

Base Metals Q2 Update: a focus on Copper & trade tariffs —where to now

What a difference May made; most base metals reverted and are trading near the bottom end of YTD ranges (Ali, Lead, Tin), or near 1 month lows (Copper, Nickel, Zinc) in sharp contrast to Q1s performance. It took the U-turn on May 10th, when trade talks between the US and China fell apart, to show up that genuine physical demand does not offset any supply difficulties, for now. The immediate effect on global risk assets around May 10th was rather muted, given other smaller offsetting trade headlines & developments*. However, what sealed it for Copper—as usual, still the preferred macro expression for any growth-sensitive geopolitical developments—was the ugly concoction of tit-for-tat tariff raises corporate blacklisting's and threatening dialogue (see timeline in graph 1). This rupture between 2 superpowers is growing in both scope (from targeting the trade of goods & upending supply-chains, to protecting the exchange of ideas & IP) and size (\$360bn of goods are now tariffed) during a late-cycle. This naturally, only raises the threat of a global recession given its impact on demand which we've seen with a collective rollover in PMIs; Dr Copper naturally is 'required' to respond.

Copper has not only reverted back below the original key \$6300 ceiling in May (levels last associated with higher stockpiles, more equity volatility, a trade deal that was further away and slower Chinese growth), BUT below \$6000 (levels associated with imminent recession fears). Overall, Q1 was a dead cat bounce in response to dovish-inspired firming sentiment, but 1 question this piece will now explore is how much has base (proxied by Copper) over-sold, given the recent trade escalation and renewed geopolitical risks.

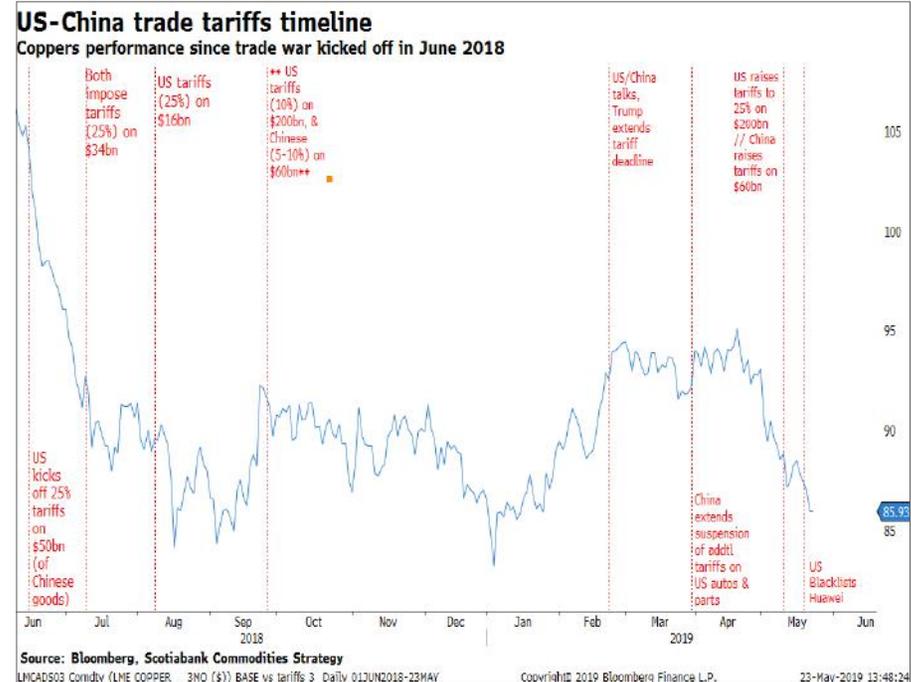
In a nutshell: If historical reactions to trade tariffs changes are any indication, Coppers repricing of 8% in May was fair in % terms, but unfair when one factors in a much lower base (vs summer 2018) and relative to other tradewar proxies such as the yuan and Chinese Equities. Copper historically shoulders most of the macro trade war risk-off flows on the way down, but cannot fully reclaim its lost ground on improving trade sentiment on the way up — \$6400 is thus the new ceiling until there is a firm and believable trade resolution. There are niggling supply-side issues which have taken a backseat given the refocus on softer demand, and are not being priced in, so while Copper remains in a 'sell-rally' mode, a cautious purchase is perhaps worth it given 1) Short paper positioning has hit extreme levels in some markets, 2) global inventories have consistently erased their inflows, suggesting spreads should tighten once/if the macro dust settles, 3) Chinese macro demand indicators show a range growth rates that seem out of sync with a 5-handle, so long as DM demand doesn't really roll over, 4) Chinas construction sector - thanks largely to the PBOCs recent stimulus package - has yet to impact Copper demand due to innate lagged effects, 5). Theres a growing belief that US and/or Chinese policy makers will respond with more easing measures

* On May 17th, Japan and the European Union were given a delay of up to 6 months to negotiate away the threat posed by their cars and car parts to the US. On May 19th, Trump declared that steel and aluminium from Mexico and Canada no longer posed a threat to America's national security, and tariffs (imposed last year) were removed.

