Commodity Trends

Desjardins Economic Studies
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Oil prices' recent pullback should not be the start of another collapse

Overall, the first half of 2016 was very good for commodities (graph 1). Most commodity price indexes capitalized on such things as a 30% rebound in oil prices and renewed investor interest in precious metals to jump more than 10% in the first half, despite the surge in concern at the end of June due to the British vote in favour of leaving the European Union (Brexit).

The last few weeks have been tougher, however. Oil prices fell back to around US$40/barrel, with investors seeming to focus on the huge crude and gas inventories and the end of the temporary problems that had hampered oil production in some countries, including Canada. This situation may be reminiscent of what happened last year, when an unjustified spring upswing gave way to another spectacular tumble in oil and commodity prices in the second semester of 2015. In our opinion, the situation is quite different this year, with the advance in crude prices based on a true rebalancing of the global oil market (graph 2). It should also be noted that most commodity prices have not follow oil prices down recently. The outlook thus remains fairly good for commodity prices in the next few quarters.

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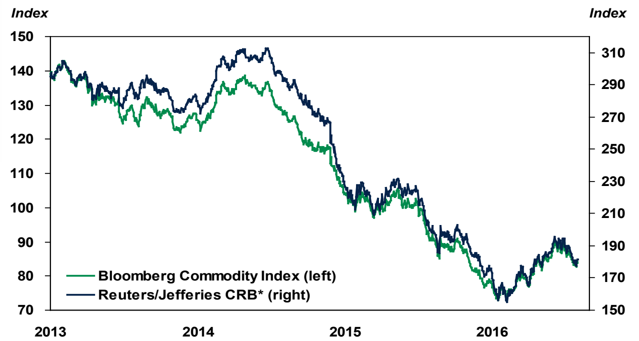
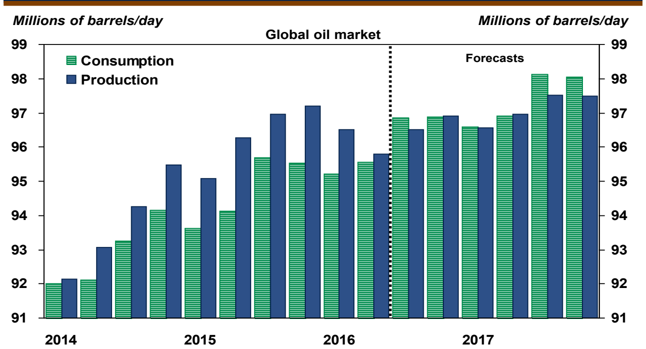
Graph 1 – Commodity price indexes are still higher than their early 2016 cyclical lows



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

Graph 2 – The major oil surplus period seems to be over



Sources: International Energy Agency and Desjardins, Economic Studies

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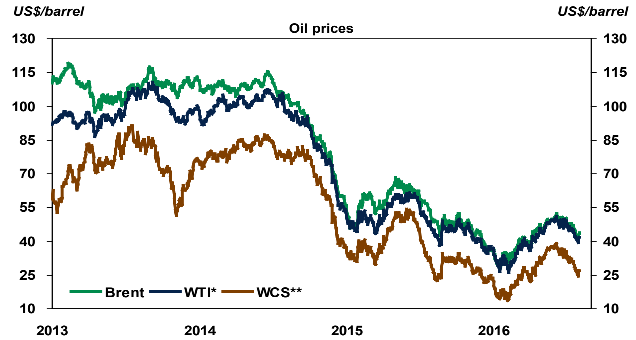
ENERGY

