

Commodities Remain Weighed Down by Dour Macro Sentiment, Stronger Dollar

- Raw material prices have disconnected from fundamentals and commodity contracts remain depressed by the combined weight of deteriorated macro sentiment and a stronger US dollar.
- The potential that the US-China trade dispute slows Chinese industrial activity is the largest risk currently informing negative commodity market sentiment; we continue to expect that fears will subside through summer's end as trade progress is made and that additional Chinese stimulus will help lift prices back to where most were back in early June.
- Despite mixed but still encouraging economic fundamentals, commodities are currently being driven by bets that growth will be derailed and speculative shorting has recently reached all-time highs for commodities like copper, which is typically seen as a bellwether of the global industrial cycle.
- The outlook for Western Canadian oil market access was dealt a significant blow when the Federal Court of Appeal voted to overturn the approvals for the Trans Mountain Pipeline Expansion, citing insufficient First Nations consultation and a lack of consideration for tanker activity in the environmental assessment.

Raw material prices have disconnected from fundamentals and commodity contracts remain depressed by the combined weight of deteriorated macro sentiment and a stronger US dollar—the origins of which are discussed more fully in [July's report](#). Scotiabank's Commodity Price Index fell by 0.7% m/m in July mainly on weakness in the metals sub-index. Further tariffs and the subsequent hit to Chinese manufacturing activity (chart 1), uncertainty regarding Beijing's policy balance between deleveraging and stimulus, emerging market financial stress, as well as a material boost to the US dollar have all conspired to put a brake on the gains made by commodities over the past two and a half years. Base metal prices—down by more than a fifth since mid-June—continue to absorb the brunt of the headwinds, but oil's march forward also appears to be slowing on demand concerns and gold is trading below \$1200/oz for the first time since late-2017 on a stronger greenback. While there are signs that materials-intensive activity is slowing, the global economy remains strong and economic growth broad based, and we expect commodity prices to recover through the end of the year.

FOCUS ON BEIJING: TIME FOR STIMULUS?

China, which accounts for the more than half of global demand for most industrial materials, is always a key focus of concern. Chinese construction activity, a major driver of metals demand, was already easing (chart 2) thanks to Beijing's deleveraging efforts (see more on China's economic pivot [here](#), pg 1–2). Now manufacturing is also slowing thanks to the mounting US tariffs, and domestic equity markets are reflecting the strain on exporters. Policymakers in Beijing are now faced with a choice between 1) maintaining the current deleveraging bias in the interest of long-term stability, or 2) offsetting the drag of US tariffs with

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Chart 1

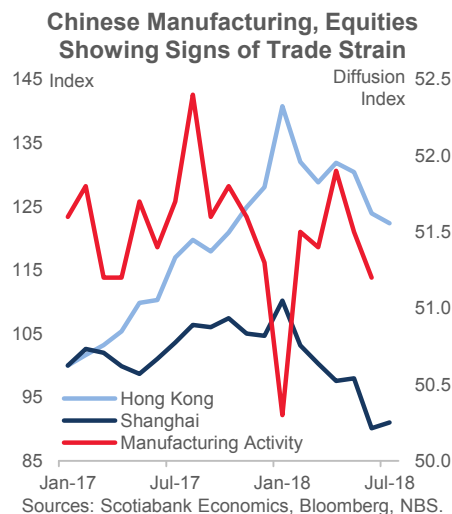


Table 1

Scotiabank Commodity Price Index			
July 2018	(% change)		
	MM	Y/Y	YTD
All Commodity*	-0.7	13.6	12.7
Industrials	-0.7	19.4	14.5
Oil & Gas	5.0	29.6	16.8
Metal & Minerals	-4.8	5.6	5.1
Forest Products	-3.0	26.6	28.2
Agriculture	-1.1	-8.4	4.7
	January 2007 = 100		
	2018		
	Jul	Jun	YTD avg.
All Commodity	120.9	121.7	121.3
Industrials	118.9	119.7	118.6
Oil & Gas	100.1	95.4	95.6
Metal & Minerals	117.3	123.2	125.4
Forest Products	173.4	178.8	167.1
Agriculture	131.5	132.9	136.4

* Weights: Oil & Gas (39.9%), Metal & Minerals (30.1%), Forest Products (14.7%), Agriculture (15.3%); Full technical note on page 7.

renewed stimulus out of perceived short-term necessity. While the timing of any stimulus response is uncertain, the Chinese government has plenty of resources at its disposal to mitigate tariff impacts and provides a powerful backstop for Chinese resource demand—especially given that stimulus would likely boost traditional sectors like construction and infrastructure, which are equally if not more metals-intensive than manufacturing.

