Commodities Forecast Update

Rebound in Q2 but no H1 catch-up with equities

Commodities have struggled to move higher since the start of 2013, despite improving Chinese and US data and decent risk appetite, which has supported other risk assets, notably equities. Energy, metals and grains prices are lower than at the start of 2013, begging us to question why commodities have failed to perform. We see three main reasons for this underperformance, which should alleviate in Q2, but we do not expect commodities to be able to catch up with, for example, equities in H1 overall.

First, while cyclical conditions have improved, weak spots have also surfaced. Although China avoided a hard landing, its recovery has been less sturdy and less commodities intensive than expected around New Year. Indeed, the pickup in physical buying from Chinese manufacturers that many (including us) were looking for after the Chinese Lunar New Year never really materialised. Also, while the US growth engine has certainly shifted into a higher gear, it has become increasingly evident that a soft patch as a result of the heavy federal budget cuts is unavoidable. As a result, commodities have not been granted an outright positive demand background to move unilaterally higher.

Second; uncertainty following the dizzy Italian election outcome has hit risk appetite and, not least, the EUR and the Cyprus crisis have not helped to lift sentiment either. Rising speculation on when the Fed will initiate its exit from QE has also held a hand under the USD. The move lower in EUR/USD has thus weighed on commodities partly from a denomination point of view (for USD-traded products) and a partly from a risk sentiment point of view. In this respect, it is interesting to note that speculators have shred crude, copper, gold and corn alike of late, hinting that it may not take much bullish news for prices to start recovering from here.

Third, supply conditions have generally surprised on the upside. Non-OPEC crude oil production has edged higher as North American shale supplies add and maintenance in key areas has ended. Although the Saudis have cut production as a result, other OPEC countries have ensured that output from the cartel is still running above 30mb/d. We have argued for a while that it was simply a matter of time before Chinese imports of copper picked up, as booming bonded warehouses had to be run down first. This has not happened. While there is little visibility on the amount of metal in bonded warehouses, it is now clear that recent months have seen a significant ramp-up in global copper production, LME stocks have surged to post-crisis highs and future supply prospects look much brighter than they did in the autumn. Notably, the International Copper Study group (ICSG) now projects 2013 will see the first refined copper market surplus since 2009. Finally, for grains, US weather conditions have improved and, while drought is still an issue in some areas, recent prospective plantings data point to a marked recovery in production of most grains this season.
Overall, our forecasts for Q1 have generally proved too optimistic and we look to revise the level of our forecast profiles lower for most products. However, we still expect to see a peak in commodity markets in Q2, as the underlying cyclical picture continues to improve but much depends on the eurozone: if the ECB goes for a rate cut, Italy remains without a government and/or the debt crisis resurfaces, commodities stand to miss out on the H1 risk recovery altogether. From the summer, conditions stand to deteriorate as an improving supply outlook, softer demand from China and markets eyeing the Fed exit should weigh on the complex.

**Demand and FX outlook: set for Q2 rebound**

In the recent *Global Scenarios*, 18 March, our economists argued that the global economy is now on a path to a sustainable recovery that will gain pace in coming years.

In China, a two-year slowdown has come to an end but the economy is recovering at a lower potential growth rate than before and at present there is little visibility in terms of the country’s cyclical stance. It seems, however, that the recovery will be less strong than we projected at the start of the year. This has hurt demand for raw materials and been one factor behind the dismal performance of base metals in particular. However, we expect Japan to see a strong rebound in growth in 2013 on the back of ‘Abenomics’, i.e. an aggressively easing Bank of Japan. Albeit risks loom again in 2014, in the short term Japanese manufacturers may emerge as key buyers of energy and iron ore.

In the US data have been strong since New Year but recently signs of a soft patch for US growth has emerged following the extensive fiscal tightening currently being effectuated (the sequester). This suggests Q2 could be somewhat weak but we expect the underlying positive growth recovery to remain intact. The substantial improvement in the labour market that remains a prerequisite for the Fed to start scaling back on QE may thus take further to materialise.

