Commodity Trends

Desjardins Economic Studies
www.desjardins.com/economics

August 11, 2015

Another very difficult summer

In early June, we noted that the spring upswing in commodity prices seemed fragile, especially for oil, because it was not founded on stronger demand or a weaker supply. Commodity prices then retreated sharply in July, with some price indexes even sliding below the lows hit during the financial crisis (graph 1).

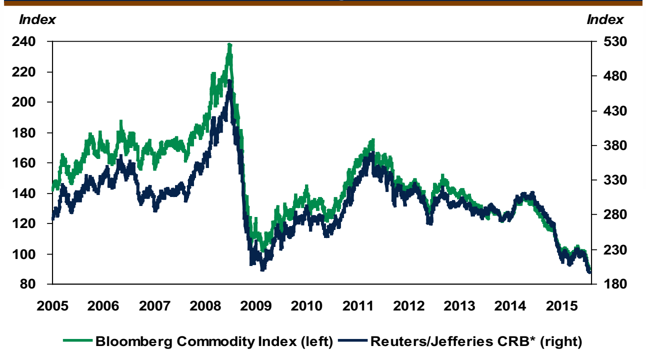
The recent setbacks in commodity prices are primarily due to two factors. Given that the global oil supply already generously exceeds demand, the agreement between Iran and the major powers in early July triggered a major drop in oil prices. A surge in concerns about China's economy, magnified by the bursting of the stock bubble (graph 2), also did a lot of damage to metal prices.

Although the recent slide in some metal prices seems to have gone a little too far, we cannot expect commodity prices to see a widespread surge soon. Oil prices in particular could stay very low for several more quarters. In a context in which the U.S. dollar could start to trend up again, with the Federal Reserve likely poised to initiate monetary firming, investor interest in commodities could remain subdued for the next few months.

François Dupuis
Vice-President and Chief Economist

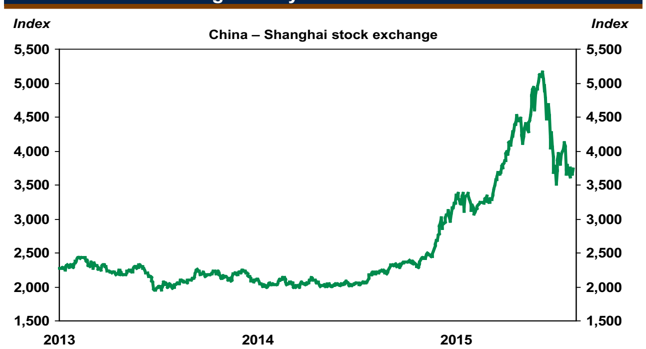
Mathieu D'Anjou, CFA
Senior Economist

Graph 1 – Some commodity price indexes have fallen under the lows reached during the financial crisis



*Commodity Research Bureau
Sources: Datastream and Desjardins, Economic Studies

Graph 2 – The surge in China's stock market gave way to a correction



Sources: Datastream and Desjardins, Economic Studies

Contents

François Dupuis
Vice-President and Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou
Senior Economist

