Commodities

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Commodity roundup

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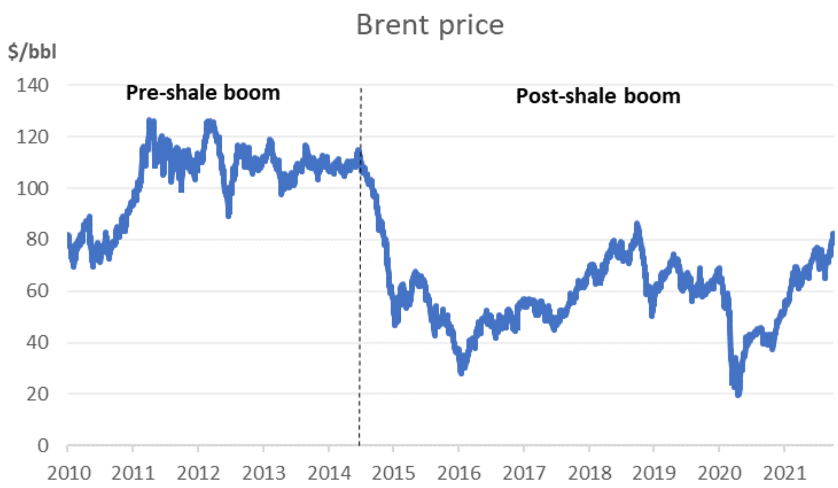
Energy: no justification for $100 oil.

How much higher can oil go? I remain highly sceptical about $100 oil, as I have been the entire time. Many are looking at oil's price chart and pointing out the lack of notable resistance levels from here to $100 for their $100-oil justification. But to do that demonstrates a lack of understanding of the oil market structure. The era of $100 oil was before the US shale boom and stocks were way tighter than what they are now. For example, in the US, the current implied gasoline stock-to-use in the US is about 42.5 days (time taken to fully deplete commercial reserves assuming current pace of consumption); since the 2015 shale boom this ratio has very rarely fallen below 40.0 days. Pre-shale days, this ratio easily clocked 38-39 days.

In other words, despite the current stock tightness, stocks are still not as tight as the pre-shale era – hence, it does seem *ambitious* to suggest prices return to pre-shale days.



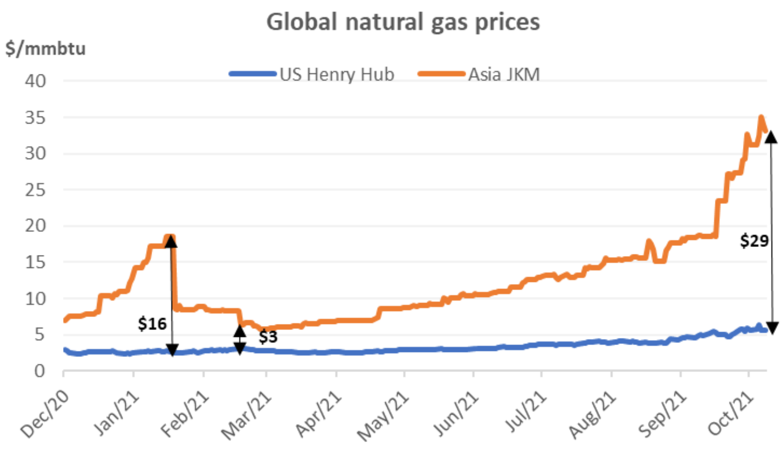
Source: Bloomberg, OCBC

So what would it take for this ratio to return to pre-shale numbers? If implied gasoline consumption increases from 9,750kbpd to 10,500kbpd on a sustained basis (+8%), or commercial oil inventories fall by 70mn barrels to 350mn barrels (-17%) then that $100 theory may have a chance – but these are huge hurdles that I am not particularly optimistic about. On that lack of optimism, it appears that this is as high as the oil market may go – Brent at $85, WTI at $80 – with the potential for a slight overshoot by $3-$5/bbl.

Attempting to short this market, however, will be courageous. Instead, I will recommend patience and wait for opportunities to go long oil again.

Natural gas: there are no solutions to this crisis and the world will have to ride this winter out.

Let's start with the ridiculously wide arb between Henry Hub and JKM gas prices. The fact that US Henry Hub gas is trading at $5-6/mmbtu while Asian LNG gas is currently at $33/mmbtu is enough exhibition of how out-of-whack this market is.



