

OCBC Commodities Outlook – May 2018

Energy

Crude oil prices continue to rally despite the fall in CFTC net-long positions. Note that speculative net-long positions have fallen for three consecutive weeks. Gains in energy prices can be attributed to higher risk premiums owing to geopolitical uncertainties amid a supported oil demand levels from Asia and Europe. We remain uncomfortable over higher oil prices into the weeks ahead, owing to the potential ebbing of risk premiums as well as higher US-led oil production into 2018.

Base Metals

Base metal prices continue to stay elevated, except for aluminium which fell 1.6% since last week as investors look beyond the Rusal sanctions. Trade risks between US-China alongside dollar strength of late may continue to lead prices in a range-bound fashion. Elsewhere, do note that aluminium prices remain prone to headline risks.

Precious Metals

Interim dollar strength seen since April 2018 in tandem with higher yields in the shorter-end of the US treasury curve dragged gold prices from its \$1,370/oz handle to near its \$1,300/oz support. Higher short-term US rates may continue to drag gold prices given the yellow metal's status as a zero-yielding asset. Moreover, street talk for ECB to taper its quantitative easing programme in Sept 2018 and a potential rate hike into 2019 could garner further greenback weakness and consequently stronger bullion.

Agricultural and Asian Commodities

Palm oil prices have been weakening since the start of the year, although recent MYR weakness leading into Malaysia's GE14 election has supported prices somewhat in May. Supply-wise, Malaysia's production disappointed at 0.67% y/y in April, versus its 1Q18 production growth of 12.8% y/y. Still, overall supplies are likely to climb further into early 4Q18, though demand may pick up as Ramadan nears.

Commodities Performance Table

Updated as of 14 May 2018

Selected Indices	Close	Weekly Change	MTD	QTD	YTD
US Dollar Index (DXY)	92.5	-0.6%	0.1%	2.8%	0.4%
Reuters / Jefferies (CRB)	203.8	0.9%	1.3%	4.3%	5.1%
Dow Jones Industrial Avg	24,899	2.2%	3.3%	3.3%	0.7%
Baltic Dry Index	1,476	3.1%	11.2%	39.9%	8.1%
Energy	Close	Weekly Change	Net Position	Weekly Change	YTD
NYMEX WTI Crude	70.7	2.3%	723,189	-12,682	17.0%
ICE Brent Crude	78.2	4.4%	569,448	-22,009	16.9%
NYMEX RBOB Gasoline	219.5	3.9%	86,633	1,999	22.0%
NYMEX Heating Oil	222.4	3.1%	32,632	5,496	7.2%
NYMEX Natural Gas	2.8	3.0%	-124,424	-28,514	-4.7%
Base Metals	Close	Weekly Change	Net Position	Weekly Change	YTD
LME Copper	6,885	2.1%	32,171	-1,665	-5.0%
LME Aluminium	2,319	-1.6%	-	-	2.2%
LME Nickel	14,055	1.2%	-	-	10.1%
Precious Metals	Close	Weekly Change	Net Position	Weekly Change	YTD
COMEX Gold	1,311.3	-0.2%	103,540	173	0.2%
COMEX Silver	16.5	0.0%	-1,185	6,974	-3.9%
NYMEX Platinum	908.8	-0.4%	10,130	-329	-3.1%
NYMEX Palladium	977	1.4%	10,365	-430	-7.9%
Agriculture	Close	Weekly Change	Net Position	Weekly Change	YTD
CBOT Corn	397	-1.7%	351,002	20,785	13.0%
CBOT Wheat	495	-3.9%	16,379	20,154	15.8%
CBOT Soybeans	1,020	0.0%	163,909	-38,512	6.0%
Asian Commodities	Close	Weekly Change	MTD	QTD	YTD
Thai W. Rice 100% (USD/MT)	476	-1.0%	-1.9%	2.8%	11.5%
Crude Palm Oil (MYR/MT)	2,410	1.2%	2.0%	-0.6%	-3.7%
Rubber (JPY/KG)	192	0.3%	-0.3%	4.5%	-7.0%