Spurts of stimulus are reappearing already, but the unpredictability of the trade negotiations with the White House makes it difficult for Beijing to commit to a more robust policy package. The US-China trade war remains the most serious threat to the global demand for commodities, and despite the self-defeating nature of the White House’s mercantilist brouhaha it is unlikely that the conflict will be resolved anytime soon. Unfortunately, the fate of the economic outlook increasingly comes down to a tug-of-war between rationality and personality, with the latter having the recent advantage. However, even with a trade war raging in the background, we believe that global growth will remain resilient. Mining companies are putting forward a similar thesis, with the world’s largest miner saying that while trade disputes have increased the risks to economic momentum, they do not rise to a “recessionary level shock” to the global system.

Emerging market strain beyond China’s borders is concentrated in Turkey and Argentina, both of which present idiosyncratic risks not representative of the broader asset class (chart 3). We expect that fears will subside through summer’s end as progress is made on the trade file and that additional Chinese stimulus will help lift prices back to where most were back in early June.

PRICE WEAKNESS REMAINS DRIVEN BY SPECULATIVE BETS THAT GROWTH WILL SLOW, BLUNTING FUNDAMENTAL SIGNALS

Despite mixed but still encouraging economic fundamentals, commodities are currently being driven by bets that growth will sour. Prices have been driven lower more by speculative shorting than by weakness in spot purchases, and the overextended short position—the largest ever in COMEX copper contracts (chart 4)—makes it likely that any future price recovery is likely to be sharp and abrupt as shorts are eventually covered. BHP Billiton warned its investors that “downside risks have increased” alongside seemingly endless trade disputes. While trade disputes aren’t a “recessionary level shock,” they have dented the broad-based and synchronized global growth that has underpinned metals prices over the past two years.

Macro headwinds are blunting signals from commodity-specific fundamentals. Copper’s summer was supposed to be filled with intrigue related to labour contract turnover at major Latin American mines, but resolution of negotiations at Chile’s Escondida mine, the world’s largest single source of copper, failed to budge copper prices distracted by the latest trade negotiation leak. It will take a major development to shake this macro cloud hanging over commodity prices, most likely something related to the US-China trade dispute or firm direction on renewed Chinese stimulus.

While most financial press ink has been spilled in service copper’s rout, zinc’s performance has been even less inspiring. Since hitting an 11-year high of more than \$1.60/lb in February, prices of the metal used primarily in the galvanizing of steel has fallen by more than a third to two-year lows of little more than \$1/lb (chart 5). Zinc’s bull run was fed by fears of supply shortages, but those high prices are now seen as

