OCBC Bank

Monday, August 20, 2018

OCBC Commodities Outlook – August 2018

Energy

Sustained concerns over oversupplies into 2H18 amid fresh trade war concerns dragged growth-related commodities lower in the recent month. Since the start of July, WTI has fallen over 10% into the first week of August, while Brent fell 9.5% in tandem over the same period. OPEC's oil production rose for its third straight month into June, led by Saudi Arabia. US oil production also gained starkly to 11.0 million bpd, underpinning stronger supplies to-date. We keep our WTI and Brent outlook at $65/bbl and $70/bbl, respectively at year-end.

Base Metals

Copper has long been viewed as a bellwether for the health of the Chinese economy, with the country accounting for roughly half of global demand of the metal. The metal is also increasingly being seen as a proxy for whether a trade dispute with the U.S. will stifle global growth. Copper prices have fallen to as low as $5,643/MT in mid-August, suggesting investors' concern over copper demand.

Precious Metals

The mix of dollar strength and lacklustre gold demand were key reasons for lower yellow metal prices into mid-August. Note that the dollar has strengthened to its 4-week high of late, while physical and ETF gold demand tapered lower in the second quarter of the year. Market outlook has been increasingly divided of late, an inevitable phenomenon given the uncertainty of things in the near horizon. Gold prices can quickly swing north should an escalation of trade war risks spark recessionary fears, though it remains to be seen if current tariff threats may be carried out in full.

Agricultural

US-based weather experts cite a 60-70% chance of a El Nino weather pattern emerging into the fourth quarter of 2018. Despite that, crude palm oil prices have failed to rally in the same fashion seen in past El Nino weathers as palm oil demand remained weak to-date. palm oil futures could likely see little upside impact from the weather extremity into end 3Q18 as demand stays weak.

Commodities Performance Table

Updated as of 20 August 2018

Selected Indices	Close	Weekly Change	MTD	QTD	YTD
US Dollar Index (DXY)	96.1	-0.3%	1.7%	1.7%	4.3%
Reuters / Jefferies (CRB)	188.7	-0.8%	-3.0%	-3.0%	-2.6%
Dow Jones Industrial Avg	25,669	1.9%	1.0%	1.0%	3.8%
Baltic Dry Index	1,723	0.8%	-1.4%	-1.4%	26.1%
Energy	**Close**	**Weekly Change**	**Net Position**	**Weekly Change**	**YTD**
NYMEX WTI Crude	65.8	-2.0%	609,143	-30,463	9.0%
ICE Brent Crude	71.7	-1.3%	336,416	-17,489	7.2%
NYMEX RBOB Gasoline	197.9	-1.8%	105,414	-5,396	10.0%
NYMEX Heating Oil	209.7	-1.9%	36,867	-1,323	1.0%
NYMEX Natural Gas	2.9	-0.2%	-77,861	31,304	-0.9%
Base Metals	**Close**	**Weekly Change**	**Net Position**	**Weekly Change**	**YTD**
LME Copper	5,926	-3.7%	3,112	988	-18.2%
LME Aluminium	2,030	-2.5%	-	-	-10.5%
LME Nickel	13,480	-0.6%	-	-	5.6%
Precious Metals	**Close**	**Weekly Change**	**Net Position**	**Weekly Change**	**YTD**
COMEX Gold	1,190.2	-0.7%	-25,349	-18,354	-9.1%
COMEX Silver	14.8	-1.4%	-2,937	-7,264	-13.9%
NYMEX Platinum	787.1	-1.6%	-9,923	-2,536	-16.1%
NYMEX Palladium	889	0.9%	1,960	-1,712	-16.3%
Agriculture	**Close**	**Weekly Change**	**Net Position**	**Weekly Change**	**YTD**
CBOT Corn	379	2.2%	49,178	-3,026	8.0%
CBOT Wheat	580	4.7%	60,592	-2,627	35.8%
CBOT Soybeans	893	2.8%	-54,065	-12,604	-7.2%
Asian Commodities	**Close**	**Weekly Change**	**MTD**	**QTD**	**YTD**
Thai W. Rice 100% (USD/MT)	424	-0.2%	1.7%	1.7%	-0.7%
Crude Palm Oil (MYR/MT)	2,238	1.5%	2.0%	2.0%	-10.6%
Rubber (JPY/KG)	168	-2.2%	-1.5%	-1.5%	-18.8%

