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Commodities

Commodities outlook

10 Developments to watch out for in 2018

A mixed outlook in all sectors

Commodities have started 2018 on a strong footing. Oil prices have rallied to levels last seen in 2014, with cold weather in the US and growing unrest in Iran proving supportive for prices. However the fundamental outlook for oil remains bearish, and we do expect prices to weaken through 2018. The key event for the oil market this year will be how OPEC go about exiting their output cut deal, if at all.

For base metals, the outlook over 2018 remains constructive, with most metals continuing to see tightening balance sheets. Production capacity cuts in China should remain supportive for prices, while for copper, there are a number of labour contract negotiations in Chile and Peru this year, and so like 2017, there is the risk that we see disruptions to supply.

While for agricultural commodities, it does appear that most markets are still dealing with large inventory levels, which should mean limited upside to prices. However the key risk to this view is La Nina, a weather event that can cause disruptions to crops. Currently NOAA expects that there is more than an 80% chance that La Nina conditions last through until the end of the northern hemisphere winter.

Here are ten themes we'll be looking at in 2018:

1. OPEC and non-OPEC deal exit strategy
2. Global oil demand growth and market balance
3. LNG supply from Australia and the US
4. Coal plant closures
5. Chinese winter capacity cuts
6. Glencore zinc mine restarts
7. Potential copper mine disruptions
8. Palladium substitution risk
9. "La Nina conditions are present"
10. Brazilian sugar/ethanol dynamic

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1. OPEC and non-OPEC deal exit strategy

ING take – With US oil production increasing strongly, we believe OPEC may have to delay their exit plan or risk a sharp price reversal in 2H18.

On 30th November 2017, as widely expected OPEC and a handful of non-OPEC countries decided to extend the 1.8MMbbls/d output cut deal through until the end of 2018. Libya and Nigeria also agreed to cap their production at their 2017 highs, following the strong growth in their output over the last year. Initially conceptualised only for six months, the current extension means the deal will run for a total of two years by the end of 2018. The group will next review the deal at the semi-annual meeting in June 2018, and lay out an exit strategy if market conditions allow.

An exit strategy is likely to be complicated. For one, the global oil market is expected to be largely balanced over the year, thanks to strong production growth in the US, while demand growth is expected to slow from the stronger levels seen over 2017. This means that the 45MMbbls inventory withdrawal reported over the first ten months of 2017 may be harder to repeat in 2018 despite the deal extension. Any premature return of OPEC/Russian supply would likely see inventories start to grow once again, a scenario which would likely see speculators start to liquidate their record net long in ICE Brent.

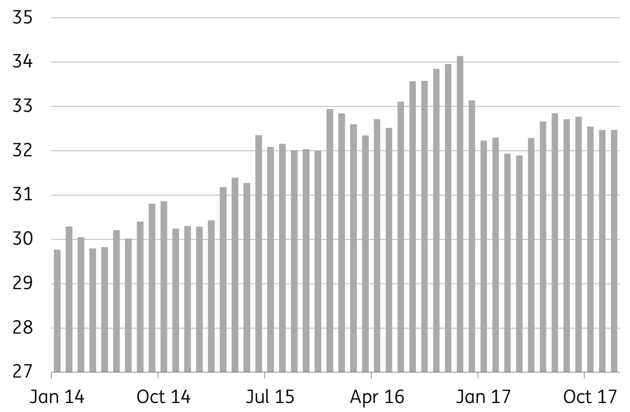
Meanwhile, Saudi Arabia has been very committed to the deal, cutting output by more than it agreed. However, there is the real risk that the Saudis become less disciplined following the IPO of Saudi Aramco, which is expected sometime over 2H18.

2. Global oil demand growth and market balance

ING take – Oil demand growth is set to slow over 2018, partly as a result of stronger prices. Importantly demand growth is likely to fall short of the expected increase in non-OPEC supply.

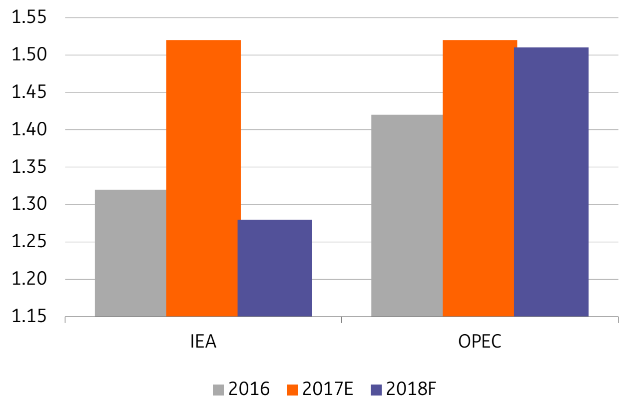
The IEA estimates that global oil demand grew by 1.5MMbbls/d in 2017, and expect demand growth to slow to 1.3MMbbls/d in 2018. This is slightly at odds with OPEC, who expects global oil demand growth will remain fairly resilient over 2018 at 1.51MMbbls/d. The IEA anticipates a more balanced market for 2018; with a small surplus expected over the 1H18, and inventory drawdowns over 2H18, although this does assume unchanged OPEC output over the year.

