Monday, September 15, 2014

OCBC Commodities Outlook

Energy

The bearish behavior in both WTI and Brent is unsurprising amid the healthy supply fundamentals and stronger greenback. More importantly, the easing geopolitical tensions in Ukraine and softening concerns over oil supply disruptions in Iraq have effectively narrowed the risk premium in oil prices. Going forward, we still maintain our bearish outlook in 4Q14.

Base Metals

In the kaleidoscope of drivers, including Chinese property slowdown and falling decelerating copper consumption from China, US and Europe have dragged copper prices below its $7,000/MT handle. Meanwhile, similar concerns, amid the crackdown on commodity collateral trading in China have led iron ore prices nearing its $80/ton support. We opine that the slowdown in the Chinese property market will likely continue for the rest of 2014, and lacklustre base metal demand should sustain as a result.

Precious Metals

As the market draws nearer to the completion of the US Fed's QE tapering in October, we continue to eye on Fed's rhetoric regarding its exit strategy from easy monetary policy. Still, while the first rate hike may only surface in 2H15, the prospect of a stronger greenback, improving global economic indicators, and weaker-than-usual physical demand from China and India should continue to drag gold prices lower into 2H14.

Agriculturals and Asian Commodities

It is back to the fundamental drawing board once again, and in this, the scare of higher palm oil inventories, amid strong seasonal CPO production and falling soybean oil prices dragged CPO prices below its critical MYR2,000/MT mark. Given the low prices, note that Malaysia cut its CPO export tax to zero, vs an initial 4.5%, to boost export demand, hopefully by 600,000 MT over the next two months as targeted by the Malaysian commodities ministry. Still, be reminded of Nov-Feb's lower seasonal production as palm trees rest from its harvest season, where prices may see some rebound back to its MYR2,200/MT.

Commodities Performance Table

Updated as of September 9, 2014

Selected Indices	Close	Weekly Change	MTD	QTD	YTD
US Dollar Index (DXY)	84.3	1.5%	1.8%	5.6%	5.3%
Reuters / Jefferies (CRB)	285.8	-1.2%	-2.4%	-7.3%	2.0%
DJIA	17,013.9	-0.3%	-0.5%	1.1%	2.6%
S&P 500	1,988.4	-0.7%	-0.7%	1.4%	7.6%
Energy	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
NYMEX WTI Crude	92.8	-0.1%	-5.8%	302,568	-1,058
ICE Brent Crude	99.2	-1.2%	-10.5%	62,986	-2,012
NYMEX RBOB Gasoline	254.8	0.2%	-8.5%	40,479	-771
NYMEX Heating Oil	279.2	-0.2%	-9.3%	-3,404	-2,724
NYMEX Natural Gas	4.0	2.4%	-5.8%	-190,529	-16,260
Base Metals	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
LME Copper	6,840.0	-1.8%	0.0%	-9,760	-5,841.0
LME Aluminum	2,035.5	-2.5%	15.5%	-	-
LME Nickel	18,848.0	2.0%	36.2%	-	-
Precious Metals	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
COMEX Gold	1,247.3	-1.3%	0.00%	102,284	-3,540
COMEX Silver	18.8	-1.2%	-2.56%	14,849	-4,186
NYMEX Platinum	1,385.8	-1.6%	1.07%	35,392	-3,417
NYMEX Palladium	860.1	-2.5%	19.74%	27,141	+295
Agriculture	**Close**	**Weekly Change**	**YTD**	**Net Position**	**Weekly Change**
CBOT Corn	336.3	-5.5%	0.0%	142,712	-2,412
CBOT Wheat	527.5	-2.9%	-12.8%	-51,301	-7,667
CBOT Soybeans	1,076.5	-1.9%	-18.0%	-31,885	-11,403
Asian Commodities	**Close**	**Weekly Change**	**MTD**	**QTD**	**YTD**
Thai Hom Mali Rice (THB/KG)	31.4	0.3%	0.3%	2.6%	-3.0%
Crude Palm Oil (MYR/MT)	2,050.0	4.4%	5.8%	-16.3%	-22.0%
Rubber (JPY/KG)	181.0	-1.8%	-2.9%	-9.5%	-35.3%