Source: Bloomberg, CFTC, OCBC Bank
Note: Closing prices are updated as of 20 August 2018
Note: Speculative net positions are updated as of 14 August 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

Institutional Sales
Tel: 6349-1810

Crude Oil: The trend is your friend

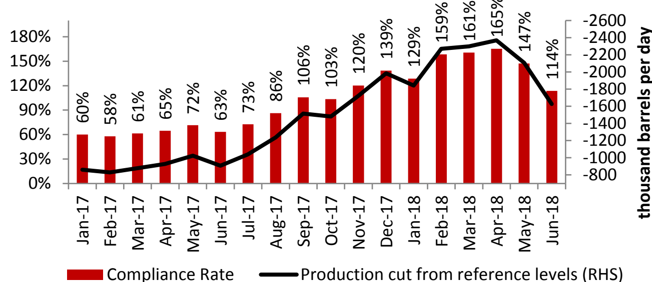
Highlights

- Sustained concerns over oversupplies into 2H18 amid fresh trade war concerns dragged growth-related commodities lower in the recent month. Since the start of July, WTI has fallen over 10% into the first week of August, while Brent fell 9.5% in tandem over the same period.
- Importantly, OPEC's oil production rose for its third straight month into June, led by Saudi Arabia. US oil production also gained starkly to 11.0 million bpd, underpinning stronger supplies to-date.
- We continue to see lower oil prices into 3Q18 and keep our year-end WTI and Brent outlook at $65/bbl and $70/bbl, respectively.

Crude Oil: The demise of production curbs

More news surrounding higher global oil production into July should continue to plague oil prices lower. The US Energy Information Agency (EIA) reported that US oil production rose to 11.0 million barrels per day (bpd), just second to Russia's 11.2 million bpd. This compares to the 9.4 million bpd production print seen in the US just a year ago. Unsurprisingly, much of the increase was attributed to higher shale oil production at 7.43 million bpd (+28.2% y/y, accounting for 67.5% of US total oil production) while June's crude oil exports reached record high of 2.4 million bpd.

OPEC's compliance levels fell for two straight months into June 2018

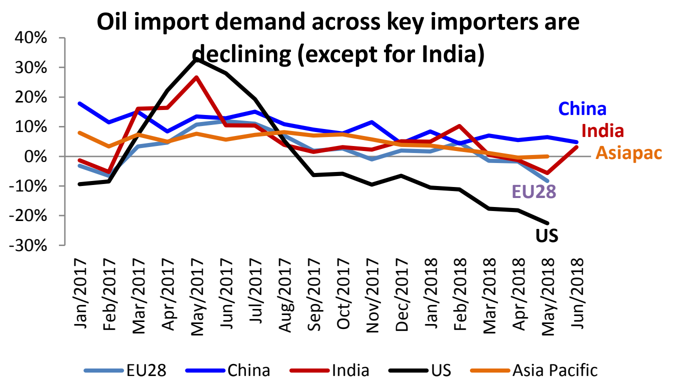


Source: Bloomberg, OCBC Bank

More importantly, the decision to increase oil production into the start of 2Q18 marks the end the collective effort to reduce global oil production. Production data from the key OPEC producers indicate a distinct shift away from the cartel's initial goal of reducing oil supplies; OPEC's compliance rate in adhering to its 2017's target production level of specifically 29.8 million bpd has fallen for two straight months into June 2018. More starkly perhaps, is the rapid rise in Saudi Arabia's oil production to 10.7 million bpd in July, up from 9.9 million bpd seen at end 2017. Russia, in an effort to signal for higher supplies, cited that "an increase in oil production in excess of 1 million barrels a day may be discussed" by the OPEC+ cartel into September 2018. Specifically, Russian oil minister Alexander Novak announced plans to increase its own production by up to 250,000 bpd into 2018, and another 80,000 bpd into 2019.

