Copper — 50% of the trade war discount has now been unwound

CONTACTS

Nicky Shiels
Commodity Strategist (Metals)
212-225-6724
Commodities Derivatives

nicky.shiels@scotiabank.com

Copper prices broke out of its comfortable $5800-$6300 range last week, in a move that seemed to pre-empt Trumps announcement this weekend to delay the trade deadline (March 1st) since "progress" has been made; that helped to fuel rallies across trade– sensitive assets this week , in the yuan (now through 6.70), Shanghai Comp (up a staggering ~7% in 2 session) and extending last weeks Copper gains through psychological $6500.

The below provides some thoughts on both Coppers drivers, incorporating some fundamentals and the macro.

In summary: Inventories plunged and spreads backwardated to coercively inject a strong technical break higher driven by largely macro flows. While inventory stock changes can be smoke & mirrors (that will be put to test given increasingly volatile spread action), price action in outright 3m and its technical close this week (as we face up to Chinese data/PMIs*), is important. A hold above old-resistance levels (~6300) fairly argues for the next higher range being $6300-$6600 as trade war fatigue and a dovish Fed support being long deficit metals with inflationary (less so growth) exposure. Just as macros were blamed for spoiling coppers party last year, don't underestimate additional *tactical* rallies within (as outlined in our FICC piece) as price action puts it back on the map. Similarly, there is a risk that Copper unwinds recent "trade-on" optimism flows, but arguable not enough to sustainably hold < $6300

Trade War discounts:

- Since the US administration first announced large tariffs on Chinese goods in June 2018, Copper prices fell ~$1500 and the yuan tested its 7 threshold (from 6.4 vs the US$). Both have (eerily) clawed back ~50% of their trade-induced discounts/weakness, in the lead up to the original March 1st deadline.
- The U-turn in price responses during typical trade negotiation periods is worth noting: Copper has recently been trading bid in the lead-up to this March 1 deadline, which contrasts with its price action in the early stages of the trade dispute (June'18-Dec'18) in which it was in sell-the-rally **mode** (E.g.: in the lead up to G-20 in November). **This set-up risk indicates pre-emptive flows is creating a classic "sell the news" event — in which most trade-sensitive risk assets (Including SPX, Cu) could unwind if some deal is finally announced or when trade progress drags out further, all else equal (a Fed pause and China PMIs <50).**
- Clearly there are other micro, technical and positioning drivers outlined below that could explain the change in Coppers attitude, ranging from the macro perception that the Fed will let the (global) economy run a little above their inflationary target, to tighter balances and stock drawdowns, to the tendency for assets to overshoot; its certainly not sustained Chinese growth (more likely the perception that a GDP bottom is nigh).

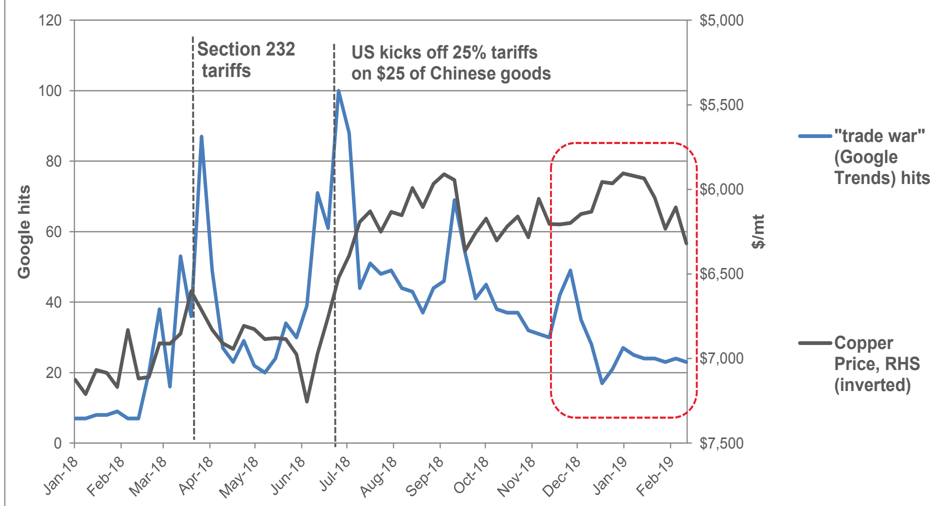
While Economists argue that Chinese Jan/Feb data should be overlooked (due to CNY distortions), the "old Copper" would internalize any bearish data updates. We're looking for a change in tune and response to highlight/confirm suspicions of fresh participation.