Source: Bloomberg, CFTC, OCBC Bank

Note: Closing prices are updated as of 15 May 2018

Note: Speculative net positions are updated as of 08 May 2018

Note: Speculative net positions for Aluminium and Nickel are unavailable

OCBC Treasury Advisory

Barnabas Gan

+65 6530-1778

BarnabasGan@ocbc.com
**Corporate FX &
Structured**
Products

Tel: 6349-1888 /
1881

**Investments &
Structured**
Products

Tel: 6349-1886

**Interest Rate
Derivatives**

Tel: 6349-1899

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Tel: 6349-1810

Gold: Signs pointing towards a dearer metal

Highlights

- Interim dollar strength seen since April 2018 in tandem with higher yields in the shorter-end of the US treasury curve dragged gold prices from its \$1,370/oz handle to near its \$1,300/oz support.
- Higher short-term US rates may continue to drag gold prices given the yellow metal's status as a zero-yielding asset. Moreover, street talk for ECB to taper its quantitative easing programme in Sept 2018 and a potential rate hike into 2019 could garner further greenback weakness and consequently stronger bullion. Note also developed economies (especially ECB, RBA, BOE, RBNZ) potentially seeing higher rates into 2019 should overall inflation climbs further.
- We have upgraded our gold outlook to \$1,400/oz at end-year in our previous Commodities Outlook report. Overarching this bullish call is the underlying perceived weakness in the dollar into end-year. With rate differentials likely to govern how the dollar could move into year-end, the year 2018 could potentially see higher gold prices, not as a move towards safe haven, but simplistically, a reaction to a weaker greenback.

Sometimes, a safe haven it is not

Should one compare how equities performed in the first five months of 2018 versus that of 2017, the difference can be quite stark; the S&P index rallied a strong 27.2% from the start of 2017 to end Jan 2018, before bouts of risk aversion and geopolitical uncertainties brought it lower to-date. In contrast, safe haven demand in 2017 should have been dull given the uptick in risk-taking behavior, while the rather choppy equity market seen to-date should give gold bulls a run for their money.



Source: Bloomberg, OCBC Bank

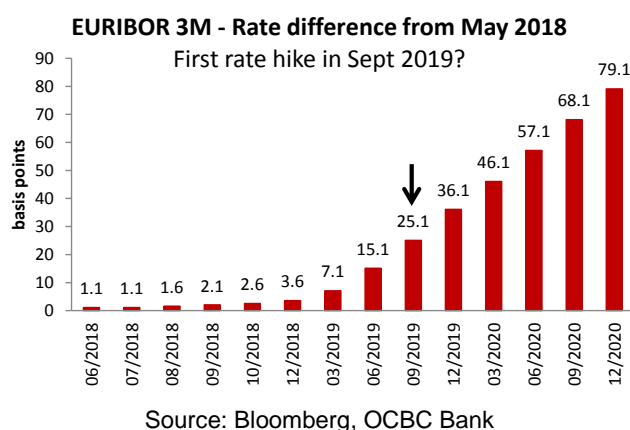
However, gold's behavior has defied market risk appetite trends. Factually, the yellow metal rallied by 14.5% in 2017

despite the equity rally, and in turn remained range-bound between \$1,300 - \$1,370/oz in the first five months of 2018. Importantly, the relationship between the greenback and gold remains intact, suggesting that how the dollar may trend into 2018 would be key in determining how the bullion may behave.

It's not only about the Fed rate hike

Conventional understanding points towards currency strength should an economy's overall interest rate level increases. Simplistically, the higher interest rate raises the rate of return of investment in one country, and thus attracts inbound fund flow. This phenomenon subsequently raises the demand for one's currency, and assuming constant supply, the currency appreciates.

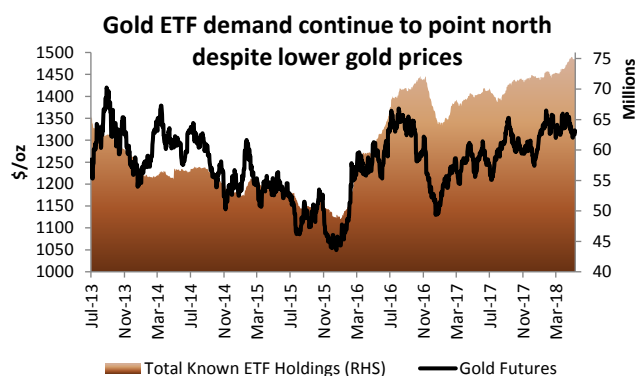
However, in a closely-knitted world where many economies and their interest rate regimes are intricately inter-twined, rate differentials between major economies would need to be considered in order to make an informed outlook on how the greenback, and subsequently gold prices, may move. Importantly, while the US Federal Reserve is likely to see further rate hikes into 2018, other major central banks including the ECB, RBA, RBNZ and BOE have signaled their intention to normalize policy rates higher as well. In addition, note that the ECB itself "confirms that the net asset purchases (EUR30bn) are intentioned to run until the end of September 2018". Should we also look at the Euribor 3M forward curves, investors are increasingly pricing in a potential ECB rate hike as early as September 2019 as well.



