Commodity Trends

Desjardins Economic Studies
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The oil market is rebalancing

Commodity prices have continued to perform well in recent months. The main price indexes are now up more than 20% from their early 2016 lows. Oil prices have posted solid advances lately. Even without an agreement to curb the output of nations in the Organization for Petroleum Exporting Countries (OPEC), the global oil market is rebalancing and the time of a huge production surplus could even be over already.

The data on economic growth in advanced nations for the first quarter confirmed that the situation is not catastrophic, with Japanese and euro zone performances both beating expectations (graph 1). The early part of the year was tougher in the United States, but clear signs of much livelier growth in the second quarter are encouraging in terms of commodity demand. The solid performance by commodities since the start of the year has, however, been helped by financial factors, including a weak U.S. dollar and increase in commodity speculation in China. Recently, the U.S. dollar began to rebound (graph 2), as the Federal Reserve seemed poised to raise its key rates soon. However, highly disappointing employment figures have raised a lot of uncertainty about U.S. monetary policy and the trend for the greenback.

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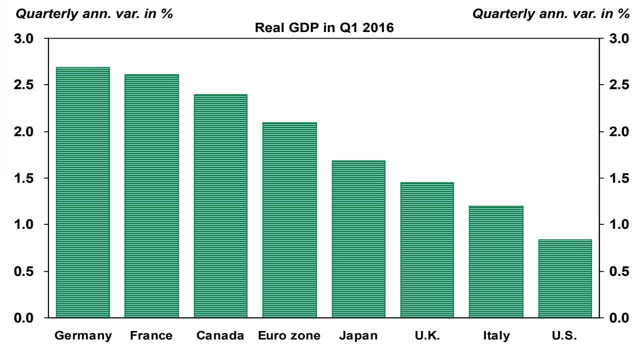
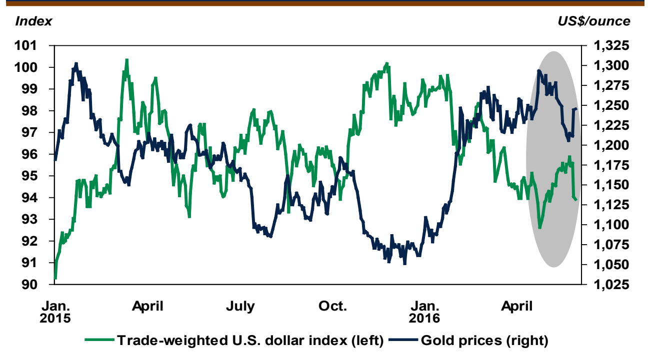
Graph 1 – Overall, the advanced economies got the year off to a good start



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – The greenback's recent rebound pulled gold prices back down



Sources: Bloomberg and Desjardins, Economic Studies

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

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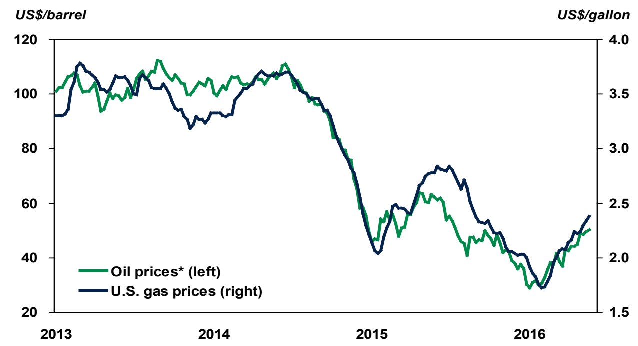
ENERGY