Jimmy Jean
Senior Economist

Hendrix Vachon
Senior Economist

Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

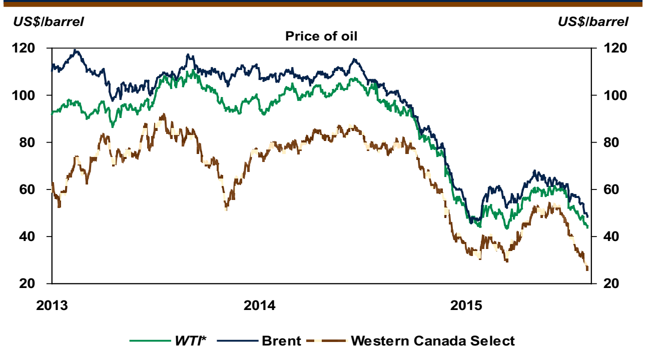
ENERGY

Weak oil prices could persist

OIL

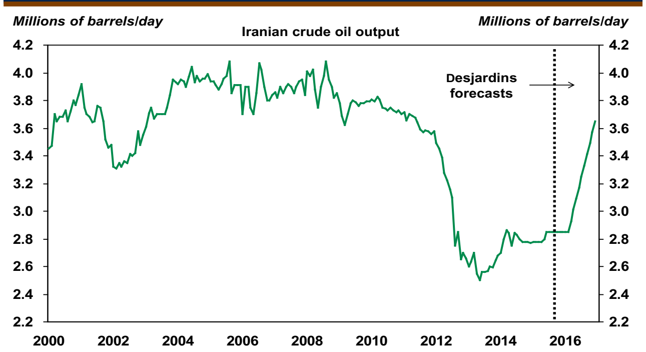
- WTI (West Texas Intermediate) prices had risen above US$60/barrel at the end of spring, with investors focused on the U.S. situation, characterized by signs of stabilizing oil production and the end of the surge in crude inventories. However, oil prices retreated sharply in July, when an agreement between Iran and the major powers put the focus on a push in production by Organization of Petroleum Exporting Countries (OPEC) nations and a continuing major surplus in the oil market. Brent and WTI prices dropped under US$50 and US$45 a barrel respectively, while Western Canadian oil prices dropped back to around US$30/barrel (graph 3).
- The intense negotiation effort made in the last few years finally resulted in an agreement designed to curb Iran's nuclear ambitions. The agreement's fine print is fairly complex, but it should result in lifting all trade sanctions towards the start of 2016. Iran is not renouncing its nuclear program or its destabilizing activities in the region; this is raising a lot of opposition to the agreement, especially in Israel and the United States. However, it will be very hard for opponents to block the agreement: President Obama has promised to use his veto to protect the agreement, and his administration is using all of its political might to convince the Democrats in office to support it. In this context, we can expect Iran's oil production and exports to increase substantially in 2016 (graph 4).
- Most analysts therefore think that Iran's oil production could rise by 0.5 to 1.0 million barrels a day (mbd) by the end of 2016. Although not negligible, the increase would normally have a fairly limited impact on a global market of more than 95 mbd, especially given that North American oil output should stagnate. However, the current situation is far from normal, as the surge in Saudi and Iraqi oil output (graph 5) has already driven total output by OPEC nations up by about 2 mbd in the last year. Although oil production growth has moderated elsewhere in the world, and petroleum product demand is slightly more robust, especially in the United States, the gap between the global supply and demand for oil widened, exceeding 3 mbd in Q2 of 2015.
- Saudi Arabia seems to be trying to maximize its market share before the return of Iranian oil, with no concern about the impact on oil prices. Nothing suggests it will cut output in the near future. In this context, OPEC production should keep rising, hitting about 33 mbd at the end of 2016. This level of output would maintain a major surplus in the global oil market for several more quarters (graph 6), an environment that would not be propitious to a rise in oil prices.

Graph 3 – Oil prices plunge again



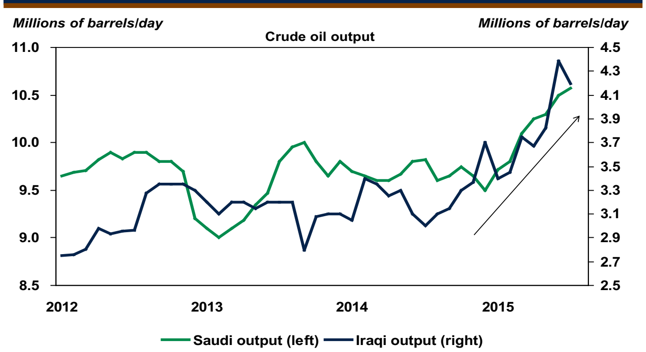
* West Texas Intermediate.
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