A wrong time to raise production?

We note that the uptick in global oil production is occurring amid falling demand prints, suggesting that the weakening oil fundamentals will eventually lead prices lower. Global oil demand growth has decelerated to 0.5% y/y in June 2018, down from the 3-year average print of 1.6% y/y. Available oil import demand data from Asia Pacific indicate slowing oil demand into May 2018, while oil import growth contracted in EU28 and US. We think oil demand environment into 2H18 (and potentially into 2019) may remain soft given two key reasons.



Source: Bloomberg, OCBC Bank

Firstly, the ongoing US-EU-Sino trade tensions create uncertainty on oil demand. Statistically, the United States, European Union, and China make up the world's top three consumers of oil, and collectively account for almost half of the world's consumption of oil. The increased volatility surrounding growth-related asset prices, including crude oil, thus suggests that investors are turning concerned over how economic growth prospects and oil prices may react should issues turn unexpectedly downhill. Recent data from the US EIA also stated that crude oil inventories unexpectedly rose by 3.8 million barrels for the week ended 27th July 2018 given weaker implied demand.

Secondly, China's oil demand weakness seen to-date has largely been attributed to a tighter tax regime on independent Chinese refiners. Small Chinese refiners, or know as teapots, account for a fifth of China's crude oil imports of nearly 10 million barrels a day. As of 1st March, China is reportedly using

a new tax reporting system which further narrowed teapots' refining margin amid higher crude oil prices. The new system are implemented to enforce collection of gasoline consumption tax ($38/bbl) and diesel tax ($29/bbl), in which some refiners have been said to have enjoyed tax breaks by its respective local governments. In response to the losses, several teapots were reportedly shut for maintenance into May and June, while Platts data indicate that crude oil imports by teapots declined to its 20-month low in June.

Adopt a longer-term paradigm?

Many say that the trend is your friend, and the falling oil prices into early August should tell a tale. Crude oil prices fell to its lowest in almost six weeks on the weaker oil fundamentals in the first week of August, given the weaker oil fundamentals as discussed earlier. Still, short-term factors including geopolitical tensions surrounding production shortfall from Iran and its threat to close the Hormuz Strait may provide mere momentarily reprieve from crude oil's bearish move. In a nutshell, we reiterate our sell on rally call on crude oil prices with our year-end call for WTI and Brent to touch $65/bbl and $70/bbl, respectively.

Gold: Defying logic? Not quite.

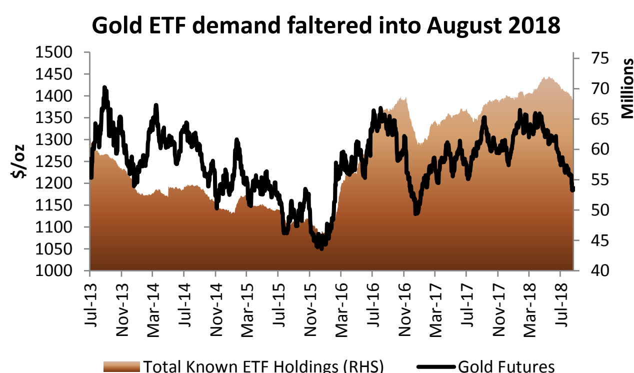
Highlights

- The mix of dollar strength and lacklustre gold demand were key reasons for lower yellow metal prices into mid-August. Note that the dollar has strengthened to its 4-week high of late, while physical and ETF gold demand tapered lower in the second quarter of the year.
- Gold prices also saw little support from the escalation of trade war concerns, suggesting that gold's natural correlation with the greenback has ruled over the yellow metal's popular safe haven status. Elsewhere, lower gold demand could have also been attributed by stronger downside risks surrounding prices. Softer ETF gold demand (-46%) in 2Q18 dragged overall gold investment demand lower, amid poorer physical demand in India.
- Market outlook for gold prices have been increasingly divided of late, an inevitable phenomenon given the uncertainty of things in the near horizon. Gold prices in our opinion can quickly swing north should an escalation of trade war risks spark recessionary fears, though it remains to be seen if current tariff threats may be carried out in full.

