Wednesday, August 24, 2016

OCBC Commodities Outlook (Aug 2016)

Energy

Crude oil prices have remained range-bound for the last weeks, though volatility was led by events including the unexpected gains in US oil-rig counts and inventory builds, followed by the sudden and previously-unannounced informal OPEC meeting in September. Street-chatter is pointing towards a possible oil-freeze move then, though it is not in our base-case scenario.

Base Metals

Copper prices remained resilient at the onset of a Brexit vote, but fell 4.0% from its July's peak following a surprisingly weak Chinese Caixin manufacturing PMI print. This continues to suggest that copper is still largely driven by Chinese growth prospects. Further disappointment down the road seen in China's industrial production and imports did little to support prices as well.

Precious Metals

We reckon that gold will retain its safe haven appeal during this period of economic uncertainty, even in the midst of yield-seeking behaviour and supposedly overrated Brexit fallout consequences. Meanwhile, although the implied Fed rate hike probability has gradually picked up from June, the chance of it happening in the eyes of the market is still a 50-50 chance.

Agricultural and Asian Commodities

El Nino has officially passed us, while its counterpart, La Nina, is said to only have a 55 – 60% chance of it happening in 2H16. Even if it occurs, weather experts opined a relatively weak La Nina instead. Should it not occur, it may well then be delayed to 2017 instead. Long-story short, the La Nina should occur in the next 6 – 18 months horizon, and should lift agricultural prices then. Despite the lack of weather extremities, recent pick up in palm oil exports from Asia, namely Malaysia, has surprised higher (+21% yoy in July). Should strong prices persist into 4Q16, there may be further upside bias beyond MYR2,800/MT given seasonally production then.

Commodities Performance Table

Updated as of 15 August 2016

Selected Indices	Close	Weekly Change	MTD	QTD	YTD
US Dollar Index (DXY)	95.7	-0.7%	0.2%	-3.0%	-3.0%
Reuters / Jefferies (CRB)	182.7	-0.1%	0.9%	3.7%	3.7%
Dow Jones Industrial Avg	18,576.5	0.3%	0.8%	6.6%	6.6%
Baltic Dry Index	671	5.5%	2.3%	40.4%	40.4%
Energy	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
NYMEX WTI Crude	44.6	3.6%	20.4%	278,615	-15,494
ICE Brent Crude	47.1	3.7%	26.2%	291,123	30,735
NYMEX RBOB Gasoline	137.1	0.7%	8.2%	48,834	2,884
NYMEX Heating Oil	141.1	5.0%	28.2%	11,682	-3,338
NYMEX Natural Gas	2.6	-6.7%	9.7%	-116,691	-12,841
Base Metals	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
LME Copper	4,761	-1.0%	1.2%	-4,648	-7,407
LME Aluminium	1,655	0.7%	9.8%	-	-
LME Nickel	10,305	-4.3%	16.8%	-	-
Precious Metals	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
COMEX Gold	1,335.8	0.2%	26.0%	312,721	-13,543
COMEX Silver	19.8	0.0%	43.5%	94,555	-2,227
NYMEX Platinum	1,132.2	-2.0%	27.0%	56,853	2,024
NYMEX Palladium	687.7	-0.8%	22.4%	16,448	472
Agriculture	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
CBOT Corn	322	-0.9%	-10.2%	-18,790	-40,078
CBOT Wheat	421	1.0%	-10.4%	-102,623	8,301
CBOT Soybeans	1,000	-1.8%	14.8%	144,721	6,230
Asian Commodities	**Close**	**Weekly Change**	**MTD**	**QTD**	**YTD**
Thai W. Rice 100% (USD/MT)	444	-3.9%	-2.8%	21.6%	21.6%
Crude Palm Oil (MYR/MT)	2,620	2.7%	10.4%	9.3%	9.3%
Rubber (JPY/KG)	183	2.2%	-0.4%	24.4%	24.4%

Source: Bloomberg, CFTC, OCBC Bank
Note: Closing prices are updated as of 15 August 2016
Note: Speculative net positions are updated as of 09 August 2016
Note: Speculative net positions for Aluminium and Nickel are unavailable

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Energy: An Arduous Climb

Highlights

- A confluence of factors, chiefly driven by the hype over a potential oil deal in the upcoming informal OPEC meeting (26 – 28 Sept) has fueled bullish calls.
- Though we remain skeptical of any concrete action, history be of reference, the informal meeting should still serve as a platform to build participants and market-watchers expectations to an eventual re-implementation of a production quota in OPEC's Nov meeting.
- The rebalancing of the oil market has been delayed, no doubt, as US oil rig count and overall production have increased of late. This phenomenon illustrates a distinct fact: The US oil industry has the capability and capacity to lift production with oil prices as low as $42/bbl.

