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Rubber Prices Not Yet Poised to Tire

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Rubber Bounces

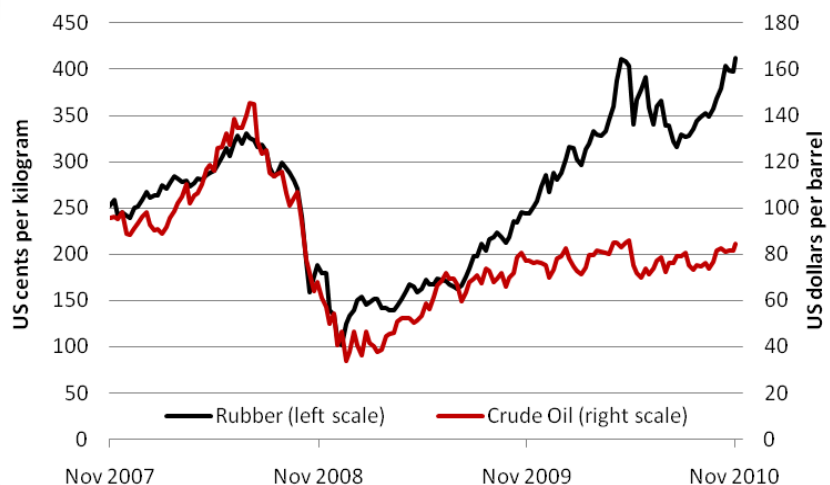
We anticipate the supply of rubber, already in tight global supply, to worsen through the end of the year and into 2011. The reasons are threefold: 1) Southeast Asian monsoons, 2) the strengthening of producing nations' currencies and 3) a rise in crude oil prices.

Rubber is unique in being an agricultural product that is consumed as an industrial raw material. The tires and tubes industry is the largest consumer—66% of output—while the remaining 34% is taken up by the general rubber goods sector including door and window profiles, hoses, belts, matting and flooring, gloves, balloons, adhesives, rubber bands and erasers.

Taking the supply issue into account and its resultant effects on industry and farming, we recommend the following strategies:

- Long futures or call options
- Short tire and auto supply manufacturers
- Long land/plantations (Southeast Asia)

Figure 1: Rubber Outpaces Crude Oil in Gains



Source: Bloomberg

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Rubber futures in Thailand, the world's largest producer, have reached record prices as a result of severe floods, cyclones and monsoon rains. Such weather calamities have spread across Southeast Asia over the course of the past month, affecting the heavy producing nations of Singapore, Malaysia and Vietnam. Expectations are that a supply shortage will intensify.

Thai province Songkhla—territory that accounts for 68% of its plantation—was forced to close its cash-rubber center this week while 10 of the nation's 14 provinces are flooded. Singapore Commodity Exchange futures rose to a record US\$4.14/kilogram this week while futures in Shanghai rose 3.5% to 33,165 yuan (US\$4,969)/metric ton. This is just shy of the October 26 peak of 33,165 yuan/metric ton. Monsoons and flooding have prevented the tapping of trees and, while there are some areas where plantations escaped destruction, electricity blackouts and transport hindrances have ensued. Shipments of latex to Malaysia are suspended, while shipments to China and other countries are stuck at ports. Normally, about 20,000-30,000 metric tons of latex are sent monthly to Malaysia alone via land transport.

Production Declines...

Thailand, Indonesia and Malaysia—the top three producing nations—account for 70% of global supply. The Association of Natural Rubber Producing Countries (ANRPC) expected a 6.3% increase in global production this year, but supply disruptions led ANRPC to revise expectations to 5.3%. Vietnam exports are expected to decline by 4.1% in Q4 2010, while output in India, the world's fourth-largest supplier, declined by 7.6% to 82,000 metric tons during October. China also downscaled its output, having lost about 15,000 metric tons of output in 11 days in October alone, while Cambodia has also made a downward revision. It is anticipated that ANRPC's 5.3% figure will be further reduced once data comes out in mid-November on Malaysia, Thailand and India.

...While Consumption Grows

China is the world's largest rubber consumer and second-largest importer, accounting for over 33% of global demand, while India and Malaysia accounts for another 8.5% of global demand. While China's economy has cooled modestly since recent government measures to slow growth, Chinese demand for rubber has not been impaired. China's stockpile has fallen 71% from this year's highs, while imports are expected to rise 42% in the fourth quarter, bringing total purchases to 1.68 million metric tons. India's appetite for natural rubber is also growing; importing 81,500 metric tons in October 2010 versus 77,950 during October 2009.