Source:Bloomberg, CFTC, OCBC

Note: CFTC net positions are updated as of September 9, 2014

Note: CFTC net positions for Aluminum and Nickel are unavailable

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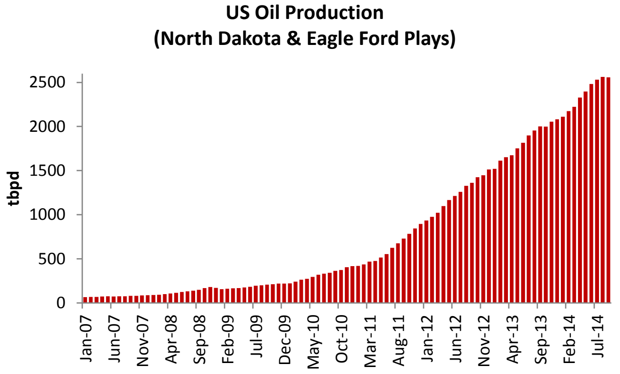
Energy: Three fundamental drivers and one wildcard

Geopolitical instabilities, just like a broken record, remained as one of the top drivers for higher crude oil prices in the first 8 months of 2014. Indeed, we are reminded by civil wars in Iraq (previously Syria in 1H14), as well as the recent Russia-Ukraine oil supply scare. Geopolitical risk however, remains to be an unquantifiable driver that is influential on oil prices, and continues to cloud the healthy fundamental backdrop though some initial easing of tensions have removed a significant portion of the risk premium. On this, amid the sustained healthy crude supplies, Brent touched below its $100/bbl for the first time in 14 months, a strong signal that fundamentals are playing a larger role in moving energy prices to pre-tension levels.

Three fundamental pillars

In our previous commodity outlook release, we introduced three wildcards that may dominate price drivers, with geopolitical concerns topping our list of concerns at that juncture. Given the easing tensions of late, geopolitical risks are likely to take a backseat for now, and allowing fundamentals to take charge. As such, in this issue, we present three fundamental drivers in return:

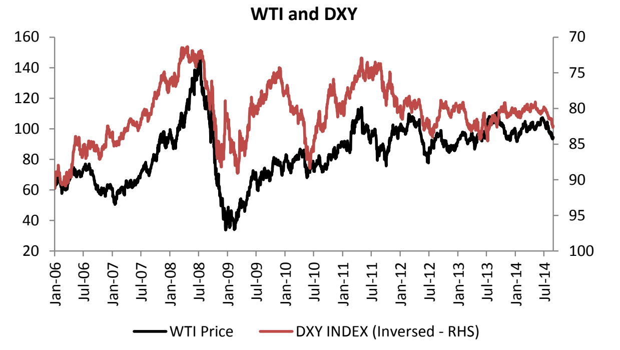
Firstly, we are still facing a very healthy global oil supply scenario. Specifically, US crude oil production in July is the highest in 27 years, according to the US Department of Energy (EIA), averaging an estimated of 8.5 million barrels a day (mbpd). The strong production seen has also led to EIA's upward adjustment of the agency's full year US crude oil production to 8.5 mbpd and 9.3 mbpd for 2014 and 2015 respectively, and a downward revision of oil price to average $94.67/bbl (down from $96.08/bbl) in 2015. The issue of healthy US production has also continued to fuel talks about lifting the 40 year ban on the export of crude oil, thus possibly injecting further downside risk to oil prices should this come to pass.



Source: Bloomberg, OCBC Bank

Secondly, crude oil demand growth appears less than stellar given slowing oil imports from China and India. Meanwhile, empirical oil consumption in Japan and Europe specifically, continue to contract given specific economic woes that possibly translated itself into overall weaker demand readings. On top of that, our oil demand model (which leads empirical oil demand for 7-8 months) indicate that global oil demand will likely stay within its 2.0% growth handle for the year, similar to what we saw in the last two years. Contrast this with healthy global supplies, crude prices have strong fundamental reasons to see further downside risk.

Thirdly, the stronger greenback seen of late serves to drag oil prices further, given that energy prices are denominated in the US dollars. On this, note that the Fed Chairman, Janet Yellen, have voiced the completion of the current quantitative easing program (QE) taper by October 2014, while assuring that accommodative rates are to stay to support the Fed's twin inflation-unemployment mandate. Still, we pencil the first Fed rate hike in 2H15, the stronger greenback towards year-end from pricing-in behavior, amid ECB's LTRO program that strengthened the dollar index (a weighted geometric mean comprising of 6 currencies, with EUR accounting for a significant 57.6% weight) to its highest since July 2013.