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BACKDROP & PRICE ACTION:

Copper was able to reach the top-end of its short-term range, earmarked by \$6600 in mid April as disruptions at Las Bambas, a rebound in Chinese data (Q1 GDP print at 6.4%, PMIs above 50 from the trough of 48.3 seen in January), a decline in LME stocks and optimism stemming from CES-CO week around Coppers long-term electrification demand trends, drove prices higher. However it was a tail of 2 halves, with the second half of April and May seeing the comfortable \$6300-\$6600 range (we believed was fair) broken to the downside, and more recently, psychological \$6000 breached.

The first wave of Coppers repricing lower (through \$6300) occurred over the Asian holidays the end of April/beginning of May which sapped much needed liquidity and physical support. The reversal of the stock decline story (with LME inventories hitting 6month high pushing spreads back into contango) coincided with an increasing focus and worry over a European recession (large copper consuming countries in Europe have posted sub-50 contractionary prints) and fears of Chinese policy tightening (given their better than expected Q1 data), drove this price weakness. The 2nd more recent wave recent saw prices fall further away from \$6000 after tariffs were upped to 25% and Huawei was blacklisted; this macro derisking and a “shoot-first” mentality allowed systematic short sellers (see section...) to capitalize on the risk that this cold trade war turns into a sudden financial panic or recession.

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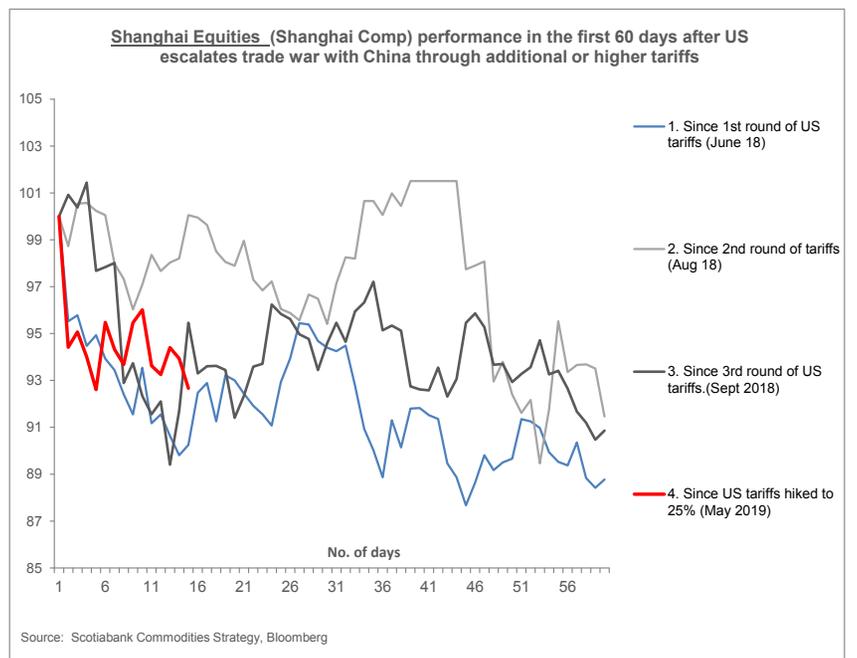
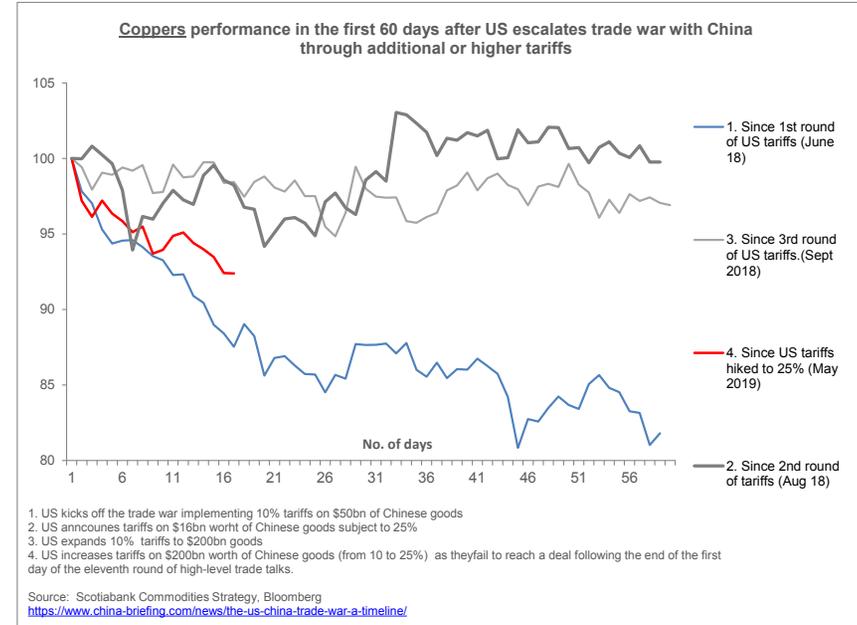