The risk of a major relapse in oil prices seems slight

OIL

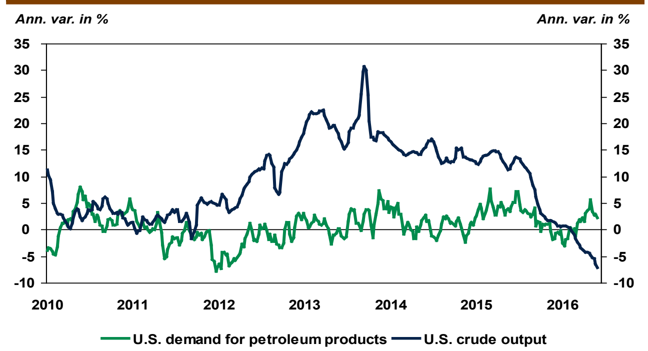
- Oil prices have kept rising in the last few months. Note that financial turbulence and concerns about the global economy had pulled WTI (West Texas Intermediate) down to US$26 a barrel on February 11, a 12-year low. WTI ended the first quarter close to US$40, then recently reached US$50 a barrel for the first time since October 2015. Prices for Brent and Canadian oil were on similar trends, and gas prices also continued to climb back up (graph 3).
- Negotiations between Russia and the Organization for Petroleum Exporting Countries (OPEC) to freeze oil production ended in resounding failure at the meeting on April 17, and nothing suggests that any such agreement will eventually be ratified. This did not have much of an impact on oil prices, as investor focus quickly shifted to the United States, where the contraction in U.S. production is increasingly evident. The latest weekly numbers from the Department of Energy show a decline of more than 0.8 mbd (million barrels a day) in U.S. crude output, clear confirmation that the tumble in prices and investment has ended the surge in U.S. production (graph 4). In a context in which oil demand continues to rise at a solid pace, in the United States and elsewhere, everything suggests that the major surplus in the global oil market is winding down (graph 5).
- There is reason to wonder whether the fact that oil prices have almost doubled since mid-February will persuade U.S. producers to start ratcheting up production again. If so, the global surplus could persist and prices could eventually drop to new lows. Before starting to invest again, producers will use the futures market to hedge against a relapse and make sure they can sell their oil at a profit. Note, however, that futures prices have not been going up as spectacularly in the last few months (graph 6 on page 3). A producer wanting to freeze the price of WTI in one year would have to sell it forward at US$52 a barrel, barely US$8 more than the futures price that was prevailing at the start of 2016. In this context, drilling is continuing to wane, with nothing auguring a looming rebound in U.S. output.
- While Iran's production has already gone up substantially in the last few months, only a big surge in Saudi Arabia's output could maintain a major oil surplus in the next few quarters. This scenario could depress prices in the near term, but would open the door to a rapid rebound after that. It seems more likely that Saudi Arabia will want to keep some leeway so as to maintain its influence over the oil market.

Graph 3 – Following their spectacular tumble, oil and gas prices have come up in recent months



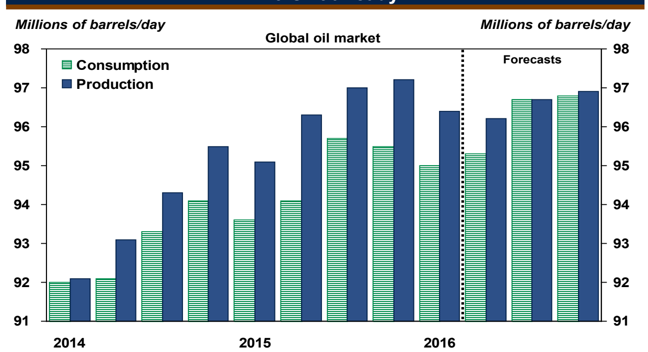
* Average of Brent and West Texas Intermediate oil prices.
Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Not only is U.S. oil production declining, demand is fairly lively



