

# Hallgarten & Company

## Sector Strategy

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## Zinc & Lead – Apocalypse Now?

# Zinc & Lead

## Apocalypse Now?

- ✘ Zinc and lead prices have been on a slide since early December despite strengthening economic news in the first months of 2010. The eurozone's travails have now sent both metals into a tailspin down to levels at which most producers are scarcely breaking even
- + Mercifully Lead and Zinc have started to trend up again after a flirtation with the 71 ct per lb level which would have implied mine shutdowns if it had lasted
- + The scare has again claimed hedge funds as victims as they wandered into the commodity minefields without really knowing what they were doing. Each of these setbacks whittles down the number of hedge funds foolish enough to play these games
- + The pain of this downfall has, curiously enough, been mitigated the most for European producers who found their terms of trade on the production side less damaged than those miners in countries with a closer relationship to the US dollar, while European smelters/refiners and end-users found that they had suddenly become more competitive.
- ✘ The two metals' retreat after a brief flirtation with \$1.20 per lb has left projects even more firmly on the drawing board with little likelihood of any new projects being contemplated until the Zn and Pb lead prices establish some consistency above the \$1.20 level.
- ✘ This augurs ill for long term supply (but good for longer term prices) looking 3-4 years out

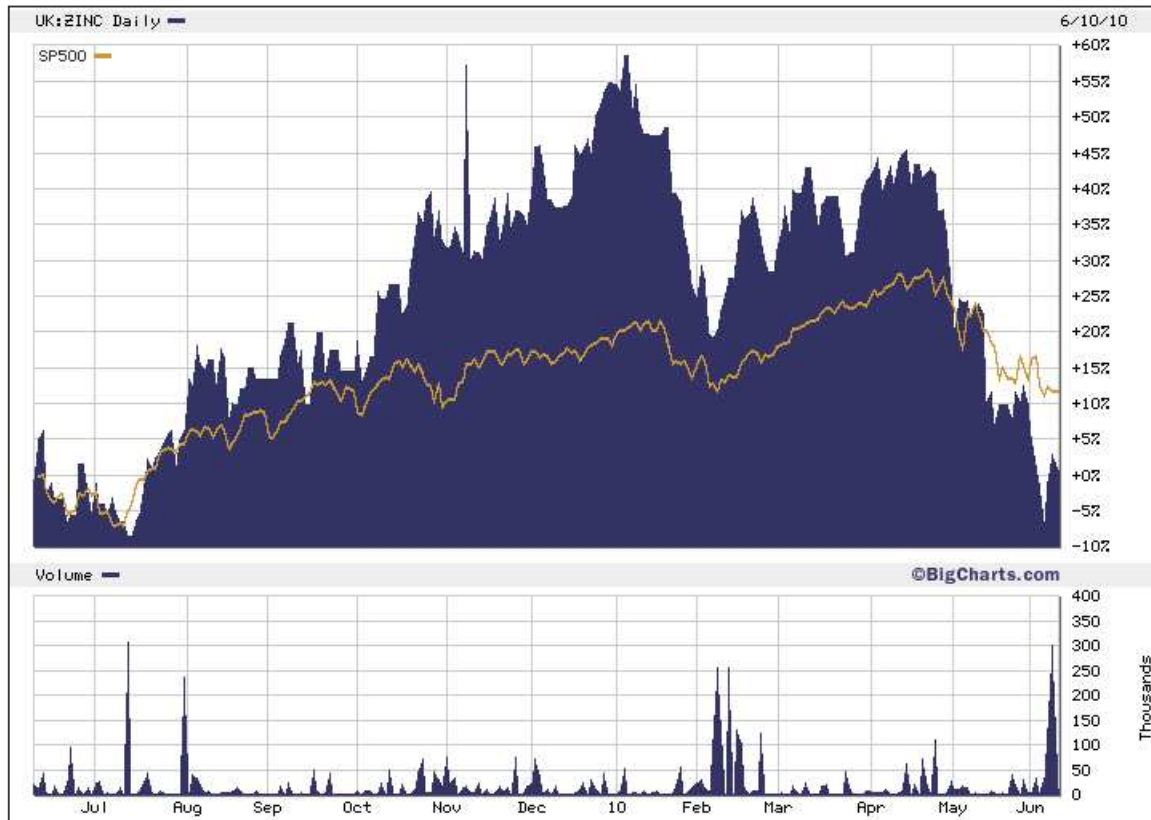
### Dire Straights

Just when you thought it was safe to go back in the water, something nasty comes along and snaps at you beneath the waist. It had seemed a mere six months ago as though zinc and lead's catalogue of miseries was a closed book. Zinc and lead are joined at hip because of their usual appearance together in mining. Zinc had a worse time of it though during the post-2008 slump as demand went off a cliff due to its linkage to galvanized steel. Lead however maintained its demand much better due to the seemingly undaunted rise of the Chinese auto production numbers which required increasing amounts of lead for batteries just as China was reining in lead refineries (both legal and illegal) that were creating an environmental disaster. Despite the stronger real end-user demand for lead, its recovery pretty much paralleled that of zinc due to Chinese stockpiling of zinc, of which more later.

On to the recent travails with the chart that follows showing the relationship between the Zinc ETF (ZINC.L) and the S&P500. The goal here is to show that zinc's woes began well before the Euro-wobbles of recent months. The S&P could act as a proxy for economic sentiment. Thus a rising S&P500 and a falling zinc price would be anomalous.

Zinc's recent high was in December 2009 (when gold touched \$1,200 previously on "inflation fears"). That moment was the high tide of the dollar carry-trade with the Euro also reaching its apogee at that

time. The S&P 500 powered on to new highs and zinc tried several rallies and failed, never getting even vaguely close to its previous high at year end.

