the skills to harness market dynamics and expectations in consulting projects with long-term impact for our clients. We look forward to helping our clients further in 2011. Furthermore, we will be implementing some improvements to our research and website in the next few weeks. We believe that these improvements will make our research more thoughtful, accessible, and aesthetically pleasing than ever before. We hope you like the changes.

We wish you all a healthy and prosperous 2011!

Sincerely,



Jason Schenker

President and Chief Economist

Prestige Economics, LLC

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# ECONOMIC OUTLOOK

## Outlook Constants

While a number of financial markets have displayed significant volatility over the last year, we have unfailingly expected six fundamental constants:

- 1) A global economic recovery remains underway
- 2) The U.S. recovery is slower than elsewhere and is likely to remain tepid
- 3) The U.S. job market recovery will take years
- 4) Commodity prices are likely to rise on trend
- 5) The dollar is likely to weaken on trend
- 6) Housing prices will remain relatively flat nationally for a number of years

In 2011, we believe these expectations will continue to ring true. For the United States, jobs will pose the greatest threat to consumer spending, while depressed housing prices pose continued threats to meeting municipal budget and debt obligations.

## Caution Ahead

Throughout the last 12 months, the global economic recovery has appeared touch and go at times, with the most significant volatility across markets engendered by sovereign debt concerns in Europe. While concern about mispriced sovereign debt of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) has faded somewhat, we have not likely heard the end of mispriced government debt. Furthermore, we believe there is still a high probability of a global re-pricing of government debt and that it would likely spill over to municipal and other government debt. For the United States, this could be a particularly nasty problem, given the significant amount of city, county, state, and other non-Treasury debt for which the United States government could likely become a direct or indirect backstop. Plus, there are U.S. entitlements and government, military, and other pensions to consider. We should be cautious about cajoling Europeans for bailing out their fellow EU and EMU member states. After all, the U.S. federal government could also very well be forced someday into some large bail outs at some point.

## Prestige Economics Forecasts

	10 Q1	10 Q2	10 Q3	10 Q4	11 Q1	11 Q2	11 Q3	11 Q4	2009	2010	2011	2012
Real GDP (Year-over-Year)**	2.4	3.0	3.2	2.5	2.2	2.3	2.2	2.6	-2.6	2.8	2.3	2.8
Unemployment Rate	9.7	9.7	9.6	9.7	9.7	9.6	9.5	9.4	9.4	9.7	9.6	9.2
Core Consumer Price Index	1.3	1.0	0.9	0.7	0.9	1.2	1.4	1.6	1.7	1.0	1.3	1.8
Fed Funds Rate*	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	1.00

\* Fed Funds Rate figures and forecasts are for end of period. All other figures are for period averages

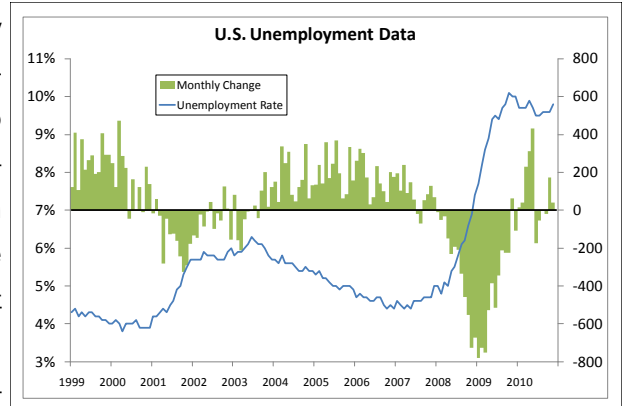
\*\*Real GDP rates are year-over-year seasonally adjusted annualized growth.

*In 2011, depressed U.S. housing prices pose continued threats to municipal budgets and debt obligations.*

# EMPLOYMENT OUTLOOK

Despite the hopes and wishes of the American public and its politicians, the employment situation in the United States has remained particularly dire over the last year. After the massive bleeding of jobs with the onset of recession, economic armchair athletes glued to

CNBC, Bloomberg, FBN, BNN and any number of other business media outlets had expected a speedy return to prosperity and full employment. Unfortunately, jobs are quite sticky in recovery, as productivity leads the way to more growth. During the last recession, the bleeding of jobs in 2001 was followed by a job-loss recovery in 2002 and jobless recovery



The unemployment rate rose to 9.8 percent in November.

in 2003. Only in 2004 did jobs return. Furthermore, the recession in 2001 was the mildest in U.S. history. As such, in this cycle, significant job growth will take time to occur, and it may be many years before there is a significant drop in the U.S. unemployment rate.

## November Jobs Report Implications for 2011

The November jobs report showed an increase of only 39,000 jobs for the month. This was significantly lower than the Consensus estimate of 160,000 new jobs. Despite upward revisions, the headline number was wildly off, and wildly disappointing. October's jobs report opened the door to the notion that the job-less recovery may be coming to an end. But, even then, we wrote that "Solid Numbers in One Report Does Not a Trend Make." Unfortunately, it looks like we were right. Also disappointing, is the fact that the U.S. unemployment rate rose in November to 9.8 from 9.6 percent. We continue to expect the unemployment rate will average above 9.5 percent next year. In fact, there could even be a short-term rise in the unemployment rate as individuals who have abandoned the labor market flood back in.

