

## In Case You Missed It: Nothing thrilling

In a quiet week for economic data, politics once again set the tone for global markets. President Trump's remark that he's "not thrilled" about Fed rate hikes, escalating fears of a trade war and ongoing uncertainty over Brexit further muddied the outlook for investors and led us to revise some of our near-term forecasts

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## Trump strikes the dollar down

In an interview with CNBC, President Trump cited that he's "not thrilled" with the Fed raising interest rates and noted that the Chinese yuan is "dropping like a rock". The administration's desire for a weaker US dollar shouldn't come as much of a surprise to markets - we've heard this before. But Trump's comments will most likely mark a top in the USD rally



### Initial thoughts on Trump's dollar jawboning... anyone surprised?

We suspect [the President's comments on US interest rates and currency markets](#) will almost likely put an end to the USD rally - and in the absence of any immediate escalation the global trade war, it's a mini lifeline for EM and risky currencies elsewhere. We'd always been wary of the administration's desire for a weaker USD - and that in itself USD weakness could become self-fulfilling if that is the White House's objective.

Indeed, this draws parallels to what we saw in January 2018 - when Treasury Secretary Mnuchin let slip about a "weak US dollar". Moreover, Donald Trump's views shouldn't be new news to USD markets - we heard the President talk down the US dollar and cite a desire for low interest rates back in April 2017. The White House may be running damage control by quickly coming out with a statement that the President "respects the independence" of the Fed.

### Political economy of a weak dollar is a medium-term negative

While back in January the DXY index fell around 5% in a short window (with Secretary Mnuchin's

comments partly adding fuel to the weak USD fire) – we're shouldn't get too carried away. The political economy of the dollar is a medium-term negative; however, the fundamental outlook for major currencies - such as the EUR, JPY and CNY - is considerably weaker relative to January 2018 (when markets were dominated by the theme of synchronised global growth, which the current trade wars have put a dent to). As such, the President's comments are more likely to, on the margin, stem flows into USD assets given renewed (explicit) uncertainty over the US administration's dollar policy – however, we're unlikely to see the same degree of weakness that we saw back in January.

## Bottom line: A top in the USD rally but no material decline for now

With the short-term fundamental USD dynamics having already started to turn before President Trump's comments (Fed Chair Powell merely gave the USD one final push) – we think this now almost likely marks a top in the USD rally in the absence of any further near-term escalation in the global trade war narrative. It'll certainly sow renewed seeds of doubt into global investors when assessing the outlook for USD assets. It's likely that major FX pairs return back to trading within current (narrow) ranges.

We look for EUR/USD to stay within the 1.15-1.18 range for the rest of summer - while the odds of USD/JPY moving above 114-115 have been greatly reduced.

## Political economy of the US dollar a medium-term negative

For more on why the Trump administration's implicit weak dollar policy will be self-fulfilling over the medium-term, please our previous notes:

- [FX Hot Topics: A 'Mercantilist and Mercurial' Dollar Policy](#) (January 2018)
- [USD: The Trump Trilemma](#) (January 2018)
- [Deconstructing Trump's Dollar Talk](#) (April 2017)

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## GBP: Stormy outlook as dark clouds gather over Westminster

We think the stormy political clouds over Westminster will remain in place until at least October – and are thus confined to pencilling in a 1.27 to 1.28 trough for the pound against the dollar in the third quarter (EUR/GBP at 0.92). This accounts for a significant degree of political uncertainty – in spite of the Bank of England raising rates in August



Source: Shutterstock

### Summary: Short-term GBP downside risks as politics outweighs economics

All the drivers for the pound have turned on their head – with a strong dollar (weak global economy), domestic political uncertainty and a muted UK economic cycle all weighing on the pound. We think the stormy political clouds over Westminster will remain in place until at least October – and are thus confined to pencilling in a 1.27-1.28 trough for GBP/USD at some point in 3Q18 (EUR/GBP at 0.92). This compares to our previous third-quarter forecast of 1.34-1.35 for GBP/USD and 0.88 for EUR/GBP.

This near-term downgrade accounts for a significant degree of political uncertainty – in spite of the Bank of England raising rates in August. While we could be positively surprised by the Brexit progress, we feel the balance of risks suggests that further uncertainty is more likely between now and October – so long as the UK government's Brexit strategy remains one

that is seemingly trying to fit a square peg into a round hole.

## Politics to outweigh economics for GBP in the short-term... despite an Aug BoE rate hike

The price of GBP continues to reflect an enigma of uncertainties: a fragile UK government, uncertainty over the Brexit end-state and economic and monetary policy uncertainty.

GBP is cheap both on a short-term (Bank of England and UK economy) and long-term (soft or status quo Brexit) basis. But the political chaos in Westminster makes it a good reason to trade at a discount. A benign scenario would be an easing of short-term political headwinds that sees GBP/USD moving back to 1.35 (EUR/GBP to 0.87).

Yet, the difficulty with this is that we don't see the stormy political clouds over Westminster lifting any time before October – at the least until the Tory Party conference and the October EU leaders' summit. Both domestic and Brexit political uncertainties may remain high until then.

Despite the Bank of England raising rates in August, we believe the politics will continue to outweigh the economics for GBP in the short-term – especially if the Brexit strategy of the UK government remains one that is seemingly trying to fit a square peg in a round hole.

Only a concrete resolution between UK and EU officials over the Irish backstop dispute – which would effectively finalise the Withdrawal Agreement and significantly reduce the odds of a 'No Deal' Brexit – would trigger a material move higher in GBP over the coming months.