The situation is progressing as anticipated for oil

OIL

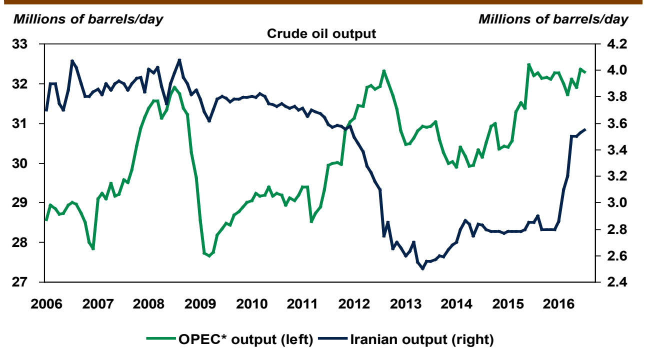
- Oil prices stabilized at around US$50 a barrel in June, and WTI (West Texas Intermediate) prices initially showed a lot of resilience in the days after the Brexit vote. Then, however, they fell to around US$45/barrel at the start of July, as investors appeared to be disappointed with the pace at which stocks were declining. In the final weeks of July, a true downtrend then took WTI down to around US$40/barrel (graph 3). That was all it took for several articles to be published in the media about the huge oil glut and another looming price correction.
- The end of temporary production problems in some countries seems to justify some moderation of oil prices. Activity in Canada's oil sector has kicked up in the last two months after plunging as a result of May's forest fires. Other positive developments in such places as Nigeria and Libya also helped push production by OPEC (Organization of the Petroleum Exporting Countries) nations near its peak (graph 4). Lastly, the spectacular plunge in U.S. drilling and oil output recently gave way to a slight upswing (graph 5). As stocks of crude and petroleum products are in fact very high (graph 6 on page 3), we can see why negative sentiment has recently reappeared in the oil market.
- However, it is important to note that these developments were predictable and will have little impact on the balance between oil supply and demand over the medium term. In particular, Alberta output had been fully expected to come back quickly. A temporary improvement of the situation in unstable countries like Libya is also completely normal. Analysts had also predicted that the collapse in U.S. drilling would soon give way to an upswing. This does not alter the fact that U.S. crude output is down by more than one million barrels a day from last year's peak. We cannot know exactly how U.S. production will move in the near term, as we could see both small increases and small declines. Drilling would have to go up a lot more, however, before we can hope to see another true uptrend. In our view, as global demand continues to rise at a solid pace and the potential for a further increase in OPEC output seems limited, the risk of seeing another major surplus in the oil market remains very low.

Graph 3 – The second semester gets off to a tougher start for oil



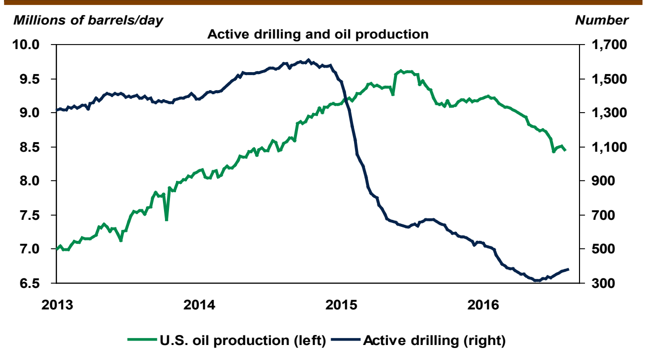
* West Texas Intermediate; ** Western Canada Select.
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

Graph 4 – With the return of Iranian output, OPEC* production is very close to its peak



OPEC: Organization of the Petroleum Exporting Countries; *Excluding Indonesia but including Iraq.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 5 – After taking a spectacular plunge, the U.S. oil sector may have hit bottom



Sources: Baker Hughes, Energy Information Administration and Desjardins, Economic Studies