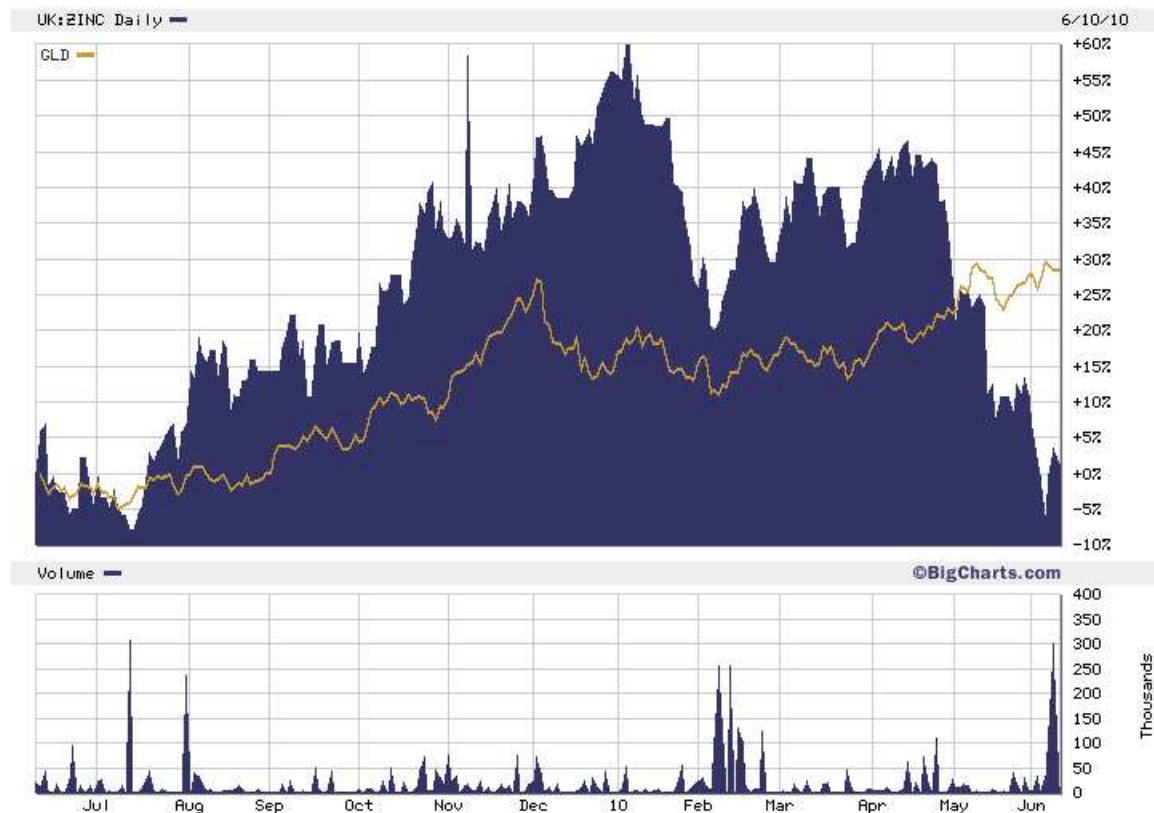


The Zinc ETF (ZINC.L) is a relatively recent discovery for us. It is no surprise that it passed under our radar, and that of many investors, as it trades on the London Stock Exchange with relatively minor daily volumes. It represents a very interesting means to get some pure exposure for investors that do not want the event risks associate with the big zinc miners (very few of which are pure plays in any case).

### Gold and zinc – diametrically opposed?

Curiously, there seems to be more relationship between the S&P and zinc than between gold and zinc. The inflation school of thought that supports unbridled gold buying would hold that rising commodity prices is a sign of inflationary outbreak and thus a reason to buy gold as zinc and others rise. However the gold bugs changed their tune when Europe started to go to the dogs with inflation being put on the backburner and “flight from risk” being the new mantra. This allowed gold to rise when there was decreasing inflation risk, particularly from commodities.

The following chart shows the Zinc ETF versus the Gold ETF. Gold, as we know, has been uptrending after it doodled around for months after its initial retreat from \$1,200.