In the absence of this, we are confined to pencilling in a 1.27-1.28 trough for GBP/USD in 3Q18 – amid heightened short-term political risks and a dovish BoE rate hike. The Bank's policy reaction function goes beyond economics – and officials have explicitly conditioned their policy outlook on the assumption of a 'smooth Brexit adjustment'. We feel that markets are unlikely to price in an extensive BoE normalisation cycle until further clarity on overall Brexit risks; indeed, the recent history suggests investors tend to adjust to BoE policy on a meeting-by-meeting basis – and that means a likely dovish August rate hike is unlikely to lead to sustained GBP upside.

## Perceived odds of 'No Deal' Brexit high but low actual odds points Cable at 1.40 in 2019

The perceived odds of a 'No Deal' Brexit have increased – and this is likely to keep GBP under wraps in the near-term. There are signs that GBP markets are pricing in some degree of political uncertainty (reduced sensitivity to macro data surprises and relative interest rates, and a pick-up in short GBP positioning).

But we still feel the actual odds are significantly lower – with economic logic to triumph over political ideology in the end. Our base case continues to look for GBP/USD to move to 1.35 on the easing of short-term political risks in October/November, setting Cable on a path towards 1.40 by year-end – conditional on reduced structural Brexit risks (a steer towards a soft or status quo Brexit) and a weaker USD. The former poses the bigger threat to our outlook at present – and we shall present our alternative GBP Brexit paths in a forthcoming note.

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## China: GDP forecasts cut on trade war

The ongoing trade war will affect future GDP directly via the manufacturing and logistics services sectors. Though the government will provide support via fiscal and monetary policies, it is inevitable that industrial production will slow, which could hurt wage growth and consumption



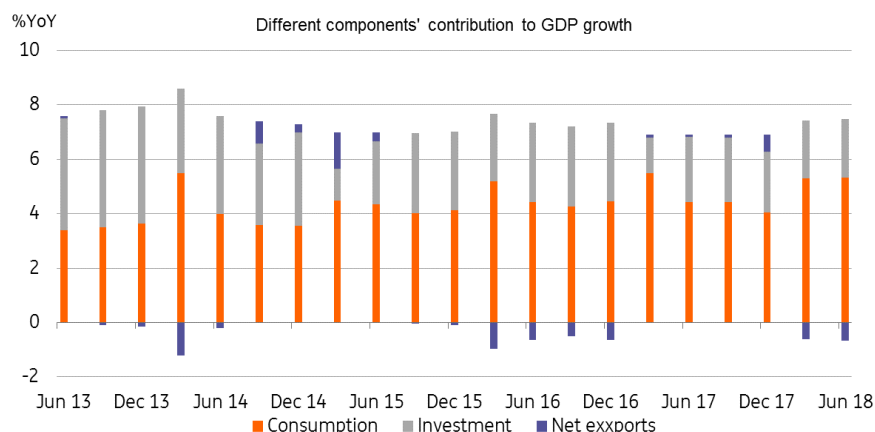
Source: Shutterstock

### As expected GDP rose 6.7% YoY

GDP grew 6.7% YoY in 2Q, slightly lower than 6.8% in 1Q. Consumption was still the growth engine, contributing 78.5% of economic growth in 1H18, followed by investment (31.4%) then net exports (-9.9%).



## China



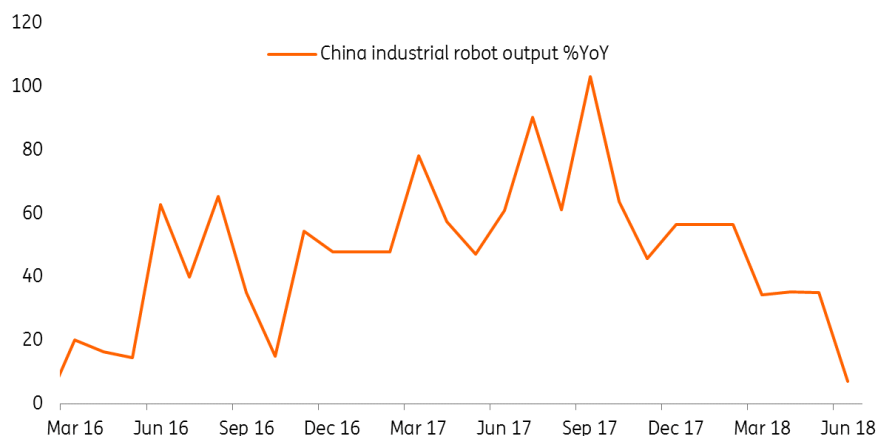
Source: ING, CEIC

### Manufacturing slowed - even high tech

Industrial production slowed to 6.0% YoY in June, from 6.8% in May. We expect manufacturing in export sectors will slow further as the trade war begins to materially impact the economy.

Even robot production grew just 7.2% YoY in June, compared to 23% YoY YTD. This is a significant drop and could be a reflection of over cautious export manufacturers.

### Exporters are cautious on investment even high-tech equipment



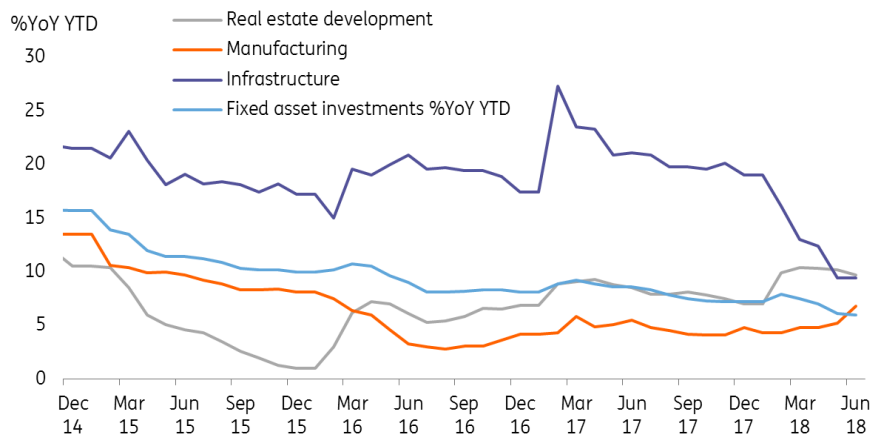
Source: ING, Bloomberg

### Investment growth stabilised

Investment growth remained at 6.0% YoY in June. Infrastructure investment continued to fall as financing tightened.