GASOLINE

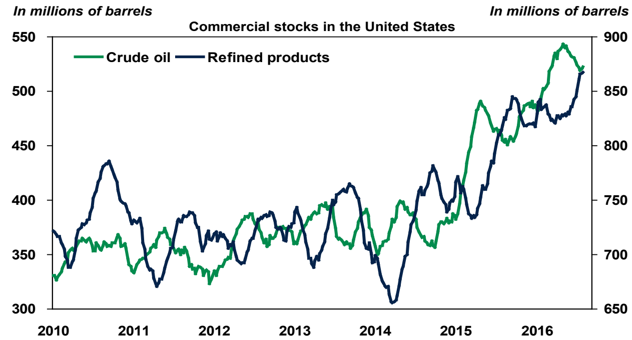
- Gasoline prices have also started to slide again after climbing last spring. At US$2.40 in mid-June, the average price for regular gas in the United States recently fell to around US$2.10, with many expecting that it could shortly drop below the psychological threshold of US$2 a gallon. A similar trend pulled the average price down by about ten cents in Canada, taking it to around C$1 a litre (graph 7). Along with reflecting the relapse in oil prices, the drop in gas prices reflects the big gas inventories, which are putting downside pressure on refiners' margins. This situation seems to be worrying investors, and contributing to the current negative sentiment about oil. True, refiners could consume a little less oil in the next few months to try to decrease their inventories and drive margins up. This would have a limited, temporary impact on U.S. oil demand, however, especially in a context in which gas demand is showing robust growth.

NATURAL GAS

- Natural gas prices generally oscillated below US$2/MMBTU (Million British Thermal Units) in the early months of 2016, then shot up in June to close in on US$3 (graph 8). Since then, they have been moving without a clear trend, consolidating a substantial portion of their gains. The price surge seems justified by favourable developments in terms of supply and demand. The tumble of energy sector investment is resulting in near stagnation for U.S. natural gas production, while the warm weather in the last few months is creating strong demand, particularly from electricity producers. The very low gas prices of the last few quarters have a hand in both trends. Accordingly, the summer increase in natural gas stocks promises to be quite small this year, although, inflated by the mild winter, inventories remain high.

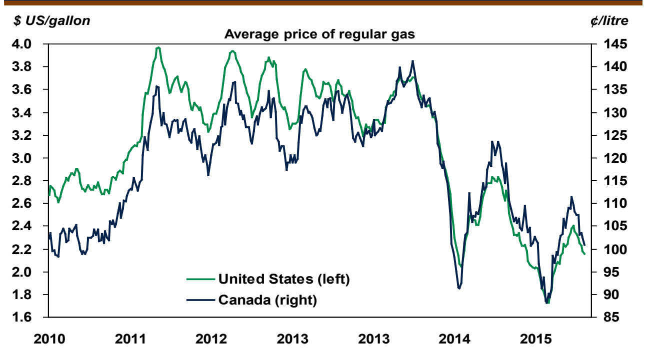
Forecasts: Oil prices were expected to temporarily drop to around US$45 a barrel this summer as inventories remained very high. The recent decline is now starting to be overdone, however, and a lasting downswing to less than US$40 would not be justified by the supply and demand outlooks. Instead, we still expect an upswing that would take WTI to just above US$50 a barrel at the end of 2016, and to around US$65 a barrel at the end of 2017. Natural gas prices went up a little more quickly than we had anticipated and could now consolidate their gains before starting to climb again next year.

Graph 6 – Commercial oil and petroleum product stocks are very high in the United States



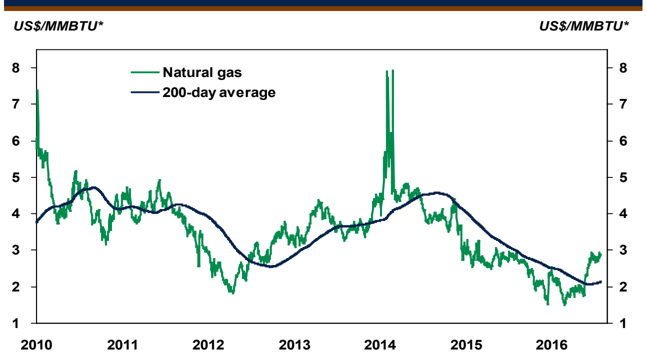
Sources: Energy Information Administration and Desjardins, Economic Studies