Sources: Energy Information Administration and Desjardins, Economic Studies

Graph 5 – The global oil market will soon be in balance, if it isn't already



Sources: International Energy Agency and Desjardins, Economic Studies

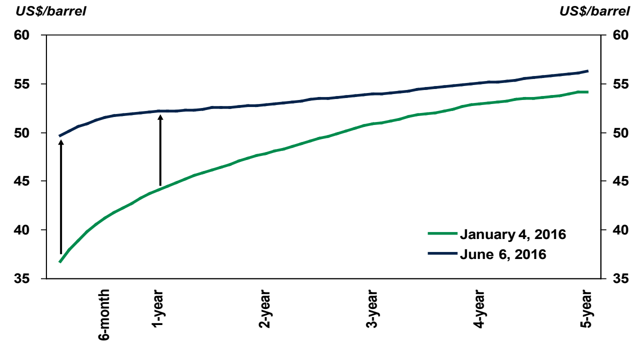
- The catastrophic Fort McMurray fires have gotten a lot of attention since the start of May, when they suddenly put a stop to about one third of Canada's output (1.2 mbd). This will have a major impact on Alberta's economy and substantially impact Canada's economic data. In the context of extremely high U.S. crude inventories (graph 7), the temporary production shutdown had little impact on oil prices. Oil facilities were not damaged, so production should gradually ramp up over the next few weeks, returning to normal in the third quarter. Once the global market is back in balance, similar production problems could have a much bigger impact on prices. We thus will have to keep a watch on the situation in several OPEC nations, including Nigeria, Angola and Venezuela, where the situation seems especially unstable.

NATURAL GAS

- Natural gas prices have stayed low in the last few months, generally oscillating below US$2/MMBTU (Million British Thermal Unit). They have rebounded substantially in the last few days, going to US$2.32/MMBTU, a five-month peak (graph 8), as the forecast of a fairly hot June raises hopes of robust demand for natural gas. The latest figures also show that low prices and the drop in drilling are curbing growth in U.S. natural gas output. The very large natural gas inventories, swelled by a mild winter, are a substantial obstacle to a big rise in gas prices in the near future. Strong demand this summer, especially from electricity producers, could open the door to substantially higher prices at the end of 2016.

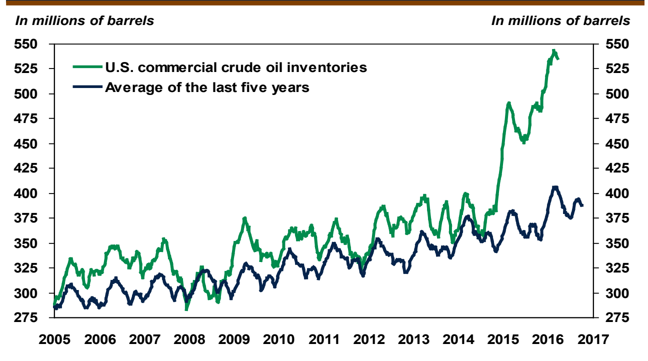
Forecasts: The rise in oil prices and confirmation that the global market will be back in balance shortly prompt us to tweak our targets for WTI, raising them slightly. The price for WTI could therefore end the year at around US$55 a barrel, and finish 2017 at US$65. Even though another tumble seems unlikely, a U.S. key rate increase this summer could temporarily take WTI prices down to around US$45 a barrel. Natural gas prices should remain low in the near term, but are then still expected to rise.

Graph 6 – The price of oil futures has not gone up as much as the spot price



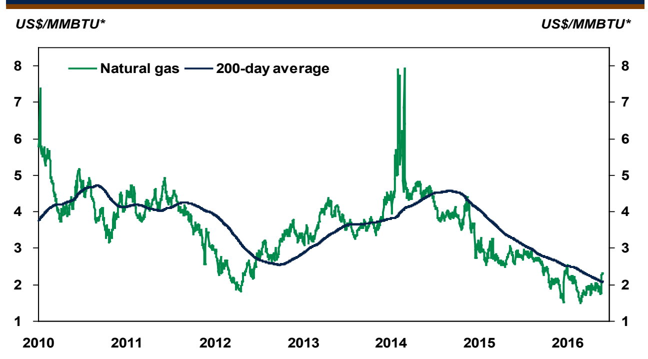
Sources: Bloomberg and Desjardins, Economic Studies

Graph 7 – U.S. crude inventories are enormous, but seasonal factors are starting to foster a decline



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

Chinese speculators trigger volatility

Metal prices posted a surprising increase in the first quarter, and then maintained their momentum in April. The LME (London Metal Exchange) index hit 2,414 at the end of April, its highest point since last October (graph 9). It was becoming increasingly clear, however, that the rapid rise in metal prices was largely based on a surge in purchases by Chinese speculators. This was especially evident in the spectacular rise of iron prices (graph 10), despite the metal's tough ongoing supply and demand environment.