Property investment (9.7% YoY) emerged as the main pillar to support headline investment, while investment in electronics (19.7% YoY YTD) also registered traction. Entertainment-related investment, anchored by strong domestic demand, also grew quickly (17.5% YoY YTD).

## Real estate will continue to be the support of fixed asset investments in this trade war



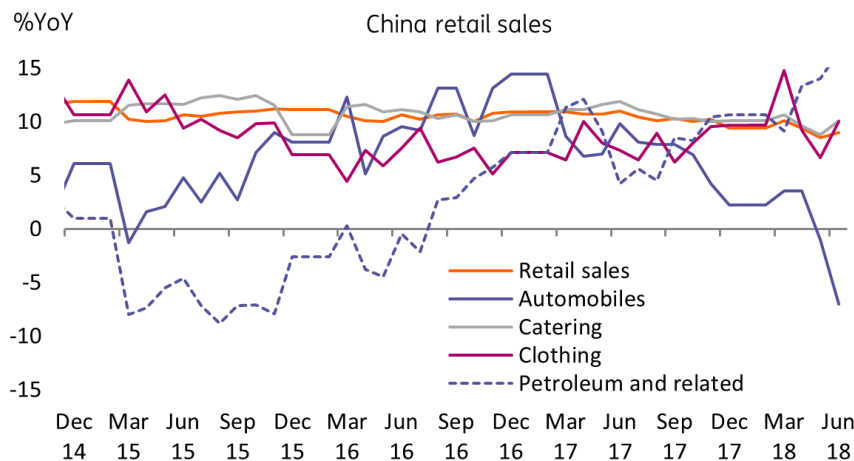
Source: ING, Bloomberg

## Retail sales grew faster

Retail sales grew faster at 9.0% YoY in June up from 8.5% in May. This shows that consumption is slower to react to the trade war compared to the manufacturing sector.

The most eye-catching figure is that retail sales of vehicles shrank 7% YoY. Don't over-read this data as consumers are waiting for tariff cuts of non-US vehicles to be reflected in auto prices.

## Don't panic about negative vehicle sales, consumers are just waiting for a price cut



Source: ING, Bloomberg

## Future growth relies on supportive policies

Consumption growth depends on salary rises, which in turn depend on business profits. The ongoing trade war will limit profits of exporters, as well as those of supply chain linked participants, including shipping and ports. Though SOEs will be able to absorb labour from the private sector in hard times, wage growth will still likely slow.

We believe that fiscal spending on high-tech R&D will increase quickly to offset the loss in investment from exporters. Similarly, reform of salary taxes could boost consumption.

Required reserve ratio (RRR) cuts for SMEs will probably continue every quarter. Borrowing costs for SMEs will need to be lower to survive the trade war.

If the trade war does hit the economy hard, then the government will substantially increase investment, especially in high-tech sectors. This will help stabilise economic growth and job security to stave off social unrest.

In this instance, the central bank will put financial deleveraging aside to focus on growth.

## Revising GDP growth

We are revising our GDP growth forecast to 6.6% in 3Q and 6.5% in 4Q from 6.7%, as the drag from trade should be partially offset by policy support.

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## ECB preview: The meaning of summer

Some ECB veterans might be longing for the good old days when the bank's summer meeting was held in the form of a teleconference. With little news, ECB President Mario Draghi will simply reiterate the main message of the June meeting



Source: Shutterstock

### What will be on the ECB's mind?

With the announced de facto end of QE at the June meeting, the ECB clearly stuck out its neck on the outlook for growth and inflation in the eurozone. The discussion on the sustainability of the recovery and any acceleration of inflation will continue.

*Soft patch or downswing?* In our view, the jury is still out on whether the eurozone only went through a soft patch in the first months of the year or is actually already in the middle of a protracted cooling. While hard macro data released since the ECB's June meeting has been encouraging and points to stable growth in the second quarter, soft indicators have only shown tentative signs of a bottoming out. On top of that, increasing trade tensions and growing geopolitical uncertainty could further undermine sentiment in the eurozone. Which direction will prevail? The one of sound and re-strengthening fundamentals or the one of a gradual denting of domestic confidence on the back of increasing trade tensions?

*Inflation pick-up, still more wish than reality?* As regards inflation, it's still hard to share the ECB's confidence in a convergence of underlying inflation towards the ECB's target. On the back of higher

energy prices, headline inflation has returned to the 2%-level but the fact that core inflation dropped to 0.9% year-on-year in June shows that the ECB still has a long way to go, to say the least. However, do not expect the ECB to deviate from its June assessment. Rather, expect it to focus on the bright side.

## How long can an ECB summer last?

With little substantial change to the economy, the ECB could definitely take it easy at today's meeting. The main focus, in our view, will be on cementing the message from June and removing any doubt about the bank's determination. Still, Draghi might have to address some of the recent market chatter during the press conference. In recent weeks, there's been conjecture about the ECB's next steps, be it an operation twist or rate hikes in the summer of 2019. In particular, the definition of the summer period seems to have provoked much speculation.

