Commodity Trends

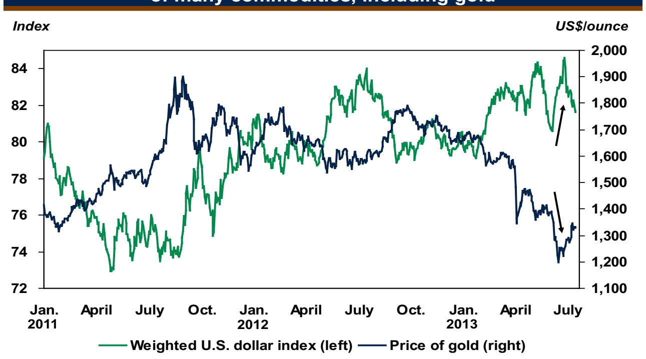
Desjardins Economic Studies
www.desjardins.com/economics

July 30, 2013

A summer of ups and downs

The past few weeks have been quite tumultuous for the commodity market. Most resource prices fell in June, with investors worrying about the economic health of the emerging countries and the possibility of hasty monetary tightening in the United States. The days that followed June 19, when the chairman of the Federal Reserve (Fed) confirmed that U.S. monetary authorities were considering scaling back their financial securities purchases soon, and halting them altogether around mid-2014, were a particularly tough time for commodities. The sudden spike in investor concern, combined with a surge of the U.S. dollar, drove many resource prices to lows not seen in many years (graph 1).

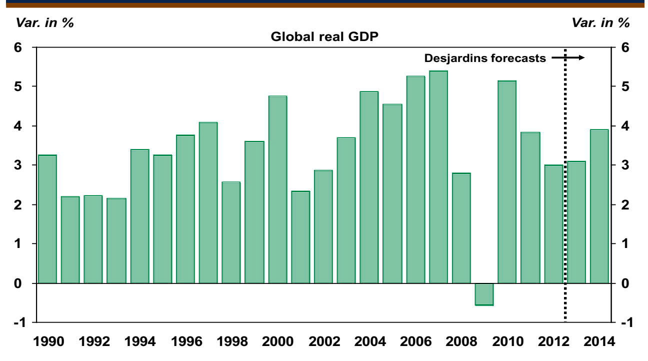
Graph 1 – The greenback's surge has driven down the prices of many commodities, including gold



Sources: Bloomberg and Desjardins, Economic Studies

Generally speaking, commodity prices rebounded in July, when Fed officials managed to convince investors that U.S. monetary policy would remain very stimulative for a long while yet. However, we note some significant variations in the price trends of various commodities. The price of North American oil in particular made a surprising surge, given the expanding production of crude in that region. Conversely, the price of natural gas is now going through a rough patch, after a good start to the year. On the metals side, platinum and palladium are doing well, since the automobile industry keeps gaining strength. We still expect a more sustained rally in resource prices next year, when global economic growth should pick up steam (graph 2).

Graph 2 – Global growth should close in on 4% next year



Sources: World Bank and Desjardins, Economic Studies

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ENERGY

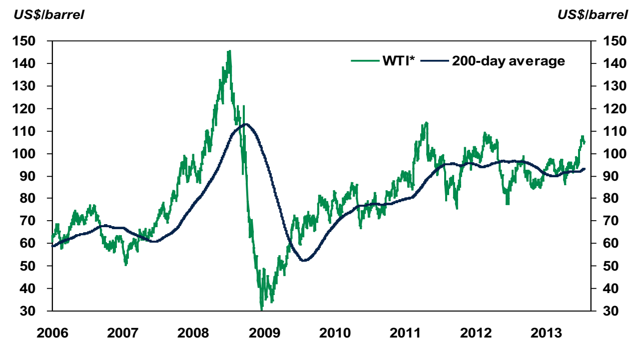
Is the higher price of WTI oil sustainable?