8months into a trade dispute with no deal, 50% of the trade discounts erased

Source: Scotiabank Commodities Strategy, Bloomberg

LMCADS03 Comdty (LME COPPER 3MO ($)) copper cnh shcomp Daily 26FEB2018-26FEB Copyright© 2019 Bloomberg Finance L.P. 26-Feb-2019 10:34:54

Copper: trading "trade policy" with worst case outcome/fear being priced in sub $6300

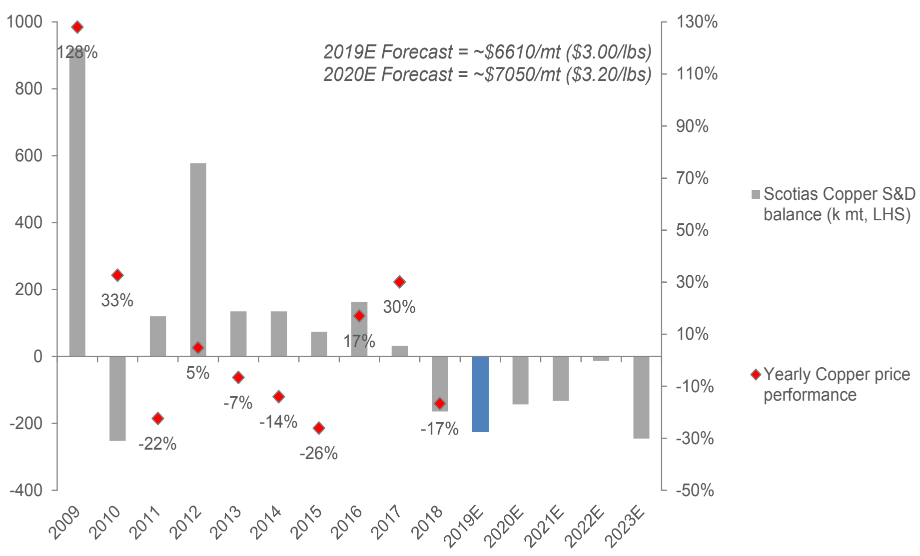


Source: Scotiabank Commodities Strategy, Bloomberg, Google Trends

Micro / physical: some incremental updates

- On warrant LME inventories plunged 70% in 2days to the lowest since 2005 has been the well cited spark for Coppers outperformance. With the LME now holding only less than 30K mt of deliverable tonnes, the market has plenty of questions around both the LMEs ability to maintain an orderly/functional market (theres some talk around the threat of a short covering) given that there are now 3 known dominant holders of both warrant and cash/tom holdings equivalent to 50-90% of stocks*. Last week, Copper spreads (cash-3mo) spiked to almost $60 back as shorts covered, providing further bullish tailwinds to the tightening market thesis.
- CME inventories have also persistently fallen the past 9months, some of which is attributed to the large CME-LME arb that opened last year, attracting metal to LME warehouses instead.
- In contrast, Chinese physical premiums are weakening; Yangshan copper premium has drifted lower to $60/ mt, matching Q2'2017 lows and Shanghai stocks are up ~120k mt in 5weeks (seasonably usual as this is a low spot for manufacturing given CNY)
- Supply side updates and risks announced last week**, was enough to fit any bullish argument despite most updates having yet to actually reduce balances, outside of Glencore (who provide an "updated mine plan" at its Mutanda copper operation in the DRC which would reduce output by 100kt/year and). Scotia has a 226k deficit for 2019E which is updated on quarterly basis.
- **Overall, spreads, less so outrights, should continue to be increasingly volatile until the point (steeper backwardations vs current levels) where surplus metal is attracted back to exchange.** Recall, exchange stocks can fall (and swing!) to mislead—in 2017, LME flows were changing hands multiple times a year at a rate of ~1.5m mt in days...

Copper balances vs performance - no strong correlation between surplus (deficits) and associated price falls (rallies)



Source: Scotiabank GBM (Equities Metals & Mining) estimates, Bloomberg

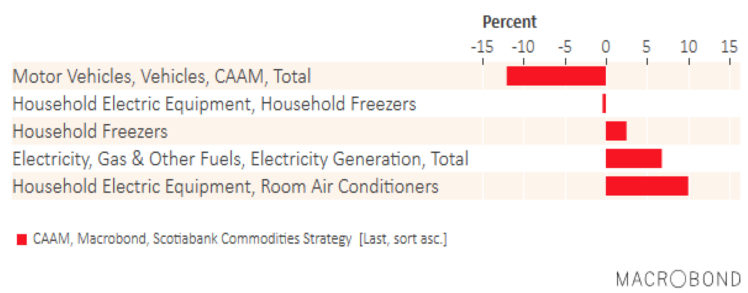
Macro: China

- Stimulative efforts are piecemeal, measured and stabilizing, not a shot in the arm like stimulus packages seen in 2009/2010 and or 2015/2016. The mix of fiscal, monetary & infrastructure measures is working through the economy, with many expecting a pickup in actual manufacturing activity (from the sub 50-contractionary prints seen in both December & January) only in 2H'18; however, Copper—a favorite amongst macro world in expressing turns in the Chinese economy and/or inflationary outlook—is forward looking and doesn't seem to be not awaiting for a data confirmation of stimulus.
- Auto sales are is the outlier sore print across key demand sectors, outweighing some mildly bullish effects from power (the State Grid is largely expected to increase spending in 2019), and construction (housing starts pickup last year to feed through).