Graph 4 – Iranian oil production should rebound next year



Sources: Bloomberg and Desjardins, Economic Studies

Graph 5 – Iraqi and Saudi output is already up sharply



Sources: Bloomberg and Desjardins, Economic Studies

GASOLINE

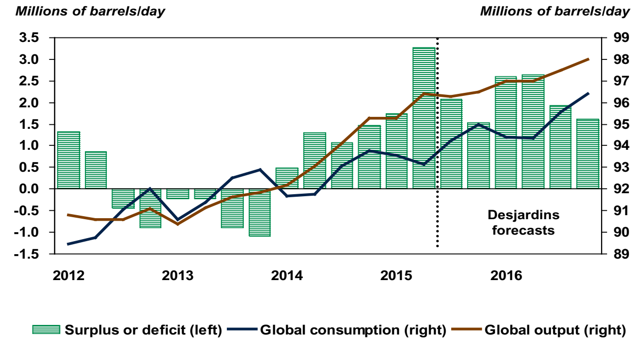
- After shooting up in the spring, North American gasoline prices retreated a little in the last few weeks. However, to the dismay of drivers, gas prices are still about 30% above the lows hit in early 2015, unlike oil prices. This is primarily a reflection of high refinery margins, supported by positive seasonal factors and strong demand from U.S. drivers (graph 7) which is keeping gas inventories from rising too much, for now. The next few months look good for drivers, however, as the end of the driving season should put downside pressure on margins. A surplus has already emerged in the U.S. diesel market, taking prices down steeply. The same could happen shortly with gas.

NATURAL GAS

- After climbing to nearly US$3.00/MMBTU (Million British Thermal Units) early this summer, natural gas prices edged back in the last few weeks, dropping to around US$2.75 (graph 8). The U.S. natural gas market continues to feature low prices, reflecting some equilibrium between the sharp upswing in natural gas supply and demand. In terms of supply, imports of Canadian natural gas have rebounded, helping to keep the U.S. market well supplied. As for demand, the growth is especially solid for energy producers, which continue to favour natural gas over coal. For the first time in history, the Energy Information Administration noted that, last April, more electricity was produced in the United States using natural gas than coal. The Obama administration's ambitious plan to combat climate change disappointed the natural gas industry by aiming primarily to replace coal with renewable energy. Despite these good intentions, the tougher conditions imposed on coal-powered plants should primarily benefit natural gas in the next few years.

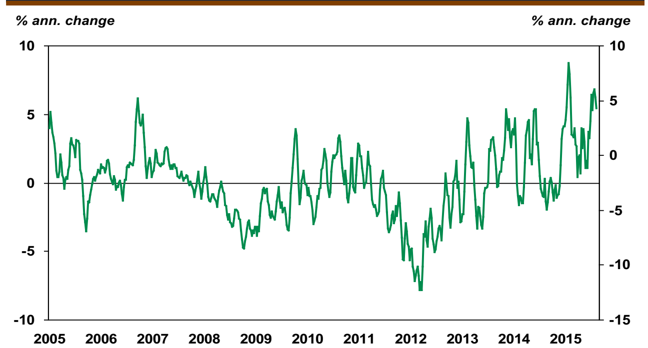
Forecasts: A major ongoing surplus in the oil market should keep prices close to where they are for at least a year. New cyclical lows could even be tested in the months to come. Still, more robust global demand could take WTI to around US$65/barrel at the end of 2016. Gasoline prices should slide in the next few months, while natural gas prices could edge up, following the usual seasonal trend.

Graph 6 – A major surplus could persist in the global oil market



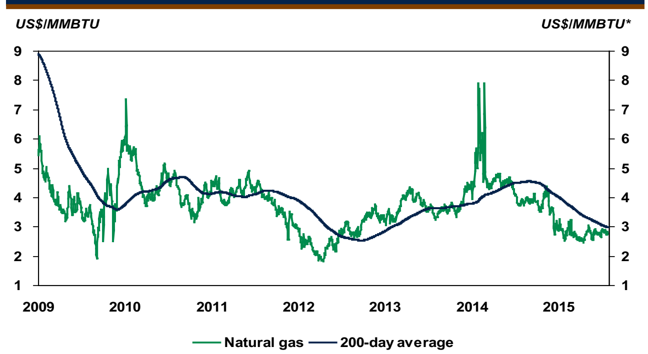
Sources: International Energy Agency and Desjardins, Economic Studies

Graph 7 – U.S. demand for gas is showing fairly lively growth



Sources: Energy Information Administration and Desjardins, Economic Studies

Graph 8 – Natural gas prices



* Million British Thermal Unit.
Sources: Datastream and Desjardins, Economic Studies

BASE METALS

Concerns over China hurt prices again

The last few weeks have been especially difficult for base metals. Heightened concern over Chinese demand took the London Metal Exchange (LME) index of industrial metals down to 2399, its lowest point since the summer of 2009 (graph 9). Last May, it was at 3000, and the LME index has therefore dropped a spectacular 20%.