However, the Chinese government took steps to discourage speculation at the start of May and industrial metal prices have fallen in recent weeks, taking the LME index to around 2,250. The U.S. dollar is trending up again, which also hurt metal prices. Beyond financial factors, the latest developments are fairly promising for metal demand, as the Chinese economy seems to be benefiting from the government's stimulus measures and everything indicates the U.S. economy returned to strong growth after a disappointing first quarter.

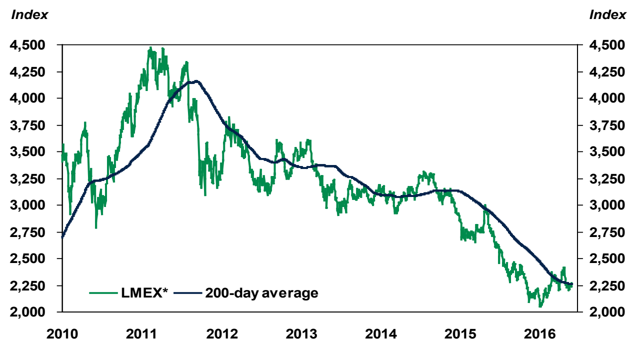
ALUMINUM

- Following the general trend, aluminum prices jumped to US$1,670 a tonne at the end of April, then quickly relapsed to US$1,517 in mid-May (graph 11). Despite the greenback's rebound, aluminum prices recently climbed to around US$1,550 a tonne, up slightly from the start of 2016. The latest figures from the International Aluminium Institute are fairly encouraging. In the first quarter of 2016, global aluminum production fell to its lowest point since the summer of 2014, down an annual 1.5%. The decline stemmed from a more than 5% cut to Chinese production. Chinese aluminum prices went up sharply recently, however, which seems to have prompted some Chinese producers to ramp up production once again.

COPPER

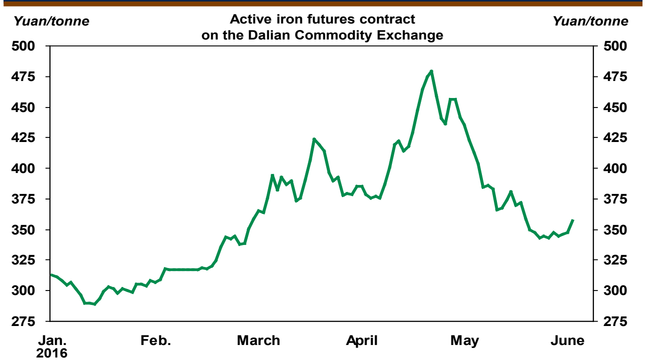
- Copper edged above US$5,000 a tonne, then recently dropped to around US$4,700. This metal's price has been casting around with no clear trend since the start of 2016 (graph 12 on page 5). The greenback's rebound is especially bad for copper, whose price tends to react sharply to financial factors. On the other hand, the efforts to jumpstart China's economy and signs of strength in the U.S. housing sector are promising developments for copper demand. Copper inventories surveyed by the LME dropped substantially at the start of the year, and have risen slightly since the start of the second quarter. This movement is consistent with the fact that global supply and demand for copper should be

Graph 9 – Industrial metal prices are fairly volatile



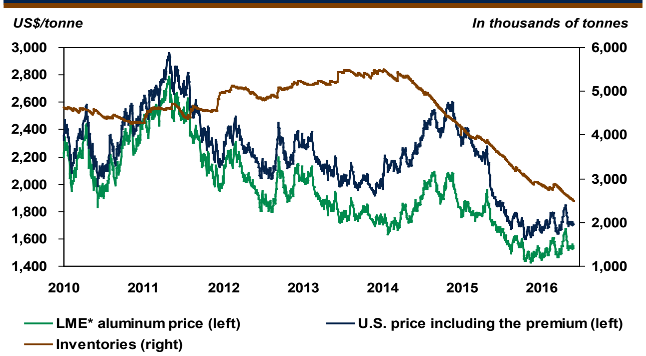
* London Metal Exchange base metal price index.
Sources: Datastream and Desjardins, Economic Studies

Graph 10 – The surge in Chinese iron prices did not last



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Aluminum prices and inventories



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

fairly balanced this year. The market could see a shortage again in a few years, however, as there does not seem to be sufficient investment in this sector.