Chart 2

Chinese Construction Activity Was Already a Drag on Materials Demand

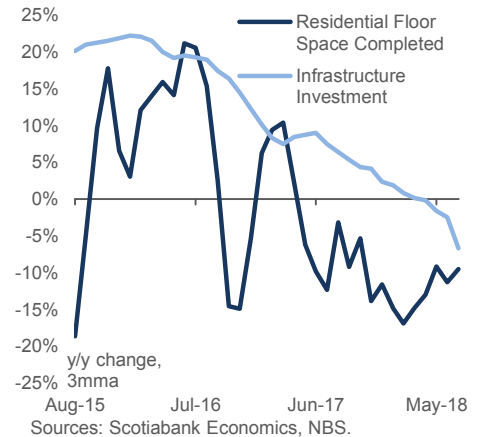


Chart 3

EM Pain Concentrated in Turkey and Argentina

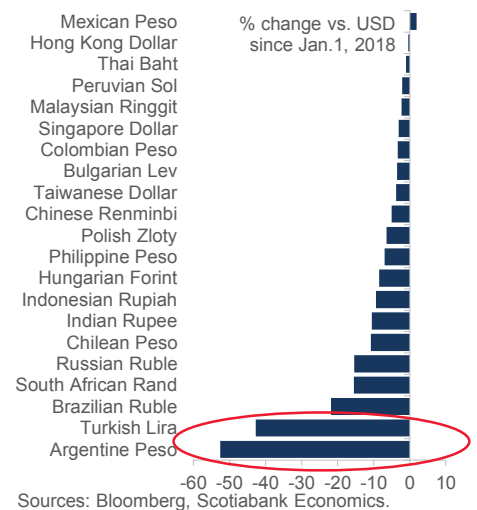
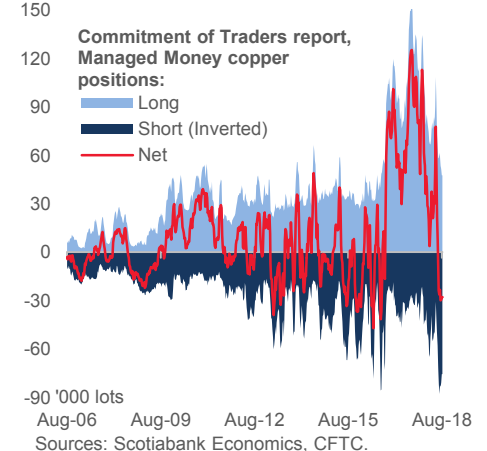


Chart 4

Record Spec Short Copper Position On Bets That Growth Will Slow



having done their job of incentivizing new mine supply investment. Demand for the galvanizing material has also waned on the back of China's slowing construction sector and US steel tariffs. Adding to zinc's fundamental concerns, bearish technical signals are providing validation for the bears taking the price lower. While zinc fundamentals have certainly slipped slightly from their early-year tightness, we believe that zinc's current rout is overdone and prices are likely to bounce with the rest of the base metals complex.

OIL TRADING SIDEWAYS WHILE FUTURE OF WESTERN CANADIAN OIL MARKET ACCESS DARKENS ON TRANS MOUNTAIN RULING

Crude, too, is being held back on macro and demand growth fears, though it was reported earlier this week that Iranian oil shipments have fallen faster than many market participants had expected. The WSJ report indicates that Iran expects its exports to fall by a third in September to 1.5 MMbpd from 2.3 MMbpd in June. A loss of ~800 kbpd, if sustained, is nearly double what [we had expected](#) back in May when it was announced that the US was withdrawing from the Iran nuclear deal. As expected, the main cause of shipment declines is not that countries don't want to purchase Iranian oil—China, the EU, etc. have stated a desire to figure out work-arounds to avoid US restrictions—but rather that banks, insurance firms, and shipping companies are increasingly unwilling to finance, insure, and transport Iranian crude for fear of running afoul US rules.

Back home, the outlook for Western Canadian oil market access was dealt a significant blow when the Federal Court of Appeal voted to overturn the approvals for the Trans Mountain Pipeline Expansion Project (TMEP). The court ruled that the government failed in its duty to properly consult First Nations groups along the pipeline's rout and took issue with the absence of consideration for associated tanker traffic in the National Energy Board's environmental impact assessment. This news comes after the discount suffered by WCS—Canada's primary heavy crude export benchmark—blew back out to above \$30/bbl on a combination of Midwest refinery weakness, Syncrude's operational return, and weaker-than-needed rail performance (chart 6). We are operating on the knife's edge of takeaway capacity limits out of Western Canada and even small movements in production, refinery demand, or rail activity can easily push discounts \$10/bbl higher over a week. However, given that oil-by-rail economics are broadly profitable at discount levels above \$18–20/bbl, movement materially above that level are expected to be temporary as rail providers move to monetize the transportation arbitrage. Given a typical discount of \$13–15/bbl in times of sufficient takeaway capacity, the latest TMEP ruling likely extends the period of sub-optimal WCS discounts—linked to breakeven oil-by-rail economics (\$18–20/bbl)—by at least a year.