TRADE WAR: COPPERS DISCOUNT / PREMIUM

Earlier, the large Copper fall through \$6300, seemed to pre-empt the threat of further trade tariffs by the US administration on May 10th. Base metals throughout 2019 had become more immune and less reactive on an intraday basis to trade war-on/off headlines (that was left to specific agriculture markets) arguably because the complacency instituted by US and Chinese monetary policy dampened any tail-risk event of a 'no-deal'. However, the reversal in trade talks and rhetoric in the 11th hour of negotiations AND the subsequent action was completely unexpected. 2H'2018 is a useful preview and graphs on page 3 & 4 showcase the reaction in trade-sensitive assets such as the Yuan, Shanghai Comp and Copper, after each instance the US escalates trade tensions with any large tariff announcement/change. Takeaways:

1. Coppers current 8% fall in May 2019 is aligned with previous selloffs in the 20days following a trade tariff announcement, not any more. However, Coppers 20% peak-to-trough fall in June '18 was from \$7000, a much higher base, while current prices are less elevated and frothy at \$6400 (levels before the recent tariff hike to 25%). The current Copper repricing is however steeper than the 2.5% weakening in the yuan, and the 7% fall in Shanghai Composite. A lot of Coppers *relative* overextension can be explained by market constraints and the lack of any authoritative support — the yuan is not widely accessible to most investors outside China, and both the yuan and Chinese equities are subject to known (PBOC openly intervenes to support the market at a reasonable and equilibrium level) and unknown (the PBOC discreetly props up equities and sentiment in large downturns) intervention. Besides physical support in Copper, there is no real large policy prop or control level- such as an OPEC (in Oil) or Central Banks (in Gold) —available to 'intervene' when Copper prices roil lower.
2. After the 1st round of tariffs (June 2018), it took ~45 days before Copper prices stabilized, while with 2nd and 3rd round of tariffs, Copper found a floor much sooner (after about 20days). Copper prices have also never sustainably rallied above their individual levels within 60days of each tariff announcement; i.e.: Copper shoulders most of the macro trade war risk-off flows on the way down, but cannot fully reclaim its lost ground on improving trade sentiment on the way up—\$6400 is the new ceiling until there is a firm and believable resolution.
3. Overall, if historical reactions are any indication, Coppers repricing of *% in May was fair in % terms, but unfair when one factors in a much lower base and relative to other tradewar proxies; prices should be nearing a bottom. Given how content Copper was in a \$6300-6600 range when trade relations were thawing, and historical performances, we expect these very rough ranges for Copper all else equal (steady macro risk/sentiment and stable >200k mt deficit).

