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Commodities Outlook

10 things to watch out for in 2019

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Executive summary

By nature there is always uncertainty in markets, however as we move into 2019 it is clear that there is an elevated level of uncertainty for commodity markets. This does suggest that we could be in for yet another volatile year.

The Commodities complex entered 2018 on a fairly strong footing, with the Bloomberg Commodities Index peaking in early May. Since then the market has trended lower, with the theme of trade wars weighing on the complex. The other key theme, which has partly offset the bearish sentiment from trade tensions, has been 'sanctions' for both the oil and metal markets. These two themes are likely to remain key for commodity markets over 2019, with it still uncertain how exactly they will play out.

For oil, the market will be watching closely on how OPEC+ policy evolves over the year. Whether the group needs to extend its recently agreed deal beyond six months will depend on the impact of US sanctions on Iran, growth in US oil output and the demand outlook for 2019. Recent OPEC numbers suggest that OPEC+ may have to take further action over 2H19. However, intervention from OPEC+ should mean that oil prices trend higher from current levels over 2019.

Turning to the metals market, it is clear that trade talks will be key to how the complex evolves over 2019. Base metal fundamentals are generally constructive, which should be supportive for prices, but the potential for a China slowdown will likely keep the market wary. Sanctions are now somewhat less of a concern, with the US administration announcing plans to lift sanctions against aluminium producer, Rusal, although there is still the potential for Congress to try to block the decision over the next 30 days. Finally, crucial for the direction of the metals complex is the outlook for the USD. The strength in 2018 has surprised many, and while it appears as though there could be upside in the USD in the near term, there is growing consensus that the USD will weaken in the latter part of 2019.

In agriculture markets, once again the outlook will depend on trade talks. Recent discussions between China and the US at the G-20 summit were constructive, which has seen China return as a buyer of US soybeans. However, as long as the 25% import tariff on US soybeans remains in place, China is unlikely to return as a significant buyer. This has repercussions on other agriculture markets, with US farmers likely to make a significant switch from soybeans to corn when it comes to 2019 plantings. Meanwhile for sugar, we believe the lows are behind us with the expectation that prices strengthen over 2019, particularly over the latter part of the year, with a narrowing in the 2018/19 surplus, and expectations that 2019/20 will see the market return to deficit.

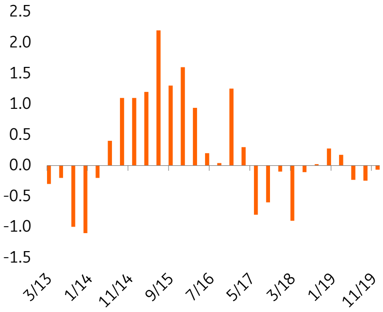
We'll be closely watching the 10 themes below:

1) OPEC+ oil strategy in 2019
2) IMO sulphur regulations
3) The LNG boost
4) EU carbon prices to remain well supported
5) Trade concerns and copper
6) Gold and central bank policy
7) Sanctions overshadow the aluminium market
8) Palladium substitution
9) US soybean acreage reduction
10) Global sugar market tightens

1. OPEC & oil strategy in 2019

ING take: OPEC+ agreement to cut output by 1.2MMbbls/d over 1H19 should be enough to see the market return to balance, and therefore we expect prices to trend higher from current levels. We forecast ICE Brent will average US$70/bbl over 2019.

Quarterly global oil market balance (MMbbls/d)



Source: IEA, ING Research

It has been a year of increased volatility in oil markets, with OPEC+ cuts, US sanctions on Iran, risks around Saudi politics and concerns over the impact of a trade war on oil demand all dictating price movement. This saw ICE Brent break through US$70/bbl in the early part of the year, and the trend was clearly higher, with Brent trading above US$86/bbl in early October, as the market became more concerned about the impact of US sanctions against Iran.