Chart 5

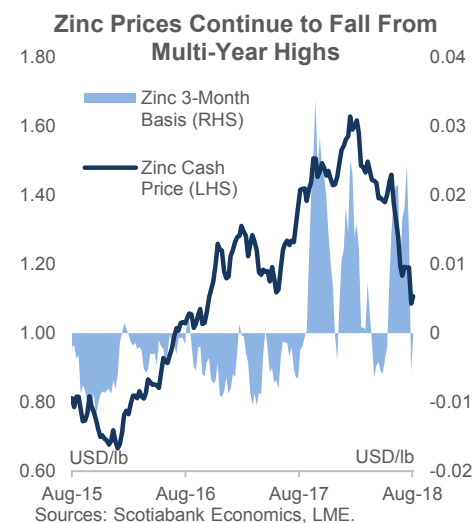
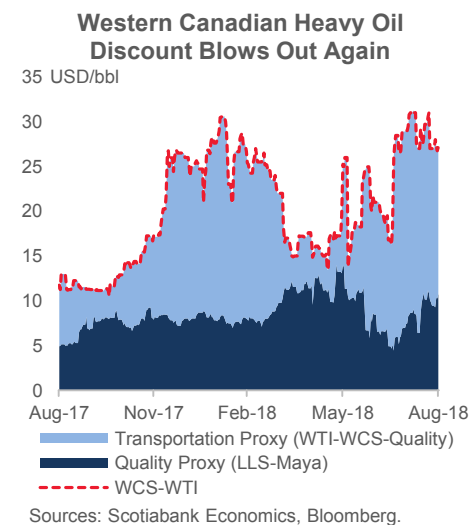
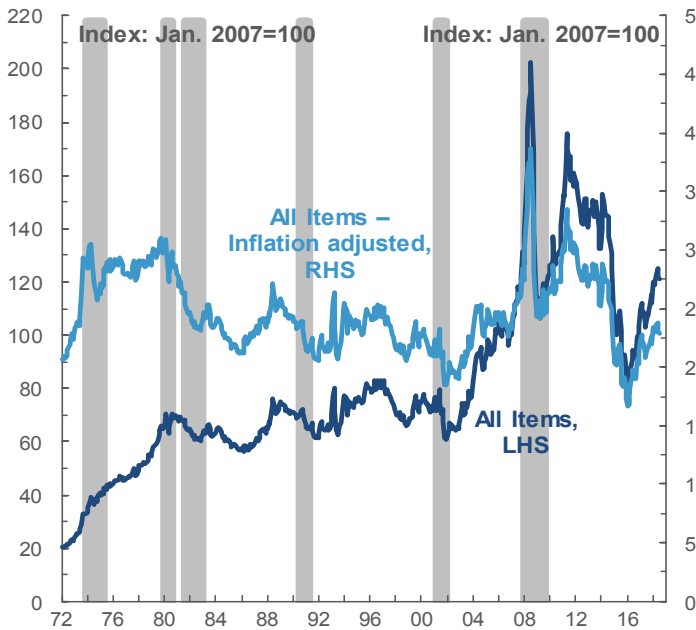
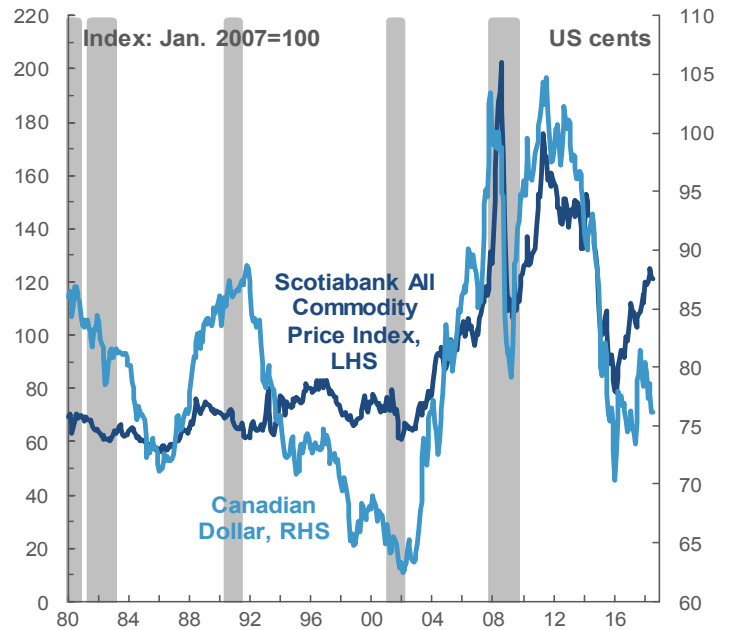
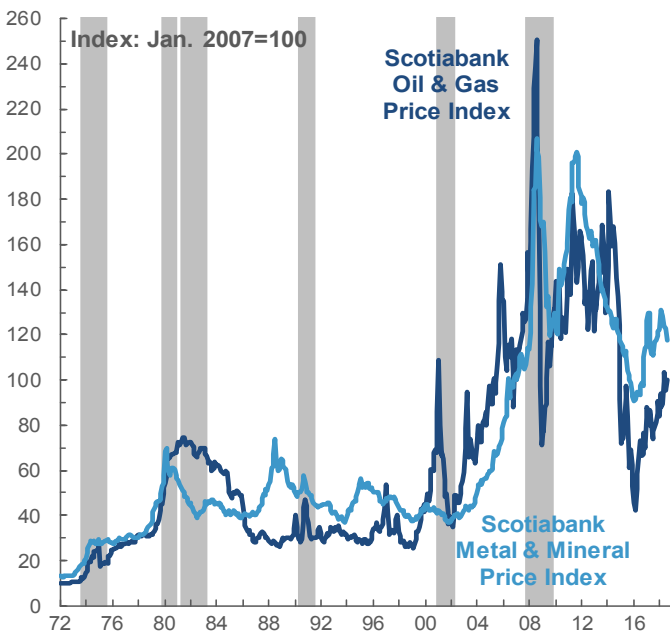
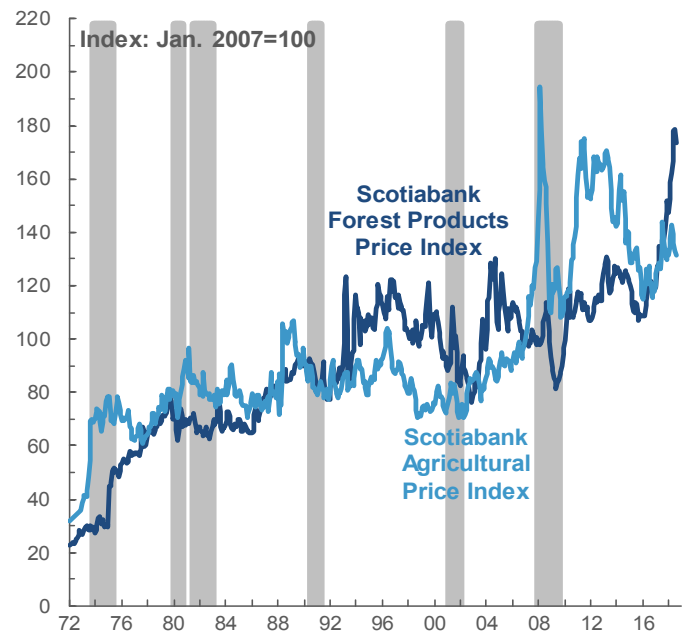