At the other side of the Atlantic, a key headache for the ECB remains the two-speed recovery within the eurozone: while Germany is performing decently, this cannot be said of most other EMU countries. Also, Europe has recently been challenged further by the dizzy Italian election outcome and the Cyprus crisis.

While the risk of an ECB rate cut is certainly not negligible, our economists expect the ECB to go instead down the route of non-standard measures to improve the monetary transmission mechanism and introduce a measure to improve lending to medium to small eurozone companies (SMEs). This, combined with a continued expansion of the Fed’s balance sheet, should ensure that EUR/USD ticks higher on a 3M horizon. This is set to be a supportive factor for USD-denominated commodities in Q2.
**Commodities Forecast Update**

**Oil: geopolitical risks undervalued – set for Q2 rebound**

Oil prices have continued to move lower since peaking at end-January; initially the fall centred on the US, with the Brent and WTI spread widening in early February. Weakness has since become broader based and Brent has suffered relatively more in recent weeks, as North Sea production has rebounded while demand for crude from refiners has been subdued due to maintenance. Not even the death of Venezuela’s Hugo Chavez could do more than induce a blip in oil prices, with markets sensing ‘things can only get better’ after years of decelerating production growth in the world’s No.1 reserve country. Saudi Arabia has continued to cut supplies over the past few months, probably in an attempt to set a floor for oil prices.

The ICE gasoil spread to crude oil has headed lower since New Year, from USD18/bl around New Year to USD14/bl now. This underlines that industrial demand for light products has not been as strong as might have been expected given improved activity despite the maintenance seasons leading to reduced oil product supplies from refiners. That Saudi Arabia has cut production significantly of late has also induced a twist in the quality of oil being put on the market: relatively less heavy oil now presumably comes on the markets as the Saudis rationally prioritise the high-quality crude in periods of output rationing. This tends to depress the light-heavy product spread, everything else being equal.

For now, OPEC appears happy with the situation as it is; the cartel’s secretary general El-Badri recently said the collective quota system works ‘beautifully’ and reused the old saying regarding prices that at present these are ‘comfortable for both consumers and producers’. The next OPEC meeting is due to be held on 31 May, with a decision on El-Badri’s successor due in December this year – an issue that last year gave rise to conflict between key members such as Saudi Arabia, Iraq and Iran, highlighting awaning sense of unity within the cartel.

We still think the challenges OPEC faces due to the rise in production in North America and Iraq in particular will make it much more difficult for the cartel to stabilise the oil market – unless Saudi Arabia bites the dust and cut production even more to accommodate the rise in supplies elsewhere. This suggests the oil market may end in a surplus this year, as was also the case in 2012.
Commodities Forecast Update

However, prices may still see decent support from current levels, as the geopolitical situation remains tense. Much of the Middle East and North Africa is still plagued by turmoil, with Syria a long-standing case and recent renewed uproar in Egypt. Also, while there were some hints of improvement in Iran and the so-called P5+1 negotiations earlier in the year, the latest round of talks has provided little resolution to the decade-long dispute on the Iranian nuclear programme. Israel has previously said that its de facto deadline for a resolution was spring-early summer; hence, the Iranian issue has returned as a key factor for the oil market in Q2 as Israel may bring up the threat to launch a military strike on Iran again if no compromise on the country’s nuclear activities is reached. Add to this the latest step-up in war rhetoric from North Korea against the southern part of the peninsula as well as vis-à-vis the US.

Thus, we think geopolitics remain a key factor for oil in the near future. However, our model for Brent now hints at a near-zero risk premium, which we deem somewhat unfair. This suggests to us that oil prices will have to rise from current levels in order to incorporate the renewed focus on geopolitics that we look for in Q2. As a result, we expect Brent oil to rise to trade in the USD100-120/bl range over the next couple of months, with a move higher soon to be expected. In H2, we look for prices to stabilise.