## Government Job Losses Highlight Risks

Since November 2009, government job losses have totaled a net 244,000 lost jobs. Despite all the government tax cuts and fiscal stimulus, only 6,000 net new federal jobs and only 10,000 net new state government jobs have been created since November 2009. Furthermore, these small net increases in jobs at the state and federal level have occurred amidst concomitant local government job losses totaling 260,000. Perhaps the PIIGS of Europe are not the only government issuers for whom debt could be mispriced. After all, with significant job losses frequently coming from local governments, perhaps some of our own debt – previously forecasted when real estate tax revenues were projected quite favorably – could be mispriced as well.

*We continue to expect the unemployment rate will average above 9.5 percent next year.*

# FED OUTLOOK

## **The Fed Funds Target Rate is on Hold**

Given recent Fed statements, low core inflation, and the need for additional quantitative easing (QE II), it is safe to say that the Fed will do as it says, and keep rates low for “an extended period.” We believe that this “extended period” is likely to last through mid-2012 before the Fed raises its main policy rates. As for QE II, it is going to be implemented. Given Ben Bernanke’s initial apprehensions about implementing such a program, however, the Fed could possibly elect to not fully implement the \$600 billion in purchases currently planned, on the off chance that growth were to suddenly tick up.

## **Sovereign Debt Concerns Persist**

Despite further accommodative monetary policy, an upward revision to U.S. GDP, a solid U.S. jobs report, and solid financial market performance, there are still significant risks to growth of which the Fed is cognizant. Interest rates, access to capital, and growth are all dependent on the notion that mispriced debt and risk have been fully addressed in the recent economic crisis. Sovereign debt, however, remains an elephant in the living room. Given the bailouts already required in Europe, it seems likely that additional government debt issuers may need bailouts as well. Furthermore, the ripple effect of re-pricing sovereign and municipal debt could have a massively adverse affect on global growth and financial markets.

## **Implications of QE II and Fed Priorities**

Adding additional debt to the Fed’s balance sheet is something that Ben Bernanke cautioned against at Jackson Hole this summer. He stated that by making further security purchases, as an expansion of the Fed’s balance sheet could have an “unknown” impact on the global perception of the Fed. For the non-economist, by “unknown”, he probably meant “bad.”

Maybe no one is paying attention, but the Fed’s additional stimulus — despite the concerns Bernanke voiced — shows us clearly where the Fed is likely to come down on the issue of debt in the longer run. Even if core inflation is low now, we know that tough decisions will need to be made in the future, and the Fed has demonstrated that when push comes to shove, maintaining economic health is a higher priority than inflation.

Perhaps we should not be surprised. After all, despite economists’ praise for keeping inflation in check, and Bernanke’s perceived proclivity toward inflation targeting, he was, and is, most widely respected for his research on the Great Depression. Given secular risks currently facing the U.S. economy, Bernanke may eventually be forced into harkens back to the Great Depression — to chose between inflation (à la Germany in 1923) or major contraction (à la Germany in 1929). The Fed’s quantitative easing policy shows us that keeping inflation in check to sustain growth in the long run is not as critical as staving off economic catastrophe. Now, the question is: when does the Fed’s policy of inflation vigilance lose credibility?

*We believe that this “extended period” is likely to last through mid-2012 before the Fed raises its main policy rates.*

# FOREIGN EXCHANGE OUTLOOK

*U.S. debt concerns and secular dynamics are likely to weigh on the greenback further, and support a medium-term dollar-bearish outlook.*

## The Dollar in the Year Ahead

In the coming year, we expect the dollar to weaken slightly against most major currencies, and we also expect significant continued strengthening of commodity currencies. Dollar dynamics will be significantly impacted by Fed policy in relation to other central banks. IMF growth expectations are solid across the board, and the main driving policy of central banks will determine how they attempt to address inflation as it inevitably returns. We believe that other central banks are likely to be more hawkish as growth rebounds. Furthermore, strong emerging market and commodity economy growth also point to a weakening dollar over the coming year. While sovereign debt concerns this year prompted market participants to view the dollar as a flight to quality, the massive U.S. debt burden is likely to weigh on the dollar on trend. In fact, dollar weakness is likely to accelerate over time, especially if sovereign debt concerns were to spill over into the market for U.S. municipal debt.

## Fed Accommodative Policy to Weigh on Greenback

The big difference between the U.S. Federal Reserve Bank and the central banks of other nations is that the Fed has a dual mandate – to maintain price stability (i.e. contain inflation) and support full employment. This long-standing dual mandate of the Fed is different because other central banks are tasked purely with containing inflation. The most prominent example of a central bank functioning with pure and singular purpose is the European Central Bank (ECB), which is essentially the progeny of the German Bundesbank (BuBa). The BuBa's raison d'être had been almost entirely defined by the German experience with hyperinflation in the early 1920s, when savings were wiped out and fixed income recipients impoverished. This experience continues to inform ECB policy. In stark contrast to the ECB, the Fed's real top priority in the near term is maintaining growth. As the Fed remains accommodative while other central banks transition to more austere monetary policy, the greenback is likely to fall.