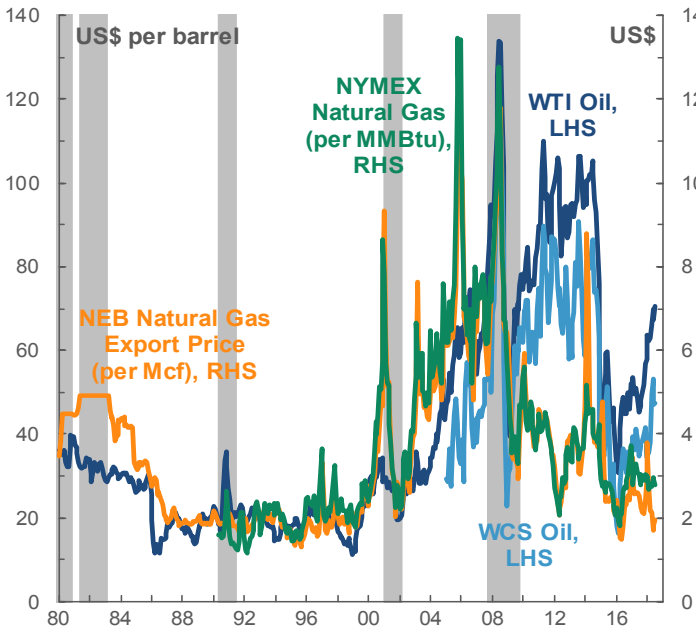
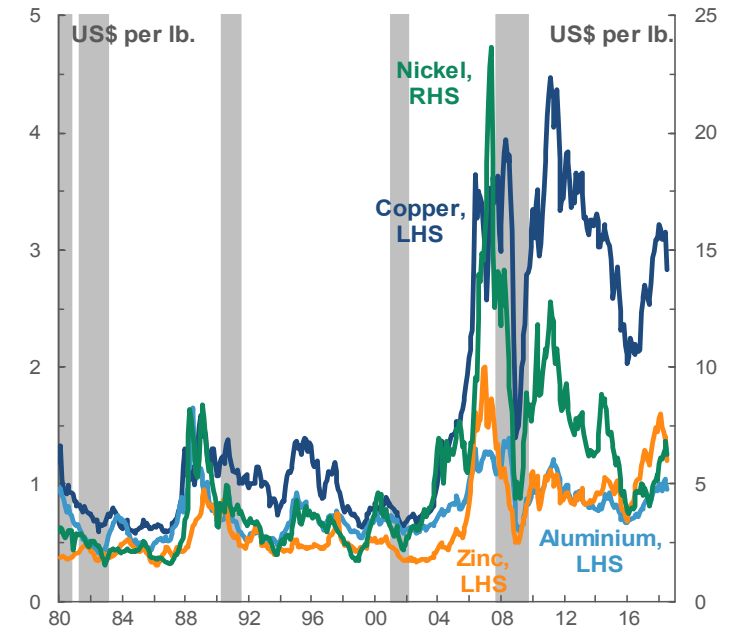
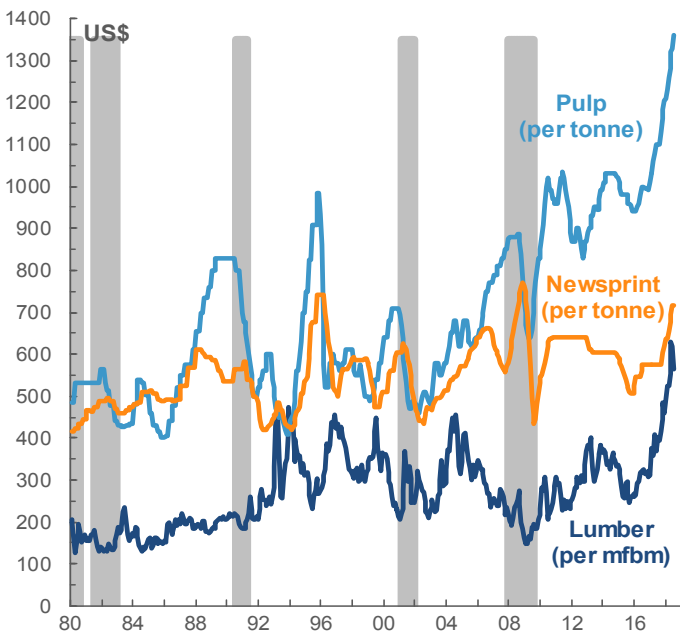
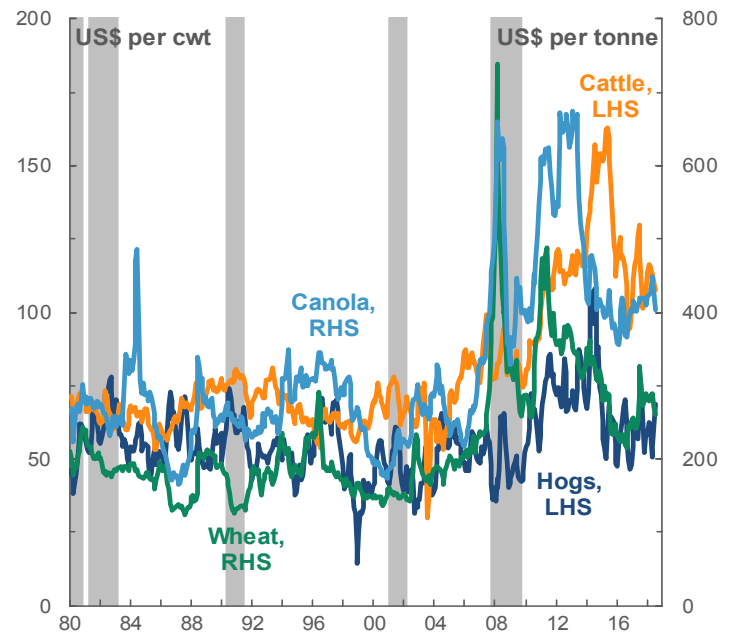
Chart 6