OIL

- The price of West Texas Intermediate (WTI) oil has kept heading up in recent months, despite a financial environment that was not favourable in June. The price of WTI recently reached US$108 per barrel, its highest level since March 2012 (graph 3). That increase does not represent an explosion in international oil prices, the price of Brent oil has risen by a much smaller degree in recent months and still stands more than US$10 per barrel below where it was last February. These contrasting trends have melted the spread between Brent and WTI prices in a spectacular way, to the point where it has practically disappeared.
- This reduction in the spread between Brent and WTI prices is partly accounted for by strong demand from refiners and by increased use of railways to ship the oil; this has significantly reduced the surplus of WTI in the U.S. Midwest (graph 4). But railway transportation is very expensive, between US$10 and US$15 per barrel, so this should justify maintaining some degree of discount on the price of WTI compared with other types of oil that U.S. refiners can buy. In reality, though, the major refineries in the Gulf of Mexico buy their oil not from the North Sea, but from other sources (Venezuela, Louisiana, etc.). In recent years, those oils were trading close to Brent prices. Now that WTI oil is increasingly reaching those refineries and is slashing oil imports, we note that Louisiana oil is competing with WTI oil (graph 5). If this trend continues, WTI oil could quickly become a good reference value for North America as a whole, and even the world, which was not the case in recent years.
- These recent trends in spreads between oil prices show the extent of the effects that the U.S. energy revolution will have on the global energy market. We published an *Economic Viewpoint* on this topic a few weeks ago.[1] The latest data and the most recent analyses confirm that the surge in U.S. oil production will continue (graph 6 on page 3). While the Lac-Mégantic tragedy is likely to result in significant tightening of the rules governing the transportation of oil by rail, the challenge of developing the infrastructures required to carry this new oil safely and efficiently is still a major one, and more bottlenecks are likely to crop up.
- Internationally, while events in Egypt have raised some concerns, nothing would seem to justify a lasting increase in oil prices. The International Energy Agency has revised its forecasts of demand for oil in 2013, upwards, and is predicting quite strong growth next year, when a more favourable economic environment is expected. However, this demand will be more than met by the sharp increase

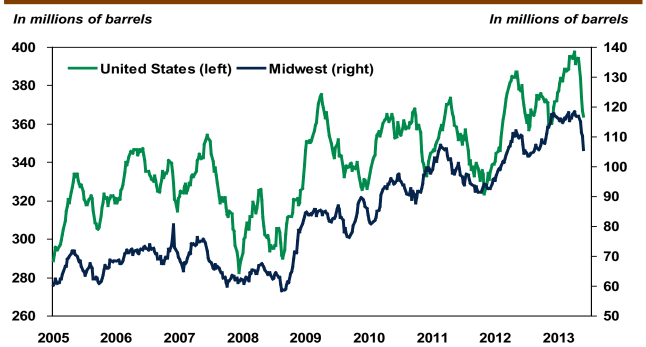
[1] Desjardins, Economic Studies, *Economic Viewpoint*, "U.S. energy revolution: We can't ignore the consequences," June 11, 2013, www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv130611.pdf.

Graph 3 – Price of a barrel of oil



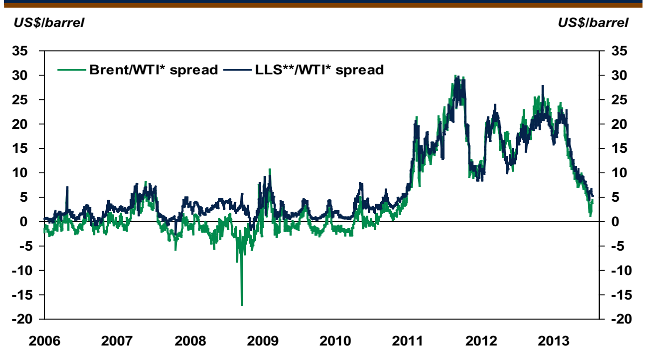
* West Texas Intermediate.
Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Commercial inventories of crude oil in the United States have contracted sharply recently



Sources: Energy Information Administration and Desjardins, Economic Studies

Graph 5 – The price of WTI* has jumped compared to prices of Brent and Louisiana oils



* West Texas Intermediate; ** Light Louisiana Sweet.
Sources: Datastream and Desjardins, Economic Studies

in production by countries that are not members of the Organization of the Petroleum Exporting Countries. The oil market should therefore remain in a balanced state in the coming years.