Metals: returning from holiday in Q2

Base metals have followed gold lower since early February and, notably, copper and zinc have been hit hard by higher supplies. For metals as a whole, there is a sense that the Chinese buyers never really returned to the market after the Lunar New Year holiday in February. Indeed, imports of both aluminium and copper have edged lower still. Gold is in our view still in bubble territory despite the extended price drop seen since the autumn. Not even the signs of global currency war earlier in the year helped to prop up the yellow metal to any significant degree.
Copper supply surprises on the upside

The big story within industrial metals over the past few months has been a substantial improvement in the copper supply outlook. Copper production has excelled globally driven by heavy increases in mine production, not least in China; also, Chilean output of copper ore and concentrate has increased recently after years of stalling production. Adding further to the positive supply sentiment has been a rise in copper ore grades at key mines following years of steep declines. While it remains too early to call off the projected supply shortfall in copper for the coming years, the International Copper Study Group (ICSG) now projects a surplus for 2013 for the first time since 2009.

As a result, exchange stocks of copper have soared recently, with LME inventories at post-crisis highs; in contrast, moves higher in nickel and aluminium warehouse stocks have been much less abrupt. The amount of copper in Shanghai bonded warehouses stabilised from end-2012 to early 2013 and has picked up in recent weeks. Thus, there is a fair amount of stock overhang to work off before Chinese producers start to drive up imports.

Thus the fact that the US authorities early in the year approved two physically backed copper ETFs – under heavy criticism from a range of key consumers – has not managed to underpin prices to the extent that buyers feared. Indeed, high fees for investors looking to buy into these products may – together with the less bullish outlook for the red metal – limit their success, as has been the case with previously launched products in this category.

However, it is worth noting that copper has been widely used as collateral in corporate financing, which has been a continued source of import growth during periods of credit tightening. Although there was a sustained rise in money supply in China for most of 2012, recent indications of an overheating property market and lending curb as a result may imply that copper will continue to see demand from this side as companies attempt
to secure funding. Clearly, this also hints that a loosening in credit conditions further out could release a good amount of metal to the market and weigh on prices.

Aluminium forward curve still takes centre stage
Financing deals continue to tie up substantial amounts of aluminium inventories and thus hold a hand under prices. While interest rates globally will have to rise eventually from the near-zero levels that prevail now, the forceful quantitative easing programmes still in place across the globe (with the Bank of Japan joining the party aggressively lately), a wider unwinding of these cash-and-carry trades is not on the cards in the near future.

Reportedly, many consumers are wary of hedging not least aluminium longer term and thus live ‘hand-to-mouth’ as the long-standing supply glut is expected to cap any price upside. However, this has implied relatively low liquidity at the LME and made it possible for participants engaged in financial deals in the light metal to squeeze the market at certain points on the forward curve. Notably, the curve has been brought in to backwardation around July and October 2013 and January 2014, as the few buyers left have been willing to pay speculators an ‘extra premium’ for selling aluminium forward at these specific points in time.

The cost curve for aluminium remains relatively flat around the range where prices are trading at present suggesting that aluminium will likely continue to be somewhat range-bound: if prices rise just a little this should incentivise a fair amount of additional output, in turning capping any price upside, and vice versa for a price drop.

Metals outlook: copper, aluminium in for Q2 recovery
While demand should remain decent in the near term, it is ‘now or never’ for base metals as our economists are looking for Chinese growth to peak around mid-year. The moves higher in EUR/USD and industrial production have helped to hold a hand under fair values for base metals despite the inventory build-up. Copper prices are now broadly at par (if not slightly below) fair value (USD8,050/MT) whereas aluminium looks increasingly oversold relative to fair value (USD2,350/MT). This, combined with our relatively upbeat outlook for fundamentals in Q2, implies that we look for prices to recover from here. Crucially also, speculators have been net short copper for a while, suggesting the metal may need only a few catalysts to see investor support from here.

Our model-implied value for gold has been edging lower of late and prices remain well above hinting at further downward to come.
We have revised our metals forecasts lower. Notably, we have to acknowledge that the supply story for copper has evolved rather differently of late than expected just a few months back: global output has surprised markedly on the upside, questioning one of the few bullish commodity cases left in the aftermath of the super-cycle. We no longer project that copper will be able to see a sustained move higher: years of prices above costs for most producers have induced investment in new capacity which is now finally starting to be seen in world production figures. Copper will most likely still be prone to a large degree of volatility as labour strikes, a general decline in ore grades and adverse weather haunt the industry. We now see copper averaging close to USD8,100/MT both this year and the next.