However since then, the downward pressure on the market has been relentless, driven by a strong return of production from OPEC and Russia, whilst the US also increased output to record levels. To make matters worse, the US softened its stance on Iran with regards to oil sanctions, offering all key buyers waivers for 180 days. It soon became clear that OPEC+ would need to act, with the market set to see a surplus of around 1.5MMbbls/d over the first half of 2019, and this is exactly what OPEC did when they met in Vienna in December. They finally agreed that they would cut output by 1.2MMbbls/d for a period of six months, starting in January, and in doing so largely ignored requests from President Trump to maintain output at current levels. OPEC nations agreed to a cut of 800Mbbls/d, whilst non-OPEC nations who are part of the deal agreed to cut output by 400Mbbls/d.

Once again it is Saudi Arabia who is set to carry the deal and is set to reduce output by 900Mbbls/d in January from November levels – when they produced a record 11.1MMbbls/d. It was clearly in the interest of the Saudis to cut output, given that current prices are below their fiscal breakeven level of above US$80/bbl. As for Russia, they are better positioned when it comes to the oil price needed to balance their budget, with their breakeven level below US$50/bbl. As a result of this, they were more reluctant to make significant cuts, and also wanted to limit the period cuts were implemented for.

"The deal between OPEC+ members is set to be reviewed in April, which makes sense, given that this is when waivers for buyers of Iranian oil expire"

The deal between OPEC+ members is set to be reviewed in April, which makes sense, given that this is when waivers for buyers of Iranian oil expire, and so OPEC will be able to assess market conditions, and see if the US provides further waivers moving forward.

What is clear, and assuming prices strengthen from current levels, is that Russia will once again be reluctant to extend the deal. Our balance sheet suggests that as things stand, the deal will not need to be extended, with the market appearing more balanced over the second half of the year. However, the key will be how oil demand evolves, we are assuming that demand will grow by 1.4MMbbls/d over 2019, but given concerns of a slowdown in China, there could be downside to this number.

2. IMO sulphur regulations

ING take: IMO regulations should continue to be supportive for middle distillate cracks. Meanwhile, this regulation along with the structural change we are seeing in the crude oil market, should mean that gasoline cracks remain under pressure.

The deadline for the International Maritime Organization's (IMO) regulation on sulphur limits in bunker fuel is fast approaching. From 1 January 2020, ships will have to burn fuel with a sulphur content no greater than 0.5% compared to the current limit of 3.5%. This change will have an impact for not only the shipping industry, but for the global oil market, and in particular the refined products market, as demand for middle distillates increases in order to ensure ships comply with the new regulation.

The US administration tried to push for a phase in of the regulation, with concerns over supply and what it could mean for prices. However, the IMO continue to push ahead with the regulation, and as things stand, it is still set to be implemented as planned. But we can't rule out the possibility of the US administration intervening.

Shippers have several options to comply with the new regulation, firstly they could burn a compliant fuel, which should be supportive for middle distillates. Secondly, they can install scrubbers and continue to burn a high sulphur fuel oil. However, there are capacity constraints on how much of the shipping fleet can undergo an installation before the rules come into force, and also ship owners may be reluctant given it means additional yard time. Scrubber installations are likely something that we see more for new builds, rather than the existing fleet. Finally ship owners could retrofit vessels with LNG engines, however this will be costly and bunkering infrastructure around the globe will be an issue for the shipping industry, at least in the near term. We believe that at least initially the shipping industry will move towards a compliant fuel, which we estimate will lead to roughly a 2MMbbls/d increase in demand for middle distillates.

The middle distillate market over 2018 has been tight, and IMO changes will only mean further tightness. This is evident in the strength that we have seen in spot middle distillate cracks, whilst if we look at the January 2020 Gasoil/HSFO spread, it reflects the expected increase in middle distillate demand, and the collapse in HSFO from 2020.

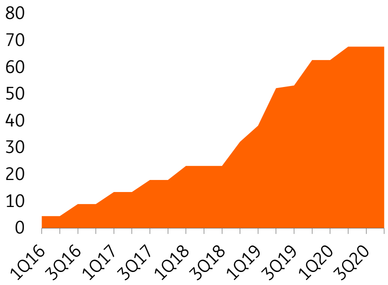
The issue for the market is more complicated. The bulk of oil supply growth that we have seen in recent years has been lighter crude oil, predominantly from the US. As a result of this, refiners are processing lighter crude oil which is yielding higher volumes of light end products, when what the market will need as we move into 2020 is larger volumes of middle distillates. Therefore, what refiners will need to do in order to ensure adequate supply is increase run rates, which suggests an increased demand for crude oil while the gasoline market will remain very well supplied. This is a trend we are already seeing- with gasoline stocks in the US remaining around the five years high.