Source: Bloomberg, S&P Global Platts, OCBC

What is stopping the arb from closing? In two simple words – infrastructure limitations. The US may have plenty of gas and is a net exporter, but about 55% of its gas exports are via pipelines to Mexico and Canada. Its ability to move gas across oceans via LNGs are more limited due to years of underinvestment in liquefaction facilities. These complexes cost >$10bn to build and have been repeatedly put off due to persistent low gas prices prior to this crisis. Compare this to top LNG exporters Qatar and Australia, whose gas exports (>90%) are almost all seaborne LNG. In any case, liquefaction and regasification facilities – whether the US, Qatar or Australia – are reportedly close to max capacity, so excess gas supply at gas wells/fracking sites are stuck at origin.

Another thing to understand: LNG exports require LNG vessels. There are not a lot of those in the world – 642, to be exact. 60% of Asian LNG trade – and by virtue, LNG vessels – are already contracted on a long-term basis from sales & purchase agreements (SPAs). Contracting LNG vessels for spot trading is a tall order at present, which in addition to inadequate liquefaction/regasification facilities, is proving to be limitation #2.

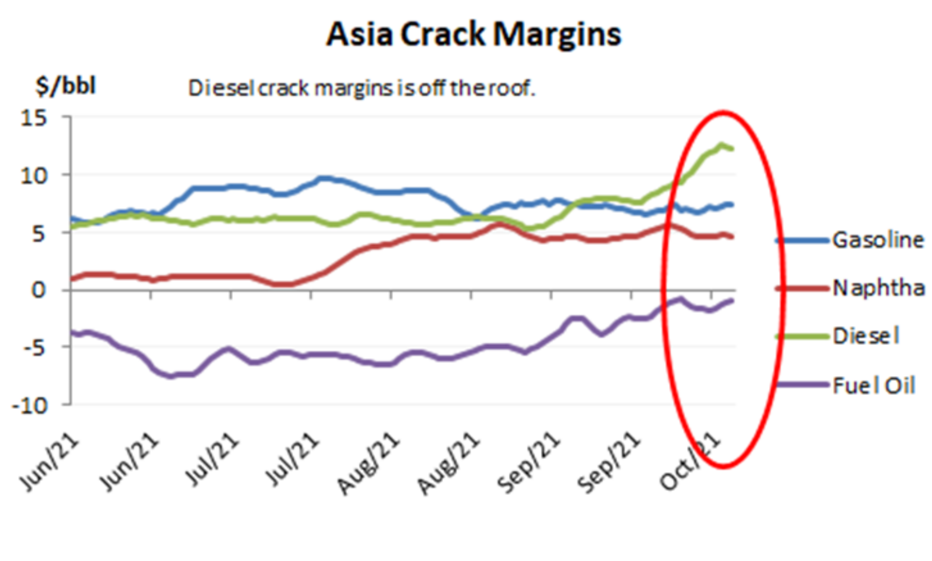
What are the solutions from here? Honestly, there are not many and they are not entirely impactful. The first is to hope for a shift in weather patterns i.e. the expected cold winter does not play out. That much is out of the market's control.

The other solution would be increased Russian piped gas to Europe, thereby decreasing Europe's LNG import demand, in turn redirecting more spot LNG flows to Asia. Russia has said it would supply more gas to Europe, but there are questions over how much it *will* pipe (given it is also facing a harsh winter) and *can* pipe (with existing pipelines to Europe already running at a relatively high capacity). Either solution appears grim, in any case.

All in all, there is very little the gas market can do other than ride out the coming storm.