GASOLINE

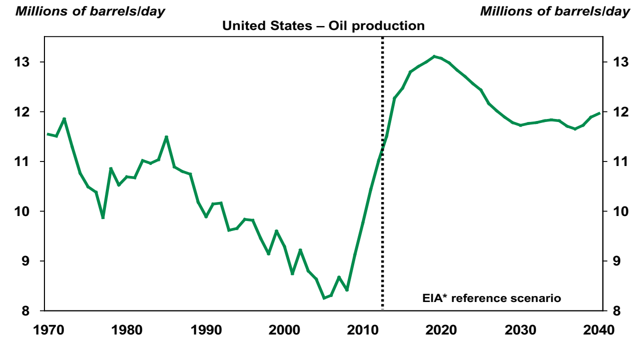
- The recent surge in oil prices has pushed up gasoline prices in North America. Strong seasonal demand and another spike in the price of ethanol credits that the U.S. refiners are required to purchase to meet ethanol use requirements have also helped to drive up the average gasoline price in the United States from US$3.50 per gallon at the beginning of July to nearly US$3.70 (graph 7). The weakness of the Canadian dollar is also adding upwards pressure on Canadian gasoline prices.

NATURAL GAS

- After an excellent start to the year, which took it to a height of US$4.38 per MMBTU (Million British Thermal Units) in April, the price of natural gas has fallen back in recent months; lately it has stood at around US$3.60. Still, that price has risen by more than 5% since the beginning of the year, and by more than 15% compared with the same period last year. After a very cold winter, which depleted inventories and caused gas prices to soar, a return to more normal temperatures in recent months has helped to moderate prices. In the longer term, if the price stays around US$4 per MMBTU, we should see a major expansion in U.S. production of natural gas; the United States could even become a net exporter of gas around 2020 (graph 8).

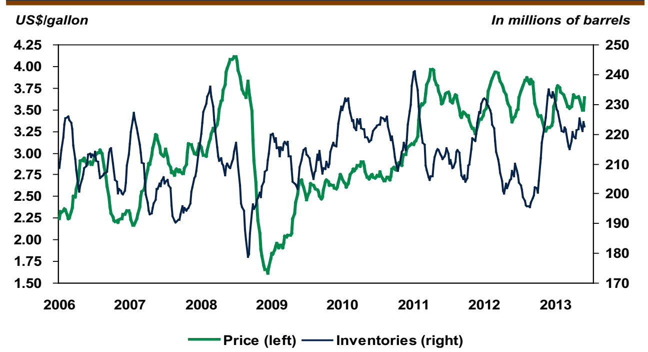
Forecasts: The recent surge in the price of WTI oil mainly reflects factors that are technical and temporary. While there are no signs of any risk of an oil shortage in the years to come, and the expansion in North American production should boost U.S. inventories fairly quickly, the price of WTI should fall back below the US$100 per barrel mark in the months ahead. The U.S. energy revolution is unlikely to generate any collapse in international oil prices but, by providing a steady supply to the market, it will considerably reduce the risk of any new and lasting explosion in prices.

Graph 6 – The U.S. oil industry is experiencing a true rebirth



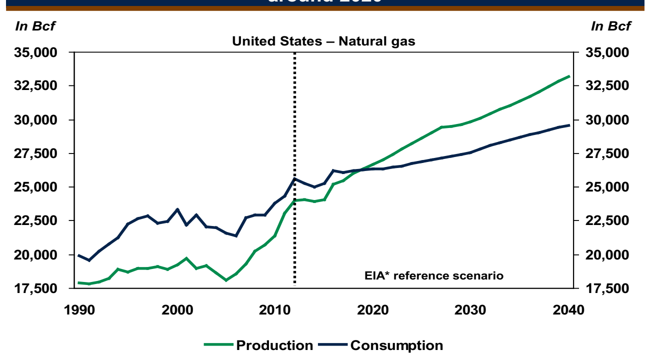
* Energy Information Administration.
Sources: Energy Information Administration and Desjardins, Economic Studies

Graph 7 – Gasoline prices and inventories



Sources: Energy Information Administration and Desjardins, Economic Studies

Graph 8 – The United States could be self-sufficient in natural gas around 2020



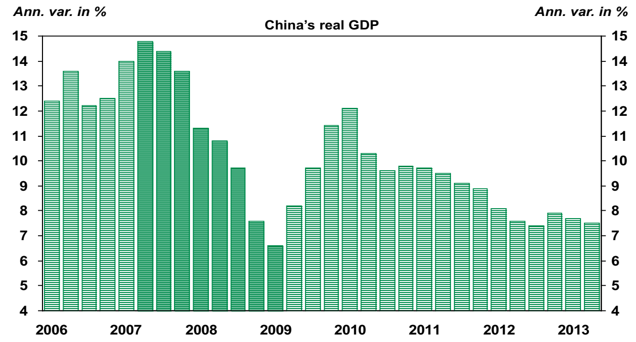
Bcf: billion cubic feet; * Energy Information Administration.
Sources: Energy Information Administration and Desjardins, Economic Studies

