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

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 ~$1500 and the yuan tested its 7th threshold (from 6.4 vs the US$). 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 preemptive 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.
8 months into a trade dispute with no deal, 50% of the trade discounts erased

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

Source: Scotiabank Commodities Strategy, Bloomberg, Google Trends

US kicks off 25% tariffs on $25 of Chinese goods

Section 232 tariffs

"Trade war" (Google Trends) hits

Copper Price, RHS (inverted)

Source: Scotiabank Commodities Strategy, Bloomberg, Google Trends
Micro / physical: some incremental updates

- On warrant LME inventories plunged 70% in 2 days to the lowest since 2005 has been the well cited spark for Copper 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 (there is 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 9 months, 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 5 weeks (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 ~1.5mt in days...

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-contractory 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 waiting 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:

- There is signs of manufacturing weakness (which is being offset by uptick in services component) across all 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: There has 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.
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