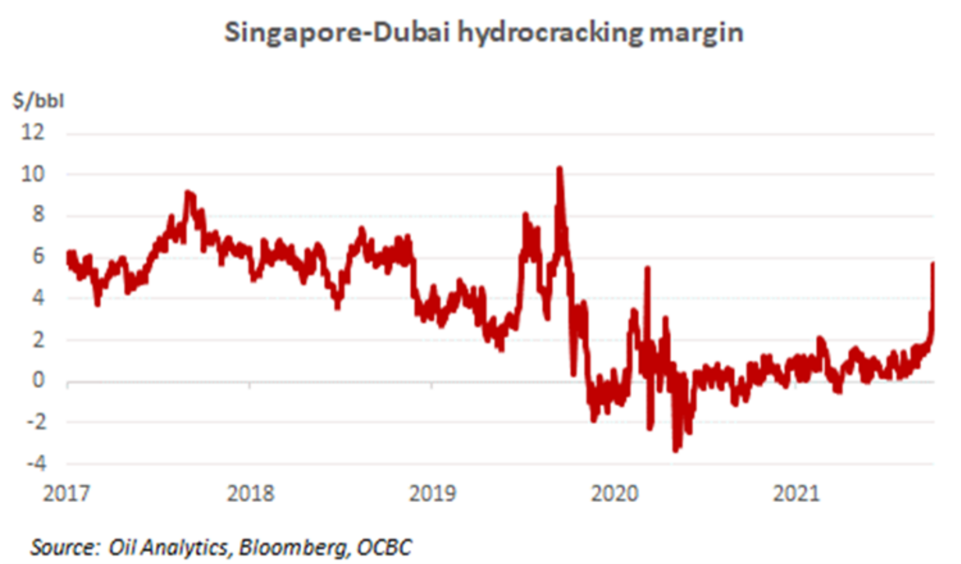
Asian oil refinery margins are soaring, thanks to China's power crunch.

Asian diesel crack margins have been soaring to a 12-month high in the last two weeks. Why? Firstly, China has been a big exporter of diesel in recent years. With the power crunch in China, oil refineries have not been able to run as much throughput and supply of Asian diesel has fallen. Secondly, with the ongoing power crunch, diesel (typically used to power factories) is used as an alternative feedstock to fire power generators. Hence the diesel market has been driving higher profits for the refinery sector at present.



Source: Bloomberg, OCBC

The positive externality is also spilling over into Singapore's hydrocracking business as well. What is hydrocracking? It is the addition of hydrogen to a long-chain distillate (typically gasoil, used as maritime fuel) into lighter distillates like diesel, kerosene, jet fuel, LPG (liquefied petroleum gas). These lighter distillates are in high demand now, for eg diesel whose crack margin has soared; LPG as a close substitute for natural gas for stove applications; kerosene for heating as the expected harsh winter draws close. With China's run rate down, Singapore is taking up the mantle for producing these distillates while enjoying handsome margins from doing so.



Source: Oil Analytics, Bloomberg, OCBC

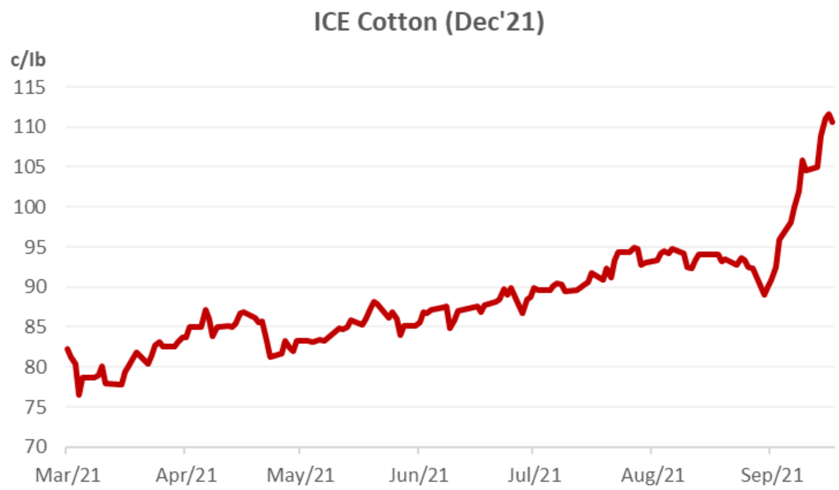
Do I expect this to persist? Yes, possibly through the end of this year until the depths of winter blows over. These high margins could be here to stay for another three months and that could continue to support oil prices.

Agriculture: feed market sags but look at the cotton market go!

China's feed market has heavily slowed down its pace of American purchases, presumably on expectations of a record domestic harvest this year. American soybean exports have fared the worst, while corn has performed marginally better.