### Zinc – potential unappreciated

At the risk of sounding eternally optimistic we reiterate our enthusiasm for zinc. The zinc equation is rather simple. At a price per pound of under 70 cts most producers of zinc are losing money. Some were sustained, when zinc first turned turtle in the 2008 rout, by their by-product credits from silver or lead but then those too slipped beneath the waves and some of the classic Ag-Pb-Zn mines were losing money on all three product lines. Some others, most particularly the Australians, got some brief relief by the Australian dollar plunging in late 2008 from 92cts to the USD to a nearly 60 cts in the space of a month. However, not to be outdone, the zinc price lost 40% in the same time, largely negating the currency move. The net result was a swathe of mine closures and mothballing across the globe. Some have reopened, some have gone for good.

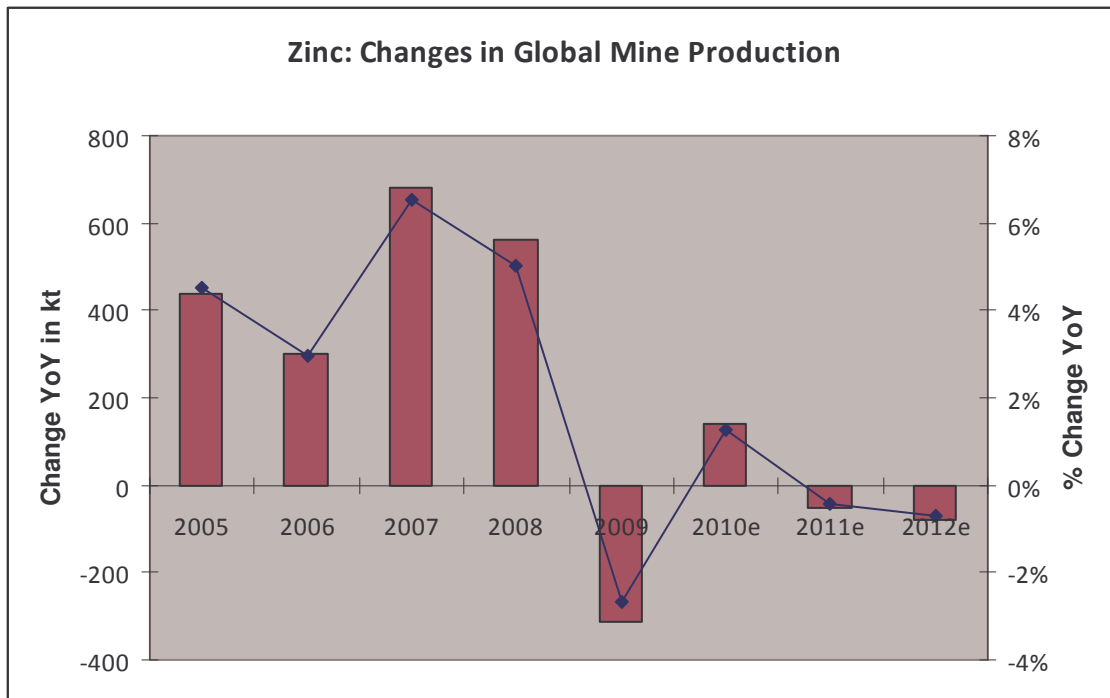
Steel production rebounded, at least in China, during 2010 and with it lifted the iron ore price making for a fevered market again in that metal. Zinc responded in a more muted fashion largely because Western demand was still way off the boil and Chinese consumption was insufficient to make up for the broader weakness. In 2009, sharp falls in zinc demand of 25% in Europe, 10.5% in the United States, 23% in Japan and 22% in the Republic of Korea were partially balanced by an increase in Chinese apparent usage of 17.8% resulting in an overall reduction in global demand of 5.3%.