We believe that middle distillate cracks are likely to remain well supported for the foreseeable future, whilst gasoline cracks are likely to remain weak

3. The LNG boost

ING take: The ramp up of LNG export capacity and milder weather in Northern Asia this winter, should limit the upside in LNG prices in the short term. However, longer term trends for the LNG market remain bullish.

US LNG export capacity (mtpa)



Source: EIA, ING research

Four new projects in the US including Corpus Christi, Cameron, Freeport and Elba Island are scheduled to start up in 2019. This is on top of the earlier than expected start date of train 5 at Sabine Pass and train 1 at Corpus Christi. This will increase US LNG export capacity to 62.8mtpa by the end of 2019 from the current 32.3mt pa. Besides the US, Russia commissioned train 3 at Yamal in 4Q18, nearly a year ahead of schedule with the first cargo likely in early 2019, while two more Russian LNG plants with a capacity of 2.7mtpa are scheduled to start in 2019.

Meanwhile, on the demand side, growth has been driven by China with LNG imports increasing 43% year on year to 41.6mt over the first 10 months of 2018. This strong import growth was driven by China's policy to switch household heating from coal to gas. In fact China is now the second largest LNG importer in the world, surpassing South Korea over 2017.

Looking ahead, it will likely not take too long for China to take the top spot, with current largest buyer Japan starting to see a slowdown in LNG imports as the country continues to see a ramp-up in nuclear power. Meanwhile, for China and their continued environmental push, LNG imports are set to continue growing moving forward. For US LNG exporters, the key issue comes down to trade tensions with China, US LNG currently attracts a 10% tariff. While the US share in total Chinese LNG imports increased from 6.4% in 2017 to 8.8% in 2018 YTD, more recently imports from the US have dried up with China imports from the US falling to zero in October.

> *"China is now the second largest LNG importer in the world, surpassing South Korea over 2017."*

In the short term LNG prices are likely to remain under pressure. US forecaster NOAA is currently expecting an 80% chance of an El Nino weather event over the Northern Hemisphere winter months and usually this means a milder winter for Northern Asia, reducing heating demand.

This, along with increasing LNG export capacity, should ensure adequate supply. However, in the longer term the global push to reduce carbon emissions should be constructive for natural gas demand and as a result of natural gas prices.

4. EU carbon prices set to remain well supported

ING take: The EU Commission is taking steps to remove surplus carbon allowances from the market. In January 2019, the introduction of the Market Stability Reserve should ensure this. As a result, we expect European carbon prices to continue trending higher moving forward, assuming there is no considerable slowdown in industrial activity in 2019.

2018 has been quite a year for the EU Emission Trading System (ETS), with carbon prices surging from €8.2/t at the end of 2017, to a high of €25.2/t in September 2018.

The main driver behind this rally has been a result of the upcoming Market Stability Reserve (MSR), which comes into effect in January 2019, taking excess permits off the market. The Commission has also decided that the 900m allowances that were postponed over 2014-16, and which were set to be auctioned in 2019-20, will instead be transferred to the MSR. These measures will be combined with a number of others to tackle the issue of surplus allowances.

"At current levels, carbon prices are still not high enough to see a meaningful switch towards greener energy and to levels that could help meet emission targets"

The MSR is the key change to a policy which, when it comes into force in January, will remove 265m credits over the first eight months of 2019, an annualised rate of 400m credits per year.

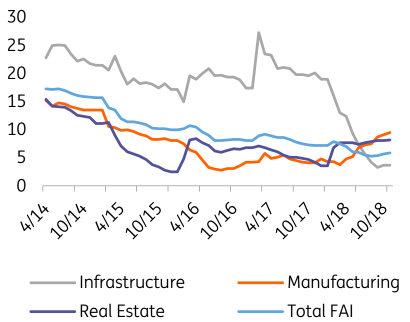
For 2019/20 (September 2019 to August 2020), allowances to be put into the MSR will be determined based on the MSR indicator report to be published in May 2019.