Price Outlook		2000–2016			2017	2018ytd	2018F	2019F
		Monthly Avg. Low	Period Avg.	Monthly Avg. High				
Oil & Gas								
Crude Oils								
West Texas Intermediate	USD/bbl	19.40	62.70	134.02	50.85	66.33	68	71
North Sea Brent Blend	USD/bbl	19.06	65.53	134.56	54.75	71.85	74	77
WCS - WTI Discount*	USD/bbl	-42.50	-16.85	-5.50	-12.74	-22.71	-23	-23
Natural Gas								
Nymex Henry Hub	USD/MMBtu	1.81	4.94	13.46	3.02	2.84	2.93	2.90
Metals & Minerals								
Base Metals								
Copper	USD/lb	0.62	2.35	4.48	2.80	3.05	3.10	3.25
Nickel	USD/lb	2.19	7.26	23.67	4.72	6.27	6.50	7.00
Zinc	USD/lb	0.34	0.81	2.00	1.31	1.41	1.45	1.45
Aluminium	USD/lb	0.58	0.86	1.39	0.89	0.99	0.95	1.00
Bulk Commodities								
Iron Ore	USD/t	27	108	302	72	69	63	60
Metallurgical Coal	USD/t	39	127	330	188	203	190	160
Precious Metals								
Gold	USD/toz	261	869	1,772	1,257	1,295	1,311	1,300