Sales numbers from China, interestingly, are still relatively decent (compared to the actual shipments). With the power crunch not expected to blow over until early Q1 2022, Chinese crushers have little urgency in calling for their shipments, since reduced crushing capacity means domestic supply may be enough to tide them over till then. What this means is a huge backlog of feed shipments could happen after Lunar New Year festivities next year, with a bidding war for dry bulk carriers possible.

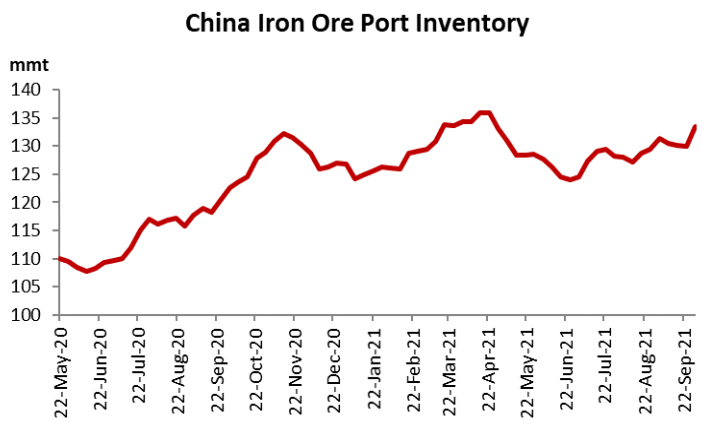
Feed market aside, has anyone seen the cotton market? In my six years covering this commodity, the cotton market has come agonisingly close to 100c/lb but never quite breach that resistance. Now at 110c/lb, China is driving this demand and the off-cycle State Reserve cotton sales for Oct-Nov is showing how short in supply the Chinese market is. With China fresh from holidays and looking to buy further, trade shorts could yet be overrun by spec longs. Expect the cotton rally to continue.



Source: Bloomberg, OCBC

Iron ore: price rebound is unsustainable and may return to $100 by year-end.

I will be majorly surprised if we do not see a drop in iron ore import from China this month. Already, the domestic power crunch has had a reverberating effect in Asia – for example, climbing Asian refinery margins. The steel industry is energy intensive and uses a whole lot of coal in production – two big reasons for the government to order an output reduction from this sector.

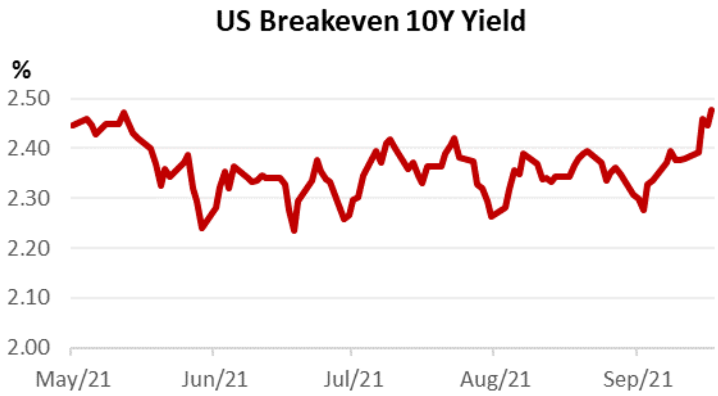


Source: Bloomberg, Steelhome, China National Bureau Statistics, OCBC

So how much output reduction is expected? Local agencies have said they do not expect full-year steel output in 2021 to materially differ from 2020. To match 2020's output, China would just need to produce 324mn tons from Sep-Dec 2021, or about 81mn tons/month. That would be 8% lower than the last 3-month average and 10% lower from a year ago. With the sizeable cut in output expected and current steel and iron ore inventories high, the iron ore price rebound since late Sep appears to be but a technical bounce. We expect iron ore to end 2021 at around $100/mt from the current $140/mt.

Gold: where are the gold bulls?

Inflation? What inflation? Gas and oil prices are way higher than they were in May, yet the 10Y US Treasury breakeven yield has barely breached the high set in Q2. Similarly, the 2y10y breakeven spread is currently trading 30bp inverted (i.e 2Y inflation expectations are 30bp higher than the 10Y expectations) – this traded steeper in Q2 at 50bp inverted.



Source: Bloomberg, OCBC

In face of this energy crisis and the poor Sep NFP, gold still traded below $1800. There is little conviction among gold bulls and we stick to our bearish gold view – that is, stabilisation at $1500 before end-2022.

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