At current levels, carbon prices are still not high enough to see a meaningful switch towards greener energy and to levels that could help meet emission targets. Various studies indicate that EUR30/t is the real climate cost and that carbon prices should ideally match or exceed this level in order to be an effective policy tool to reduce emission. We believe that European policies are likely to be aimed at pushing prices towards this level.

5. Trade concerns and copper

ING take: Trade concerns have weighed heavily on copper prices, however, we continue to believe that the outlook for copper remains constructive, and expect prices to trend towards US$7,000/t by the end of 2019.

China fixed asset investment (YoY%)



Source: NBS

A key theme for 2018, and which is very likely to dominate 2019, is the ongoing trade war between China and the US. Earlier this year, the US announced tariffs on US$250bn of goods imported from China (25% on US$50bn goods and 10% on US$200bn goods). In retaliation China imposed tariffs on US$110bn worth of US goods. This has put immense pressure on copper prices with them down 17% since their peak in June.

Despite trade talks appearing to move in the right direction following the G-20 summit, the copper market has seen little in the way of a relief rally. Chinese data continues to weigh on the market. The Chinese manufacturing PMI has trended lower since May and in fact the reading for November put manufacturing activity on the cusp of contraction. Meanwhile it is a similar story when looking at new export orders, which have been in decline since May, and in contraction since June.

The market will be focusing on how trade talks evolve, with both China and the US agreeing to hold off from imposing additional tariffs for a 90 day period whilst they try to work towards a deal.

Failing to reach a deal within this period will clearly not be positive for sentiment which would likely put some immediate pressure on the copper market. The other key data point that the market will be watching is whether we see a pick-up in Chinese infrastructure spending. As of yet there has been no significant increase, but the bulls are pinning their hopes on a pick-up.

"The fundamental outlook for the copper market remains constructive"

Sentiment aside, the fundamental outlook for the copper market remains constructive. LME inventories continue to edge lower, and have in fact fallen almost 70% from its peak of 388kt in March this year. Chinese refined copper imports remain robust, part of this is a result of a crackdown on scrap imports, and the government will become even stricter on the import of scrap over 2019, which should be supportive for refined copper imports moving forward.

The refined copper market is set to see marginal deficits over the next couple of years and these are only expected to grow larger post-2020. How large these deficits are mainly depends on how bullish one is on electric vehicle penetration rates.

6. Gold and central bank policy

ING take: Growing uncertainty over global growth, volatile equity markets and risks increasingly skewed to less than expected rate hikes by the US Fed, suggests further upside for gold prices over 2019.

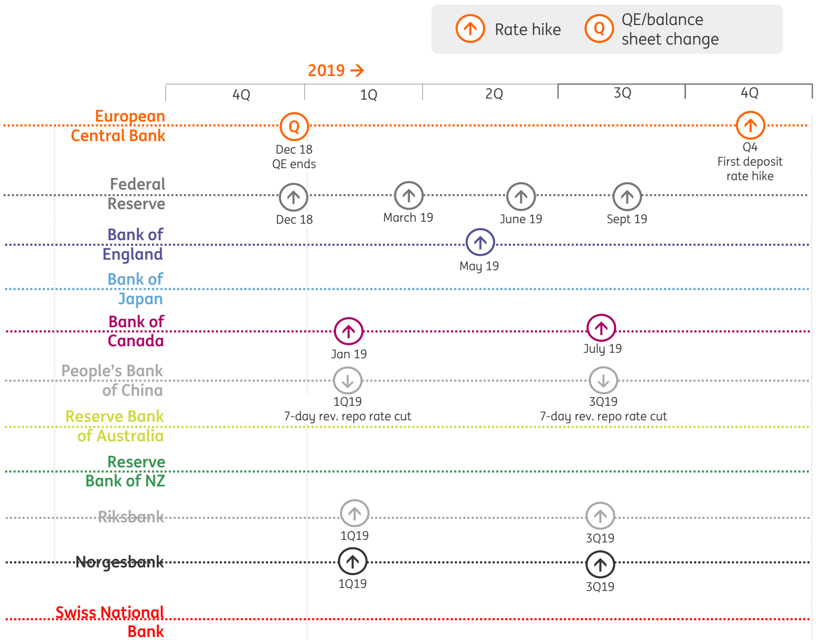
It has been clear that over 2018, a stronger USD and tighter monetary policy from the US Fed has provided little support to the precious metals complex, including gold. Moving forward, central bank policy is likely to continue to dictate the direction for gold prices.