Concern over Chinese demand seems to have been magnified by Shanghai stock exchange nearly 30% correction since mid-June (graph 1 on page 1). We do not think the movement of this highly speculative exchange should be seen as a good indication of the Chinese economy's health. For example, the Chinese stock market skyrocketed at the start of the year against the backdrop of an economic slowdown. Beyond the stock market, indications from China remain mixed. Annual GDP growth stabilized at 7.0% in the second quarter (graph 10), but purchasing manager indexes remain relatively weak. However, Chinese demand for some metals seems to be starting to firm up, a trend that could persist as the government now seems to want to focus on infrastructure investment to support economic activity.

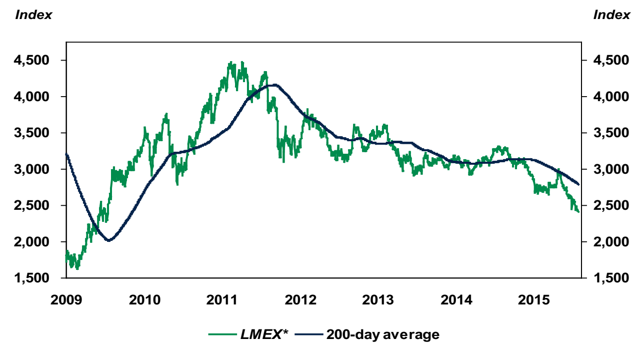
ALUMINUM

- As we noted in early June, aluminum is in a very tough position, as the new rules imposed by the LME are taking the sizable aluminum inventories into the market just as China is increasing its exports. Although a drop in inventories recorded by the LME is usually a sign of a shortage that is good for metal prices, the market's aluminum surplus has only expanded in tandem with the nearly 20% drop in aluminum inventories. Aluminum prices thus recently dropped to US$1,557 a tonne, a more than six-year low (graph 11). Factoring in the 60% drop in the premium that North American customers pay to get aluminum quickly, aluminum producers are facing selling prices that are about 30% lower than they were a year ago. However, Chinese producers seem to be unaffected by the low prices, with output there still rising fast. The context is especially tough for U.S. producers who also have to deal with a strong dollar.

COPPER

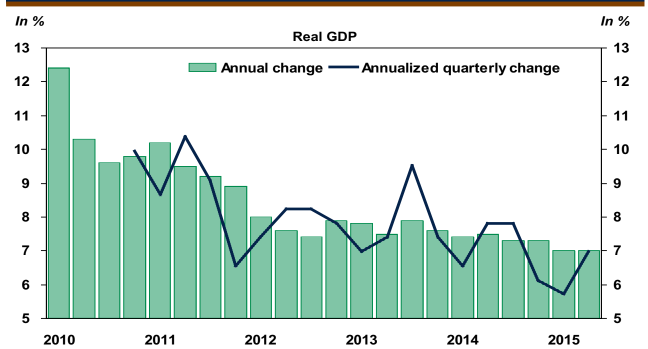
- Like other metals, copper prices have pulled back sharply recently, falling to US$5,164 a tonne, their lowest point since the summer of 2009 (graph 12). Chinese copper imports fell 10% in the first half of 2015, contributing to the rise in inventories of the metal as well as the drop in prices. In its latest statement, the International Copper Study Group (ICSG) noted that a 5% slide in Chinese demand and a 3%