The traditional safe haven status?

To many, Gold as a commodity has been widely postulated as a reliable safe haven. Historical price movements seen back during the Asian Financial Crisis (1997) and the Global Financial Crisis (2008) suggest that investors' flock to the yellow metal for safety. However, the relative risk-off market sentiments seen since the second quarter of 2018 has yet given gold prices the rally seen in past cycles. On the flipside, the escalation of trade war concerns following further tariff barbs by the US and China amid Turkey's financial woes gave market-players further reason to trade gold lower as the greenback appreciated in tandem.

Gold ETF demand faltered into August 2018



Source: Bloomberg, OCBC Bank

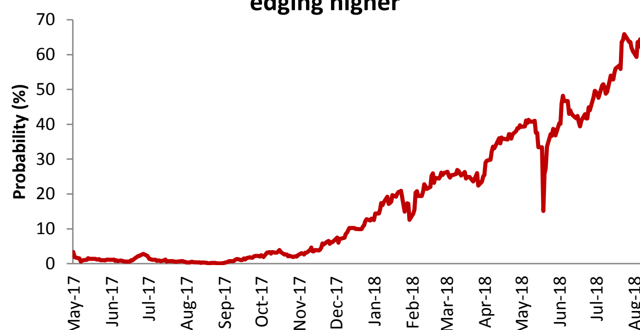
The sustained rally in the greenback suggest dollar's role as a safe guard against uncertainties, a position that the yellow gold bar once undertook in past events. In turn, gold prices saw little support from the escalation of trade war concerns, suggesting that gold's natural correlation with the greenback has ruled over the yellow metal's popular safe haven status. Coupled with the relatively stronger US economic fundamentals following the healthy corporate earnings and rosy US-centric labour and inflation growth prints, the upside trend seen in the dollar appeared formidable. In truth, the greenback this time around, has overtaken gold as the preferred safe haven at this juncture.

A murky crystal-ball

Suffice to say, the argument for gold to rally on safe haven demand has broken down on many counts, while both speculative and physical demand has weakened considerably into the first eight months of 2018. Elsewhere, the stronger dollar is seen to be the key source of gold's decline, a phenomenon that is unlikely to fade away anytime soon.

Our arguments for weaker gold prices as written in our July's Commodities Outlook remains water-tight: we have highlighted key factors that have dragged gold prices despite the elevated risk aversion which include the relatively rosier US-centric economic indicators which have supported dollar strength, while trade tariffs imposed by the US to narrow its trade deficit can be dollar boosting in nature. Elsewhere, the stronger probability for a fourth rate hike into 2018 tuned stronger into mid-August, suggesting that a higher interest rate environment could dull gold prices given its zero-yielding characteristic.

Fourth rate hike implied probability in 2018 is edging higher

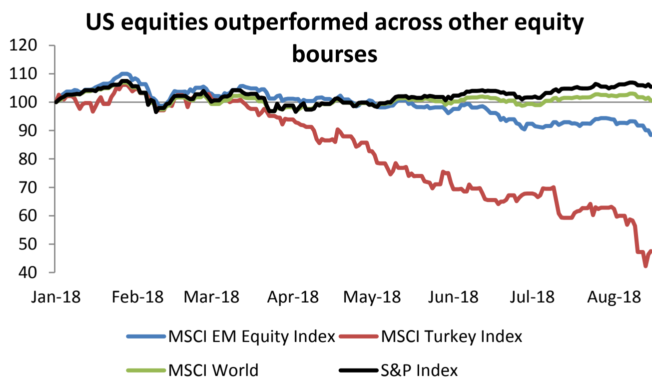


Source: Bloomberg, OCBC Bank

However, in the recent month, new signals to suggest further declines in gold prices were observed. First, the US Breakeven 5 year yield, calculated by subtracting the real yield of the inflation linked maturity curve from the US Treasury 5Y bond yield, has moved below its critical 2.0% handle. In a nutshell,