Graph 7 – Gas prices recently started to slide again



Sources: Datastream, Natural Resources Canada and Desjardins, Economic Studies

Graph 8 – Natural gas prices



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

BASE METALS

No post-Brexit pullback

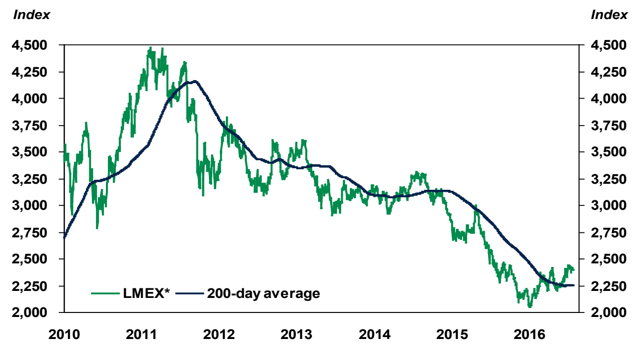
Following a somewhat more difficult May, industrial metal prices have done fairly well recently. The postponement of U.S. key rate hikes and the lack of a lasting surge in concern following the Brexit vote allowed the LME (London Metal Exchange) index to go back over 2,400 (graph 9). It is up about 10% since the start of the year.

Note that the global economic and financial environment should remain fairly favourable for metals. Economic growth is subdued in most countries, but recession fears have ebbed substantially in both China and the United States, among other countries. In the manufacturing sector, purchasing manager indexes are at adequate levels in most countries (graph 10), except in the United Kingdom, where Brexit has had a much bigger impact on business confidence. Highly aggressive central bank monetary policies suggest that interest rates will remain very low which, sooner or later, should foster faster private investment growth. The many government economic stimulus plans, which often involve infrastructure spending, will also favour industrial metals. Following Canada and China earlier this year, Japan recently announced stimulus measures, and the U.K.'s government could soon do the same.

ALUMINUM

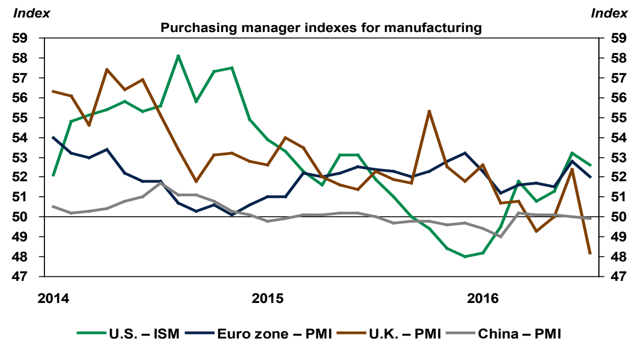
- Aluminum prices have been fairly volatile in the last few months, going from US$1,670 a tonne at the end of April to less than US$1,517 in mid-May, then temporarily rebounding to US$1,670 in mid-July. They then fell again, only to climb to around US$1,630 a tonne recently (graph 11). Although they have been casting around with no clear trend in the last few months, aluminum prices are up about 8% from the start of the year. The increase primarily seems to reflect two factors. Firstly, Chinese exports fell in the first half of 2016, as Chinese producers curbed production. However, the upswing in prices could make Chinese producers less reasonable in the coming quarters. The price increase also reflects renewed optimism about demand for aluminum, based on such things as the auto sector's solid performance and government stimulus plans, particularly in China.

Graph 9 – Industrial metal prices rise slowly



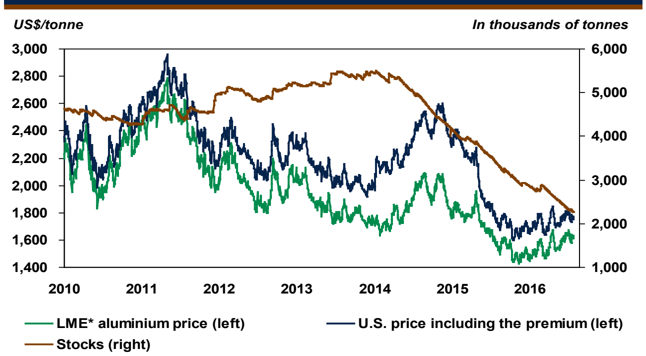
* London Metal Exchange base metal price index.
Sources: Datastream and Desjardins, Economic Studies