Graph 9 – Metal prices plunge again



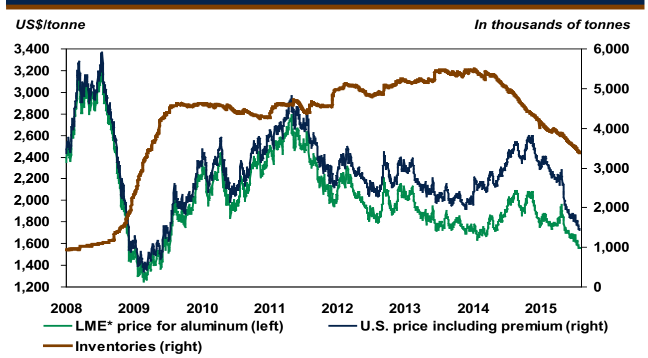
* London Metal Exchange index of base metal prices.
Sources: Datastream and Desjardins, Economic Studies

Graph 10 – China's economic growth stabilized in Q2



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

Graph 11 – Aluminum prices and inventories



* London Metal Exchange.
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

increase in copper production had yielded a slight surplus in the global market for the first four months of 2015. However, stronger Chinese demand put the global market back into deficit in April. The figures on imports also indicate some firming of Chinese demand: copper imports posted annual growth in June, the first time this year. With numerous problems still curbing an expansion of copper production, the market could quickly tighten up if signs of stronger Chinese demand prove true.

NICKEL

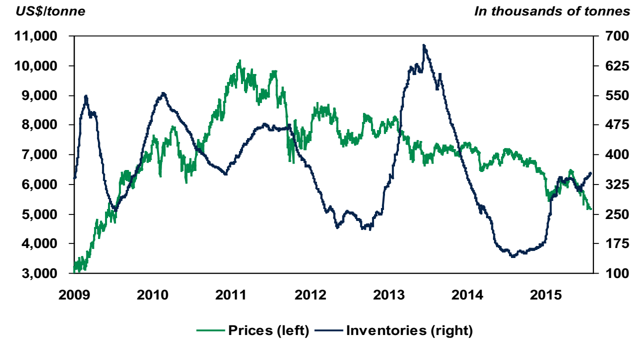
- The metal correction took nickel prices below US$10,700 a tonne; they are down more than 25% since mid-May (graph 13). However, this spectacular plunge does not seem to be justified by the news about global supply and demand. Nickel inventories surveyed by the LME remain very high, but have stabilized in recent months. Note that Chinese nickel imports were weak in early 2015, but have boomed in the last few months. Chinese imports were thus up 38% in the first half over the same period last year. Ongoing low prices are also leading to some supply cuts. For example, Australia's Mincor Resources recently announced that it could cut its nickel output by 56% over the next six months.

ZINC

- Although they showed resilience in the early months of 2015, zinc prices were unable to stand up to July's negative wave. The metal's price fell to US$1,852 a tonne recently, down 20% over the last year (graph 14). Chinese zinc imports remained low in the last few months, which did not keep the zinc inventories recorded by the LME from continuing to shrink. Most analysts are still positive about zinc over the medium range, as current prices do not seem high enough to secure an adequate global supply.

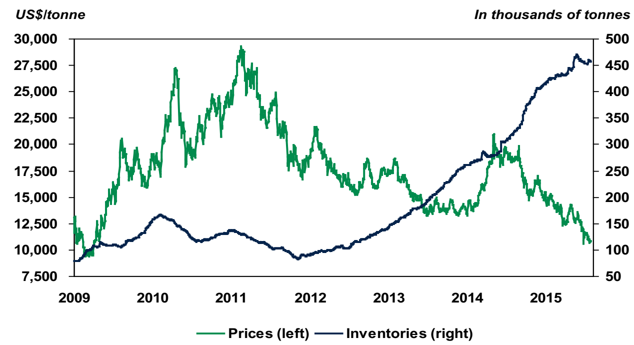
Forecasts: Except for aluminum, the recent tumble taken by metal prices does not seem justified by the fundamentals. The concerns about China will not evaporate in the near future, however, and the risk of U.S. dollar appreciation in the face of looming monetary firming in the United States could keep prices very low in the near term. Metal prices should then start to come back up, as current prices are opening the door to shortages as soon as global demand strengthens.