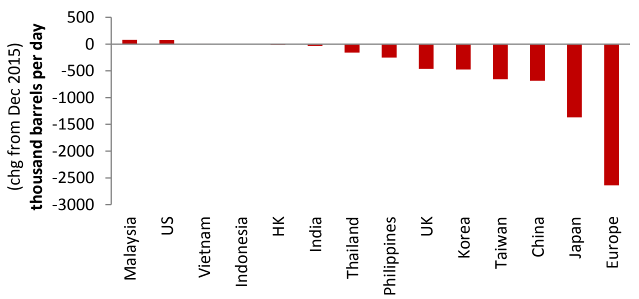
Don't celebrate just yet

Market-watchers of the energy industry seem to be in high spirits of late: crude oil prices have risen 21.7% from its August's trough while net-long speculative positions have risen substantially for the week ended 16 Aug. In regards to the said rally, one can easily point to three key attributing factors: (1) the relatively muted aftermath of the Brexit vote, (2) the consequential rise of global oil demand from 97.7 million barrels per day (mbpd) back in Dec 2015 to July's 98.6 mbpd led by OECD countries, but most importantly (3) the hype over the upcoming informal OPEC meeting in September on a possible oil deal to arrest low oil prices.

However, the expectation for oil prices to rise further into the year may perhaps be rather myopic. The truth is, the global oil environment is still in over-supply territories. Empirically, OPEC oil supply in the month of July has touched historical high of 33.2mbpd according to Bloomberg estimates, led by higher production in Iran (+0.7mbpd) and Saudi Arabia (+0.2 mbpd) in the first six months of 2016. On the other hand, imports across most of Asia and Europe over the same period have weakened considerably.

Not a pretty sight:

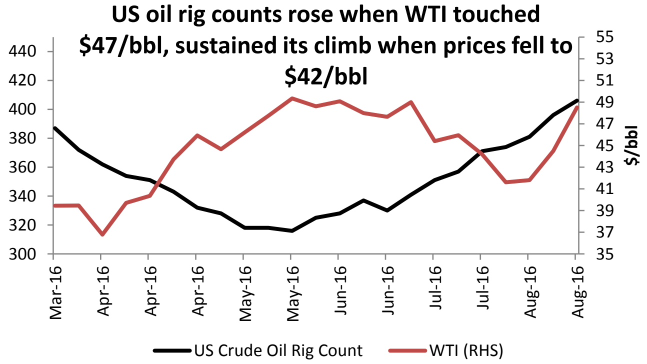
Asia & Europe crude oil imports have declined



Source: Bloomberg, OCBC Bank

The resilience and importance of US production data

Another key observation is seen from the rising importance of US oil-centric data. We have long been emphasizing that the US crude oil (including those of shale oil) has been, due to the prolonged low oil prices, forced to turn competitive and tune its production cost lower. Crucially, the US oil industry back in 2014 has transformed vastly to date: production was unable to sustain its 9.6mbpd production once seen in 2015 when prices finally dip below $60/bbl. In contrast, given technology advances and increasing expertise in their field, US oil rig counts managed to print higher when crude oil was at $47/bbl, while overall oil production in the US rose when prices were as low as $42/bbl.



Source: Bloomberg, Baker Hughes, OCBC Bank

Expect a strong resistance at $50/bbl

The quick rise in oil prices and stronger net-long speculative positions, alongside clear evidences that fundamentals are not supporting higher oil prices, sends a clear warning to signal to us. We opine that the higher oil prices of late are merely due to an unsubstantiated hype over a possible oil deal in the coming informal OPEC meeting. Importantly, should OPEC disappoint again without any concrete moves, oil prices would almost certainly stage a quick correction back to below $50/bbl. On this, we perceive little room for OPEC to decide on any concrete moves, especially with Iran's call (back in June) to return to individual producer output quota first, before agreeing on a collective quota.