Graph 10 – The manufacturing sector is not sending worrisome signals, except in the United Kingdom



Sources: Bloomberg, Institute for Supply Management and Desjardins, Economic Studies

Graph 11 – Aluminium prices and stocks



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

COPPER

- Copper prices have come up somewhat since mid-June, but are still under US$5,000 a tonne (graph 12); they have gained just 2% since the start of 2016. Copper's performance is disappointing compared with the one delivered by other metals. One factor limiting copper's gains in recent months is certainly an increase of about 35% in the copper inventories surveyed by the LME since the end of May. However, copper inventories remain relatively low: the recent upswing followed a steep drop at the start of the year. Signs of an acceleration of the Chinese economy are especially promising for copper demand, and could translate into a sharper upswing in prices in the next few months.

NICKEL

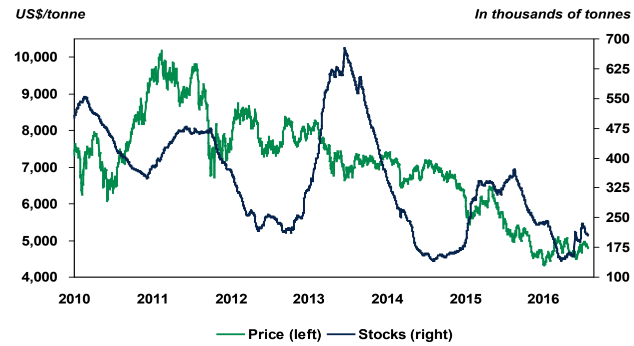
- After several difficult quarters, nickel prices have done better recently, climbing to around US$10,700 a tonne (graph 13). The metal's price has thus shot up more than 25% since the end of May, and is up more than 40% from last February's low. Some analysts think prices are rising too quickly, as global nickel inventories remain high and true industrial demand is subdued. Note, however, that the current price is still very low, historically, and too low to make many producers profitable. The recent increase was prompted by nickel mine closures for environmental reasons in the Philippines, the world's leading producer. This could help bring nickel inventories down further toward more normal levels.

ZINC

- Zinc prices have kept trending up in the last few months. They recently hit US$2,275 a tonne, their highest point since May 2015 (graph 14). Unlike the other industrial metals, zinc is now showing a major gain over the last twelve months. The metal continues to benefit from signs of an upswing in Chinese demand, as well as from the quick downside adjustment to zinc output when prices fell last year. The fears of a zinc surplus that emerged last year therefore seem to be quickly giving way to fears of a shortage.

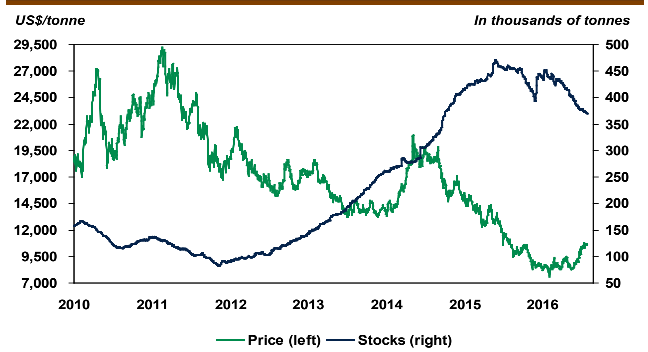
Forecasts: Overall, the economic and financial environment should continue to foster a slow rise in industrial metal prices in the coming quarters. Metal prices will however remain vulnerable to a spike of the U.S. dollar and, in particular, a rebound in concerns over the Chinese economy.