Graph 12 – Copper prices and inventories



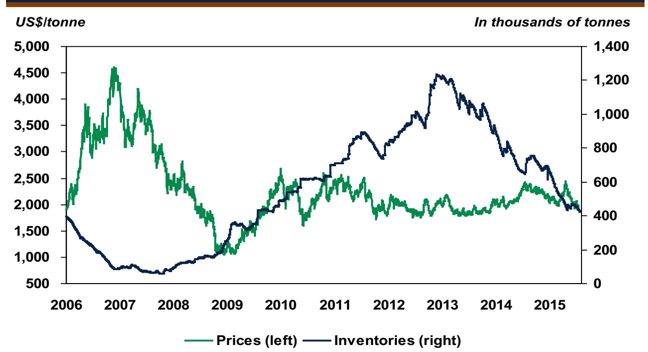
Sources: Datastream and Desjardins, Economic Studies

Graph 13 – Nickel prices and inventories



Sources: Datastream and Desjardins, Economic Studies

Graph 14 – Zinc prices and inventories



Sources: Datastream and Desjardins, Economic Studies

PRECIOUS METALS

New cyclical low for gold

The widespread metal price retreat did not leave precious metals unscathed. Heavy losses were magnified by new signs of weakness in Chinese demand and looming monetary firming in the United States.

GOLD AND SILVER

- After holding around US$1,200 an ounce last spring, gold prices dropped sharply in the last few weeks and hit US$1,084, their lowest point since February 2010 (graph 15). Several factors were behind the pullback. A last-minute agreement that avoided a Greek default decreased international risk and the appeal of safe haven securities. The recent drop in oil prices also reduced gold's appeal as an insurance policy against runaway inflation. More fundamentally, physical demand for gold remained disappointing; GFMS estimated that it retreated 14% in the second quarter of 2015 from the same time the previous year (graph 16). The news that China's gold reserves had grown 57% since 2009 also disappointed some investors, who had been expecting an even bigger increase. More recently, good U.S. economic statistics and remarks from some Federal Reserve leaders increased the likelihood that U.S. key rates would go up in September, a development that would likely be good for the U.S. dollar, but bad for gold. Silver prices also retreated sharply, dropping to around US$14.50 an ounce, a nearly six-year low.

PLATINUM AND PALLADIUM

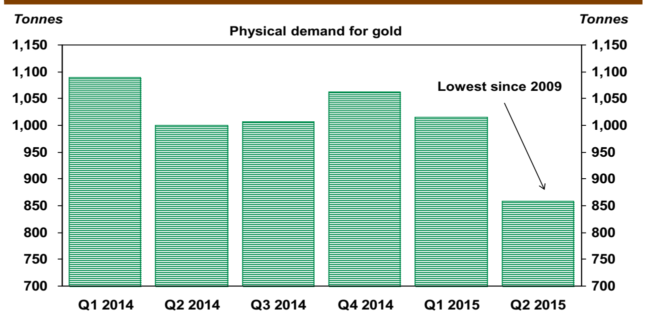
- Already under pressure, platinum and palladium prices continued to retreat recently given the concerns about China, which are contributing to a very poor environment for all metals. A sharp jump in South African platinum production and pressure not to close unprofitable mining operations there also helped take this metal's price below US$1,000 an ounce. At about US$600 an ounce, palladium is also at a low that dates back several years.

Forecasts: With nothing suggesting that gold prices will rebound sharply in the coming months, we are lowering our target to US$1,075 an ounce for the end of 2015 and US$1,050 an ounce for the end of 2016. Sooner or later, stronger global economic growth and a supply adjustment should result in an upswing by platinum and palladium prices.

Graph 15 – Gold and silver prices

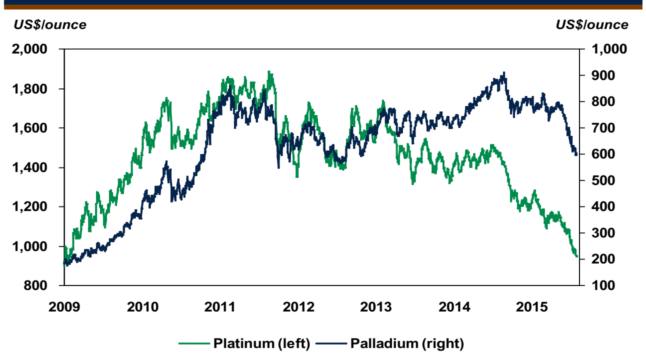
Sources: Datastream and Desjardins, Economic Studies