Fig 1 OPEC crude oil output (MMbbls/d)



Source: Bloomberg

Fig 2 Global oil demand growth expectations (MMbbls/d)



Source: IEA, OPEC, ING estimates

3. LNG supply from Australia and the US

ING take – LNG supply from Australia in 2018/19 is likely to fall short of initial expectations, supporting Asian prices, but watch out for increased US LNG exports.

In its recent Gas Inquiry report, the Australian Competition & Consumer Commission estimates that Australian LNG suppliers will export 34.7Bcm (1,217PJ) of LNG on long-term contracts and c.1Bcm of LNG on the spot market. Previously the Australian Energy Market Operator (AEMO) forecasted LNG exports of 35.6Bcm on long-term contracts and up to 1.8Bcm of spot sales, resulting in a gas shortfall of 1.6-3.1Bcm in 2018. Following the AEMO forecast, LNG suppliers agreed to prioritise domestic demand at reasonable terms before diverting supply to export markets. LNG export forecasts for 2019 have also been revised lower from 38Bcm to 36.8Bcm, as more gas is diverted to the local market.

Lower LNG supply from Australia is likely to tighten the Asian gas market, where Chinese LNG imports have been increasing robustly, while Japan has recently been facing issues in restarting nuclear power plants. Although restricted supply from Australia could be offset by increased flows from the US. LNG capacity in the US at the end of 2017 stood at c.25.8Bcm (2.5Bcf/d), and over 2018 another 21.7Bcm (2.1Bcf/d) is set to be added.

4. Coal plant closures

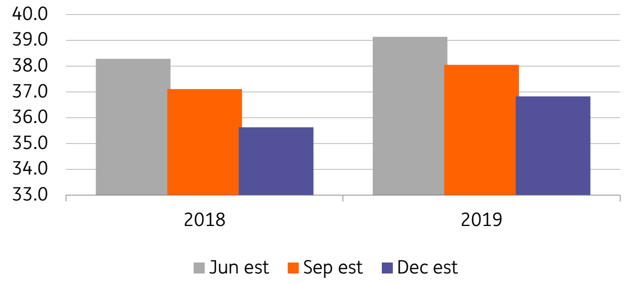
ING take – Cheap natural gas continues to drive coal plant closures in the US, while the largest coal consumer, China, continues to invest in cleaner energy. This suggests a poorer demand outlook for coal in the long term.

In the US, depressed natural gas prices continue to support coal plant closures. The EIA expects 9.8GW of coal capacity closures in 2018, however actual closures could be closer to 13-14GW, with more plants indicating early retirement, including 4GW from Luminant in Texas.

The EIA estimates that coal consumption from the power sector fell by 12m short tons over 2017, and forecast demand will fall by another 10m short tons over 2018. However, with it appearing that there will be more closures than the EIA is estimating, the decline in coal demand will likely be greater.

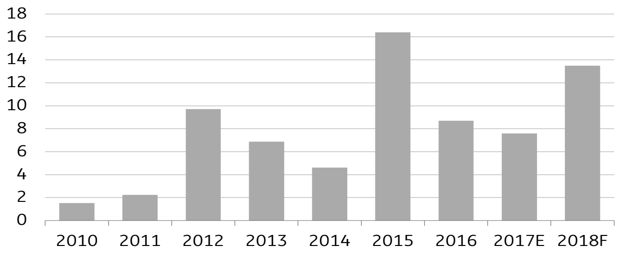
Finally, China continues to focus on cleaner energy, and in fact was the largest investor in renewable energy over 2017. The National Renewable Energy Centre in the country recently recommended to increase targeted solar and wind power capacity from 110GW to 200GW and from 210GW to 350GW respectively by 2020. The agency recommends that the renewable share should increase to 19% by 2020 compared to a current target of 15%.