Graph 12 – Copper prices and stocks



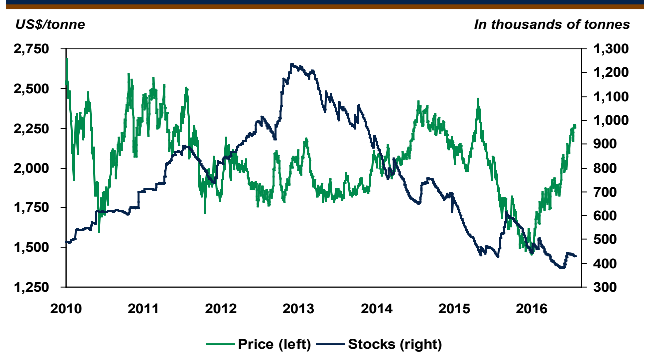
Sources: Datastream and Desjardins, Economic Studies

Graph 13 – Nickel prices and stocks



Sources: Datastream and Desjardins, Economic Studies

Graph 14 – Zinc prices and stocks



Sources: Datastream and Desjardins, Economic Studies

PRECIOUS METALS

Hurray for Brexit!

After a tough May, precious metal prices took off quickly, capitalizing on the postponement of U.S. rate increases and a surprise Brexit victory in the United Kingdom.

GOLD AND SILVER

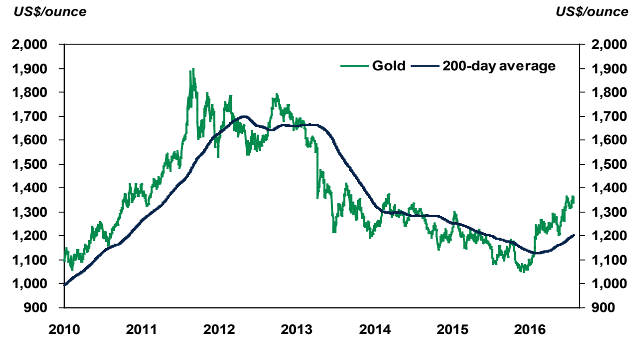
- Gold prices got the year off to an excellent start, then fell in May, dropping back to around US$1,200 an ounce with the growing perception of a looming Federal Reserve (Fed) key rate increase. The situation changed quickly in early June, when very weak U.S. job creation made concerns over monetary firming evaporate. After that, the Brexit victory pushed gold to US$1,369 an ounce, its highest point since March 2014 (graph 15). Silver prices also jumped (graph 16). Brexit is good for precious metal prices in at least two ways. On one hand, it generates a lot of uncertainty, inflating demand for safe haven securities. On the other, it encourages central banks to maintain extremely accommodating monetary policies, perpetuating a very low interest rate environment. Some central banks, for example, those in the United Kingdom and Japan, have announced additional monetary easing since the Brexit win. The situation is murkier in the United States, where a rebound by employment and solid stock market performance seem to have reassured Fed leaders.

PLATINUM AND PALLADIUM

- The factors driving gold and silver prices have also pushed platinum up more than 15% since the end of May (graph 17). Palladium prices are doing even better, up more than 25% over the same period. In addition to financial factors, prices for both metals are benefiting from positive fundamentals. In particular, good growth of motor vehicle sales in several countries is buoying demand, while the supply is limited and threatened by problems in the South African mining industry. The two metals' global markets could therefore remain in deficit.

Forecasts: Precious metal prices made substantial gains in the last few months, and now seem ripe for some consolidation. In the next few months, the main downside risk would be another greenback rise, especially if the Fed really seems to want to go into action. Next year might be less favourable for gold and silver.