Graph 16 – Weak physical demand is also dragging gold prices down



Sources: GFMS, Thomson Reuters and Desjardins, Economic Studies

Graph 17 – Platinum and palladium prices



Sources: Datastream and Desjardins, Economic Studies

OTHER COMMODITIES

Too much rain

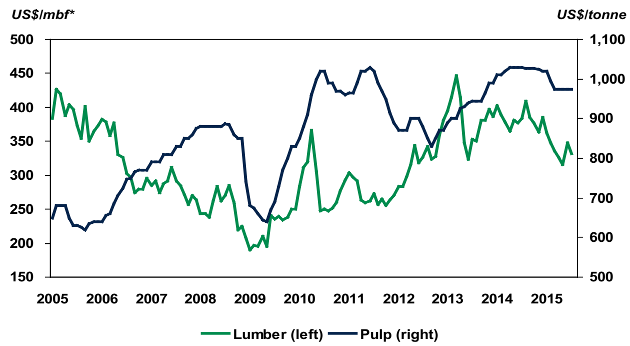
FOREST PRODUCTS

- After sliding to US$310/mbf (thousand board feet) in May, lumber prices climbed at the end of June, flirting with US$350 (graph 18). They have since come back down to around US$330/mbf, but lumber is still one of the few commodities to have appreciated in the last three months. **The very encouraging housing market data that continues to be released in the United States has certainly contributed to lumber's relatively strong performance and means we can hope to see an uptrend in the next few quarters.** For their part, pulp prices have been stable in recent months.

AGRICULTURAL COMMODITIES

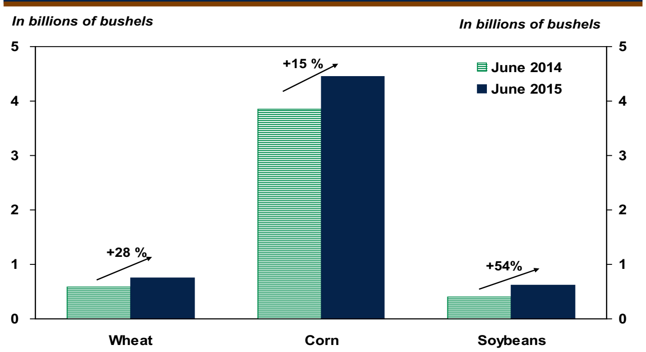
- Prices for the three primary grains have been fairly volatile in the last few months, with a substantial upswing at the end of June giving way to another pullback recently. Surprisingly, prices rebounded after the U.S. Department of Agriculture (USDA) confirmed that U.S. grain inventories had grown substantially between June 2014 and June 2015 (graph 19). Note that USDA data also shows some encouraging signs for grain demand.
- However, the USDA projections for global supply and demand released in mid-July indicated that the global grain market remains very well stocked. The projections for global wheat stocks were even upgraded. Grain prices have therefore recently dropped back to the lows hit earlier this year (graph 20).
- At this time of the year, the weather, especially in the United States, is what usually has the most influence on grain prices. Although U.S. farmers are always worried about drought, some farmers had the reverse problem this year, with record rainfall in some states. The situation has turned around in the last few weeks; at this point, harvest conditions seem only slightly less favourable than they were in 2014, an excellent year. In Australia, the rain received in the last few weeks has eased fears of drought associated with the El Nino phenomenon. **The latest report from the International Grain Council therefore projects that the global 2015–2016 harvest for all grains will be down by just 2% from last year's record harvest. This will limit the potential for grain price increases.**

Graph 18 – Forest product prices



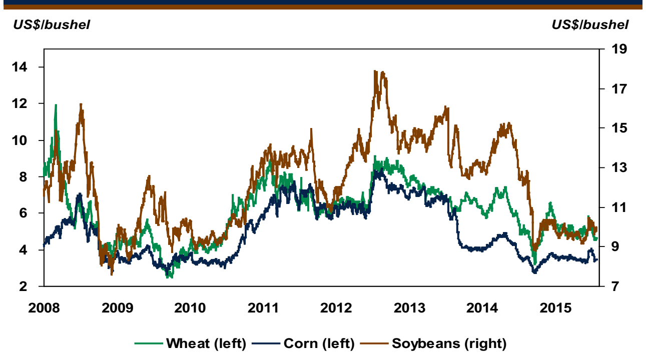
*Thousands of board-feet..
Sources: Datastream and Desjardins, Economic Studies