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*ECB president Draghi's main aim will be to reiterate the June message and create as little doubt as possible about the ECB's determination to stay on the chosen path. To give market participants a quiet summer, he could also consider spelling out how long a real ECB summer can last.*

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Remember that in June, the ECB announced that it expected interest rates to remain unchanged "at least through the summer of 2019". To some, this statement suggests that a first rate hike could come as early as July 2019. In our view, however, EU aficionados should know the official European summer break always ends in the last week of August. This should leave Draghi with two opportunities to hike rates before his term in office ends: in mid-September and late-October. In our view, he will use at least one of these two opportunities. In any event, talk about ECB steps beyond the end of QE is premature. The ECB will have its hands full this year just trying to end QE. If the recovery is derailed on the back of increased trade tensions or there is no increase in underlying inflation, the bank's efforts to end QE will be compromised. Nevertheless, it's obvious that the broad majority of ECB members seems determined to end QE, though as quietly as possible, and would like to return to interest rates as the main policy tool. This, however, does not necessarily mean that they will be in a hurry to hike rates. In our view, something completely unexpected would have to happen for the ECB to alter its plan to keep rates unchanged "at least through the summer".

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## Crude oil: Free fallin'

An escalation in the trade war, supply returning from Libya and Nigeria and the potential for the US to tap its emergency Strategic Petroleum Reserve, have all weighed heavily on the market. While we remain comfortable with our current forecast for weaker prices, we do believe the market remains vulnerable



Source: Shutterstock

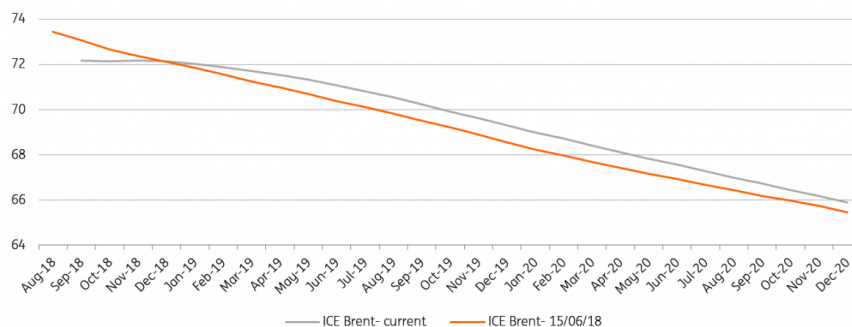
### Time to say goodbye to the backwardation?

One of the most interesting changes in the oil market has been the ICE Brent forward curve, the front end has flattened considerably, which has seen the backwardation in the prompt spread flip to contango. Trade war concerns do seem to have pulled out a lot of macro money from the oil market, along with the broader risk-off approach across the commodities complex. The flatter curve does now appear to be more aligned with a somewhat weaker physical market. A flatter curve also means that the market becomes less appealing to those speculators who have enjoyed the roll yield, and so the potential for further long liquidation at the front end, keeping the curve under pressure.

The same however cannot be said for WTI. While the prompt WTI spread has come in considerably since the start of July, from over \$2.50/bbl to just under \$1/bbl currently, the curve is still in deep backwardation, with the spot US physical market looking tighter. Inventories in Cushing have fallen to 25.7MMbbls, down from 57.6MMbbls at the same stage last year, and the lowest inventory levels at the WTI delivery hub since 2014. The 360Mbbls/d Syncrude outage in Alberta, Canada will

certainly not help, with the facility only expected to be fully operational by September. As of yet, flows from Canada do not seem to have been affected, in fact, Canada exported a record 3.73MMbbls/d the week following the outage. However moving forward, this loss in supply should start to feed through to lower flows into the US. Syncrude recently stated that they will cut supply to buyers by 35% over August.

## ICE Brent curve flattens at the front end (US\$/bbl)



Source: Bloomberg

## US SPR release?

President Trump has put a large amount of pressure on OPEC to increase output, in the hope that this would see domestic gasoline prices edge lower. However, it would appear he has grown frustrated that they are not responding to his 2MMbbls/d increase request. So it seems that he may take matters into his own hands now, with media reports that the US is looking at a release from the Strategic Petroleum Reserve, with anything ranging between 5-30MMbbls. In terms of ability to do so, the US sits on a significant amount of SPR, with it totalling 660MMbbls. As the US has become a bigger crude oil producer, net imports of petroleum have fallen significantly, and so the amount of SPR that the US must hold has also fallen. At the moment the US holds around 295 days of import coverage. Under IEA regulations, the US needs to hold just 90 days of import cover, and this includes both private and public inventories. So there is plenty of room for a release, however it may be more effective if the government were to put in place some export restrictions on refined products.

## US SPR import coverage- 4 week rolling average (days)



Source: EIA, ING Research

## OPEC+ ramp up output

Casting our minds back to the OPEC meeting at the end of June, there was plenty of confusion around how much OPEC+ would increase output. The group's comment to "strive" for 100% was not enough for the market. But fast forward a couple of weeks, and it has become very clear from those who have spare capacity, that production is only going higher.

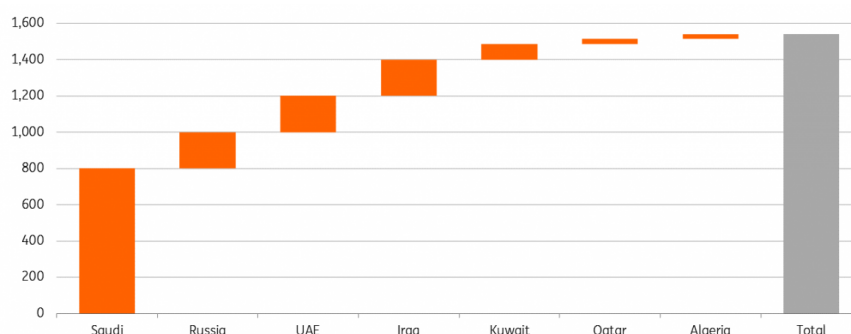
Any OPEC+ production increases were going to have to be largely driven by Saudi Arabia, given that they are the member with the largest amount of spare capacity. In May, Saudi Arabia produced a little over 10MMbbls/d. In June, the Kingdom produced 10.49MMbbls/d, a clear sign that they knew exactly how the meeting was going to play out. Expectations for July are that the Kingdom could produce as much as 11MMbbls/d, which would be a clear record.