the above-mentioned breakeven rate is akin to investors' inflation expectation over a 5-year period, as one would expect to receive the same total return on Treasury Inflation Protected Securities (TIPS) as you would with a 5-year UST if CPI inflation averages that level over the next 5 years. As such, the fall in the US 5-year breakeven suggest that inflationary expectations have declined into August, which could in turn drag gold as an inflation-hedge.

Second, the falling VIX index (or as widely known as the fear index) suggested that much of the risk aversion is centered on the Emerging Markets (EMs), rather than concerns over US economic weakness. This volatility index measures market's expectation of volatility implied by US-centric S&P 500 index options, in which an uptick in the VIX index suggest market expectations of high volatility in stock valuation. Recent Wall Street behaviour since the start of 2H18 suggests investors' confidence over US-centric economic prints and healthy corporate earnings results, which in turn argue market's selected risk-taking behaviour in US-centric assets instead.

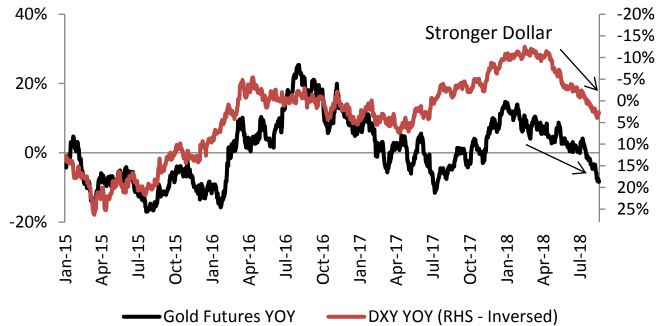


Source: Bloomberg, OCBC Bank

Breaking gold's decline

For now, it could still be futile to catch a falling knife. Sustained trade tariff issues originating from the United States will likely serve to improve US trade balance, while the positive equity-buying environment amid rosy US-centric economic prints would give investors reasons to shore up dollar strength.

Dollar movement continue to dictate gold trend



Source: Bloomberg, OCBC Bank

We note that market outlook for gold prices have been increasingly divided of late, an inevitable phenomenon given the uncertainty of things in the near horizon. Gold is likely to remain slaved to dollar value, and further rally in the broad dollar strength will likely depress gold prices into 3Q18. The six million dollar question however, is on when gold-buying could return as a safe haven instrument, in which we think could happen still should an escalation of trade war risks spark recessionary fears and in turn inject spill-over risk aversion calls into US shores. But until that happen, the risk-taking behaviour into US equities and declining inflation expectations are effective drivers to send the yellow metal lower.

Palm Oil: Will weather extremities aid prices?

Highlights

- US-based weather experts cite a 60-70% chance of a El Nino weather pattern emerging into the fourth quarter of 2018. The last El Nino has occurred in 2015/6, and has caused drought in eastern Australia and South-east Asia.
- Asia, being home to over 85% of global palm oil production, will likely see its palm oil produce negatively affected by the extreme hot weather. The last El Nino has rallied palm oil futures to as high as MYR3,185/MT at end 2016, up from a low of MYR2,188/MT in July 2016.
- There is a key differing variable for palm oil this time around however; demand has remained lacklustre into July while falling palm oil production seen in both Indonesia and Malaysia hasn't aided prices to-date.