Fig 3 Australia LNG export forecasts (Bcm)



Source: AEMO, ACCC, ING estimates

Fig 4 US coal plant retirement (GW)



Source: EIA, ING estimates

5. Chinese winter capacity cuts

ING take – Winter cuts in China have clearly been supportive of metal prices, repeating cuts next winter would offer further support to markets.

Winter capacity cuts to tackle pollution in major Chinese cities are currently underway, with aluminium production in the country falling 16.8% YoY to 2.35mt in November 2017, levels not seen since February 2015, and down 20% from the record 2.93mt produced in June 2017. Similarly, steel production also fell 8.9% MoM to 66.2mt in November 2017; levels not seen since December 2015.

These cuts have helped the Chinese government reduce pollution over the winter months, improve industry health, reduce overcapacity and see exports fall, which will ease some of the pressure from both the US and Europe. There is the possibility that the Chinese government re-implement these cuts next winter, which could mean further support for aluminium and steel prices towards the end of the year.

But Chinese producers could look for ways around further potential cuts, and this could be by opening capacity elsewhere. It was widely covered in the media that Chinese aluminium producer, Hongqiao was looking at potentially moving 2.7 mtpa of idle capacity to Indonesia. Ample availability of bauxite and the country's aim of developing a local smelting and refining industry supports this idea.

6. Glencore zinc mine restarts

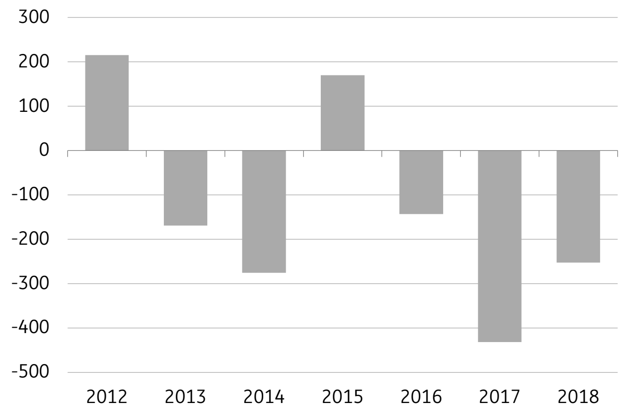
ING take – Zinc prices should remain well supported over 2018, with the market set to see another deficit. Glencore's announced capacity restart does little to improve global supply over 2018 significantly.

Recently, Glencore announced that it would restart the 160 ktpa Lady Loretta zinc mine in Australia gradually, with the mine possibly reaching full capacity by 2019. The company expects its zinc production to increase from 1.02mt in 2017 (excluding the 85kt from two African mines that were sold to Trevali Mining in August last year) to 1.09mt, only a 70kt increase in zinc supply over 2018. The remaining 340 ktpa of capacity that was closed in 2015 will remain shut. While global refined zinc supply is set to increase by 3.9% in 2018, it is expected that the refined market will see a deficit of around 250kt over the year. Another year of inventory withdrawals should mean zinc prices remain well supported.

Fig 5 China aluminium output (mt)

Source: Bloomberg

Fig 6 Global zinc market balance (000 tonnes)



Source: ILZSG, ING estimates

7. Potential copper mine disruptions

ING take –A large number of labour negotiations in Chile will be followed closely, with the potential for significant supply disruptions if negotiations fall apart.

2017 was a year of significant disruption to copper mine supply, with workers at the world's largest copper mine, Escondida in Chile going on strike for 44 days, after unions and the mine operator, BHP Billiton failed to negotiate a new contract. This action led to the loss of 214kt of copper supply. Negotiations are set to resume in June, and failing once again to come to an agreement would likely lead to further industrial action.

BHP Billiton is not alone in contract negotiations; Chilean state miner, Codelco is set to renegotiate 15 contracts over the year, while a handful of other miners will also enter labour negotiations. Supply disruptions have the potential to drive the market higher, particularly in the current market environment.

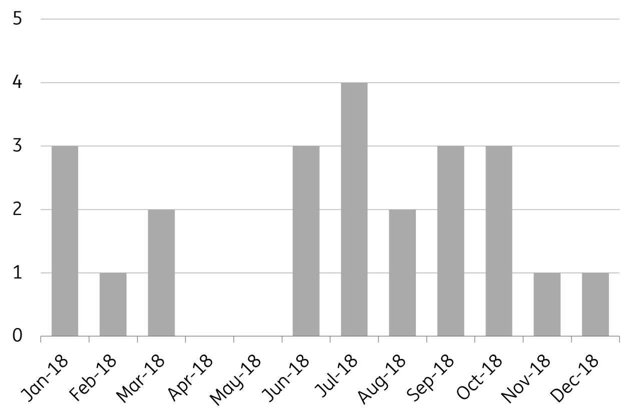
8. Palladium substitution risk

ING take – The platinum/palladium ratio continues to fall, and further weakness in the ratio could start to hit palladium demand.