Turning to Russia, and over June the country increased output to 11.06MMbbls/d, up from 10.97MMbbls/d in May. It is no secret that Russia has been keen to relax the production cut deal for some time now, and Russia's energy minister has said that output from the country could increase by 200Mbbls/d moving forward.

If we add up potential increases from other members of the deal, we could see a further 500Mbbls/d of additional supply coming onto the market. These increases come from the UAE, Iraq, Kuwait, Qatar and Algeria.

In total, this does suggest a potential increase of around 1.5MMbbls/d in supply in the coming months, compared to the 1MMbbls/d mentioned at the OPEC+ meeting in June.

## Potential OPEC+ output increases from May levels (Mbbls/d)



Source: OPEC, ING Research

## Libya makes a return... for now

Libya was one of the drivers that initially saw oil prices rally towards \$80/bbl at the end of June. Fighting in the fractured country led to supply disruptions, whilst forces handing over oil ports in the east of the country to the unrecognised National Oil Corporation led the official NOC to declare force majeure on loadings from a number of export terminals.

These disruptions saw Libyan oil supply fall from 962Mbbls/d in May to 527Mbbls/d in early July. However since then, the recognised NOC has regained control of these ports, and exports should start to resume as normal, which also means that output should start to edge higher once again. The latest numbers show that output has edged back up to around 650-700Mbbls/d.



Given the volatility in Libya though, it is difficult to forecast with accuracy about where output is going. However, it is probably safe to assume that output from the country will remain fairly volatile moving forward.

## US sanction impact on Iran remains the big unknown

A key bullish factor for the market has been the US insisting that allies cut purchases of Iranian crude oil to zero by 4 November, with no waivers on offer. However, the US does appear to have relaxed this stance somewhat, and waivers are now expected to be granted on a case by case basis. Who will receive waivers is still a big unknown and there are reports that the US has rejected requests from Europe for waivers against the sanctions. It seems that the key for Iran will be trying to convince Asian buyers to purchase more Iranian crude oil. Iran has already lowered its official selling price into Asia for August by \$0.20/bbl to \$2/bbl for its Iranian Light.

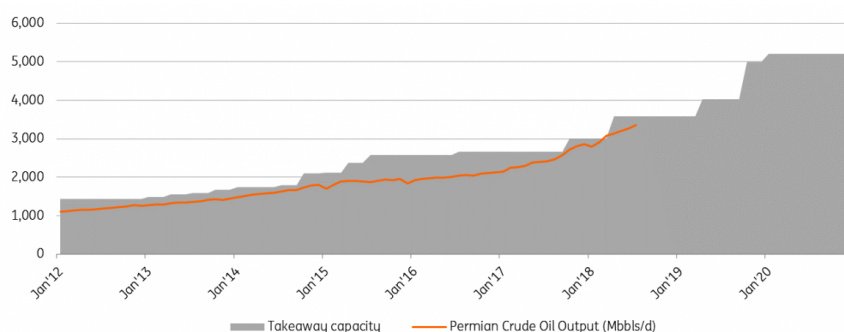
Key to this will be China, and given the worsening relationship between the US and China with the escalating trade spat, China is unlikely to listen to calls from the US to cut purchases. If anything, with the potential for discounted Iranian crude, we could, in fact, see China stepping in as a bigger buyer. In doing so, this would partially offset the impact from US sanctions on Iran. We continue to assume that we will see Iranian supply fall by 500Mbbbls/d but are conscious of the fact that we may have to increase this number moving forward.

## US pipeline constraints and supply growth

Limited pipeline capacity in the US continues to hit spreads, with crude in Midland, Texas continuing to trade at large discounts to Cushing and the Gulf. The concern has been that pipeline constraints would start to have an impact on production growth in the Permian region, and it does appear that we are seeing early signs of this. If we look at the US oil rig count it has been largely flat since the beginning of June, whilst EIA weekly production data has been flat since early June as well.

Pipeline capacity is going to remain an issue through until at least the 2H19, which is when new capacity is expected come online. If pipeline constraints do continue to hold drillers back, we believe that there could be some downside to the EIA's current production forecast of 11.9MMbbbls/d for 2019.

## Permian oil output vs. takeaway capacity (Mbbbls/d)



Source: EIA, Company reports, ING Research

**ING price forecasts**

	2018				2019				2020			
	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
ICE Brent (US\$/bbl)	67	75	70	68	64	66	67	66	61	66	71	66
NYMEX WTI (US\$/bbl)	63	68	62	60	56	58	61	61	57	62	67	62

Source: ING Research

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# Metal price outlook: When the going gets tough...

Escalating trade tensions and fears about the impact on global growth, and with it metals demand, have wiped 15% off the industrial metal index from its June peak. But keep calm, we expect the rhetoric to die down after the US mid-terms and prices to recover



Source: Shutterstock

	ING Price Forecasts (\$/t)												
	3Q18	4Q18	FY18	1Q19	2Q19	3Q19	4Q19	FY19	1Q20	2Q20	3Q20	4Q20	FY20
Copper	6,450	6,750	<b>6,780</b>	6,900	7,000	7,100	7,100	<b>7,030</b>	7,100	7,100	7,100	7,100	<b>7,100</b>
Aluminium	2,025	2,150	<b>2,150</b>	2,225	2,300	2,300	2,400	<b>2,305</b>	2,375	2,300	2,250	2,250	<b>2,295</b>
Nickel	13,800	14,000	<b>13,915</b>	14,000	14,000	14,500	15,000	<b>14,375</b>	15,500	15,500	16,000	16,000	<b>15,750</b>
Zinc	2,650	2,850	<b>3,000</b>	2,750	2,600	2,600	2,600	<b>2,640</b>	2,500	2,500	2,500	2,500	<b>2,500</b>
Lead	2,300	2,400	<b>2,400</b>	2,350	2,300	2,250	2,250	<b>2,290</b>	2,170	2,170	2,170	2,170	<b>2,170</b>
Iron ore (62% Fe)	64	66	<b>66</b>	65	60	58	62	<b>61</b>	60	55	55	55	<b>56</b>