World Refined Zinc Supply and Usage 2004 - 2009											
000 tonnes	2004	2005	2006	2007	2008	2008	2009	2009			
						Jan-Dec	Jan-Dec	Sep	Oct	Nov	Dec
Mine Production	9709	10146	10447	11129	11690	11690	11378	974.0	1007.6	1018.6	1092.9
Metal Production	10395	10221	10655	11360	11655	11655	11277	965.9	985.6	1043.0	1058.4
Metal Usage	10650	10611	11015	11307	11436	11436	10832	980.6	947.7	959.8	1004.0

Source: ILZSG

The table above shows mine production crawling upwards over the last six years before a small retreat in 2009. Both metal usage and production turned down in 2009 and production of refined zinc exceeded usage by 445,000 tonnes, the largest surplus since 1993. This should have been enough to send zinc even lower but the Chinese surged into the marketplace and vacuumed up the surplus, clearly stashing it away for a rainy day.

Below can be seen our projections for the YoY change in production over the next few years. Production will be up in 2010 despite the recent price slump because of momentum from a strong finish to 2009 and the rising Zn/Pb output from the strong silver price and new production in the Ag/Zn/Pb polymetallic category. However, under this frothy layer primary base metal sources of Zn/Pb will be heading down as mines expire and no new production appears. This is where the real crisis is brewing.