BASE METALS

China continues to raise concerns

Investor concern following the June meeting of the Federal Reserve drove down the prices of most metals to lows not seen in many years. The prices of the main metals subsequently rallied slightly, but they all currently stand more than 10% below where they were at the start of this year. While hopes are growing that the U.S. and European economies will accelerate in the second half of 2013 and in 2014, it is mainly emerging countries, particularly China, that are weighing metal prices down. China's real GDP grew by just 7.5% year-over-year in the second quarter of 2013 (graph 9), and the weakness of some other statistics is arousing fears that the slowdown will continue. Chinese authorities do seem ready to take action to avoid a further slowdown, though: the Prime Minister recently declared that he would not allow growth to fall below 7%.

Graph 9 – Chinese economic growth is slowing

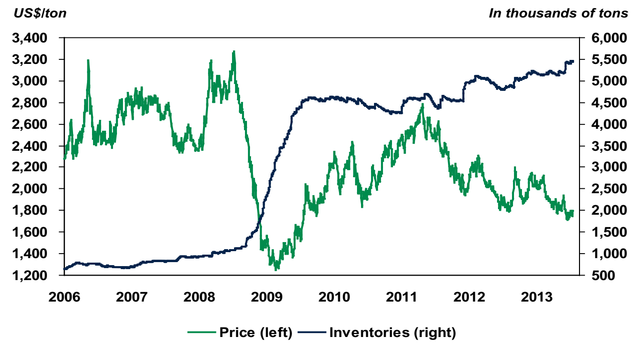


Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

ALUMINUM

- Already very low, the price of aluminum tumbled to US$1,721 per ton on June 27, its lowest level since the summer of 2009 (graph 10). One of the main reasons for soft aluminum prices is the excess supply of the metal, which has led to a real explosion in inventories as compiled by the London Metal Exchange (LME). These have swollen by 5% since the beginning of the year, another sign that the surplus situation is continuing. It has been known for some time that a portion of these immense inventories is held over the long term for financial reasons, by the large investment banks among others. An investigation conducted by the New York Times even suggests that Goldman Sachs is manipulating the enormous inventories that it holds in order to artificially inflate the price paid by American buyers of aluminum. Goldman officials have categorically denied those allegations, but it remains to be seen whether they will spark a reaction from the politicians, who are already worried about the influence that these financial giants wield over commodity prices.

Graph 10 – Aluminum prices and inventories

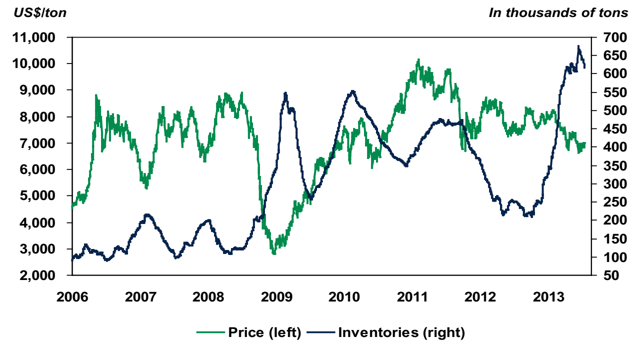


Sources: Datastream and Desjardins, Economic Studies

COPPER

- Given that copper is usually the metal that is most affected by financial turbulence, it comes as no surprise that its price plummeted in June to its lowest level since the summer of 2010. It has since gained back about US$200, returning near US$6,900 per ton (graph 11). This price point is interesting. On one hand, it is significantly below the cyclical peaks of recent years, as a marked decline in Chinese imports of copper in the first half of this year has generated ballooning inventories. On the other hand, it is still well above the production cost of copper, which is no longer the case for the other metals. Now that copper mining production finally seems to be expanding, Chinese copper

Graph 11 – Copper prices and inventories



Sources: Datastream and Desjardins, Economic Studies

demand will have to firm up soon if a further downturn in its price is to be avoided.