Source: ING Research

## A disappointing year-to-date for the bulls

At the end of 2017, it all looked so bright for commodities. Macro themes of higher inflation and synchronised global growth provided a solid backdrop for commodities as a broad asset class. Being long the basket was a popular strategy and as funds built allocations through December 17, a brief return of correlation was ushered in, as prices went up across the pack.

But disappointment soon set in and with it, cross-commodity correlation has lulled once again.

Earlier in the year, Chinese demand wobbled amid a longer than expected New Year slowdown. This was a temporary blip but enough to reinstate copper back below \$7k, with evident signs of macro funds already losing faith and liquidating positions.

That move has since been eclipsed by a 16% drop following the G7 summit, as a tit-for-tat trade war undermines the initial premise of synchronised global growth. Unlike the first quarter however, the recent sell-off has been different. It has spread beyond just a liquidation of what was already fairly flushed-out fund longs, to now also inviting a hoard of fresh shorts that are actively chasing a collapse in base metals.

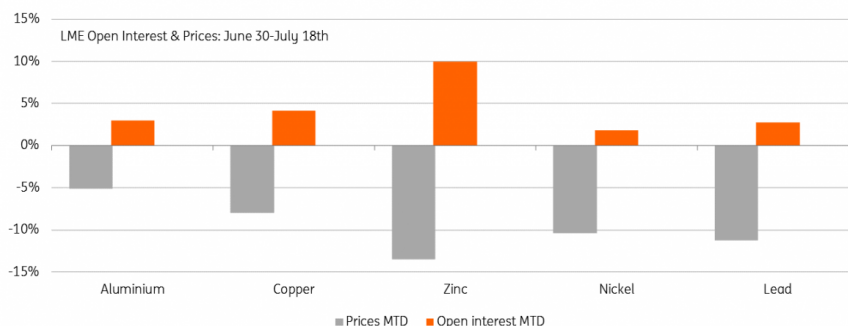
This is evident through the increasing open interest on the LME through the turmoil of the first half of July. Shorting zinc ranks at the top but it's certainly a common trend across the base metals. We think there is a high likelihood for a decent size rebound as those shorts take profits and cover positions, but we acknowledge it will largely be the sentiment around trade wars that will take the steer for the next quarter, at least.

Our forecasts, therefore, see a slight short-covering rebound from spot in the third quarter, but we still see prices remaining largely depressed through the quarter, as our economists expect President Trump to stick to his hard-line trade rhetoric in the run-up to the November mid-term elections.

Thereafter, it gets more plausible that a deal or compromise is sought, so most price improvement should come about in the fourth quarter. Our trade economist has identified fairly minimal direct impacts to GDP from the trade tariffs (and with it minor impacts to metal demand) unless an all-out US vs. the world trade scenario unfolds. Moreover, it's the indirect hits to business and market sentiment that pose the biggest risks and that should let up with the rhetoric. The Shanghai Stock Index shows the damage done in the meantime and is down 10% since the start of June.

If you agree with our thesis that much of this trade war gloom will roll over, then metals certainly stand a good chance of recovering. The rebound will be aided by a reversal in the dollar as those safe haven flows into the greenback die down and critical US issues return to the fore (twin deficits, tight mid-term elections etc). ING's FX team predict the dollar at 1.23 against the euro by year-end, going down to \$1.35 by the end of 2019. But we don't think metals will recover their losses so quickly. The physical trends for many metals are pretty tepid so might not provide much in the way of direction.

## LME open interest rises through the July turmoil as funds build short positions



Source: LME, ING Research

## Aluminium: Waiting for Rusal

Our base case now assumes Rusal will achieve a deal co-ordinating the lifting of US sanctions sometime in the third quarter. The reshuffling of executives and extended share/debt trading between Rusal and EN+ show the ongoing attempts to appease OFAC. The key news to watch will be whether Oleg Deripaska relinquishes his stake suitably below 50%. We are aluminium bulls but think it's most suitable to go long after the market digests the news that Rusal supply is returning to the market unsanctioned. Conversely, if we did get towards the end of the third quarter without a deal, our bull case expects another frenzy, with prices touching close to \$3,000 once more.

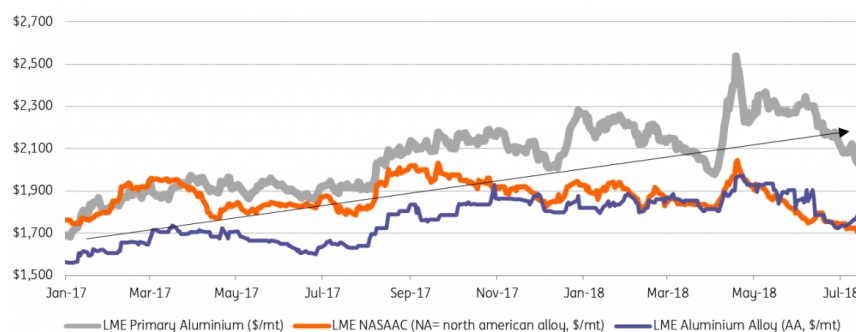
With Rusal's expected return to the market, any dips below \$2,000 should be seen as especially cheap. We were aluminium bulls before Rusal sanctions and remain so. We think the fourth quarter would still show some tightness as it takes time for buyers and financing for the flow of Rusal material to resume, but thereafter an upward trend should take hold. We see deep deficits ex-China for primary metal that surpasses potential semis exports. As high physical premiums continue to surpass lower warehouse incentives, we expect more frequently sharp backwardations on the LME, like the extreme July-August backwardation just past. Each backwardation will raise LME prices by squeezing out short position holders including those hedging off-warrant stockpiles that will gradually be liquidated.