Graph 15 – Gold prices

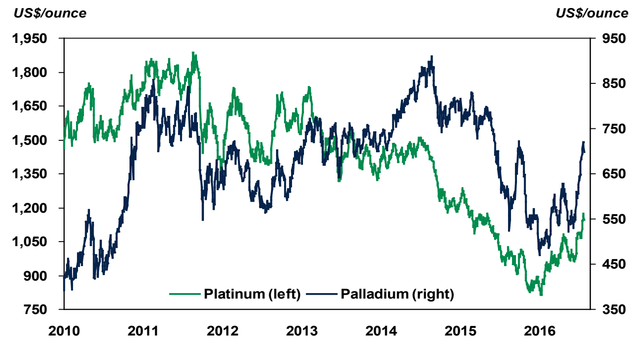


Sources: Datastream and Desjardins, Economic Studies

Graph 16 – Silver prices

Sources: Datastream and Desjardins, Economic Studies

Graph 17 – Platinum and palladium prices



Sources: Datastream and Desjardins, Economic Studies

OTHER COMMODITIES

Favorable weather pulls grain prices down

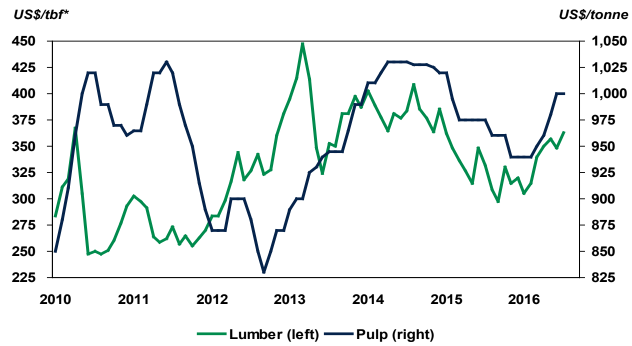
FOREST PRODUCTS

- Lumber prices weakened slightly in June and early July, then climbed in recent weeks, going to US$367/tbf (thousand board feet). They are up around 10% in the last year, though still well below 2013 levels (graph 18). At first glance, the second quarter's annualized 6.1% drop in the residential investment component of U.S. real GDP could seem worrisome for demand for wood. However, such a drop is not a concern following several quarters of strong growth, especially as other housing market indicators remain promising. In particular, **U.S. new home sales recently jumped to their highest point since the financial crisis, an encouraging sign for wood demand**. For Canadian producers, we must keep watching the negotiations over a new lumber export agreement with the United States.

AGRICULTURAL COMMODITIES

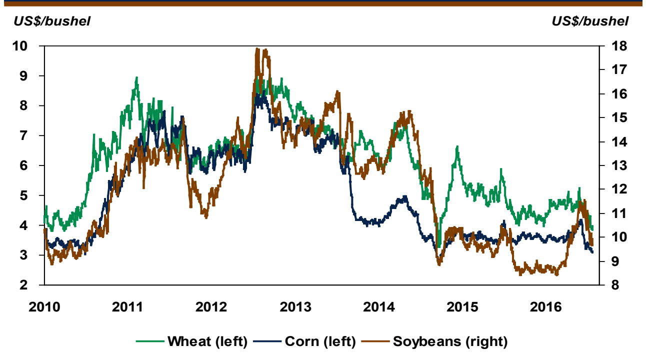
- As with oil, a good spring was followed by a tougher summer for the main grains. Wheat prices fell from US$5.25 a bushel to just under US$4 recently, hitting their lowest point since the fall of 2014. The correction was widespread: corn prices are down more than 20% since mid-June, while soybeans have posted a decline of about 10% (graph 19).
- **The slide in grain prices primarily reflects the fact that all signs point to another very good harvest this year in the United States.** The U.S. Department of Agriculture upgraded its forecasts in early July, with everything suggesting it will have to adjust them again in August. Overall, the weather has been favourable in grain-producing regions, resulting in harvest conditions similar to those seen in 2015 (graph 20), an excellent year. Weather conditions are not quite as good in other countries, especially in Europe, but, overall, global grain harvests promise to be very strong. We noted last time that strong demand for soybeans and corn put them in a better position than wheat. This is still true, but wheat prices have come down so much that they seem to be starting to prompt some users to use this grain more, particularly at the expense of corn.

Graph 18 – Forest product prices



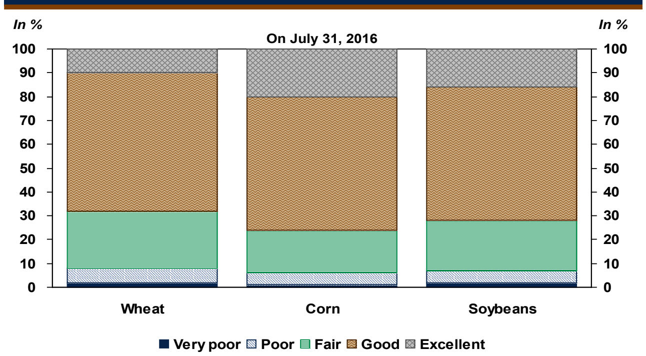
* Thousand board feet.
Sources: Datastream and Desjardins, Economic Studies