Expectations are that the Fed will continue with its path of higher rates, however there is growing uncertainty over how many hikes we could see next year. While policymakers acknowledge that they are getting close to neutral policy, our US economist believes that policy is still some way off from being restrictive. ING is currently forecasting two rate rises next year but with plenty of uncertainty, largely related to trade.

Other factors which could see the Fed take a pause in their policy are some early signs of a slowdown, particularly in the US housing market, whilst the recent volatility in equity markets also supports this view. Finally, while the Fed is independent, President Trump has made it clear that he is not happy with the current path of higher rates, which only adds to uncertainty over Fed policy moving forward.

Growing uncertainty over global growth, and the increasing risk that the US Federal Reserve is approaching a neutral policy suggests that there is upside to gold prices over 2019. We are currently forecasting that gold prices will average US$1,270/oz next year.

Fig 1 ING Policy rate forecasts

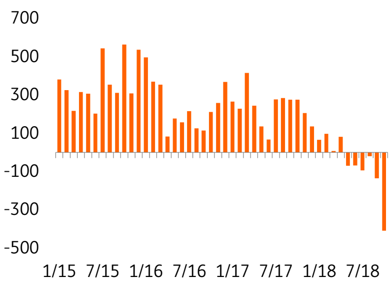


Source: ING

7. Sanctions overshadow the aluminium market

ING take: The US decision to lift Rusal sanctions has removed a significant amount of uncertainty in the aluminium market, with flows to continue uninterrupted. However, despite this, we remain optimistic regarding LME aluminium with expectations of another ex-China deficit.

China alumina net imports (000 tonnes)



Source: China Customs

After extending the deadline for Rusal sanctions multiple times since the first announcement in April 2018, the US administration has decided to lift sanctions on the company following an agreement with Oleg Deripaksa, which will see him reduce his stake in the company. The sanctions will be removed in 30 days, unless Congress blocks the deal. We believe that the market was already expecting an agreement, with LME aluminium trading below US$2,000/t, down from a peak of US$2,500+ in April 2018 despite tight supplies. Whilst sanction relief has put some immediate downward pressure on the market, we feel this will be short-lived. Even with Rusal supplies remaining unaffected, the ex-China market is set to remain in deficit.

We think that aluminium prices are undervalued given the deficit environment, rising production costs and constrained raw material supplies. While we have seen an increase in ex-China smelting capacity in 2018, which is expected to continue into 2019, we still see a significant ex-China deficit next year as demand grows. True, Chinese exports can help offset part of this deficit, but it will have to be in the form of semis, with an export tax ensuring the export arbitrage is firmly shut for primary aluminium.

“Whilst sanction relief has put some immediate downward pressure on the market, we feel this will be short-lived. Even with Rusal supplies remaining unaffected, the ex-China market is set to remain in deficit”

Furthermore, there are concerns about the alumina market. Alunorte, the largest alumina refinery in the world, continues to operate at 50% capacity, Hydro is hoping that operations will return to full operations over the course of 2019, however this will depend largely on when they receive government approval. As a result of this, the alumina market is likely to remain tight. China will try to fill the void as they have demonstrated in 2018, turning from a net importer to a net exporter of alumina. However, winters cuts will likely limit exports over the winter months.

A tighter alumina market along with weaker aluminium prices means that smelter margins are under pressure. This is sending the wrong signal to smelters – given the deficit outlook, margins should be at levels which encourage an increase in throughput rates or capacity extensions – something that is unlikely at current levels. Therefore we believe that aluminium prices need to trend towards US$2,300/t by the end of 2019.