NICKEL

- The price of nickel dropped to US$13,232 per ton at the beginning of July, its lowest point since the spring of 2009, before climbing back up to around US$14,000 (graph 12). Even though Chinese imports of nickel are heading up, the global market is still clearly in a surplus position; inventories have skyrocketed by more than 40% since the beginning of the year. The outlook remains quite gloomy, as there is nothing to suggest that demand will firm up sufficiently to catch up with the supply of this metal. Given that some analysts estimate that the price has fallen below the production costs of approximately 40% of nickel producers, the nickel market is likely to rebalance itself through production cuts. For the time being, however, announcements of such measures are still few and far between.

ZINC

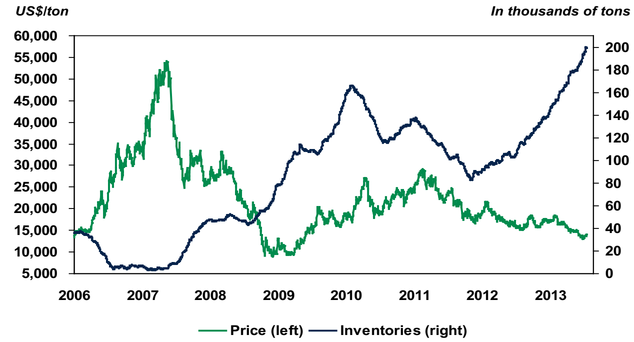
- After falling below US$1,800 per ton at the end of June, the price of zinc quickly rebounded to around US$1,820 (graph 13). Zinc is one of the few industrial metals whose price has not drop strongly over the past 12 months. This is mainly due to relatively robust demand, which has reduced inventories since the beginning of the year, despite strong growth in zinc production. Acceleration in the construction and automotive industries in the United States is helping to support demand for zinc. The combination of strong growth in both supply and demand of zinc should continue in the coming quarters.

STEEL

- The price of steel on the LME is still very low, and it even dropped below US$100 per ton temporarily, in the middle of July (graph 14). Hopes of production cuts helping to reduce the excess supply of steel faded when a minister indicated that Chinese steel production was up sharply since the beginning of the year, and that it should reach a new peak for 2013 as a whole.

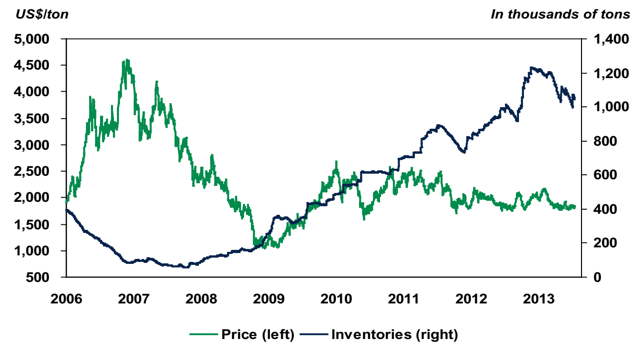
Forecasts: In the short term, industrial metal prices will probably remain fairly low. Even though producers have reacted to a limited extent so far, the fact that the prices of metals (apart from copper) have fallen to levels where it is no longer profitable for many producers to continue their activities is limiting the possibility of further drops in prices. The news from China will be key in the short term. If growth in that country accelerates, the stage will be set for prices to advance strongly in 2014, when global economic growth should firm up.

Graph 12 – Nickel prices and inventories



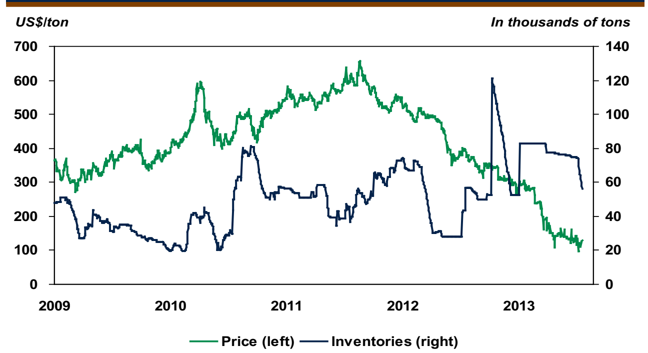
Sources: Datastream and Desjardins, Economic Studies

Graph 13 – Zinc prices and inventories



Sources: Datastream and Desjardins, Economic Studies

Graph 14 – Steel prices and inventories



Sources: Datastream and Desjardins, Economic Studies

PRECIOUS METALS

The price of gold should now stabilize

Fears that the Federal Reserve would tighten its monetary policy amplified the correction in gold and silver prices in June. The prices of platinum and palladium are still doing better, benefiting from favourable developments in terms of supply and demand.