Prestige Economics Currency Forecasts													
	09 Q1	09 Q2	09 Q3	09 Q4	10 Q1	10 Q2	10 Q3	10 Q4	11 Q1	11 Q2	11 Q3	11 Q4	
Dollar Index	85.4	80.1	76.7	77.9	81.1	86.3	78.7	80.0	79.0	78.0	77.0	76.0	
USD/EUR	1.33	1.40	1.46	1.43	1.35	1.22	1.36	1.32	1.33	1.34	1.35	1.37	
USD/GBP	1.43	1.65	1.60	1.62	1.52	1.50	1.57	1.55	1.56	1.57	1.58	1.59	
CAD/USD	1.26	1.16	1.07	1.05	1.02	1.06	1.03	1.01	1.00	0.99	0.98	0.96	
JPY/USD	99	96	90	93	93	88	83	84	84	83	82	82	
USD/AUD	0.69	0.81	0.88	0.90	0.91	0.84	0.96	0.98	1.00	1.02	1.04	1.06	
ZAR/USD	9.50	7.71	7.51	7.40	7.38	7.76	7.05	6.95	6.85	6.75	6.65	6.60	

All foreign exchange rates are end of period values.

# ENERGY OUTLOOK

## Higher Crude Oil Prices

Stronger economic growth, a gradually weakening dollar, and continued market concern are good for commodity markets. Oil is poised to take its place in the financial market spotlight again in 2011. With sovereign debt concerns potentially poised to plague Treasuries and inflation concerns growing, commodities look very attractive. Oil also has the advantage of being consumed, and the tangible asset play – while relatively dead in real estate – is still interesting for assets that are consumed, finite, and experiencing rising demand.

## Soft Natural Gas Prices

Unlike crude oil, natural gas is experiencing a major production boom across the United States, and may well see one abroad as well. Significant new supplies will likely dampen prices for a number of years, making natural gas a commodity market outlier.

IMF Growth Forecasts			
Real GDP			
Year-over-Year Percent Change			
	2009	2010	2011
Global	-0.6	4.8	4.2
Euro-zone	-4.1	1.7	1.5
U.S.	-2.6	2.6	2.3
Japan	-5.2	2.8	1.5
U.K.	-4.9	1.7	2.0
Canada	-2.5	3.1	2.7
Brazil	-0.2	7.5	4.1
Russia	-7.9	4.0	4.3
India	5.7	9.7	8.4
China	9.1	10.5	9.6

*Crude oil prices face some significant asymmetric upside risks in 2011.*

## Prestige Economics Energy Forecasts

### Brent Crude Oil - \$/Bbl

	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Quarterly Forecasts	\$77.09	\$86.75	\$90.75	\$92.75	\$94.75	\$96.75
	2008	2009	2010	2011	2012	2013
Annual Forecasts	\$99.86	\$62.94	\$80.21	\$93.75	\$106.00	\$115.00

### WTI Crude Oil - \$/Bbl

	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Quarterly Forecasts	\$76.24	\$84.85	\$89.75	\$92.25	\$93.75	\$96.25
	2008	2009	2010	2011	2012	2013
Annual Forecasts	\$99.89	\$62.21	\$79.49	\$93.00	\$105.00	\$115.00

### Natural Gas - \$/MMBTU

	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Quarterly Forecasts	\$4.24	\$3.95	\$4.50	\$4.00	\$4.25	\$4.00
	2008	2009	2010	2011	2012	2013
Annual Forecasts	\$8.92	\$4.17	\$4.39	\$4.19	\$5.00	\$5.75

# CRUDE OIL OUTLOOK

*For Brent crude oil, we continue to expect a price rise on trend and a disconnect with WTI across most of our forecast time horizon.*

## Looking Back and Looking Ahead

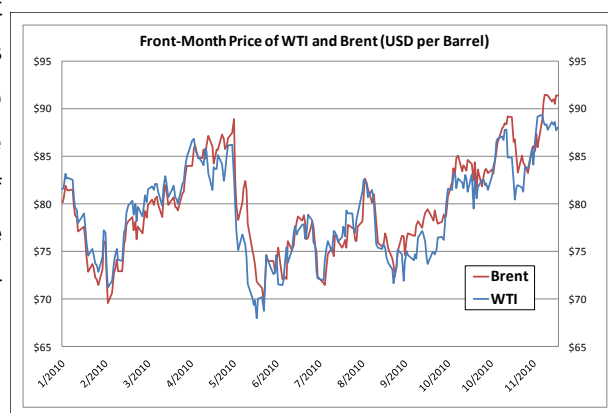
In 2010, the price of crude oil behaved almost exactly as we expected, with an average WTI price close to \$80 per barrel, and ranging between \$70 and \$90 for most of the year. In 2011, we expect crude oil prices will continue to rise, and average \$93 per barrel for WTI and \$93.75 per barrel for Brent. The last time crude prices averaged above \$90 per barrel was in 2008 – during the peak of the last business cycle at the zenith of speculative activity. If there is one lesson we should take away from that period, it is that prices can rise, over-correct, or suffer a pile-on or exit of participants swiftly. As such, and in consideration of current global growth dynamics, the momentum behind crude oil, growing real demand, and recent market history, there are significant asymmetric upside risks to the price of crude oil in 2011. Although OPEC may very likely raise production quotas amidst strong demand and high prices in 2011, it may not be enough to significantly dampen prices, especially if speculators decide to pile into the crude oil market.