Despite the possibility for another inaction conclusion in the coming month, we believe that the meeting should serve as a platform to return to both individual and collective quota by the next official OPEC meeting in November 2016. For the year ahead, the rebalancing should continue into 2017, albeit at a slower pace given the higher production blip seen in the last few months while demand declined. Given the resilience of the US oil industry, we observe that any upside to $50/bbl would certainly be met with higher production, hence our call for oil prices to see a strong resistance at $50/bbl for the year.

Gold: Rate hike and other exogenous factors

Highlights

- Gold is one of the best performing asset class this year. The bullion has managed to sustain above $1,300/oz, clocking a strong 27.7% growth year-to-date. The gains overshadowed the recovery in equities namely in Asia (+12.1%) and S&P 500 (+6.8%) over the same period.
- Upside surprises in US non-farm payrolls amid muted repercussion from the Brexit aftermath has lifted the implied probability for a rate hike in Dec 2016. That alone has then dragged gold prices below its critical $1,350/oz.
- Despite the improving US-centric fundamentals, we expect investors to remain long in gold given the need to insure against wildcards into the year, namely the growth risk from Brexit into 2017 and the upcoming November's US presidential elections.

The known unknown

It was as though it was yesterday when George Soros commented that a Brexit vote would make *"some people very rich, but most voters considerably poorer."* By that fateful afternoon of 24th June, the results were clear. The vote to leave had caused Britain its place in the EU, as well as monetary losses of USD127.4 billion in a single day from the world's 400 richest people, according to Bloomberg.

The immediate monetary loss due to speculation by itself is a known consequence from the Brexit vote. What follows from there is perhaps a 'known unknown' aftermath from the eventual triggering of Article 50. From official rhetoric by Britain's new prime minister, Theresa May, Article 50 will not be triggered before 2017 in order to ensure a *"smooth and orderly"* exit. As such, the 'known unknown' does suggest that while we do know that Article 50 will be triggered in time to come, the market is relatively unsure of when, and of what consequence, will it spell for both Europe and global growth engines. Note that downside risks portrayed by the IMF (Britain faces a recession in 2017), OECD (OECD economies to see 3.3% less GDP versus Britain staying in the EU by 2020) and World Bank (Britain's trade and foreign investment will be adversely affected, and a no-trade scenario with the EU will drag trade activities down by 55%) are possible outcomes till then. At least at this juncture, it is a fact that a full-blown consequence from the Brexit is still not felt at this juncture.

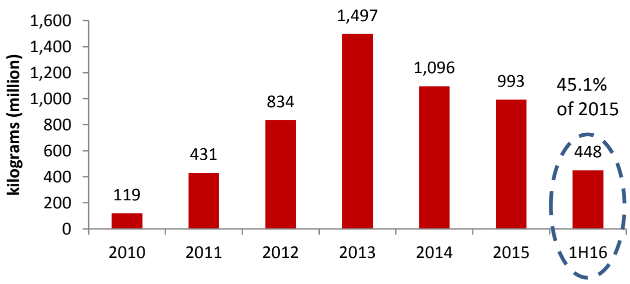
With that, we approach another wildcard looming on the horizon, namely the US November presidential election. Note that the Economist Intelligence Unit placed the prospect of President Donald Trump to be one of the top 10 risks facing the world (March 2016).

Given these wildcards namely from the Brexit consequences and suspense from the US November presidential election, it is of no surprise that gold has been one of the best performing asset class this year, outperforming those of equities even. We view that these wildcards may be able to dominate potential upside in US economic data and rate hikes into 2016.

Physical demand update

Moving away from the speculative demand that may pick up given the said wildcards, the physical demand environment has also been lackluster since the start of 2016. Empirically, India gold imports have fallen 70.5% yoy in July (note that India has seen 6 consecutive months of negative growth). The hope for stronger physical demand however, may lie in the purchasing power of the Chinese, given that Chinese gold imports from Hong Kong has risen substantially to 122k kilograms (highest since Dec 2015), and clocking three consecutive months of double-digit positive growth.

Chinese gold imports from Hong Kong has fallen over the last two years



Source: Bloomberg, OCBC Bank

Rate hike to occur, but gold will still rally

All-in-all, we note that the full-blown consequence from the Brexit vote has not materialized yet, owing to the delay in triggering Article 50. Elsewhere, the suspense over the US presidential elections should be monitored as well into 2H16.