GOLD AND SILVER

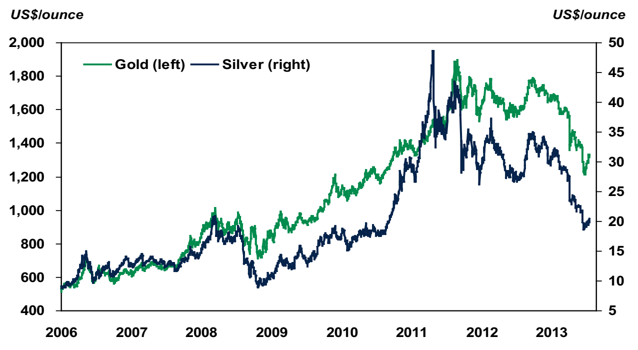
- The price of gold took another hit due to fears of hasty monetary tightening in the United States and the concomitant surge in the U.S. dollar. It verged on US$1,200 per ounce at the end of June, nearly US$500 below the level observed at the beginning of the year (graph 15). It subsequently rebounded to above US$1,300 per ounce when the U.S. dollar lost ground. It is worth noting that if the price of gold were to fall below US$1,200 per ounce, many gold mining projects would become unprofitable, which could well reduce the supply of this metal in the medium term. The marked slump in gold prices should also support demand from the emerging countries, which could compensate to some degree for the flagging financial demand (graph 16). The price of silver continues to follow the trend set by the price of gold, it has now dropped by more than 30% since the beginning of the year.

PLATINUM AND PALLADIUM

- The prices of platinum and palladium faltered temporarily in June, but since then have returned close to the levels observed at the end of May (graph 17). Both these metals have made gains over the past 12 months, unlike gold and silver prices, which have lost a good deal of ground. This favourable trend in platinum and palladium prices reflects considerable uncertainty about the supply, since the situation in South African mines is still tense, and growing industrial demand due to expanded production of motor vehicles.

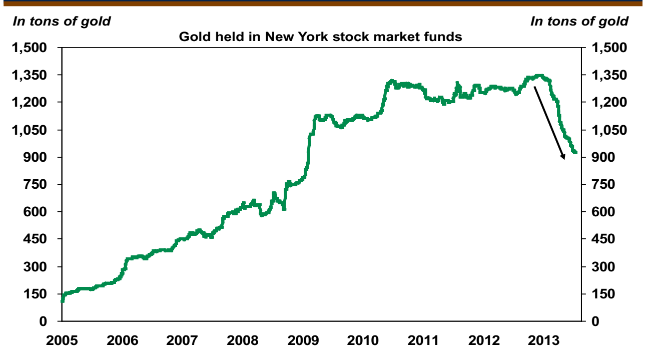
Forecasts: There are no signs pointing to an upswing in financial demand for gold, as interest rates have embarked on an upwards trend. Despite that, a further strong decline in gold prices would be surprising, as it could trigger a significant surge in demand from the emerging countries and a reduction in the supply of gold on the markets. We therefore predict that gold will wind off the year at around US$1,350 per ounce and will settle near this level next year. However, uncertainties about U.S. monetary policy could cause gold and silver prices to keep fluctuating sharply.

Graph 15 – Gold and silver prices



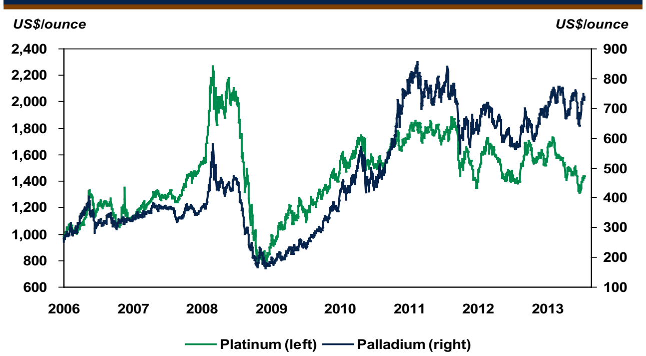
Sources: Datastream and Desjardins, Economic Studies