## Brent Crude Oil Forecast

Recently, the disconnect between crude oil prices for Brent and WTI has widened. For Brent crude oil, we continue to expect a price rise on trend and a disconnect with WTI across most of our forecast time horizon, with the differential between the two main benchmarks widening until the medium-term cyclical outlook is different in 2013. Until then, the prospect of near- and medium-term economic growth, and incrementally rising oil demand, are likely to engender a forward curve contango that supports the continued disconnect between benchmarks. The inventory dynamics at Cushing, Oklahoma – the physical delivery point for WTI – are also likely to depress WTI pricing relative to Brent at the front end of the curve.

## Forward Curve Disconnect Continues

Historically, Brent trades at a discount to WTI. This supports a transatlantic arbitrage that fundamentally meets U.S. crude oil demand. In recent quarters, however, Brent has traded at a noticeable premium to WTI. A real or perceived lack of available storage at Cushing engenders a prompt-month contract price disconnect, as physical surplus quantities of crude oil are forced into the market at any price. Given the fact that a contango is supportive of this disconnect, WTI is likely to trade at a discount to Brent until the contango dissipates and a more bearish crude oil outlook forces the forward curve into backwardation.



Throughout the second half of 2010, crude oil prices rose steadily.

# OPEC OUTLOOK

## The Central Bank of Oil and its Policy Statements

Like central banks, OPEC is concerned about an anticipated deceleration of global GDP growth in 2011. GDP growth and oil demand growth are expected to rise, but at a slower pace than in 2010. The deceleration is likely to be slight, but given other concerns like sovereign debt, OPEC voiced concerns in its recent meeting statement from Ecuador.

Along these lines, we would like to point out that OPEC meeting statements have become increasingly structured. Part of the reason we subscribe to the notion that OPEC is the “Central Bank of Oil” is tied to the format with which they communicate their intentions and observations to the global oil market. Most recent statements have contained the following:

- 1) Observations about recent price moves
- 2) Assessment of price levels
- 3) Identification of key price risks
- 4) Discussion of OPEC actions prior to the meeting and future actions
- 5) Analysis of risks to future price risks in light of actions

This structure makes OPEC watching similar to Fed watching, and is likely to continue in this manner for the foreseeable future.

## Production Expectations

It is highly likely that OPEC members will continue to allow a certain amount of production creep in increasing violation of quotas. This policy was firmly supported at the October 2010 OPEC meeting in Vienna, when individual country quotas were suspended. The truth is, that as long as member countries are producing as a result of higher demand, they are meeting global demand needs and their quota violation is not critical. If the global economy were weaker or markets were flooded from the supply side, it would be a different story. There may be no need for a production quota increase now, but if global growth continues to rise (even at a decelerated pace), there may very well be a need for OPEC to raise production quotas in the near future. OPEC's next move will be to increase production quotas.

## OPEC May be Forced to Have a Spring Meeting

The next “Ordinary Meeting” for OPEC is scheduled for June 2, 2011. Nevertheless, given recent price moves in the crude oil market, it is easily conceivable that if the price of crude were to surge on fundamentals and/or speculation, OPEC may feel pressure to meet in Vienna for an “Extraordinary Meeting.” The likelihood of such a meeting would be very high if crude prices were to begin trading consistently over \$100 per barrel, which we expect to happen at some point in 2011. Even if OPEC were to have a spring meeting and increase crude oil production quotas, it may only be enough to dampen prices if fundamentals were the main price drivers. If speculative forces push crude prices markedly higher, it may be difficult for OPEC quota changes to significantly impact prices.

*OPEC's next move will  
be to increase production  
quotas.*

# NATURAL GAS OUTLOOK

*Winter weather may prompt some producers to complete wells to maximize immediate-term spot gas price spikes driven by seasonal weather dynamics.*

## Looking Back

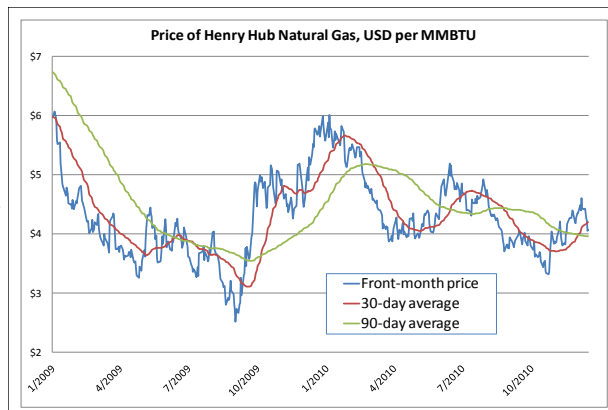
While other commodity prices have risen sharply in 2010, natural gas prices have remained relatively depressed. After high prices kicked off the year amidst record cold weather in February, prices fell back sharply and remained low throughout the year. Adding to the downward price pressures this year were a weak hurricane season, soft industrial demand, and strong inventory injections. In fact, inventories are currently high — down only 1.0 percent over last year's historically high levels, and up 9.9 percent versus the 5-year average. In the immediate term, winter weather may also prompt some producers to complete wells to maximize immediate-term spot gas price spikes driven by seasonal weather dynamics.