* 2008-16 average.

Scotiabank All Commodity Price Index

Canadian Dollar vs. Commodity Prices

Scotiabank Oil & Gas and Metal & Mineral Indices

Scotiabank Forest Products & Agricultural Indices


Oil & Gas Prices

Metals Prices

Forest Products Prices

Agricultural Prices


Technical Note
**Scotiabank Commodity Price Index — Principal Canadian Exports
January 2007 = 100**

This Index has been designed to track the spot or transactions prices paid in U.S. dollars for key Canadian commodities and resource-based manufactured goods in export markets. The weight of each component is based upon its net export value in 2010. Prior to January 2007, the weight of each component was based on its export value in 1995-97, except for crude oil & refined petroleum products, uncoated freesheet paper and linerboard, where net exports were used. Canada imports a significant quantity of these products, and use of their export value alone would have overstated the importance in Canada's trade performance.

The following prices are included:
OIL & GAS

Crude Oil & Refined Petroleum Products (US\$ per bbl) MSW light sweet crude oil at Edmonton (previously Edmonton Par crude) and Western Canadian Select heavy oil at Hardisty, Alberta; price differentials off WTI near-by futures from Bloomberg.

Natural Gas (US\$ per mcf) Average export price quoted by the National Energy Board.

Natural Gas Liquids (NGLs – Propane, Butane, Ethane & Pentanes-Plus) (US\$ per bbl), Propane at Edmonton & Sarnia.

METALS & MINERALS

Copper & Products (US\$ per lb) LME official cash settlement price for grade A copper.