Graph 16 – Investors are still turning their backs on gold



Sources: Exchange Traded Gold and Desjardins, Economic Studies

Graph 17 – Platinum and palladium prices



Sources: Datastream and Desjardins, Economic Studies

OTHER COMMODITIES

Outlooks for lumber remain favourable

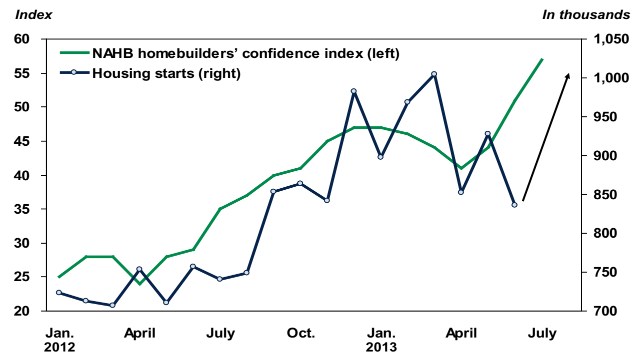
FOREST PRODUCTS

- The price of lumber continued its downwards trend in June, even falling below US$325 per thousand board feet (tbf) after the meeting of the Federal Reserve. This serious correction since mid-April confirms that the earlier spectacular surge in lumber price to an eight-year peak was exaggerated. The price of lumber subsequently rallied to nearly US$350/tbf. Although some recent U.S. data on the real estate market were disappointing, the rise in the homebuilders' confidence index suggests that this rough patch is temporary (graph 18). **The price of lumber should therefore go up in the next few quarters.** The price of pulp continues to inch up gradually, unlike the price of newsprint which is tending to decline (graph 19).

AGRICULTURAL COMMODITIES

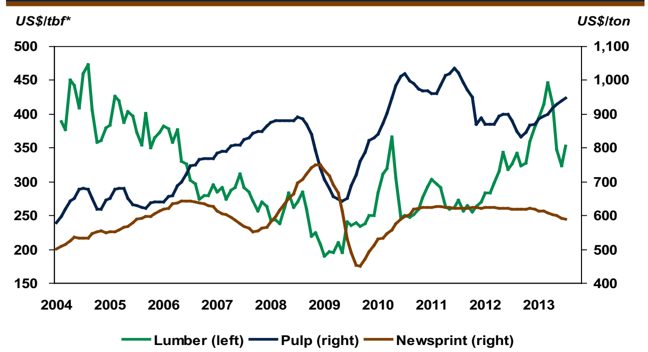
- Signs confirming that grain harvests will be much better this year than last are continuing to drive grain prices down. This year is a particularly difficult one for wheat. Its price recently fell back below US$6 per bushel, a slump of over 20% compared with the start of the year (graph 20). Another upwards revision to the global wheat harvest forecast for this year contributed to that trend.
- The price of corn has dropped recently as conditions became better for the U.S. harvest. It is now down significantly compared with the same period last year, when a serious drought was wreaking havoc on the U.S. harvest. **A record global corn harvest should send inventories of that grain to their highest level in more than a decade, and the price of corn will probably move downwards in the months to come.**
- Despite excellent harvests in South America, the price of soybeans recently climbed above US$16 per bushel, achieving a gain of nearly 13% since the beginning of the year. This increase was partly due to a lack of precipitation that was threatening U.S. harvests. In the past few days, however, favourable weather in the Midwest has driven the price of soybeans back below US$14. **In the short term, U.S. weather conditions will have a crucial influence on corn and soybean prices.**

Graph 18 – The upwards trend in homebuilding in the United States should resume quickly



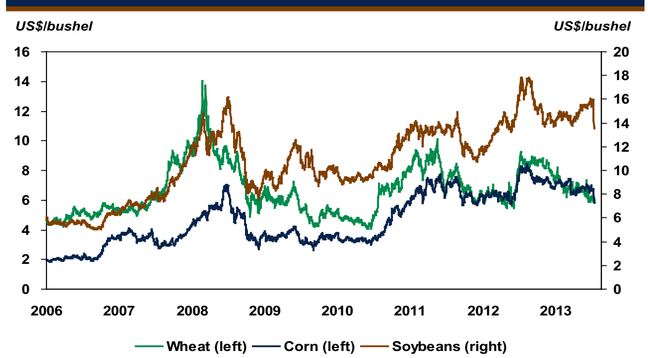
Sources: U.S. Census Bureau, National Association of Homebuilders and Desjardins, Economic Studies