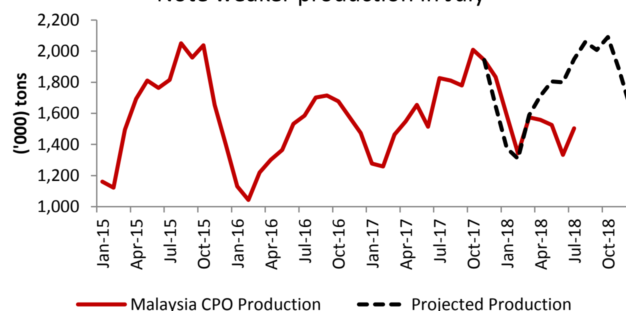
El Nino and its effects on palm oil

For palm oil watchers, the onset of an impending El Nino weather extremity is likely to persuade the bulls to turn confident. Historically, past El Nino weathers have rallied palm oil futures to between 20% and 55% as palm oil supplies turn weak on poor produce. Notably, the last El Nino measured in 2016 was the most severe El Nino cycle in history as calculated by Oceanic Nino Index (ONI), and has rallied palm oil prices from MYR2,188/MT to MYR3,185/MT between July to December 2016. The key culprit to the sudden surge in palm oil prices was the quick downtick in palm oil production, which in Malaysia's case, fell to 2.441 million tons in February 2016, the lowest since January 2004.

According to the US National Oceanic and Atmospheric Administration's (NOAA) Climate Prediction Center, there is a 60-70% chance for an El Nino phenomenon occurring into Autumn (60%) and Winter (70%) 2018. The brewing hot weather has already caused drought and fire in various regions of the world, while weather temperatures have been rising especially in South East Asia. Still, the NOAA cites a "weak to maybe moderate [El Nino]", suggesting that the severe weathers seen in 2015/6 are unlikely for now.

Still, Asia being home to over 85% of global palm oil supply, will likely see a negative impact on overall production should the hot weather intensifies. Into June 2018, both Malaysia and Indonesia's total palm oil production has fallen for the first time since Feb 2018. Note that Malaysia's crude palm oil production has fallen for three consecutive months into July on a year-on-year basis, and marking its lowest CPO production at 10.4 million metric tonnes in 7M18 in the last two years.

Malaysia's CPO production affected by El Nino?
Note weaker production in July

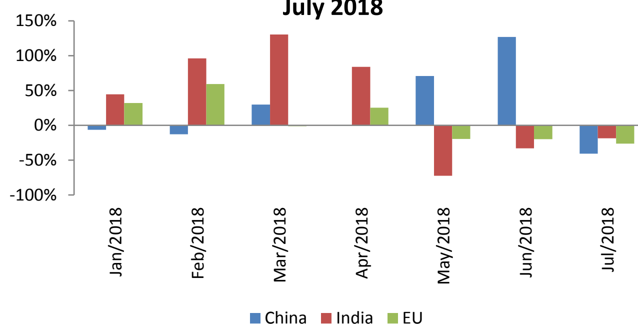


Source: Bloomberg, OCBC Bank

Demand is (still) weak

Despite the impending El Nino weather extremity, crude palm oil prices have failed to rally in the same fashion seen in past El Nino weathers. In fact, CPO futures fell to MYR2,194/MT at end July 2018, the lowest since Aug 2015 as investors focused on the rather lacklustre export prints. Note that Malaysia's export of palm oil to EU and India have contracted for three consecutive months on a year-on-year basis into July 2018 while exports to China (-40.8% y/y) contracted the most since Jun 2016 (Jun 2016: -58.7% y/y).

Palm oil import from Malaysia tuned lower into July 2018



Source: Bloomberg, OCBC Bank

The prognosis over palm oil demand remains soft to-date. The recent contraction in palm oil demand in both EU and India are likely to persist into 2018. In India's case, falling palm oil demand has been blamed on India's uptick in import tax which made imported palm oil prices significantly more expensive. In EU's case, the lower palm oil demand can be blamed on importers' likely shift away from non-sustainable palm oil sources based on its European Sustainable Palm Oil (ESPO) project which aims to achieve 100% imports from sustainable palm oil sources by 2020. On the flipside, less 17% of the total 11.9 million hectares of Indonesia's oil palm plantations are ISPO (Indonesia Sustainable Palm Oil) certified, according to Indonesia's Ministry of Agriculture back in August 2017.