## Looking Ahead

In the end, not all commodity markets are the same, and the natural gas market is awash in supply and future anticipated supply. Very few markets are on the edge of such a boom. Furthermore, while natural gas prices have been depressed this year, there are asymmetric downside risks to prices next year as additional supplies come to market. In fact, natural gas is the only commodity we cover that we believe could experience lower average prices in 2011 than in 2010. This is shocking, especially given that crude oil prices are poised to rise significantly, the dollar is poised to fall, and the U.S. and global economies are poised for recovery.

## Buttressing Prices

The prospect of medium-term dollar depreciation and continued capital market interest in commodities could buttress natural gas prices on trend. At the same time, however,



the additional gas expected to **Despite winter weather, natural gas prices remain depressed.**

come online in 2011 make it difficult to forecast higher prices. It should be noted that this dynamic could squeeze natural gas producer profits while driving up production.

## Cost-side Challenges to Cheap Gas

The near-term competition for skilled labor and resources in horizontal drilling is highly competitive and providing upward pressure on gas production costs. Nevertheless, producers may be forced to “Drill Baby, Drill!” especially given the size of recent investments in gas production. Additional costs that stem from gas infrastructure build-outs competing with the oil complex for resources may be discounted as irrelevant, given the need to produce gas no matter how cheap it gets. This sentiment could further depress natural gas prices in 2011.

# METALS OUTLOOK

## Looking Back at 2010

In 2010, metals prices rose across the board. Our forecasts for 2010 had articulated exactly what occurred: a rise in prices to pre-recession levels for key metals except aluminum and steel. A return of global growth, improved growth prospects, low interest rates, a weakening dollar, and quantitative easing by the U.S. Fed provided price support. Aluminum and steel prices remained below their 2008 pre-recession peak levels largely because of low natural gas and coal prices, as well as significant spare production capacity (and high inventory levels in the case of aluminum). On the flip side of the industrial metals, global fears about credit and growth stoked gold and silver prices higher.

## Looking Ahead to 2011

In 2011, we expect metals prices will continue to rise. Furthermore, we see significant asymmetric upside price risks for most metals. Growth remains a key driver behind our metals price expectations. Accommodative Fed monetary policy and dollar-bearish fundamentals are also likely to buttress prices further in the near and medium term. At the same time, however, concern about global growth and international sovereign, municipal, and other government debt has risen. A mispricing of sovereign debt risk could have a catastrophic impact on the global economy, global growth, and industrial metals prices.

## Sovereign Debt, Gold and Silver

For gold and silver, sovereign debt concerns lurking in the background pose a very bullish price risk. After all, a real or perceived contagion effect stemming from mispriced sovereign debt could easily send gold sharply higher, should any form of crisis be assessed – especially if that globally re-pricing of debt were to be accompanied by questions regarding U.S. debt or the Fed's balance sheet. Prices are likely to rise for gold and silver on trend, but volatility could continue to plague the market in 2011. Precious metal and commodity price speculation, in general, is not for the faint of heart.

*For gold and silver, sovereign debt concerns lurking in the background pose a very bullish price risk.*

## Prestige Economics Metals Forecasts

		10 Q4	11 Q1	11 Q2	11 Q3	11 Q4	2008	2009	2010	2011
Gold - Spot	\$/OZ	\$1,370	\$1,400	\$1,425	\$1,450	\$1,500	\$873	\$975	\$1,227	\$1,444
Silver - Spot	\$/OZ	\$26.30	\$28.00	\$30.00	\$32.00	\$35.00	\$15.02	\$14.71	\$20.15	\$31.25
Copper - COMEX	\$/LB	\$3.90	\$4.25	\$4.50	\$4.75	\$5.00	\$3.13	\$2.37	\$3.43	\$4.63
Aluminum - LME Spot	\$/MT	\$2,325	\$2,400	\$2,500	\$2,600	\$2,700	\$2,576	\$1,671	\$2,169	\$2,550
	\$/LB	\$1.05	\$1.09	\$1.13	\$1.18	\$1.22	\$1.17	\$0.76	\$0.98	\$1.16
Nickel - LME Spot	\$/MT	\$23,580	\$25,000	\$27,000	\$30,000	\$32,000	\$21,050	\$14,709	\$22,047	\$28,500
	\$/LB	\$10.70	\$11.34	\$12.25	\$13.61	\$14.51	\$9.55	\$6.67	\$10.00	\$12.93
Steel - Hot Rolled Coil	\$/ST	\$625	\$700	\$725	\$750	\$775	\$890	\$454	\$611	\$738

All Prices are period averages.