Graph 19 - Grain inventories in the United States



Sources: U.S. Department of Agriculture 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		
	August 11	1 month	3 months	6 months	1 year	High	Average	Low
Index								
Reuter-CRB[1] (CCI[2])	405.3	-4.5	-5.8	-6.0	-21.8	518.1	450.3	397.7
Reuters/Jefferies CRB[1]	202.5	-7.2	-11.3	-8.8	-31.1	293.8	240.1	198.3
Dow Jones AIG[3]	92.6	-6.8	-10.4	-8.9	-27.5	127.7	107.4	90.4
Bank of Canada	393.8	-8.8	-14.0	-5.9	-38.2	640.9	486.6	389.1
Energy								
Brent oil (US$/barrel)	49.3	-14.6	-22.9	-10.4	-53.0	104.9	68.6	45.7
WTI[4] oil (US$/barrel)	44.9	-14.8	-24.1	-7.9	-54.2	98.1	63.8	43.4
Gasoline (US$/gallon)	2.63	-5.9	-2.3	20.0	-25.0	3.52	2.75	2.04
Natural gas (US$/MMBTU[5])	2.85	3.6	0.0	0.0	-27.8	4.41	3.20	2.48
Base metals								
LMEX[6]	2,454	-4.1	-15.8	-9.1	-24.6	3,296	2,874	2,399
Aluminium (US$/tonne)	1,586	-4.3	-14.1	-12.0	-21.5	2,089	1,845	1,557
Copper (US$/tonne)	5,296	-5.1	-16.8	-5.6	-24.5	7,098	6,200	5,164
Nickel (US$/tonne)	11,108	-1.0	-22.0	-24.4	-40.2	19,846	14,644	10,604
Zinc (US$/tonne)	1,872	-6.6	-19.0	-11.1	-18.4	2,434	2,166	1,852
Steel (US$/tonne)	124.0	-1.2	-57.8	-74.4	-70.2	490.0	355.1	124.0
Precious metals								
Gold (US$/ounce)	1,103	-5.0	-6.9	-9.8	-15.6	1,315	1,204	1,084
Silver (US$/ounce)	14.9	-3.7	-9.2	-12.2	-25.0	20.1	16.7	14.5
Platinum (US$/ounce)	971	-5.9	-14.2	-19.1	-34.0	1,475	1,193	946
Palladium (US$/ounce)	600.0	-8.4	-23.4	-22.2	-30.6	911.0	773.7	597.0
Other commodities								
Lumber (US$/tbf[7])	329.0	-5.5	4.4	-9.4	-16.1	409.0	359.0	310.0
Pulp (US$/tonne)	975	0.0	0.0	-4.4	-5.3	1,030	1,004	975
Wheat (US$/bushel)	4.85	-11.2	1.5	-8.7	-6.2	6.63	5.05	3.26
Corn (US$/bushel)	3.73	-8.9	6.4	1.5	5.1	4.15	3.54	2.79
Soybean (US$/bushel)	10.34	0.5	6.8	6.7	-15.8	12.89	10.02	8.83

[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	2013	2014	2015f	2016f
WTI* oil (US$/barrel)	98	93	Target: 51 (range: 48 to 54)	Target: 57 (range: 50 to 64)
Natural gas Henry Hub (US$/MMBTU**)	3.73	4.34	Target: 2.85 (range: 2.70 to 3.00)	Target: 3.50 (range: 3.00 to 4.00)
Gold (US$/ounce)	1,411	1,266	Target: 1,145 (range: 1,100 to 1,200)	Target: 1,060 (range: 980 to 1,150
LMEX*** index—base metals	3,183	3,117	Target: 2,620 (range: 2,475 to 2,720)	Target: 3,000 (range: 2,500 to 3,500)

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