Macro: ex China:

- Theres signs of manufacturing weakness (which is being offset by up-tick in services component) all across Europe, in US and parts of Asia. Global manufacturing PMI is hanging onto 50.7 from the "synchronized" global growth peak of 54.4 in Jan 2018.
- However, the Feds convincing rate pause in January has provided the greenlight for financial conditions globally to loosen. This has fueled a re-commitment to under loved, cyclically low real assets (Nickel, Copper, Zinc, Platinum) this year by the less fundamental but rather large (passive, macro) participants, as they search for yield within the commodities space (see positioning showing strong inflows)

Chinese Macro demand indicators for Copper



**recall these % positions are measured against the overall low headline stock figures, so aren't huge on notional terms.*
***supply concerns that fit the bill 1). Freeport Indonesia failed to obtain new copper concentrate export permit, 2) restart order of Vedanta copper smelter overturned by Indian Supreme court, 3) a nationwide truckers strike in Peru hit food and metal cargoes, 5) Chiles Lumina Copper's Caserones mine was charged with using too much water*

Technicals:

- **The chart shows a resistance ceiling extending back to March 18, which arguably was a harbinger of both producer and those trade-off / "sell-the-rally" systematic flows**. Technicals always should be respected when they mark a change in sentiment and daily price action, thus with old resistance now convincingly broken, its arguably the next new support level which needs to be confirmed/tested.
- In addition, broader macro indexes (e.g.: BCOMIN Index and COPX ETF) and highly levered producers (e.g.: Lundin & First Quantum) have also persuasively bottomed and now are confronting and broken through key resistance levels (200DMA) which hasn't gone unnoticed by large generalist community. Daily Moving Averages are the simplest (and 1 of many) technical indicators, but when the crowd follows, one should be mindful...

Positioning:

- Overall, investor positioning, across all dominant exchanges (SHFE, CME & LME) own a cumulative ~13.7m mt of Copper. These inflows (presumably since OI was associated with price increases) grew from 5year cyclical lows at <12m mt seen earlier this year. **Overall positioning remains somewhat neutral here**
- The strong "inflows" into HG (arguably the most systematic and macro) vs LME as it outperforms this year is noteworthy. Net managed money was still running a net short (of ~18k contracts) as of Feb 5th*, and helps to explain the subsequent move; for average HG positioning to be regained, 410K mt of Copper had to be bought back over the last 3week timespan, arguably most of which has been 'fulfilled' (given the price action and a fall in Agg OI).
- Copper upsides: Theres been significant purchases of options across LME (expiring next week) & CME (expiring the end of March), as investors search for defined risk plays for upside exposure layering into the $6300, $6400 & $6500s strikes as the strike map highlights. **There are however, no strong strike 'magnets' above $6500 in the near-term**

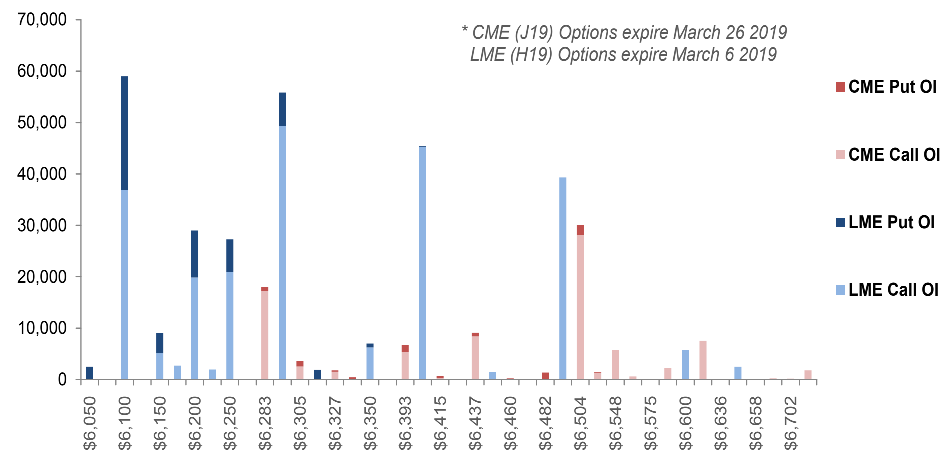
*COT only covers data up until Feb 5th (when HG was $2.80), given the government shutdown.