# GOLD AND SILVER OUTLOOK

*All of the potential pesky currency wars that have been bolstering gold prices (and threatening German exports) used to be a very standard modus operandi for the PIIGS.*

## The Year in Review

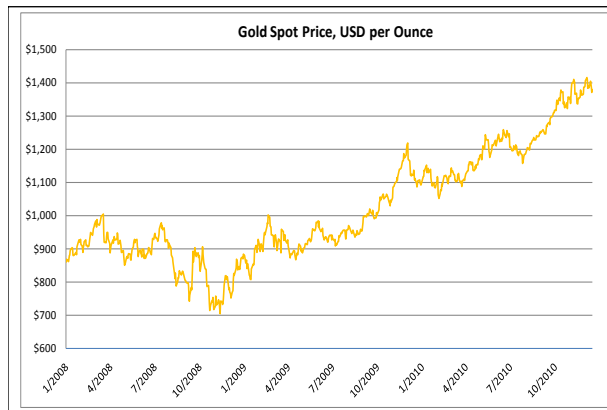
Gold and silver prices have been on a tear this year. Gold was viewed as an effective safe haven when instability abounded – from concern about a double-dip recession (which reached its peak this summer when Bernanke handicapped the probability at about a third), to the on-again, off-again fears about the potential demise of the euro or potential dissolution of the entire Euro-zone, as well as the additional feared prospects of international currency wars.

## Unjustified Euro Fears Bolster Gold

While we had been forecasting rising gold prices throughout 2010, we believe it will be a very cold day before the euro disappears. The Germans will not let the euro fail easily. After all, the same potential pesky currency wars that have been bolstering gold prices (and threatening German exports) used to be a very standard modus operandi for the PIIGS. After decades of currency shenanigans perpetrated by their neighbors, the Germans finally have the PIIGS under a fiscally responsible currency regime, and they most certainly are not going to risk losing that over a little Greek bailout. Nevertheless, some market participants are skeptical, and every time the Fed gets more accommodative, the PIIGS' sovereign debt looks a bit more suspect, or concern about mounting U.S. debt comes to the fore, gold gets a boost. Silver does as well.

## Looking Ahead

In 2011, gold and silver are likely to remain very attractive means for shorting the dollar while serving as a safe haven against economic growth concerns, instability (à la North Korea), and the potential for currency wars that have been fearfully anticipated in the wake of the Fed's announced quantitative easing. We expect gold and silver prices will continue to rise on trend in 2011, but also expect volatility to remain exceptionally high. Due to the significant volatility of high-volume traded commodities like gold and silver, we feel a distinct obligation to caution potential investors that all that glitters may not be gold. Given increased interest in gold and commodities by a rising number of relatively unsophisticated market participants, we gave an interview on this topic, which can be found at: <http://www.prestigeconomics.com/commentary/in-the-media>.



Gold has surged all year, and is poised to rise further.

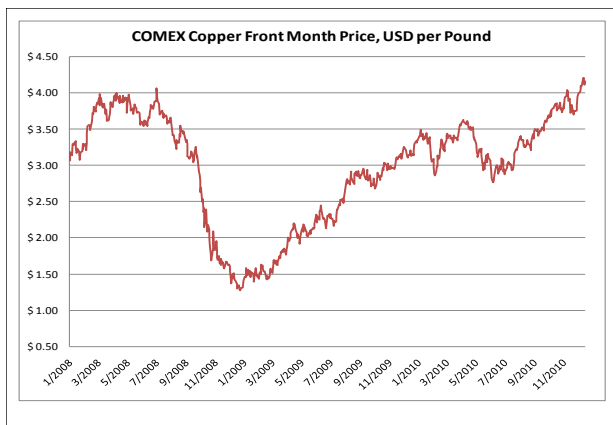
# COPPER OUTLOOK

## Copper in 2010

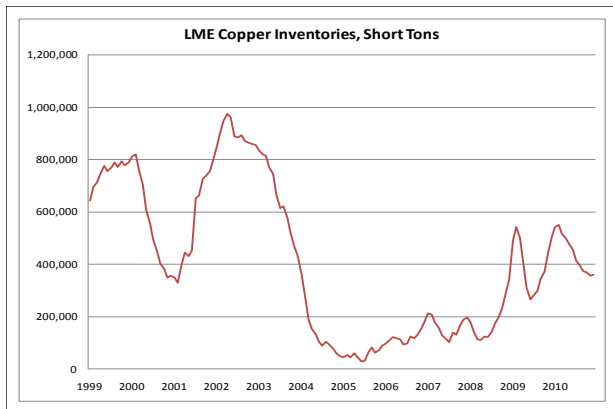
In 2010, we had expected the price of copper to rise to pre-recession levels. Not only did the price rise to pre-recession levels, however, but it achieved an all-time historic high average price. A resurgence in global growth, low and falling inventories, as well as the prospects of a weaker dollar have buttressed the price of copper. Global growth is on a tear, and even if the U.S. housing market is weak, emerging market demand growth is consuming additional copper supplies. Copper inventories on the LME have fallen by a third since the first quarter of the year, and the potential for a continued drop in inventories has provided significant additional upward price pressure.