NICKEL

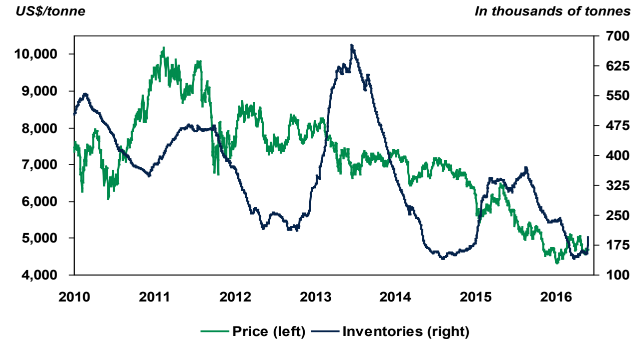
- Nickel jumped in April and fell in May, with prices recently returning to around US$8,500 a tonne, where they ended the first quarter. Nickel prices are thus down about 2% since the start of the year (graph 13). Inventories surveyed by the LME are down 10% from the start of 2016, but many think the decline mainly reflects a shift in inventory to China. Very high global nickel inventories are the primary obstacle to a surge in nickel prices, as nickel production could be slightly behind demand this year. Mining outfit South32 recently declared that it could cease operations at a major nickel mine in Colombia. Production cuts such as these, or signs of a recovery by Chinese stainless steel production could signal the start of a true upswing in nickel prices.

ZINC

- Zinc remains the clear star among industrial metals. Zinc prices temporarily weakened in early May, then started to trend up, recently crossing above the US$2,000/tonne mark (graph 14). They are up more than 25% since the start of 2016. Inventories surveyed by the LME are off almost 20% from the start of the year, demonstrating that the global zinc market has firmed, with producers rapidly adjusting to last year's tumble in prices. Chinese government efforts to stimulate economic activity are also good for zinc demand.

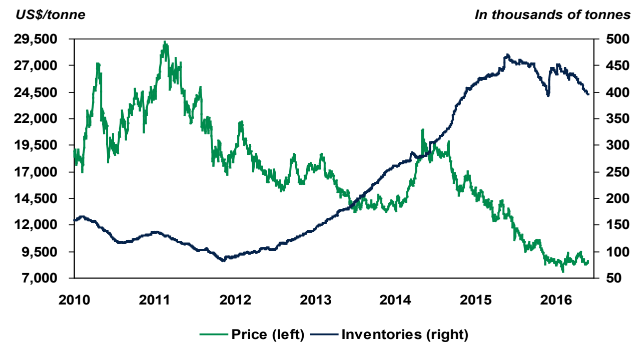
Forecasts: Investor attention will primarily be focused on the Federal Reserve in the coming weeks, which could make metal prices fluctuate. The outlooks for both supply and demand remain fairly good over the medium range, which should allow metal prices to gradually rise to more normal levels, somewhat as we are currently seeing with zinc.

Graph 12 – Copper prices and inventories



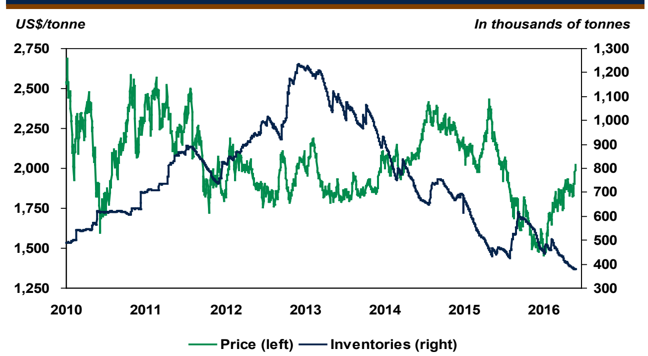
Sources: Datastream and Desjardins, Economic Studies

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

The greenback rebound brought gold prices down

Precious metal prices maintained their momentum in April. May was tougher, however, as the U.S. dollar's rebound prompted a big pullback.