Source: Bloomberg, OCBC Bank

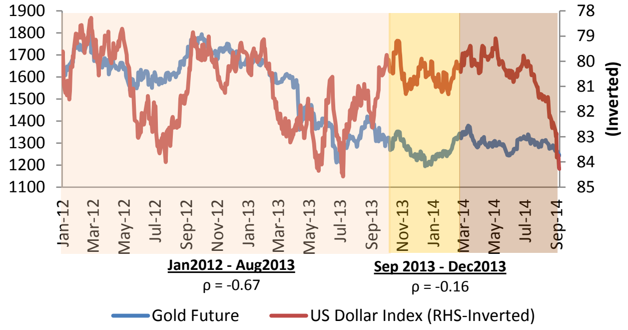
Sanctions and geopolitical issues

The big question mark thus, behind the fundamental backdrop, is the progress (or deterioration?) of the geopolitical climate. On this, further risk of sanctions by Europe against Russia still stand, while conflicting signals including Russia's willingness to achieve "permanent cease-fire" with Ukraine may ease tensions and remove risk premiums from oil prices. As such, while the suspense over further progress is still observed, any further easing should drag oil prices further to our year-end forecast for WTI and Brent at $90/bbl and $95/bbl respectively.

Gold: Still more downside risk

In a nutshell, the completion of the US Fed's QE tapering in October, lacklustre physical gold demand, and eventual higher interest rates in time are very persuasive drivers to drag gold prices. On this, we see little upside risk to gold prices at this juncture, except for periodic news-flow on geopolitical happenings, and unexpected economic softening from EU and China that may lift safe haven demand.

Gold remains correlated with USD



Source: Bloomberg, OCBC Bank

Risk premium narrowed… significantly!

Previous geopolitical tensions, specifically the retaliatory agricultural-ban imposed by Russia, as well as the surprise US authorised airstrikes in Iraq, lifted gold futures above its $1,320/oz handle. But with the tame geopolitical climate at this juncture, the relative calmness only allowed deteriorated safe haven demand and led gold prices to dip below its $1,250/oz support handle of late.

While we make no outlook as to how the geopolitical climate may progress, we observed that the ceasefire signed in Ukraine had largely eliminated a significant portion of risk premium in gold prices (as well as in oil prices in our oil report above). On this further easing tensions, should it come to pass, is likely to drag gold prices further as risk premiums continue to narrow.

This is perhaps, the most significant issue at this juncture, as easing tensions, relatively healthy US economic prints, and the dearth of the Fed's quantitative easing program are clear drivers to bring gold to lower grounds. On this, we remain convinced that gold prices have more downside risk for the rest of 2014, as we approach the end of the QE taper in October, amid concerns over an earlier-than-expected interest rate hike by the Federal Reserve and relatively healthy economic prints by key economies.

Physical demand check

The less-than-stellar physical demand from China and India are likely to sustain in 2H14. Firstly, Chinese gold demand slumped 52% in 2Q14, according to the World Gold Council (WGC), dragged by lower demand of bars, coins and jewellery. On this, we opine that gold demand in China should continue to stay weak given recent weak economic prints, as well as the on-going anti-graft drive in China at this juncture.

In India, we hold little confidence that the Indian wedding season around Diwali in October may inject any significant rally in gold prices. Traditionally, gold rallied during Sept and Oct as Indian consumers stock up gold in view of wedding and other auspicious needs. However, the rally in gold prices have not been observed at this juncture, given tame Indian gold demand in 2Q14 at 204 tonnes, an inch below Greater China's lacklustre demand at 208 tonnes, according WGC. More importantly, the hefty import duties imposed on gold last year, aimed to reduce the country's trade deficit and had been effective in dampening physical demand, would likely not be adjusted from its current 10%, according to trade minister Nirmala Sitharaman, suggesting that Indian gold demand should still face headwinds for the year ahead.

Not so clear

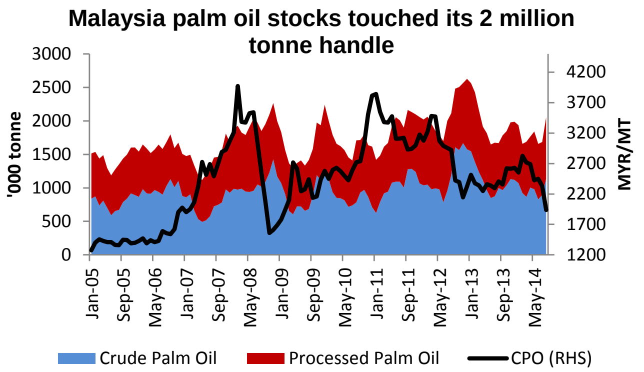
Despite the expected softening of speculative demand (lower risk premium and continued QE tapering) and physical demand (China and India), we continue to monitor political/central bank decisions that may waver investor sentiments, especially FOMC meeting (Sept 18), as well as the heavily monitored Scottish referendum (Sept 18), and the recent new EU sanctions placed on Russian oil companies. Of course, given historical reference, any injection of growth/geopolitical risk in any given time have the potential to support gold prices, though it may short-term phenomenon given the strong fundamental drivers to suggest its eventual downside to our $1,150/oz forecast at year-end.