Trade progress: \$6200 - \$6500
 Trade escalation: \$5800 - \$6100
 Trade neutrality: \$6100—6400

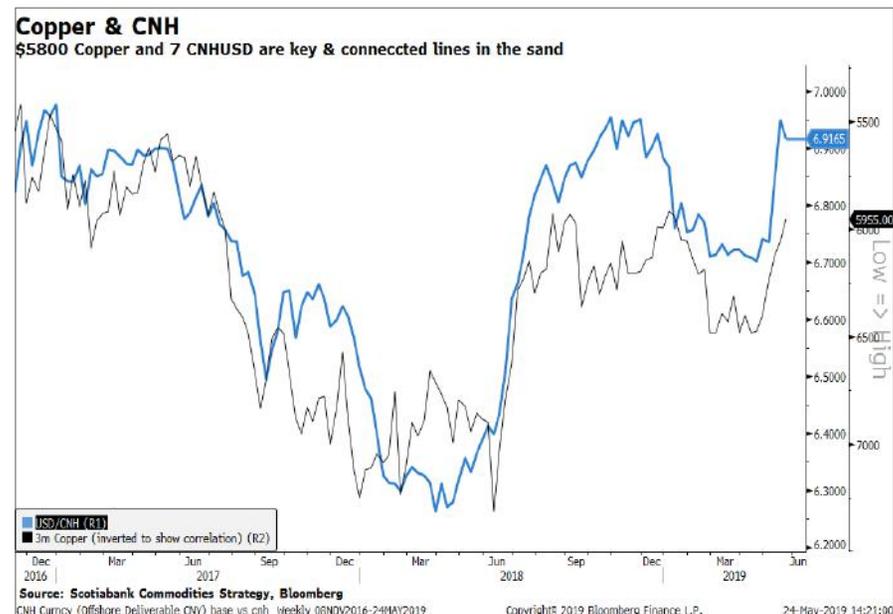
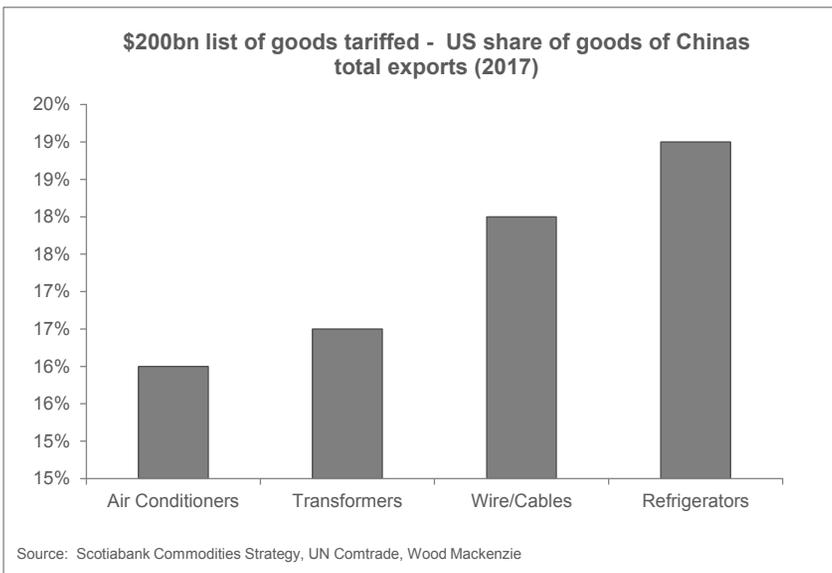
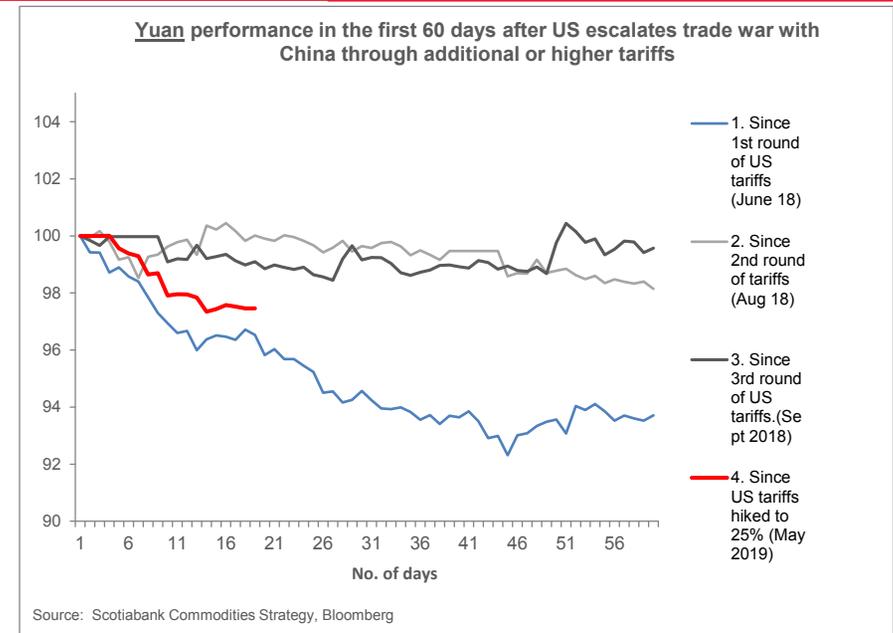