Coppers technical breakup/out through old resistance / new support

Source: Scotiabank Commodities Strategy, Bloomberg

LMCADS03 Comdty (LME COPPER 3MO ($)) copper tech old res new Daily 22FEB2017 Copyright© 2019 Bloomberg Finance L.P. 26-Feb-2019 11:47:33

Option Pull? Aggregate Open Interest expiring within the next month* - - few upside targets



Source: Scotiabank Commodities Strategy, LME, CME, Bloomberg

The information contained in this presentation is being provided for information and discussion purposes only. An investment decision should not be made solely on the basis of the contents of this presentation. This presentation is being provided upon the express understanding that no representation or warranty, express or implied, is made, or responsibility of any kind accepted, by The Bank of Nova Scotia, Scotiabank Europe plc, or any of their respective affiliates ("**Scotiabank**"™), their directors, agents or employees with respect to the completeness or accuracy of the information, conclusions and opinions provided herein, or as to the achievement or reasonableness of any projections, targets, estimates, or forecasts and nothing in this presentation should be relied upon as a promise or representation as to the future. Past performance or simulated past performance is not a reliable indicator of future results. Forecasts are not a reliable indicator of future performance.. This presentation has not been prepared (i) by a member of the research department of Scotiabank, or (ii) in accordance with the legal requirements designed to promote the independence of investment research. It is considered a marketing communication for regulatory purposes and is solely for the use of sophisticated institutional investors. This presentation does not constitute investment advice or any personal recommendation to invest in a financial instrument or "investment research" as defined by the UK Prudential Regulation Authority and the UK Financial Conduct Authority, and its content is not subject to any prohibition on dealing ahead of the dissemination of investment research.

The information contained in this presentation reflects prevailing conditions and our judgment as of the date of the presentation, all of which are subject to change or amendment without notice, and the delivery of any such amended information at any time does not imply that the information (whether amended or not) contained in this presentation is correct as of any time subsequent to its date. Scotiabank undertakes no obligation to update or correct any information contained herein or otherwise to advise as to any future change to it. Scotiabank does not provide any applicable tax, accounting or legal advice and in all cases independent professional advice should be sought in those areas.

This presentation incorporates information which is either non-public, confidential or proprietary in nature, and is being furnished on the express basis that this information will not be used in a manner inconsistent with its confidential nature or be disclosed to anyone other than as may be required by law or to those who have been informed of the confidential and proprietary nature of this presentation. This presentation and its contents are strictly confidential to the person to whom it is delivered and may not be copied or distributed in whole or in part or disclosed by such persons to any other person without the prior written consent of Scotiabank. This presentation and the information contained herein remain the property of Scotiabank.

This presentation is not and shall not be construed as an offer, invitation, recommendation or solicitation to sell, issue, purchase or subscribe any securities or bank debt in any jurisdiction or to enter into any transaction. Nothing in this document contains a commitment by Scotiabank to sell, issue, purchase or subscribe for financial instruments, or securities, to provide debt or to invest in any way in any transaction described herein, or otherwise provide monies to any party. Any participation by Scotiabank in any transaction would only be provided in writing after satisfactory legal, financial, tax, accounting and commercial due diligence, as well as being subject to internal approval processes. Any transaction implementing any proposal discussed in this document shall be exclusively upon the terms and subject to the conditions set out in the definitive agreement related thereto.

This presentation is not directed to or intended for use by any person resident or located in any country where the distribution of such information is contrary to the laws of such country. Scotiabank, its directors, officers, employees or clients may currently or from time to time own or hold interests in long or short positions in any securities referred to herein, and may at any time make purchases or sales of these securities as principal or agent. Scotiabank may also have provided or may provide investment banking, capital markets or other services to the companies referred to in this presentation.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable. Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including Scotia Capital Inc., Scotia Capital (USA) Inc., Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Designated Activity Company; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank Group and authorized users of the mark. The Bank of Nova Scotia is incorporated in Canada with limited liability. Scotia Capital Inc. is a member of CIPF. Scotia Capital (USA) Inc. is a registered broker-dealer with the SEC and is a member of the NASD and SIPC. The Bank of Nova Scotia is authorised and regulated by the Office of the Superintendent of Financial Institutions of Canada. Scotia Capital Inc. is authorised and regulated by the Investment Industry Regulatory Organization of Canada. The Bank of Nova Scotia and Scotiabank Europe plc. are authorised by the UK Prudential Regulation Authority. The Bank of Nova Scotia is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Scotiabank Europe plc is regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia 's regulation by the UK Prudential Regulation Authority are available upon request. Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.