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China's Quarterly Growth in Consumption and Imports in 2010 (% change from same quarter 2009)

	Q1	Q2	Q3	Q4
Consumption (NR & Compound)	22.5	13.6	0.4	(1.2)
Imports (NR)	33.2	(22.5)	0.5	41.5
Imports (Compound)	84.8	(21.6)	(21.7)	16.3

NR = Natural Rubber

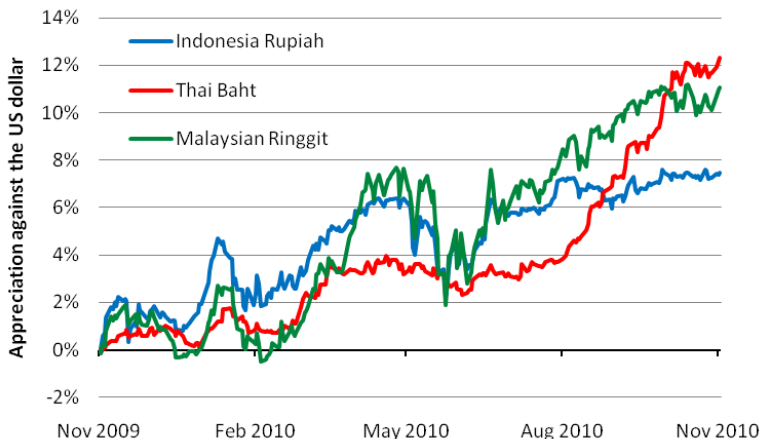
Q4 preliminary estimates

Source: Association of Natural Rubber Producing Nations

A Currency Issue

Natural rubber prices have risen on the currency appreciation of producing nations, namely the Thai baht, the Indonesian rupiah and the Malaysian ringgit. And while an appreciating yen is normally expected to depress TOCOM rubber futures, prices have continued to rise with increasing momentum as fundamental drivers have more influence than the normally negative impact of yen appreciation. Rubber contracts cost 58% more at end-September 2010 y/y on the TOCOM, and touched a 27-month high on October 26.

Figure 2: Southeast Asian Currency Appreciation: A Key Driver in Rubber Futures Prices



Source: Bloomberg

Crude Oil's Influence

Natural rubber prices tend to track crude oil market trends. Since the bulk of rubber produced is synthetic (derived from petroleum), both synthetic and even natural rubber prices are significantly affected by the price of

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crude oil. Yet even when oil prices moderated, rubber prices continued to appreciate, exemplifying the dominant role of currencies and supply shortages.

RGE Recommendations:

Long Futures/Calls: We believe there is still room for appreciation of rubber prices into Q1 2011. Moving to the balance of 2011, we see price stabilization as “cash for clunker” demand in the U.S. has been fulfilled and global growth remains weak. Secondly, a cartel of producing nations exists, similar to OPEC, which aims to control rubber sales and withhold stock in order to maintain price levels. A marked alteration in supply is unlikely in 2011, as the yielding area is unlikely to expand until 2012. At this point, a shift in the supply curve could occur as a large territory planted in 2005 is expected to start yielding, barring additional severe weather. Lastly, geopolitical concerns will pressure rubber on the upside. Natural rubber is an important military supply and is more sensitive to market reactions in the event of actual or anticipated war.

In addition to near-term contracts, there are opportunities on the futures curve beginning in May 2011, when prices switch from a contango to a backwardation. Futures trading takes place on the Shanghai Futures Exchange (SHF), Japan’s Kobe Rubber Exchange (KOBE) and TOCOM, the Singapore RAS Commodity Exchange, and the Kuala Lumpur Commodity Exchange (KLCE).

Short Industrial Equities: Tire manufacturers must address raw-material costs that slash profits. Manufacturers can only partially offset price increases by passing through to consumers. Europe’s largest tire producer Michelin & Cie expects expenses to surge by as much as €650 million this year on higher raw material input prices. Europe’s second-largest auto parts maker Continental AG said its rubber-products division will see its full-year profit decline by more than €450 million. Additionally, Goodyear Tire and Rubber, the U.S.’s largest tire producer, experienced a Q3 2010 loss due to high rubber prices.

Long Land/Plantations: A rubber tree’s economic life is about 32 years, including seven years needed before the tree becomes productive, making this investment a long-term play. A good tapper can tap a tree every 20 seconds with about 450-650 trees commonly tapped per day. Additionally, rubberwood used in furniture is considered environmentally friendly as latex production causes the tree to sequester carbon, a boon in the event of possible tax incentives and carbon credits. Productive use of the wood can be made post latex-producing years.

Despite being less liquid than other commodities, rubber offers a potential investment upside for the diversified macro or commodities portfolio. After the current rally, the market should see support as emerging market (EM) demand for cars persists, particularly in China, Brazil and other Asian and Latin American nations. Supply-side concerns should remain if demand stays consistent and EMs in particular continue to buy automobiles.

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