Gold demand update

Moving on into gold demand, note that ETF demand in gold has continued to climb higher despite the relatively weakness in gold prices. Total known ETF holdings of gold tracked by Bloomberg Data has increased to 75 million troy ounces as of mid-May, up from 71.5 million troy ounces seen at the start of the year. The higher paper demand seen in higher ETF gold

holdings suggest that market-players are still rather bullish to-date, likely given the heightened geopolitical uncertainties seen of late. In physical demand, note that China's gold import from Hong Kong has risen to 92 thousand kilograms in the first two months of 2018, up from 83 thousand kg in the same period a year ago. India's gold demand however, slackened to 164 tonnes in 1Q18, down from 243 tonnes in 1Q17.



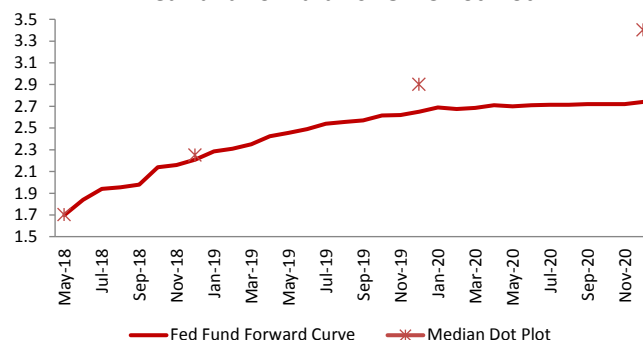
Source: Bloomberg, OCBC Bank

Dollar weakness to dictate gold's strength... but?

Our discussion has so far established (1) a weakening dollar story into 2018 would be key in supporting gold's value and (2) rate differentials between the US Federal Reserve and other major central banks needs careful monitoring to decipher how the greenback, and consequently gold, may move into end-year. Moreover, (3) paper gold demand has been supportive of

higher gold prices, though physical gold demand has been relatively tepid in the first quarter of the year.

Fed Fund Forward Vs FOMC Dot Plot



Source: Bloomberg, OCBC Bank

We continue to regard gold as an effective dollar hedge (and a safe haven should the need calls for it). With the Fed likely to see another rate hike in June 2018, the rate differential argument may be in favor for further dollar strength into the rest of 1H18. In such a scenario, gold may continue to range-trade and see a potential resistance of \$1,350/oz into the first half. Still, dollar weakness may continue to persist into 2H18, especially when other major central banks signal intentions to normalize rates higher. Should this be seen, the greenback weakness would be a key reason to lift gold prices to our year-end outlook of \$1,400/oz.

Crude Oil: Back to the drawing board

Highlights

- Crude oil prices continue to rally despite the fall in CFTC net-long positions. Note that speculative net-long positions have fallen for three consecutive weeks.
- Gains in energy prices can be attributed to higher risk premiums owing to geopolitical uncertainties amid a supported oil demand levels from Asia and Europe.
- Beyond geopolitics, oil prices will still be governed by fundamentals eventually. Further upside risk in US-led production must be addressed, while risk premiums are expected to fade as the dust settles. As such, we keep our WTI and Brent outlook at \$65/bbl and \$70/bbl, respectively at year-end.

Crude oil prices have been rallying beyond our comfort levels. Both Brent and WTI crossed their \$77/bbl and \$71/bbl handles, respectively in the previous week. Much of the rally has been due to market-watchers' pricing-in of a potential shortfall in Iranian oil supplies, following US President Donald Trump's revocation of the nuclear deal and said that the "highest level" of sanctions will be imposed. More so, countries that support Iran in developing a nuclear bomb will likewise be subject to sanctions as well, leading the European Union scrambling to arrange a meeting with Tehran while French President Emmanuel Macron highlighted his willingness "to continue enforcing the Iran nuclear agreement in all respects". Still, continued rhetoric by the members of the Organization of Petroleum Exporting Countries (OPEC) cartel, especially early week comment by UAE oil minister Mazrouei emphasising adequate excess production capacities in Saudi Arabia, Kuwait and UAE are enough to cushion Iranian potential production shortfall.