8. Potential palladium substitution

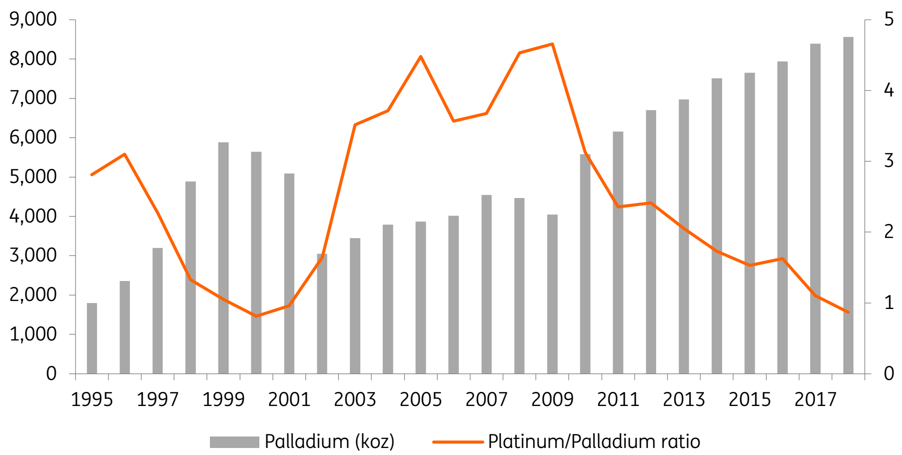
ING take: Given the deficit outlook for 2019 and the slow switch from palladium to platinum by the auto industry, we expect palladium prices to remain well supported over 2019

The star performer from the metals complex this year has clearly been palladium – the metal has become relatively more expensive than platinum as the year has progressed, with the platinum/palladium ratio standing at 0.64 at present, down from over 1.9 in early 2016. Meanwhile more recently, palladium has also become more expensive than gold for the first time since 2002. The key driver in this strength has been growing demand from the auto sector with stricter pollution standards in China increasing the amount of palladium used in auto catalysts. The trend of falling diesel vehicle sales in Europe has only added to the bullish sentiment for palladium which is used in gasoline vehicles. In Europe, the share of diesel vehicle sales has fallen from 55.7% in 2011 to 44.4% at the end of 2017.

Theoretically, given the strength in palladium, vehicle manufacturers could substitute palladium with platinum. However, this is unlikely to be a quick process with manufacturers wanting to ensure that this trend is set to remain before making such a switch. If we look back to the last time palladium traded at a premium to platinum, it did seem to take some time for it to have a significant impact on palladium demand. In 2000 the platinum/palladium ratio averaged 0.81, with palladium demand for auto-catalysts totalling 5.64moz, palladium remained at a premium over 2001, but it was only in 2002 that we saw a 45% decline in palladium demand from the auto-catalyst sector. Given this long lead time to substitute and the fact that the palladium market is set to be in deficit yet again over 2019, prices should remain well supported.

The key downside risk is whether we see a swift move towards platinum in auto-catalysts, although more concerning would be a slowdown in vehicle sales in China.

Fig 2 Auto-catalyst palladium demand



Source: Johnson Matthey, ING Research

9. US soybean acreage reduction

ING take: Trade talks between the US and China are key for planting decisions of US farmers. However, assuming no quick fix, soybean prices should remain weak pushing farmers to plant competing crops.

Soybeans have been the poster child for the trade war between China and the US.

CBOT soybeans were at one stage down almost 24% from their highs seen in early March as Chinese buyers shunned US soybeans, given the additional 25% tariff they attract. As a result Chinese buyers turned increasingly towards Brazilian soybeans.

The issue for the US is that China is the largest consumer of soybeans, making up a little over 30% of global consumption, whilst in terms of global trade China makes up in the region of 60-65% of this. In the 2016/17 season, which was before the escalation in trade tensions, China bought a little over 36mt of US soybeans. So far this season they have only bought 340kt of US soybeans.

Recent media reports suggest that Chinese buyers are returning to the US market, following trade talks at G-20. However, given we are at the low point of Brazilian supply, it was always expected that China would have to turn to the US for some supply. China will have to step up massively as a buyer in the coming weeks if it is to narrow the big gap to previous years. We believe this is unlikely as long as the 25% tariff on US soybeans remains in place.