The bright side to the demand story could however lie in policy initiatives seen in Indonesia and Malaysia. We note that there are policy initiatives that can cushion palm oil's decline: Indonesia has recently boosted the mandate for biodiesel use in a bid to decrease reliance on foreign crude oil use. Specifically, the B20 biodiesel program has been expanded and made mandatory for all diesel vehicles, including locomotive engines and heavy equipment and could save Indonesia $2 – 4 billion in import cost a year, according to Indonesia's Industry Minister Airlangga Hartarto. Elsewhere, Malaysia is said to be conducting dialogues with industries, including the automotive sector and petroleum-based companies, on enhancing the useage of biodiesel in the country.

What now?

With global palm oil demand likely to stay soft into 2018, the question is then centred on whether an El Nino phenomenon would be a game-changer for palm oil prices. At least from historical evidence, palm oil prices are seen to tune higher as weather extremities hurt palm trees and reduce supplies. However, there are several factors to consider into the next six months, which includes the likelihood for a relatively weak El Nino condition as predicted by the weather experts, amid the poor import demand seen in key consuming economies. As such, palm oil futures could likely see little upside impact from the weather extremity into end 3Q18 as demand stays weak, while some upside rally into MYR2,400/MT could be on the cards as the El Nino weather condition strengthens into December 2018.

This publication is solely for information purposes only and may not be published, circulated, reproduced or distributed in whole or in part to any other person without our prior written consent. This publication should not be construed as an offer or solicitation for the subscription, purchase or sale of the securities/instruments mentioned herein. Any forecast on the economy, stock market, bond market and economic trends of the markets provided is not necessarily indicative of the future or likely performance of the securities/instruments. Whilst the information contained herein has been compiled from sources believed to be reliable and we have taken all reasonable care to ensure that the information contained in this publication is not untrue or misleading at the time of publication, we cannot guarantee and we make no representation as to its accuracy or completeness, and you should not act on it without first independently verifying its contents. The securities/instruments mentioned in this publication may not be suitable for investment by all investors. Any opinion or estimate contained in this report is subject to change without notice. We have not given any consideration to and we have not made any investigation of the investment objectives, financial situation or particular needs of the recipient or any class of persons, and accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the recipient or any class of persons acting on such information or opinion or estimate. This publication may cover a wide range of topics and is not intended to be a comprehensive study or to provide any recommendation or advice on personal investing or financial planning. Accordingly, they should not be relied on or treated as a substitute for specific advice concerning individual situations. Please seek advice from a financial adviser regarding the suitability of any investment product taking into account your specific investment objectives, financial situation or particular needs before you make a commitment to purchase the investment product. OCBC Bank, its related companies, their respective directors and/or employees (collectively "Related Persons") may or might have in the future interests in the investment products or the issuers mentioned herein. Such interests include effecting transactions in such investment products, and providing broking, investment banking and other financial services to such issuers. OCBC Bank and its Related Persons may also be related to, and receive fees from, providers of such investment products.

This report is intended for your sole use and information. By accepting this report, you agree that you shall not share, communicate, distribute, deliver a copy of or otherwise disclose in any way all or any part of this report or any information contained herein (such report, part thereof and information, "Relevant Materials") to any person or entity (including, without limitation, any overseas office, affiliate, parent entity, subsidiary entity or related entity) (any such person or entity, a "Relevant Entity") in breach of any law, rule, regulation, guidance or similar. In particular, you agree not to share, communicate, distribute, deliver or otherwise disclose any Relevant Materials to any Relevant Entity that is subject to the Markets in Financial Instruments Directive (2014/65/EU) ("MiFID") and the EU's Markets in Financial Instruments Regulation (600/2014) ("MiFIR") (together referred to as "MiFID II"), or any part thereof, as implemented in any jurisdiction. No member of the OCBC Group shall be liable or responsible for the compliance by you or any Relevant Entity with any law, rule, regulation, guidance or similar (including, without limitation, MiFID II, as implemented in any jurisdiction).

Co.Reg.no.:193200032W