Graph 19 – Cereal prices



Sources: Datastream and Desjardins, Economic Studies

Graph 20 – Harvest conditions in the United States



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

Table 1
Commodities

	Spot price	Percentage return since				Last 52 weeks		
	August 10	1 month	3 months	6 months	1 year	High	Average	Low
Index								
Reuter-CRB[1] (CCI[2])	422.8	-1.7	4.2	16.3	4.3	436.9	394.8	353.7
Reuters/Jefferies CRB[1]	181.4	-3.1	0.6	16.0	-10.4	202.7	181.9	155.0
Bloomberg Commodity Index	83.8	-3.1	0.5	13.3	-9.6	92.6	83.1	72.9
Bank of Canada	336.4	-9.4	-3.1	25.1	-7.9	375.1	332.1	265.8
Energy								
Brent oil (US$/barrel)	45.4	-2.9	0.2	46.2	-8.0	52.4	43.4	27.8
WTI[3] oil (US$/barrel)	42.8	-5.7	-4.3	55.3	-4.8	51.2	41.3	26.2
Gasoline (US$/gallon)	2.15	-6.2	-3.2	22.2	-18.2	2.72	2.17	1.72
Natural gas (US$/MMBTU[4])	2.75	-0.7	34.8	29.1	-3.5	2.94	2.24	1.49
Base metals								
LMEX[5]	2,398	1.7	6.4	12.2	-2.3	2,467	2,284	2,049
Aluminium (US$/tonne)	1,629	-1.5	6.1	10.0	2.7	1,671	1,544	1,426
Copper (US$/tonne)	4,769	1.5	1.7	7.2	-10.0	5,417	4,840	4,328
Nickel (US$/tonne)	10,735	9.1	23.8	36.8	-3.4	11,108	9,248	7,562
Zinc (US$/tonne)	2,270	6.2	23.3	32.5	21.3	2,275	1,789	1,455
Steel (US$/tonne)	312.5	0.0	313.9	59.0	152.0	312.5	172.0	75.5
Precious metals								
Gold (US$/ounce)	1,340	-1.2	6.3	12.4	21.5	1,369	1,190	1,052
Silver (US$/ounce)	19.7	-0.1	15.6	30.3	32.4	20.7	15.9	13.6
Platinum (US$/ounce)	1,143	5.6	9.6	23.4	17.7	1,175	964.2	814.0
Palladium (US$/ounce)	687.0	13.4	17.8	32.4	14.5	723.0	582.2	470.0
Other commodities								
Lumber (US$/tbf[6])	367.0	5.2	4.0	18.8	11.6	367.0	328.5	294.0
Pulp (US$/tonne)	1,000	0.0	4.2	6.4	2.6	1,000	959.5	940.0
Wheat (US$/bushel)	3.99	-8.1	-11.3	-14.7	-17.7	5.25	4.48	3.84
Corn (US$/bushel)	3.10	-7.5	-14.6	-12.4	-16.7	4.18	3.58	3.09
Soybean (US$/bushel)	10.05	-5.5	-4.0	17.8	-2.8	11.57	9.30	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$/barrel)	93	49	Target: 44 (range: 40 to 46)	Target: 56 (range: 46 to 64)
Natural gas Henry Hub (US$/MMBTU**)	4.34	2.65	Target: 2.40 (range: 2.15 to 2.60)	Target: 3.25 (range: 2.60 to 3.80)
Gold (US$/ounce)	1,266	1,160	Target: 1,260 (range: 1,235 to 1,295)	Target: 1,200 (range: 1,150 to 1,325)
LMEX*** index—base metals	3,117	2,550	Target: 2,345 (range: 2,200 to 2,415)	Target: 2,700 (range: 2,300 to 3,100)

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