As such, despite our expectation for the Fed to hike rates by 25bps in December, we think that sustained risk aversion from the suspense will continue to lift gold demand on safe haven demand. On this, we keep our gold forecast at $1,350/oz at end-year on one rate hike, or $1,400/oz if the rate hike does not materialize.

Palm Oil: More rally into year-end

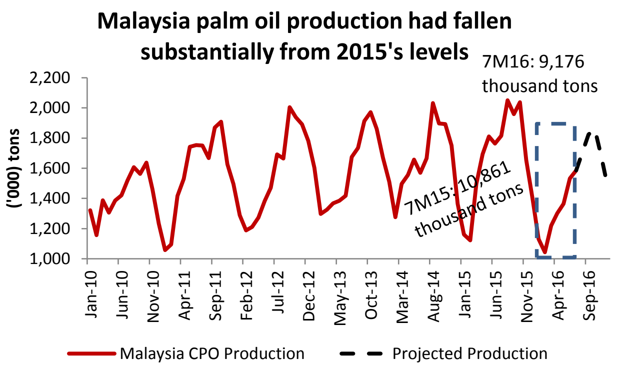
Highlights

- The rally in palm oil prices is largely due to lower production levels seen in the first seven months of this year. Empirically, weather extremities owing to the El Nino phenomenon has left Malaysia crude palm oil production growth to contract for seven months straight.
- On the other hand, demand has been robust (except for prints seen in June & July), led by double-digit growth in Malaysia's CPO exports and Indonesia's PPO exports.
- We are approaching the fourth quarter of the year, where palm oil production is expected to decline seasonally. With the already negative growth in overall production levels seen year-to-date, the further fall in production may lift CPO to exceed our initial call at MYR2,800/MT at year-end.

Let's talk pleasantries – the weather

"She's to keep to two subjects – the weather and everybody's health." That was what Professor Higgins advised to an uncouth flower street-seller in a famous 1964 play starring Audrey Hepburn. Despite it being pleasantries, for the palm oil market, weather is indeed crucial for overall production and its cues on prices. As for health, there is debate if palm oil is beneficial for one's well-being, but that is a discussion for a later time perhaps.

Empirically, the palm trees home to Asia (Asia produces more than 90% of global crude palm oil) has been struggling to keep up with historical production levels given weather extremities known as the El Nino which occurred late last year. In Malaysia alone, crude palm oil production growth has fell for seven months straight since the start of this year, and have been contracting at double-digit prints since March. Alone, Malaysia's crude palm oil production has fallen by 1.68 million tons this year, a level which equated to an average month of production in 2015.



Source: MPOB, Bloomberg, OCBC Bank

With the significant decline in palm oil production, market-watchers were right to shrug off the relative weakness in palm oil export prints in the three months leading to July 2016 (given the relative high production base seen in 2015). In-all, should we compare against the fall in Malaysian crude palm oil production (-1.68 million tons in 7M16), the fall in exports in absolute terms was only a mere 345 thousand tons over the same period, thus underscoring a supply crunch instead.

Source: GAPKI, MPOB, OCBC Bank

More rally may occur into year-end

As for the rest of this year, higher palm oil prices may continue to persist on two reasons: (1) the effects from weather extremities may have not been fully digested just yet, and (2) seasonally lower production in 4Q16 is expected to occur in the coming months.

Focusing on weather extremities, while the El Nino have peaked and gone away in the last months, it is a known fact that palm oil production will still be adversely affected given the time needed to recover and produce new fruits. Elsewhere, the risk of the La Nina (55 – 60% chance of it happening in 2H16), may well add further upside risk to crude palm oil prices should it occur. With these peculiar weather patterns, the downside to production levels into end-year may be prolonged and even magnified compared to previous years.

All-in-all, lower palm oil production seen in the first seven months of this year was dominantly enough to pressure prices higher. The fall in absolute production levels in the coming months should be closely watched then, given that production levels have been a key factor at play in determining price trends of late. Weather extremities may also persist in the form of a La Nina later this year (if not 2017). On this, we raise our crude palm oil futures to MYR3,000/MT (previous MYR2,800/MT) at year-end.