Zinc (US\$ per lb) LME SHG cash settlement: prior to Sept 1990, U.S. producers' price for high-grade zinc delivered.

Lead (US\$ per lb) LME official cash settlement price; prior to Jan. 1991, U.S. producers' price for common grade delivered.

Aluminium & Products (US\$ per lb) since 1979, LME official cash settlement price.

Nickel (US\$ per lb) since 1980, LME official cash settlement price.

Gold (US\$ per oz) 'LBMA Gold Price PM' as of March 20, 2015.

Potash (US\$ per tonne) Standard potassium chloride, spot price, FOB Vancouver.

Sulphur (US\$ per tonne) Solid, spot price, FOB Vancouver.

Metallurgical Coal (US\$ per tonne) Contract price for premium-grade hard coking coal, FOB Vancouver.

Iron Ore (US cents per dmtu) Spot price fines 62% Fe, CFR Qingdao, China; prior to Jan 2011, term-contract price for concentrates 66% Fe from Labrador/Quebec to Northern Europe (FOB Sept-Iles).

Uranium (US\$ per lb) U₃O₈ near-by-futures from Bloomberg.

Molybdenum (US\$ per lb) since March 1992, MW dealer oxide.

Cobalt (US\$ per lb) MW dealer price.

FOREST PRODUCTS

Lumber & Wood Products, Western Spruce-Pine-Fir 2x4 No.2 & Btr (US\$ per mfbm) FOB mill.

Oriented Strandboard (US\$ per thousand sq. ft.), U.S. North Central region, 7/16 inch.

Pulp, Bleached Northern Softwood Kraft (US\$ per tonne) Transactions price, delivery USA.

Newsprint (US\$ per tonne) Average transactions price, 48.8 gsm, delivery Eastern USA.

Groundwood Specialty Papers (US\$ per ton) Supercalendered-A paper, 35 lb., delivery USA.

Linerboard (US\$ per ton), delivery Eastern USA with zone discounts.

AGRICULTURE

Wheat & Flour (US\$ per tonne), DNS No 1 14% protein Duluth, Minn; prior to April 2011 No.1 CWRS, 13.5% protein at St. Lawrence.

Barley (US\$ per tonne), since Dec.1994, No.1 at Lethbridge, Alberta.

Canola & Oilseeds (US\$ per tonne) No.1 Canada, in store Vancouver.

Cattle & Beef (US\$ per cwt) Steers over 1,051 pounds at Toronto; from Jan 1993, Ontario average.

Hogs & Pork (US\$ per cwt) 100 Index Hogs at Toronto; from Jan 1993, Ontario average.

Fish & Seafood (US\$ per lb) West Coast silver coho salmon; Atlantic lobster prices; prior to 1986 cod fillets & blocks.

**Scotiabank Commodity Price Index —
Components And Weights**

Index Components	Net Export Value In 2010 (millions of dollars)	Index Weight (per cent)
OIL & GAS INDEX	46,537	39.90
Crude Oil & Refined Products	33,231	28.49
Natural Gas & LNG	11,741	10.07
NGLs	1,565	1.34
METAL & MINERAL INDEX	35,109	30.10
Copper	3,160	2.71
Zinc	1,255	1.08
Lead	579	0.50
Aluminium	6,045	5.18
Nickel	4,246	3.64
Gold	4,678	4.01
Coal	4,757	4.08
Iron Ore	3,346	2.87
Potash	5,161	4.42
Sulphur	457	0.39
Uranium	891	0.76
Cobalt	288	0.25
Molybdenum	246	0.21
FOREST PRODUCTS INDEX	17,081	14.66
Lumber & Wood Products	4,673	4.01
OSB	812	0.70
Pulp	6,818	5.85
Newsprint	2,734	2.34
Groundwood Spec. Papers	1,971	1.69
Linerboard	87	0.07
AGRICULTURAL INDEX	17,901	15.35
Wheat & Flour	4,693	4.02
Barley & Feedgrains	1,088	0.93
Canola & Oilseeds	5,398	4.63
Cattle & Beef	1,640	1.41
Hogs & Pork	2,378	2.04
Fish & Seafood	2,704	2.32
TOTAL INDEX	116,643	100.00

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