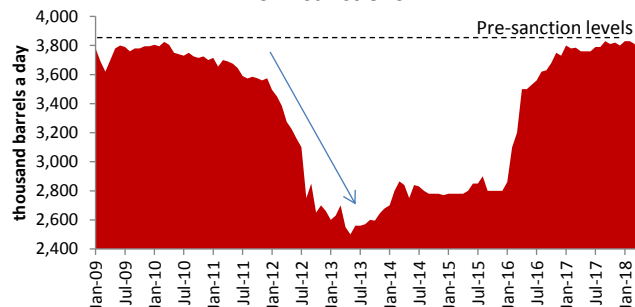
Getting very uncomfortable

It has been several weeks since we highlighted our discomfort over the rising oil prices. Back then, our key reasons for the said uneasiness were two-fold: (1) rising U.S. oil production which in fact rose to 10.7 million barrels late last week, and (2) the record-high % of speculative open interest seen in Nymex Crude which suggests that any unwinding of positions could be near and potentially inject a long overdue correction in oil prices.

However, fresh events surrounding the geopolitical arena which includes US missile strike against Syria, US-led sanctions against Iran and sustained Middle East tensions between Israel and Iran left oil prices higher. Elsewhere, investors also effectively shrugged off higher US-led supplies, given the positive global growth outlook and rising global oil import demand led by China, India and Europe. In a nutshell, although oil supplies did rise in the first three months of 2018,

the rise in global oil demand were adequate enough to absorb the excess supply, thus avoiding a supply glut scenario again.

Iranian oil production fell significantly in the last 2012 sanctions



Source: Bloomberg, OCBC Bank

In our view, we remain uncomfortable over rising oil price, given that the rally is likely to be short-lived. Our [April's commodities report](#) has established that the surge in oil prices due to missile strikes have been short-lived as seen in the previous 2017 event. Moreover, prices as of early week have trended lower as investors likely took comfort from UAE oil minister Mazrouei's comment that the combined excess capacities of Saudi Arabia, Kuwait and UAE are adequate to cushion potential shortfalls from Iranian crude oil production. Should we observe historical evidence, the previous 2012 Iranian sanctions did remove over 1.2 million barrels per day (bpd) since its 2010 peak, a short-fall that could be revisited should sanctions turn concrete in 180 days. However, things are observably different this time around, owing to Europe's wanting to keep the Iranian deal amid OPEC+ increase in production capacity now that overall supplies are purposefully kept low as per the Algiers Accord effective 1st Jan 2017.

Nymex Crude: Percentage of open interest rose to its highest in record



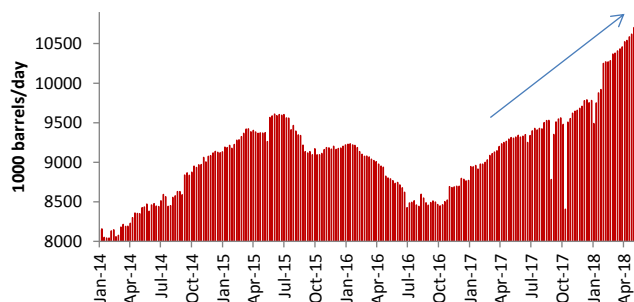
Source: CFTC, OCBC Bank

Demand still looks supported for now... but?

Beyond geopolitics, oil prices are very much a function of how fundamentals move. While concerns over higher US oil production are almost non-existent for now, any fall in global oil demand could re-inject the scenario of a supply glut. Still, demand appears supported as seen from the rising import

demand in Asia, as well as the onset of US driving season from April – September 2018. As such, the risk appears to be skewed towards higher oil prices at this juncture in the midst of potential Iranian supply shortfalls amid OPEC+ sustained production cuts that could last till end 2018 or beyond.

Watch out for higher US-led oil production to near 12 million bpd!



Source: Bloomberg, US EIA, OCBC Bank

However, upside risks in US supplies cannot be fully discounted in our view. With the US Energy Information Administration (EIA) upgrading its US oil production outlook to grow by over 1.2 million bpd to nearly 12 million bpd over the coming twelve months (and potentially surpassing Russia to be the world's biggest oil producer) could potentially revert global oil fundamentals to an over-supply environment again.

We hold on to our view that the rally in oil prices cannot be sustained given the changing fundamental landscape into the foreseeable future, amid the short-lived geopolitical drivers seen to-date that would remove the risk premiums seen in oil prices once the dust settles. As such, while oil prices may stay supported at current levels in the coming months, a revisit back to a supply glut will likely happen as early as 3Q18 should the upside risks in US oil production is sustained till then. As such, we keep our WTI and Brent outlook to \$65/bbl and \$70/bbl into year-end.

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