GOLD AND SILVER

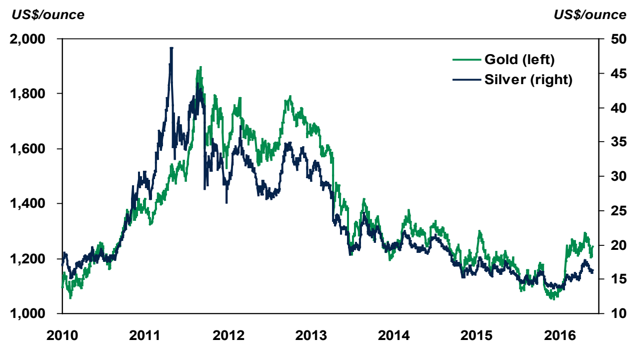
- Up 16% over the first three months of 2016, gold prices posted their best quarter in the last 30 years. The trend continued in April with another 5% gain, which took gold prices close to US$1,300 an ounce (graph 15). This excellent performance was essentially due to gold's renewed popularity with investors who were worried about negative interest rates and the fact that some central banks even seemed to be seriously considering direct monetary stimulus, the famous "helicopter money." The growing perception that the Federal Reserve (Fed) would opt for an extended status quo also favoured gold by prompting a big drop in the greenback. World Gold Council data thus shows that gold demand jumped in the first quarter, but the jump mainly came from investors (graph 16). Good U.S. economic numbers and a change in the Fed's stance temporarily altered the situation in the last few weeks, taking gold prices down to around US$1,200 an ounce.

PLATINUM AND PALLADIUM

- Like gold and silver prices, platinum and palladium prices have retreated sharply after shooting up in the first four months of 2016. Palladium has even edged below where it was at the start of the year. Platinum, for its part, is still up more than 10% from the start of 2016 (graph 17). Platinum demand should substantially outstrip the supply in the coming quarters, which should keep giving the metal's price some support.

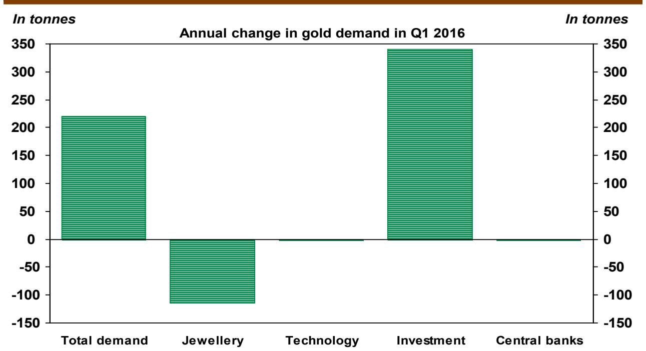
Forecasts: Disappointing employment numbers, which seem to rule out an immediate increase in U.S. key rates, reduce the risk of a further drop by precious metal prices in the near term. The possibility of a U.S. key rate increase could, however, start to hurt precious metal prices again within the next few months. Nonetheless, some investors could keep acquiring gold to protect themselves from the longer-term consequences of extreme monetary policies. We have therefore upgraded our targets for gold prices slightly.

Graph 15 – Gold and silver prices



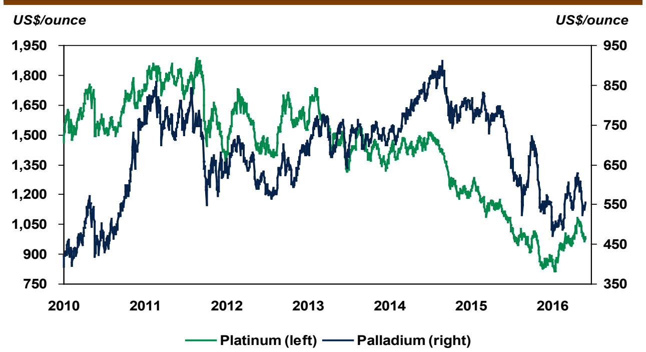
Sources: Datastream and Desjardins, Economic Studies