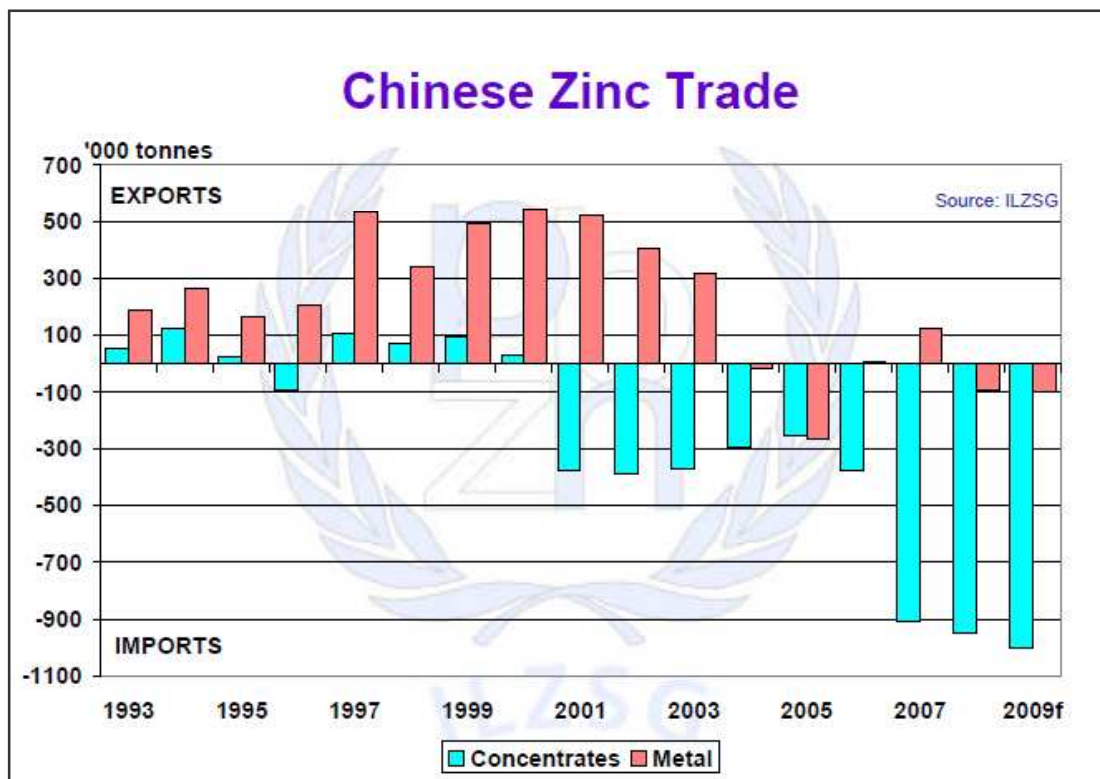
**China – main driver**

The reason that China was able to regain the pricing initiative in the zinc space was its strength during 2008-9 when everyone else was in retreat. Chinese net imports of refined zinc metal in 2009, according to the International Lead and Zinc Study Group, rose to a record 641kt of which more than 70% was

imported during the first half of the year. At 1.9 million tonnes, imports into China of zinc contained in zinc concentrates were also at the highest level so far recorded.

For a long time, until the middle of last decade, China was not only a source of large-scale exports but also a price spoiler due to its own low internal costs combined with an innate disinterest in “commercial” considerations (as we have noted elsewhere in the Rare Earths space).

The chart that follows shows that Chinese metal exports evaporated early last decade and then it became a massive net importer.



We are permanent bulls on the zinc space for the long term and found it hard to stomach in 2009 that those with a negative opinion on zinc were citing the Chinese demand issue as the reason to not like zinc. With China’s growth for 2009 having been in the order of 8-10% in most opinions and a similar forecast for 2010 it was exceedingly hard to see how this massive net importer was likely to return to its old exporter status. Our thoughts were proven to be right.

We would also note that China was firstly (from 2001 on) an importer of concentrates and an almost equal exporter of metals. As energy costs rose in China, the trade became almost one way and particularly so in more recent years as the more marginal and dangerous coal mines were shut down and competition for scarce energy resources between sectors in China became more ferocious. Thus it became an exporter of processed metal rather than mere concentrates. There are no reports to indicate that China is anywhere near resolving its energy dilemma so there could even be the paradox of them importing more finished metal rather than less.

In any case such a trend is not a requirement for sustained zinc concentrate demand with China as the end user. Merely the ongoing growth in China will continue to increase its share of global zinc consumption and its zinc output is clearly inadequate for its own needs. These issues were compounded by chronic low grades in zinc mining in China and inefficiencies that resulted in a general perception amongst informed zinc-watchers that while the major Western producers had a breakeven price of around US 80 cents per lb, the Chinese had a breakeven that was often speculated to be around US\$1.20. This is reason enough for the Chinese to have been massive zinc stockpile buyers during 2009, lifting the price from a low around 46 cents to nearly their breakeven price. Is it no surprise that the zinc price should have been walloped once it finally got over \$1.20 per lb in a brief flurry early in 2010?