For the rest of the base-metals complex, the story remains a little more bearish though: we see aluminium broadly unchanged on the year averaging USD2,065/MT in 2013, but heading lower in 2014 to USD1,990 as cyclical conditions become less supportive and monetary policy less accommodative. Similarly, gold is expected to continue correcting south from current bubble terrain.
Agriculture: normalisation set to continue

Grains prices have generally continued to normalise following the price surges seen as a result of the US drought last summer. Lately, corn prices have fallen markedly on the prospect of this year’s production making up at least partly for last year’s shortfall. When the US Department of Agriculture (USDA) published its report on prospective plantings late March notably corn dived on farmers looking to keep acres of the grain at elevated levels; also wheat is set to see more plantings this year. If weather conditions continue to evolve more favourably, the normalisation in grains prices (i.e. the move lower) should thus continue this season. Indeed, for wheat, corn and soybeans alike, our fair-value models suggest that prices are currently overvalued.

Past years’ experience underlines that this is a big ‘if’. Importantly, some key growing regions in the US are still plagued by very dry conditions and, after the conditions of this year’s winter, wheat is at relatively poor levels with only 34% of the plants rated ‘good/excellent’ at present. Thus, there is no guarantee more plantings will necessarily result in higher production. Also, we stress that on the whole, global grains markets remain tight with stocks-to-use ratios remaining in low territory and thus grains markets remain highly vulnerable to e.g. export restrictions.

Speculators have scaled back long positions across the three major grains since last summer and while investors are now short wheat, the overweight of longs in both corn and soybeans still underlines that favourable weather conditions could induce further sell-offs in these.

The price drop seen in feed grains such as corn have helped to improve the margins of some livestock producers. While corn use for fuel ethanol has been stalling as producers have hit the “blend wall” (due to a fixed 10% blend rate and falling gasoline consumption in the US), it is interesting to note that USDA highlights rising poultry production as a key source of demand for coarse grains (such as corn) as margins improve on falling grains prices. This underlines that the drop in grains may start to at least decelerate.

We have revised our grains-price forecasts lower on the better prospects for the southern hemisphere crop this season and a decent start to the northern one (US). The recent normalisation in prices should continue this season albeit some near-term dollar weakness may cap downside in Q2.
Hedging: consumers, lock in now or leave some 2014 open

We generally recommend clients on the consumer side with a need to hedge H2 prices to do so before the Q2 rebound that we envisage.

In oil we underline that current price levels appear attractive for both 2013 and 2014 despite our relatively downbeat outlook. With the Brent forward curve now in a clear backwardation even late 2014 prices can be fixed below our forecasts.

For base metals, the level shift seen in copper after the Q1 positive supply surprises has brought the forward curve well below even our updated forecasts where we see a stabilisation in prices over the next two years. With copper still prone to see a good deal of volatility we recommend clients to buy copper for both 2013 and 2014 at the price levels offered at present despite the slight contango which has emerged since the autumn. Aluminium is a slightly different story as we see prices declining whereas the market remains in a long held contango. Thus aluminium consumers may consider leaving some late 2014 exposure open to benefit from further downside next year.

For grains, consumers may consider awaiting a further normalisation in prices – not least for wheat where our forecasts are well below those of the CBOT forward curve throughout our forecast horizon. However, with global grains markets historically tight – not least for corn – and the events in recent years serving as a reminder of the significant impact of highly unpredictable weather events on crop production, hedging some buying exposure may nonetheless be advisable. Unsurprisingly, the flip side of the coin is that for producers, the wheat prices offered by the market at present look attractive with Matif milling wheat above EUR200/ton out to end 2014.
## Danske Bank Markets commodity-price forecasts

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Source: Bloomberg, Danske Bank Markets
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