Graph 16 – Investor demand for gold exploded in Q1



Sources: World Gold Council and Desjardins, Economic Studies

Graph 17 – Platinum and palladium prices



Sources: Datastream and Desjardins, Economic Studies

OTHER COMMODITIES

Speculators are also interested in grains

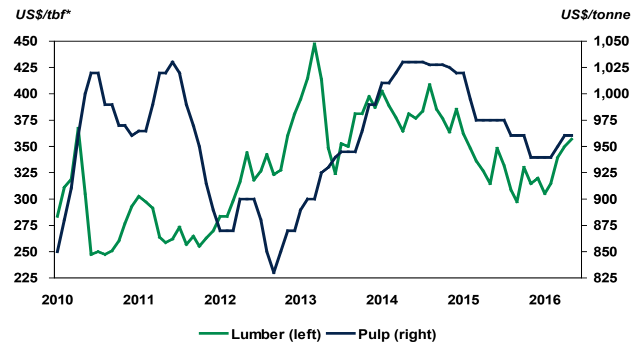
FOREST PRODUCTS

- Lumber prices have continued to trend up slightly in the last few months. The benchmark price for U.S. lumber recently hit US$360/tbf (thousand board feet), its highest price in over a year (graph 18). **The recent signs of strength in the U.S. economy, especially the encouraging numbers for real estate, are contributing to a positive sentiment toward lumber.** The negotiations over a new lumber agreement between the United States and Canada do not seem to be progressing as fast as had been hoped. This situation must be monitored closely, as a trade conflict could arise next fall if an agreement is not concluded in time. The U.S. election period could complicate negotiations. Pulp prices have also risen slightly in the last few months.

AGRICULTURAL COMMODITIES

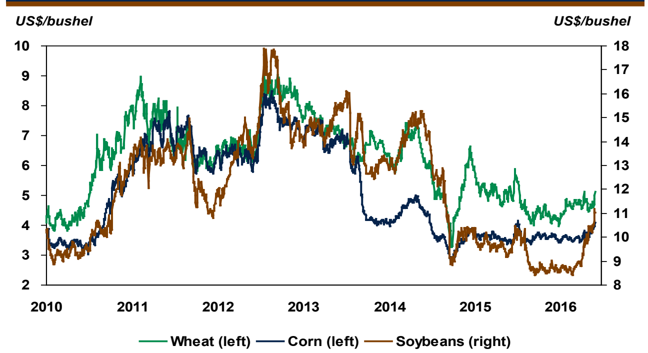
- While wheat prices retreated nearly 5% from the end of March to the end of May, corn and soybean prices jumped by 13% and 17% respectively (graph 19). The first forecasts from the U.S. Department of Agriculture (USDA) for the 2016-2017 season had a hand in this contradictory movement. While global wheat stocks should keep growing this year, hitting a record peak, corn stocks should stabilize and soybean stocks are expected to drop substantially (graph 20). As big harvests are forecast for all three grains, the difference mainly lies in consumption. A surge in Chinese demand points to a robust increase in corn and soybean consumption; wheat, for its part, should only edge up.
- Renewed speculator interest also had a hand in the recent upswing by corn and soybean prices. It started in China, but speculative positions are also up sharply in the United States. The heavy speculation opens the door to further fairly violent movements by corn and soybean prices. **The key factor for grains in the coming months will certainly be the summer weather, which could throw a monkey wrench into the USDA forecasts.**

Graph 18 – Forest product prices



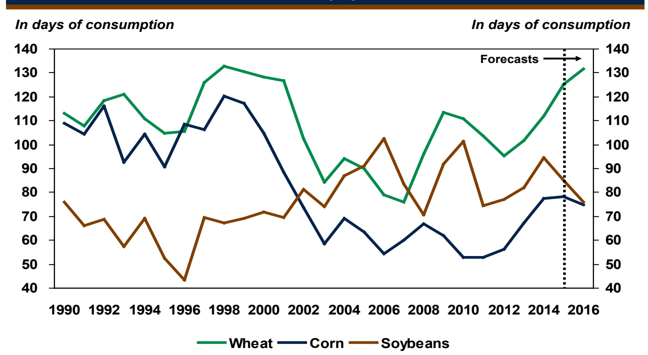
* Thousand board feet.
Sources: Datastream and Desjardins, Economic Studies