Graph 19 – Forest product prices



* Thousands of board feet.
Sources: Datastream and Desjardins, Economic Studies

Graph 20 – Grain prices



Sources: Datastream and Desjardins, Economic Studies

Table 1
Commodities

	Spot price	Percentage return since				Last 52 weeks		
	July 29	1 month	3 months	6 months	1 year	High	Average	Low
Index								
Reuter-CRB[1] (CCI[2])	509.5	1.8	-6.2	-9.7	-8.8	598.1	552.7	500.4
Reuters/Jefferies CRB[1]	283.6	2.9	-2.0	-6.0	-5.3	320.9	295.4	275.6
Dow Jones AIG[3]	126.2	1.4	-6.1	-10.5	-12.1	152.0	138.4	124.5
Bank of Canada	670.1	5.4	5.8	6.9	7.9	671.3	635.9	596.0
Energy								
Brent oil (US$/barrel)	108.5	5.7	5.3	-5.7	1.2	119.2	109.5	97.6
WTI[4] oil (US$/barrel)	104.6	8.6	11.2	7.2	16.1	108.0	93.5	84.5
Gasoline (US$/gallon)	3.65	1.9	3.6	8.6	4.4	3.88	3.59	3.25
Natural gas (US$/MMBTU[5])	3.49	-2.2	-18.5	11.1	12.6	4.38	3.50	2.64
Base metals								
LMEX[6]	2,980	1.4	-4.5	-15.3	-6.8	3,614	3,295	2,911
Aluminium (US$/tonne)	1,749	1.1	-6.0	-13.5	-6.1	2,200	1,931	1,721
Copper (US$/tonne)	6,865	2.0	-3.6	-14.9	-9.2	8,363	7,623	6,638
Nickel (US$/tonne)	13,629	-0.1	-11.7	-23.4	-13.9	18,673	16,206	13,232
Zinc (US$/tonne)	1,809	-0.7	-3.4	-12.7	-2.3	2,185	1,925	1,762
Steel (US$/tonne)	130.0	2.8	-2.1	-53.0	-65.8	380.3	255.0	99.3
Precious metals								
Gold (US$/ounce)	1,330	9.4	-9.7	-20.0	-17.8	1,792	1,581	1,215
Silver (US$/ounce)	20.1	6.6	-17.2	-35.3	-27.5	35.0	28.3	18.6
Platinum (US$/ounce)	1,436	9.0	-4.6	-14.2	1.8	1,736	1,545	1,317
Palladium (US$/ounce)	731.0	13.7	5.3	-1.1	27.4	774.0	689.0	573.0
Other commodities								
Lumber (US$/tbf[7])	353.0	9.0	-14.7	-10.6	8.0	451.0	367.9	316.0
Pulp (US$/tonne)	947.1	0.7	3.1	6.9	7.6	947.3	887.7	832.0
Newsprint (US$/tonne)	590.0	-0.3	-2.2	-4.1	-4.9	620.7	611.5	590.0
Wheat (US$/bushel)	5.87	-1.0	-16.3	-22.6	-33.9	8.99	7.50	5.87
Corn (US$/bushel)	5.91	-15.3	-13.7	-19.6	-27.2	8.49	7.23	5.91
Soybean (US$/bushel)	13.54	-13.5	-9.2	-7.6	-20.7	17.86	15.18	13.54

[1] Commodity Research Bureau; [2] Continuous Commodity Index; [3] American International Group; [4] West Texas Intermediate; [5] Million British Thermal Unit;
[6] London Metal Exchange Index; [7] Thousand of board feet.
Note: Currency table base on previous day closure.

Table 2
Commodities prices: history and forecasts

Annual average	2011	2012	2013f	2014f
WTI* oil (US$/barrel)	95	94	Target: 95 (range: 92 to 98)	Target: 94 (range: 86 to 102)
Natural gas Henry Hub (US$/MMBTU**)	3.99	2.76	Target: 3.75 (range: 3.50 to 4.00)	Target: 4.00 (range: 3.25 to 4.75)
Gold (US$/ounce)	1,572	1,669	Target: 1,425 (range: 1,350 to 1,450)	Target: 1,350 (range: 1,100 to 1,600)
LMEX*** index—base metals	3,927	3,416	Target: 3,200 (range: 3,000 to 3,400)	Target: 3,800 (range: 3,400 to 4,200)

f: forecasts; * West Texas Intermediate; ** Million British Thermal Unit; *** London Metal Exchange Index.
Sources: Datastream and Desjardins, Economic Studies