For the first time since 2001, palladium is currently trading at a premium to platinum. The platinum/palladium ratio currently stands at 0.88 compared to a five year average of 1.6. The main driver behind this has been developments in the auto industry, which is by far the largest consumer of these two PGMs. The auto industry accounts for 42% and 81% of platinum and palladium demand respectively. These PGMs are used in auto catalysts, with diesel vehicles generally using platinum, and gasoline vehicles using palladium. Given the falling share of diesel vehicle sales, the impact on platinum demand has been very clear. Meanwhile, speculators have also exaggerated the move, with them holding a sizeable net short in platinum and a significant net long in palladium.

However the larger the premium that palladium trades to platinum the more likely we are to see the auto industry start switching to platinum for auto catalysts, even in gasoline vehicles. There are also reports that some US and European manufactures are actively looking at going this route. Between 1999 and 2002, when the platinum/palladium ratio was around current levels, palladium demand from the auto industry fell from 5.88moz to 3.08moz, while platinum demand from the sector increased from 1.61moz to 2.61moz.

Fig 7 Number of copper mine labour negotiations through the year



Source: Metal Bulletin, ING estimates

Fig 8 Platinum/Palladium ratio

Source: Bloomberg, ING estimates

9. "La Nina conditions are present"

ING take – Prevailing La Nina weather conditions are expected to continue until the end of winter, which should mean wetter conditions in South East Asia and drier weather in parts of South America.

The US National Oceanic and Atmospheric Administration (NOAA) now believes that there is more than an 80% chance that La Nina weather conditions will last through until the end of the Northern Hemisphere winter. But what does this mean for regional weather, and more importantly certain commodities?

Generally, La Nina conditions mean wetter conditions across eastern Australia, South East Asia, and Southern Africa. While in parts of Argentina and Brazil it generally means drier weather, then in the Northern states of the US it does generally mean colder than usual weather. In South East Asia, excessively wet conditions could disrupt crops including palm oil, rice, sugar and natural rubber. In Australia, rains could be beneficial for sugarcane development, but could also disrupt coal exports from Queensland. In Southern Africa, rains again could prove beneficial for sugarcane development, while in South America, drier weather could have an impact on soybean, sugarcane and coffee yields in South America. Colder weather in the northern states of the US could be supportive for natural gas and heating oil demand.

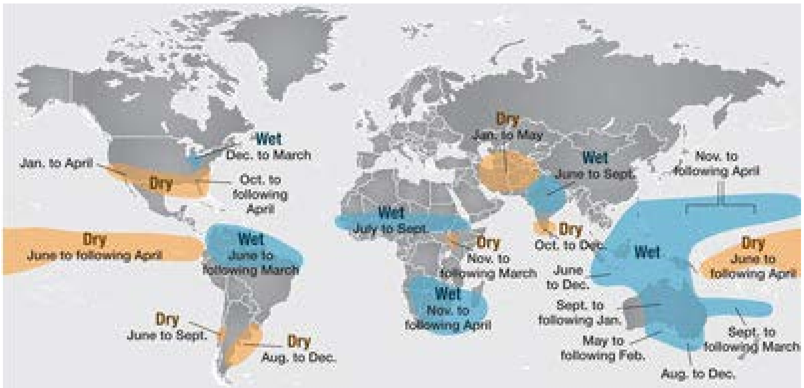
10. Brazilian sugar/ethanol dynamic

ING take – Given that the global sugar market is set to be in surplus this season, ethanol in Brazil should trade at a premium to sugar to absorb some of the surpluses.

The end of the 2017/18 CS Brazil crushing season saw millers in the country favor producing ethanol at the expense of sugar, which was no surprise given the premium that domestic ethanol was trading to sugar. Mills allocated 36.83% of cane towards sugar in 2H November 2017, compared to 47.34% for the same period last season. Stronger ethanol prices have come about due to the general strength in oil prices, and the fact that Petrobras adjusts domestic gasoline prices almost on a daily basis.

Looking forward to the next season, if stronger oil prices remain, and domestic ethanol trades at a premium to sugar, the ethanol balance sheet should absorb a significant portion of sucrose from the sugar balance sheet. This is something that the sugar market would likely need to see in order to reduce the relatively large surplus that some analysts are expecting over the 2017/18 season.

Fig 9 Rainfall during La-Nina weather pattern



Source: Agweb

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