## Copper in 2011

In 2011, we expect the price of copper will rise even further on trend. Global growth, although decelerating slightly, is poised to remain strong. Strong global GDP and copper demand growth are likely to make copper inventories fall further. As this happens, there is likely to be additional upward price pressure on copper.



Copper prices are at historic highs.



Copper inventories have fallen by a third since early 2010.

### Asymmetric Price Risks

As copper inventories continue to fall, this could cause prices to become more volatile and increase upward price risks. After all, with less supply on the market, both fundamental and speculative players may view copper as a scarce resource worth acquiring at almost any price. As such, speculative activity could exacerbate price moves higher sending the price skyrocketing at times, only to see it rush swiftly lower on technical trading factors. For copper, 2011 is going to be a very volatile year.

*For copper, 2011 is going to be a very volatile year.*

# ALUMINUM OUTLOOK

## Looking Back at 2010

At the beginning of 2010, we forecasted aluminum prices would rise, but remain below pre-recession levels. Low natural gas prices, low coal prices, high inventories, and significant spare capacity for aluminum production were the main drivers behind our forecast. Since the beginning of 2010, aluminum inventories have remained high – falling by less than 10 percent. Furthermore, while copper, nickel, and other industrial metal inventories are also low in absolute terms, aluminum has very high inventories on the LME.

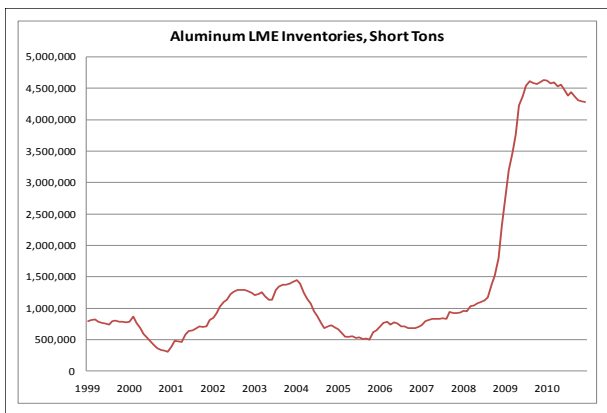
## Looking Ahead at 2011

We expect aluminum prices to average \$2,550 per ton in 2011. This is still slightly lower than the \$2,576 per ton average seen in 2008. The reason we expect a rise in the price of aluminum on average in 2011, is the same with other industrial metals: rising global growth and demand, falling inventories, and speculative interests. At the same time, however, the same conditions that kept aluminum prices relatively in check this year are also likely to keep prices from surging next year. After all, with a high level of inventories, significant spare capacity, and pervasive low natural gas prices, aluminum prices are only likely to rise so far. After all, supply is not an issue, and production costs are likely to remain relatively low.

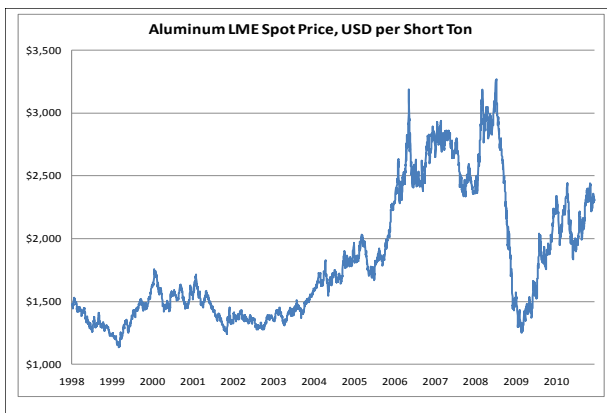
*Aluminum inventories are high, production costs relatively low, and significant spare capacity remains in place.*

## Overall Outlook

2011 will be a year of higher prices and volatility, but for aluminum prices, the trend is likely to remain more muted than for almost any traded industrial commodity except natural gas. As aluminum is in relatively abundant supply, any concerns about a slowing of growth or mis-priced sovereign debt could asymmetrically pose downward price risks to aluminum.



Aluminum inventories have remained relatively high.



Aluminum prices have remained below pre-recession highs.