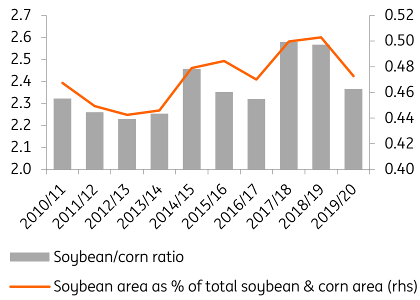
The other issue for the soybean market is that the US is currently harvesting what is expected to be a record crop, and so with the disappearance of China as a key buyer, soybean inventories in the US are building up. The EU has stepped up as a big buyer of US soybeans this year – driven by market dynamics rather than politics as some might suggest. The USDA estimates that US soybean ending stocks for the 2018/19 season will total 26m tonnes, leaving the US with stocks to use a ratio of 43%.

‘Farmers will need clarity fairly soon on how trade talks are evolving and whether tariffs on US agricultural products will be removed. This is because farmers will be starting to make planting decisions for 2019 and as things stand, we believe that farmers will switch a large area from soybeans to corn.

This is also what the soybean/corn ratio is signalling to farmers. In the USDA’s long term projections, they are estimating that soybean planted area in the US will decline by more than 7% in 2019 to 82.5m acres, with farmers switching to competing crops, such as corn.

“In the USDA’s long term projections, they are estimating that soybean planted area in the US will decline by more than 7% in 2019 to 82.5m acres, with farmers switching to competing crops, such as corn.”

US grains price ratio

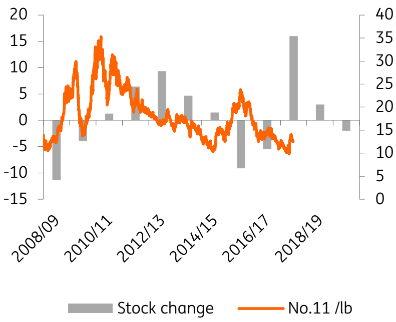


Source: Bloomberg, ING research

10. Global sugar market tightens

ING take: The global sugar market is set to tighten, returning to deficit in 2019/20, driven by falling crop prospects in a number of regions. However, before then the market will have to deal with the threat of a significant amount of Indian sugar making its way on the world market.

Sugar stock change (m mtrv) vs No. 11



Source: FO Licht, Bloomberg, ING Research

2018 has been a year of downward pressure for the sugar market, with No.11 prices trading below USc10/lb in September for the first time since 2008. A large surplus driven by strong production from India, the EU and Thailand weighed on the market, whilst weakness in the BRL only added further pressure.

However, as we have approached the end of the year, a recovery in the BRL, poorer yields in CS Brazil and expectations that the 2018/19 global surplus will be smaller than initially expected has seen the market rally. We are constructive towards the market, given the expectations of a smaller surplus in 2018/19, and with it looking increasingly likely the market returns to deficit in 2019/20.

However in the near term, we believe that there could be a bit more downward pressure. Indian producers are currently harvesting the 2018/19 crop, with peak supply expected in 1Q, and this is when we would expect a significant volume of Indian sugar to threaten the world market. Assuming sugar output of 31.5mt over 2018/19, this would leave India with a domestic surplus of around 5.5mt, adding to the 7mt surplus from last season. Given the subsidies provided to farmers and mills, we would expect exports to total around 5mt over the course of the 2018/19 season.

Looking beyond 1Q19, the picture does look more bullish. CS Brazil producers are set to begin harvesting their 2019/20 crop in April, and expectations are that we will see another season of strong cane allocation towards ethanol, at the expense of sugar production.

"The global sugar market is set to tighten, returning to deficit in 2019/20, driven by falling crop prospects in a number of regions."

In Europe, a hot and dry summer hurt yields for the current 2018/19 crop, while low prices are likely to see farmers reduce 2019 sugar beet plantings, leading to a further decline in EU sugar output over the 2019/20 season.

The other growing risk is the increasing likelihood of an El Nino weather event over the northern hemisphere winter. US forecaster NOAA expects that there is an 80% chance of an El Nino weather event. Drier weather over Southern Africa, South East Asia and South Asia are usually associated with such an event. This does mean the potential for lower yields from these growing regions over 2019.

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