The ultra aluminium bears have pointed to growing scrap supplies, especially in the US, which they say will cannibalise demand. But we think it's still a question of whether it's the right type of scrap. The USGS reports that US aluminium scrap consumption was actually down 3% year on year in Jan-April. For now at least, scrap availability is seeing aluminium alloys underperform rather than dragging on primary prices. For example, primary aluminium prices on the LME are up 22% since January 2017 but NASAAC (North American Aluminium Alloy - A380) is down 3%.

### Aluminium background:

- [Rusal scenarios: Calm before the next storm](#)
- [OFAC rules for buying Rusal metal before Oct 23rd](#)
- [Big backwardation July-August](#)
- [ING's original bullish 2018 outlook: It's not all about China](#)

## High scrap drepreses aluminium alloy prices, not primary (\$/mt)



Source: LME, ING Research

## Copper: Gradual rebound expected

Copper's diversified demand base (geographically and by sector) made it a prime target for concerns over the trade war impact on growth. Therefore it should also attract a decent amount of dip buying and short covering, should those tensions resolve. But we don't think it will fully regain its \$7k standing for a while because we see a lack of significant direction from the physical market.

In particular, whilst imports into China are strong (+16% YOY), the signals are more push than pull: premiums have dropped, SHFE is in contango and stocks have barely drawn since the New Year. We argued the backwardation, which appeared on the LME in May-June, was more technical than fundamental and are not surprised to see that a wide contango has resurfaced.

Supply themes are also fairly tepid. All eyes are on Escondida negotiations but disruption rates so far are running low so it would take an extreme duration to swing the balance significantly. We expect any near-term tightness to come from a withdrawal of scrap supplies, which is already reported in the US. More generally, we look to the higher western premiums to provide support where the Chinese market is lacking.

We don't see any reason why the strong flow of units into China should stop though. That is partly, of course, predicated on our view for a trade deal. Otherwise, copper might be particularly exposed to the demand via manufacturing exports. But even without this, our China economist is still optimistic for economic growth in the second half given supportive fiscal/monetary measures implemented by the government: RRR, VAT cuts etc. ING now expects GDP to be 6.6% in 3Q and 6.5% in 4Q, revised down from 6.7% on trade concerns but still far from devastating.

Into 2019 then, failing an all-out US vs. the world trade war, we expect the fundamental rationale to resurface that copper should trade above the incentive price for new mine supply (>\$6,800/mt). Post-2020, a lack of new mine supply will transition from a deficit in concentrates into refined metal, and prices are expected to trade higher in anticipation of the shortage. Closing the 500kt+ shortfall expected by 2023 on a topdown approach requires a 2% hit to GDP and this runs way beyond any trade war expectations.

### Copper background:

- [Copper backwardation was more technical than fundamental](#)
- [Possible trade war impacts on copper demand](#)
- [Chinese copper imports more push than pull](#)
- [China GDP forecasts cut on trade war](#)

	% GDP hit (24 months cumulative)			Copper Demand loss (kt)
	US	China	World	
6th July	0.06	-0.18	-0.03	8
Scenario 1	-0.05	-0.27	-0.1	16
Scenario 2	-0.16	-0.36	-0.17	40
Scenario 3	-1.99	-0.97	-0.82	192

Source: ING estimates,  
**6 July:** US steel and aluminium tariffs, plus 25 percentage point (pp) tariff increases on imports from China worth \$50bn. Both measures are retaliated against by trade partners.  
**Scenario 1:** US increases tariffs on imports from China worth \$200bn by 10pp and on EU cars by 20pp. China & EU retaliate  
**Scenario 2:** US increases tariffs on a further \$200bn of imports from China by 10pp, and \$100bn of imports from the EU by 10pp. China and the EU retaliate.  
**Scenario 3:** US increases tariffs by 20pp on all imports and all trade partners retaliate.

Source: ING estimates

## Nickel: Don't let the facts get in the way of a good rally

We have been wrongly sceptical on nickel for much of the year. But while we still suspect the rally will start to lose momentum, we are more comfortable with the higher prices. We were previously concerned with a squeeze on stainless steel margins because the Chinese stainless steel prices hadn't passed through surging costs. We also continue to believe that the draw on visible exchange stock is over-running any actual deficit. But don't let the facts get in the way of a good rally. Speculators have driven nickel up 25% since December 2017 but we no longer see any fundamental response to necessitate a correction.

Firstly, Chinese stainless steel producers have proved resistant to climbing LME nickel prices. Along with the backward integration, it is safe to say we underestimated the degree that nickel-pig-iron (NPI) and refined nickel prices could diverge. NPI went from a premium value to discounts as high as \$1500/mtu, alleviating the pressure on stainless. While NPI production is expected to surge in Indonesia (perhaps be curbed in China) it's the relative restraint of the class 1 nickel producers (Vale, Norilsk, Jinchuan etc) which is providing no fundamental response to cap the LME nickel rally.