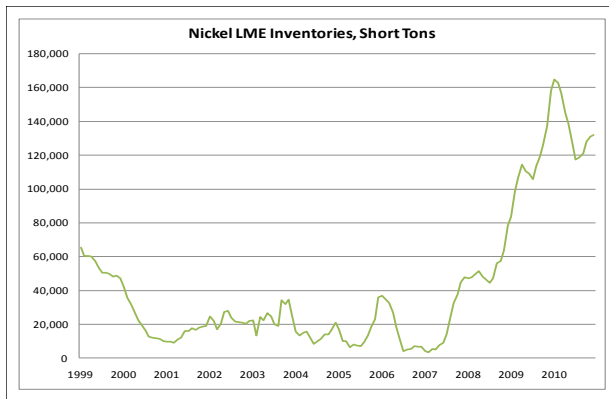
# NICKEL OUTLOOK

## Nickel in 2010

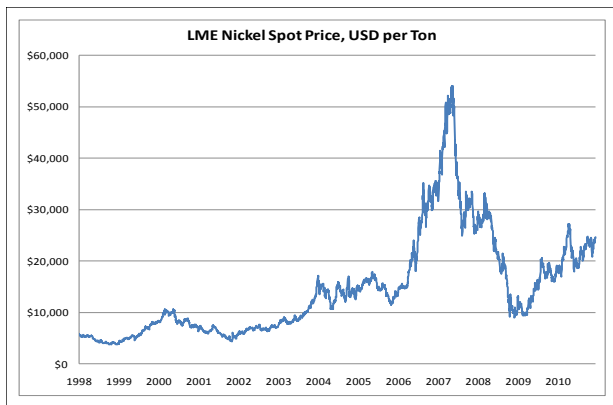
Nickel prices have risen sharply in 2010 to a new post-recession high average price of \$22,047 per ton, which was up sharply from the \$14,709 per ton average price in 2009. Rising energy prices, constrained supplies, low absolute levels of inventories, and a drop in LME inventory levels by 20 percent have engendered some of the upward pressure on prices. Strong fundamental nickel demand, economic growth, high energy prices, and a potential supply shortfall continue to pose upside price risks to nickel in 2011.

## Nickel in 2011

We expect nickel prices to rise even higher in 2011 to an even higher average price of \$28,500 per ton. Furthermore, given market dynamics, and historical nickel price behavior, we see significant asymmetric upside risks to price. During the last business cycle, nickel was one of the commodities that our Chief Economist hotly favored early on – in 2004. Especially given the prospect for rising crude oil prices, nickel is poised to see significant price increases in 2011. After all, nickel is a key component for alternative energy (e.g. hybrids, solar, ethanol), as well as conventional fossil fuel energy production. Furthermore, nickel supplies are likely to remain constrained in 2011, while inventory levels fall further, exacerbating upside price risks.



Nickel inventories have fallen 20 percent this year.



Nickel prices face extreme upside price risks in 2011.

batting upside price risks.

### Massive Upside Price Risks

Nickel is a critical and significant cost-adding component at the end of production, transport, gathering, and processing cost curves for both crude oil and natural gas. As such, nickel prices could skyrocket to the upside if crude oil prices were to spike. Additionally, despite the fact that an increase in natural gas production in 2011 will likely be bearish for natural gas prices, the increased production could be quite bullish for nickel demand and prices. There is upside price risk from all sides, and nickel is the industrial commodity with the most upside price risk in 2011.

*Nickel is the industrial commodity with the most upside price risk in 2011.*

# STEEL OUTLOOK

*In 2011, steel is likely to remain the weakest metal in terms of price, when compared to its pre-recession highs.*

### Steel Prices in 2010

Steel prices have risen in 2010 to an average price of \$611 per short ton from an average of \$454 per short ton in 2009. Over the past quarter, prices of hot rolled coiled steel have displayed significant volatility. This imputes to use that steel prices are poised to rise in 2011, but, given the low cost of inputs, and significant spare capacity in place, we expect steel is likely to remain the weakest metal in terms of price, when compared to its pre-recession average high from 2008 of \$890 per short ton.

### Steel Price Forecasts in 2011

Prices of hot rolled coiled steel have recently displayed significant volatility, largely because global growth is adding pressure to prices as demand is rising. Spare capacity may be in place, and coal and natural gas prices may remain relatively low in 2011, but steel is such a fundamentally necessary ingredient to economic growth — especially in emerging markets — that an increase in prices this year is likely to be strong. We expect the average price of steel in 2011 will be around \$738 per short ton.

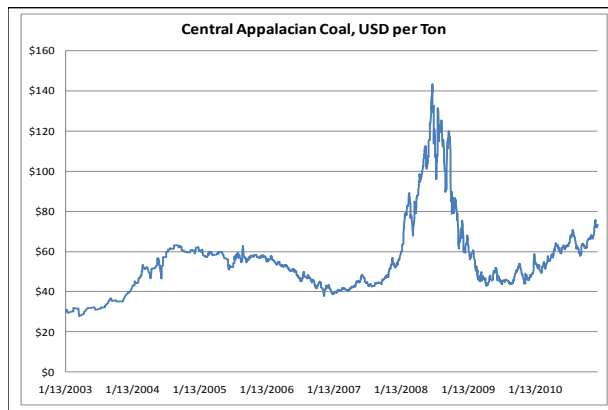
### Downside Risks to Steel Prices in 2011

As with aluminum prices, steel prices are likely to be significantly susceptible to any slowing in emerging market growth, as well as potentially higher interest rates in China. Sovereign debt and double-dip chatter are not likely to impact steel prices as much as aluminum, simply because aluminum is quite liquidly traded, while steel contracts are not as liquid, and physical forward contracts set market prices.

### Upside Risks to Steel Prices in 2011

Different from aluminum, however, is the fact that steel prices could be pushed markedly higher by stronger economic growth across emerging markets. While aluminum may have significant spare capacity and massive inventories, steel does not have LME inventories backstopping supply.

As such, if global or emerging market GDP growth were to surprise to the upside, steel prices may also tick sharply higher. Steel is the metal most vulnerable to both upside and downside price risks in 2011.



Coal prices have remained soft, keeping steel prices in check.

# 2011 Economic and Financial Outlook

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