The zinc price like so many other key metals is now subject to “market-making” by the Chinese. This is not necessarily a bad thing as speculators (largely hedge funds) serially distorted via “pump and dumps” the nickel, zinc and uranium markets in the run-up to the slump of 2008. It seems the Chinese are more interested in orderly markets where Western producers get a fair though not outrageous return on their production than Western end-users that beggared a whole swathe of the base metals industry (leading to the annihilation of virtually all the US and Canadian majors) between 1973 and 2003. “Better the tender mercies of the Chinese than the gouging of Western industrialists” should be the mantra of the surviving and up-and-coming base metals miners as they head into a new decade.

### Warehouse levels

How many hedge fund managers do you know who have space in the basements of their Midtown Manhattan or Mayfair offices for 15,000 tonnes of Zinc? If the answer to that is “none” then you have a fairly good explanation of why the old LME adage “high stocks, lower prices” and vice versa has gone the

way of the dodo. To speculate in the physical Zn space you need to have somewhere to store the physical metal that one buys. Once the market was miners on one side and industrialists on the other with some low capitalization intermediaries who held minimal long positions. Despite the well-publicized eruption of hedge funds in the LME trading sphere many observers don't seem to have absorbed the implications of this sea-change when looking at warehouse stocks. A further overlay to add to the confusion is the smoke and mirrors of the Chinese players who, having "basements" where they can stash stocks, specialise in shunting said stocks into and out of the official warehouses. Or rather we should say that they "did" do this because since their dalliance pre-2008 in the copper market where they tried this one on with the market veterans and failed we suspect this shell-game is no longer in the Chinese repertoire nor needs to be. In any case the only ones they were fooling was the hedge funds!

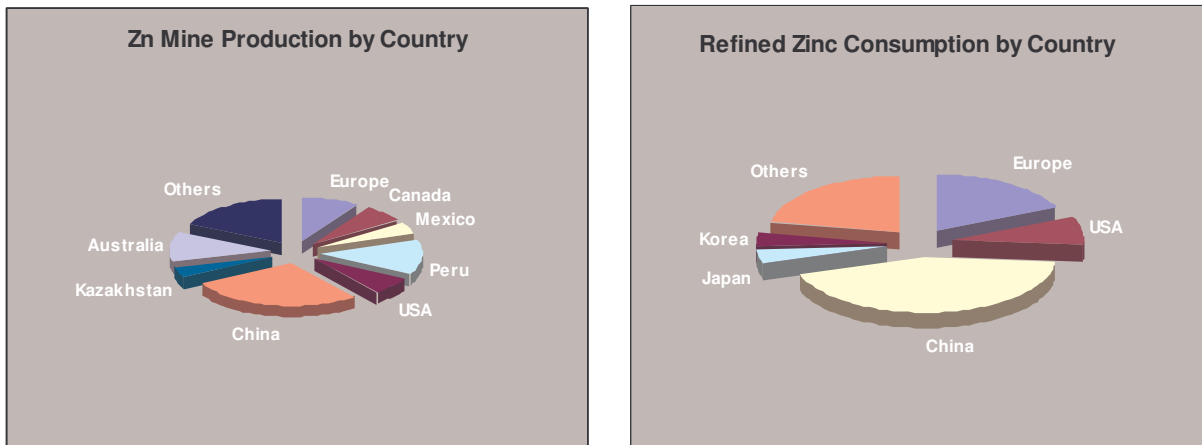


In truth the whole subject of warehouse stocks is now somewhat irrelevant. No one would say that a gold repository holding record stocks was a negative for gold. It would be read as a sign of panic buying and removal of stock from the marketplace. The same could now be said when reading the tea leaves for all metals and all warehouse stocks.

### Forex effects

It is always important to consider the local currency of the zinc/lead producer before making sweeping statements about the effects of a price fall on the sector and major players. When zinc was \$1.20 per lb in late November 2009, the Australian dollar was heading towards parity with the US dollar and the Canadian dollar was even closer to that goal. The euro back then was as high as US\$1.55. So zinc retreated to 71cts last week and the euro was flirting with US\$1.20, the Australian dollar had retreated to US 82 cts while the Canadian dollar has lost its brief supremacy over the US dollar. Most relevant for production is the Australian story though. Very important for consumption and some production

(Finland, Portugal and Ireland) is the level of the euro. The Australians have held onto some of their margins by losing ground against the US dollar but are still worse off than they were and so margins must be suffering. The European buyers of zinc are probably paying about the same in euros for their zinc as they were doing at the euros highpoint. Though that highpoint was relatively shortlived, the prolonged euro strength had been a great boon in providing European manufacturers and processors with zinc getting cheaper than it had been for most of the previous five years (excepting the 2008 dip).