Graph 19 – Grain prices



Sources: Datastream and Desjardins, Economic Studies

Graph 20 – Movements in global grain inventories could diverge in 2016



Sources: U.S. Department of Agriculture and Desjardins, Economic Studies

Table 1
Commodities

	Spot price	Percentage return since				Last 52 weeks		
	June 8	1 month	3 months	6 months	1 year	High	Average	Low
Index								
Reuter-CRB[1] (CCI[2])	428.3	5.7	12.8	13.3	0.5	433.4	393.2	353.7
Reuters/Jefferies CRB[1]	192.4	7.0	13.5	8.5	-13.7	228.2	186.8	155.0
Bloomberg Commodity Index	88.3	5.9	12.6	11.5	-12.2	102.7	85.1	72.9
Bank of Canada	377.6	3.8	20.7	9.6	-16.9	456.0	358.9	287.5
Energy								
Brent oil (US$/barrel)	51.2	11.5	27.5	26.5	-17.9	65.1	45.3	27.8
WTI[3] oil (US$/barrel)	50.4	13.0	37.4	34.5	-13.4	61.4	42.7	26.2
Gasoline (US$/gallon)	2.38	6.3	29.3	16.0	-14.4	2.84	2.26	1.72
Natural gas (US$/MMBTU[4])	2.29	24.5	47.7	15.7	-13.6	2.95	2.25	1.49
Base metals								
LMEX[5]	2,239	-3.2	-2.4	4.5	-17.8	2,751	2,320	2,049
Aluminium (US$/tonne)	1,554	-1.8	-1.0	5.7	-9.2	1,723	1,549	1,426
Copper (US$/tonne)	4,563	-5.4	-6.5	-0.6	-23.2	6,024	4,976	4,328
Nickel (US$/tonne)	8,541	-5.4	-0.2	-1.3	-36.3	13,564	9,596	7,562
Zinc (US$/tonne)	1,998	6.1	14.0	32.1	-6.1	2,149	1,767	1,455
Steel (US$/tonne)	127.0	67.1	67.5	-34.9	2.4	197.0	141.7	75.5
Precious metals								
Gold (US$/ounce)	1,241	-3.8	-2.2	15.6	6.0	1,294	1,160	1,052
Silver (US$/ounce)	16.3	-5.8	4.2	14.5	1.6	17.9	15.2	13.6
Platinum (US$/ounce)	986.0	-8.0	-1.9	15.7	-10.2	1,117	960.3	814.0
Palladium (US$/ounce)	550.0	-8.9	-4.3	-1.4	-26.3	751.0	590.5	470.0
Other commodities								
Lumber (US$/tbf[6])	355.0	0.6	12.3	13.8	10.2	360.0	326.2	294.0
Pulp (US$/tonne)	960.0	0.0	2.1	2.1	-1.5	975.0	956.0	940.0
Wheat (US$/bushel)	5.14	13.7	8.8	22.4	-1.3	5.88	4.61	3.97
Corn (US$/bushel)	4.09	13.5	16.9	11.9	16.4	4.15	3.62	3.36
Soybean (US$/bushel)	11.14	11.6	28.4	27.5	18.5	11.17	9.17	8.40

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

Table 2
Commodities prices: history and forecasts

Annual average	*2014*	*2015*	*2016f*	*2017f*
WTI* oil (US$/barrel)	93	49	Target: 45 (range: 40 to 48)	Target: 56 (range: 46 to 64)
Natural gas Henry Hub (US$/MMBTU**)	4.34	2.65	Target: 2.25 (range: 1.90 to 2.50)	Target: 2.75 (range: 2.25 to 3.50)
Gold (US$/ounce)	1,266	1,160	Target: 1,225 (range: 1,175 to 1,275)	Target: 1,150 (range: 1,050 to 1,250)
LMEX*** index—base metals	3,117	2,550	Target: 2,300 (range: 2,165 to 2,400)	Target: 2,600 (range: 2,200 to 3,000)

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