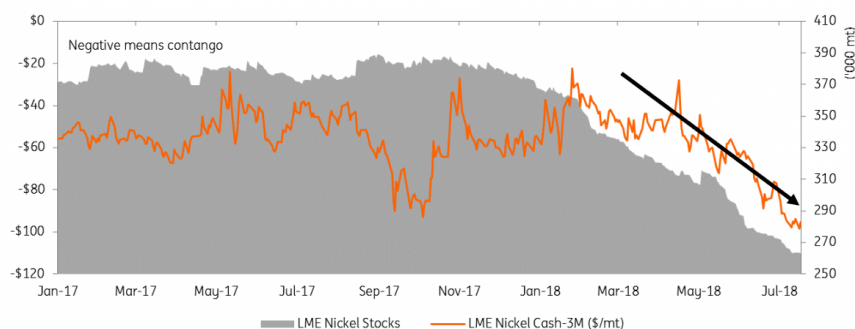
Still, we expect the rally to taper. Nickel has been fairly resistant to the trade war tensions given its longer-term bullish electric vehicle (EV) narrative but it's not immune. Prices are down 12% since the G7 meeting. We also stick to our view that there is no fundamental reason for exchange stocks to draw more this year (but likewise nothing stopping traders doing so) and if that tapers off, the speculators may lack a willing data point.

Mostly though, we are watching the ever-widening contango. Even for nickel, the move in the cash-3M spread from \$50 in April to nearly \$100 in July is extreme. On the one hand, this supports those traders looking to finance stockpiles, but amid a wobbly macro backdrop, it's now also eating into returns of the longs. That wide curve structure, along with flat premiums (Shanghai CIF has been around \$150 and down from \$300 at the beginning of the year), gives us the conviction that nickel has been gaining on speculative flows rather than the current physical trends. Key to remember is that EV is currently only c.5% of demand. We are long-term bulls but suspect things will slow down for a while.

### *Nickel Background:*

- [Nickel refined vs NPI divergence](#)
- [Something has to give: Flat stainless steel prices not reflecting the surge in nickel prices](#)

## What tightness? LME Nickel stocks draw but the contango gets wider



Source: LME, ING Research

## Iron Ore: Grade is King

We have become progressively more bullish on iron ore this year as China's preference for high-quality ores provides support for benchmark 62% and higher grades. Meanwhile, supply disruptions have significantly cut the expected seaborne surplus.

We think iron ore's (via steel) high dependency on Chinese real estate should actually make it more resistant to the trade war tensions (real estate is c.35% of Chinese steel demand) than those metals more heavily used in manufacturing and exports. Chinese new housing starts are surging, up 12% YoY as property investment (9.7% YoY) remains the main pillar of fixed asset investment and indeed is expected to get central support in order to maintain China's growth expectations through any trade hit.

With a degree of trade war immunity, we expect the main driver of iron ore prices to be the increasingly stringent environmental curbs to steel production. Such curbs boost utilisation rates and profitability at the un-curbed capacity and provide both the purchasing power and economic incentive for higher grading, higher yielding ores.

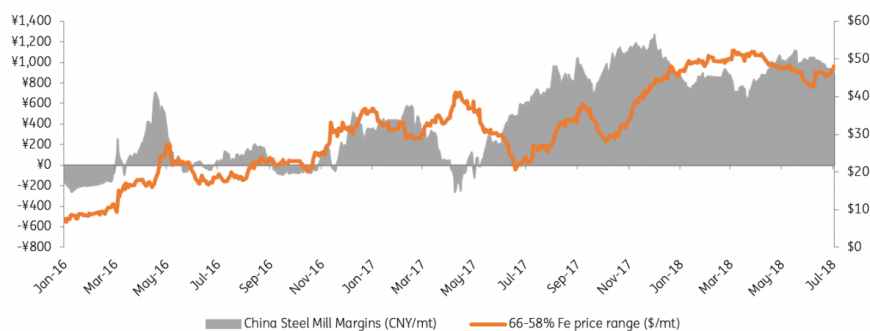
Restrictions on steel production (+sintering/coking coal) have been extended outside the winter heating seasons, supporting higher-for-longer mill profits/iron ore grade premiums but are expected to intensify during the key November-March months when we also upgrade our price forecast for the 62% Fe price to average \$66 for 4Q and \$65 for 1Q. While that's up from current levels, it would still be down on last year (even with wider-than-expected steel winter cuts) since we see more of the volatility in grade premium transitioning to those above 62% Fe.

Key to watch will be the implementation of stricter policies, particularly in the largest hub Tangshan (c.11% of Chinese steel production) and the focus centre for most of the sporadic cuts to sintering (pre-treatment of fines). Here, 10-15% cuts outside of the heating season have now been notched up to 50% for some mills in the next six weeks at least. Before October, steel, coke and coal power sectors have to meet new ultra low emissions targets or face closure.

### Iron Ore Background:

- [Iron Ore grade is king but premiums will swing](#)
- [Better supported after supply disruptions](#)

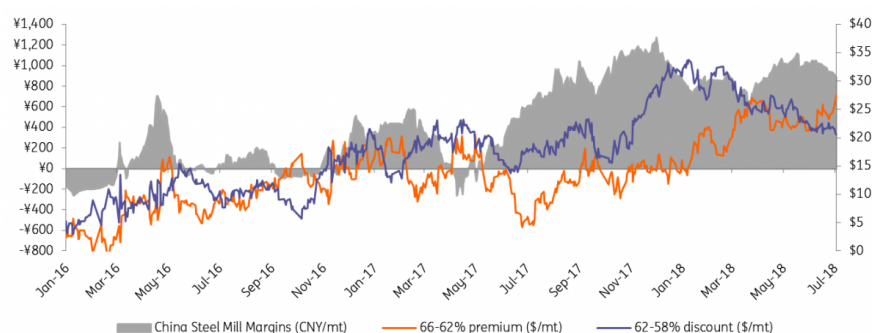
## Iron Ore grade premium follows China's steel mill profitability



Source: Steelhome, CuSteel, Bloomberg, ING Research



## But the premium is shifting to grades above 62%



Source: CuSteel, Shanghai Steelhome, ING Research

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