The pie charts above show that Europe is not an insignificant zinc production source (being bigger than Canada and Mexico combined) while on the consumption front Europe consumes twice as much as it produces implying that low Zinc prices are good for its reconversion industry and end-users.

The European miners of zinc are actually advantaged by the current Euro slump and the ideal situation for them would be to see zinc back over a dollar per pound while the Euro stays less than US\$1.30.

### Short-term Price Outlook

Up until now, one's view of the euro crisis would have given one a good guide as to where zinc and lead were going. Though we can only say this in retrospect as there is no logical argument that can be contrived that would substantiate US 71 ct Zinc equating to a US \$1.19 rate to the Euro. The real culprit here was a flight to safety that led to non-trade players ditching "inventory". The "inside-money" in the base metals space got out of the way and stood to benefit from seeing how far this knife would fall rather than leaping forward to catch it in their teeth. Thus hedge funds and other neophytes were once again cleaned out, literally and figuratively.

Meanwhile the Chinese quite clearly sat on their hands waiting for the whole situation to pan out. Indeed, it could even have been the case that they may have released stock in the \$1.20 to \$1 first leg of the fall just to punish the speculators. Beyond \$1 we feel that the Chinese must not have been happy campers because they too could see the effect an excessive fall would have on future mine plans. The \$1 to 71 cts phase was thus sheer distressed selling. This is now over and the first leg of a rebound is in train. This has brought the price back up rather smartly to near the 80 cts level. Anyone foolish enough to have been short at 71cts is thus now scrambling to cover and trade buyers must be moving in to grab some bargain inventories. We also suspect that the Chinese will return to the fray to snap up some more stock which gives them more weaponry for the future to discipline the market should it get overheated.

Thus we feel that Zinc and Lead could be back at the 90 cts level within weeks and should end the year above \$1 per lb. Our twelve month outlook is for Zn to again reach \$1.10 or slightly higher. Thus the aforementioned Zinc ETF looks a great way to play this potential move. Even better there is a leveraged ETF, from the same originator, that gives double effect to any up (or down) move.

### **Conclusion**

Not unsurprisingly zinc has rebounded rather smartly from its recent low of 71 cts, but 79 cts frankly is no consolation to anyone in the space. This includes end-users. Zinc is in a very delicate place. Having just recovered last year from the mauling that sent it below 50 cts in the market meltdown of 2008, the zinc complex needed a sustained recovery in prices to tease projects off the drawing boards and into the financing phase. While some transactions went through during the recovery phase most of these were on existing producing assets. The zinc end users need to feel that there is some new production coming on three or more years out. Short of silver mines with strong zinc/lead by-product credits there is nothing between here and the horizon in terms of new production. This then implies that a shortage bubble is coming along and prices will spike again as they did in 2006/2007.

Producers or prospective producers were rightly wary, at \$1.20 per lb back in December that they might be being led into a bear trap by the Chinese or hedge funds or whoever. Their fears were realized and thus any recovery to over \$1 per lb will more likely have them hoarding cash and tweaking production rather than launching new capex initiatives of substance and certainly not indulging in de novo mine startups.

We have no doubt that zinc and lead should both hit \$1 per lb before the end of 2010, probably on opportunistic Chinese stockpiling and a desire by the Chinese to ensure that foreign mines stay in operation to provide them with fairly reliable supplies.

Thus the perspective for stocks in the space to experience a whiplash rebound looks good. Our favorite exposure remains Nyrstar, the vertically integrated player in the space for the lesser damage that the Euro move will inflict and the advantages that will accrue from lower prices, at least if only temporarily. For the fastest return though the Zinc ETF would look to be the way to play the bounce from recent lows.



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