Palm Oil: Healthy production, healthy inventories

It is back to the fundamental drawing board once again, and in this, the scare of higher palm oil inventories, amid strong seasonal CPO production and falling soybean oil prices dragged CPO prices below its critical MYR2,000/MT mark in early September, before recovering to its MYR2,100/MT handle of late.

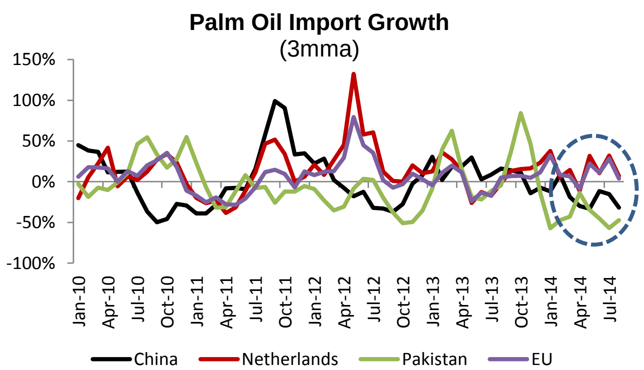
At the crux of the matter – Poor import demand

Palm oil production has been healthy, as widely expected, as Malaysia printed its record high crude oil production (2.0 million tons) in August 2014, thus bringing its total inventory print above its critical 2.0 million ton handle in the same month.



Source: MPOB, Bloomberg, OCBC Bank

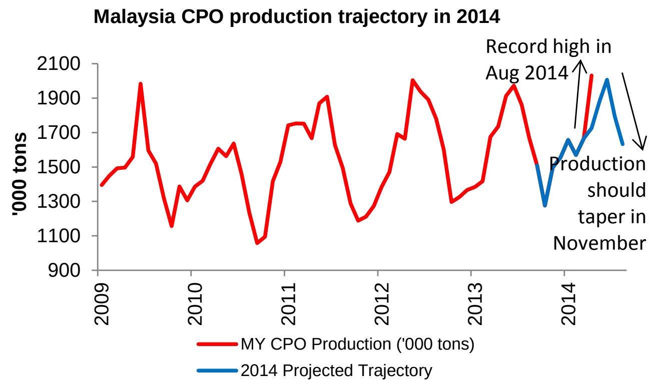
Looking closer, the ballooning inventories are also accompanied by slow exports, with shipments contracting for 6 consecutive weeks to end-August, tracked by Intertek. Aside from India which saw 136.8% import growth in August, owing to a low base year, the other major imports including EU (-23.0%), China (-53.4%), Netherlands (-17.4%) and Pakistan (-6.8%) saw year-on-year contraction in the same month.



Source: MPOB, Bloomberg, OCBC Bank

Production should taper soon

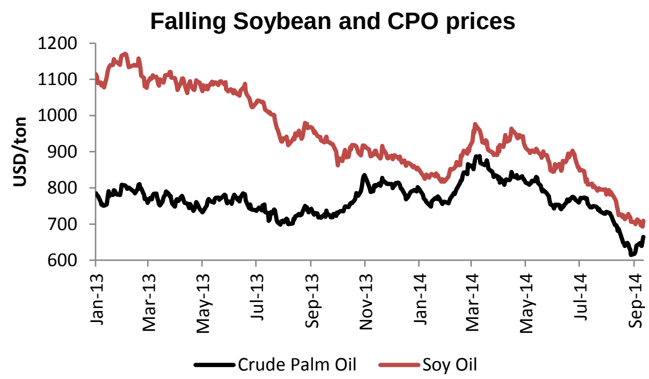
As reiterated in our previous outlooks, palm oil production follows a strict seasonal pattern, where production historically grows during March – October, and typically declines during November – February. As such, as we near towards October, which typically spells the peak of CPO production for the year, production should taper during the four months following that, thus allowing some respite to falling prices.



Source: MPOB, Bloomberg, OCBC Bank

Soybean check!

On top of the healthy production and lacklustre palm oil demand of late, we also observe that strong soybean production have been observed in 2014 YTD, even touching above its 300 million metric ton handle in 3Q14. Given that soy oil is the main alternative to palm oil, the consequent fall in soy oil prices have likely dragged CPO futures as well.



Source: Bloomberg, OCBC Bank

Year-end forecasts

Given that CPO futures have fell considerably over the last few months, we adjust our year-end forecast to MYR2,200/MT.