TRADE WAR: YUAN/COPPER RELATIONSHIP

The yuan has weakened again toward the all important 7-threshold, fueling speculation that China may weaponized its currency (despite affirmative talk from the PBOC that its targeting a stable currency), and or Treasuries in the trade war. If the 7-handle had to give way, it would be a step-change for global markets from a sentiment perspective; gloves would be off as not only would it squeeze US exports and risk a broad selloff in macro risk and credit, but the immensely stronger \$ would be a wrecking ball for EM and China. Very simply, the longer the market doesn't have a trade resolution, the higher the probability the CNY devalues (and the longer Copper remains pressured and in a "sell-rally" mode)

TRADE WAR: IMPACT ON ACTUAL DEMAND

The \$200bn trade tariff list does contain copper intensive products that China exports to the US (home appliances, electrical equipment etc), overall impacting 3% of Chinas copper consumption/year. Woodmac estimates that under 10% tariff, most of the copper intensive goods from China still have a cost advantage over products from other countries, making an impact on demand negligible. However, they estimate that Chinese total copper consumption will drop by 0.5% if the 25% tariff is implemented, making it a real difference to balances and one that would offset some supply disruption losses.

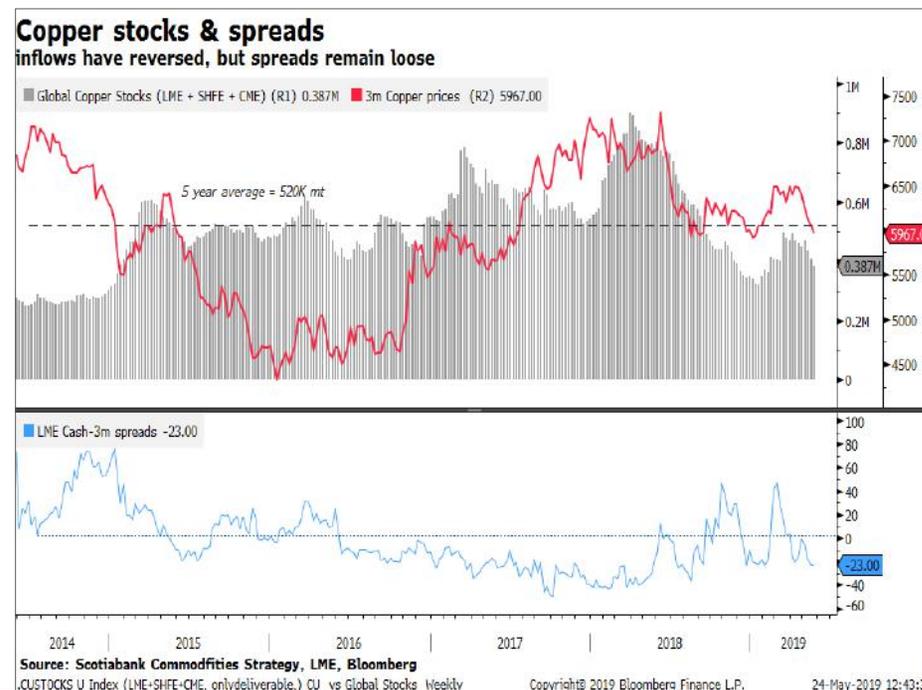


SUPPLY & INVENTORIES UPDATE:

- There's been a noted decline in both expectations and actual supply growth in Q1 (mine production fell ~2% in Q1) due to the range of supply disruption and issues (see *).
- The return of Las Bambas shipments (after indigenous communities ended 2+ month blockade of a key highway) certainly has contributed to negative sentiment or at the very least eased some concerns about tighter supplies, overhanging the market.
- Currently, market supply-side risks include the commissioning of new smelting capacity and the larger usual smelter maintenance in China, the government's stricter grips over imports of copper scrap, nationalization fears over Zambian mines (the Vedanta issue), lower Zambian output due to changes in mining tax (expected to be as much as 100K mt in 2019), Codelco wage negotiations (a 2nd final offer was presented today as workers threatened to strike if the company does not meet demands), and structural decline in output or hiccups at Codelco giant Chuqui mine as it undergoes transformation into an underground shaft mine)

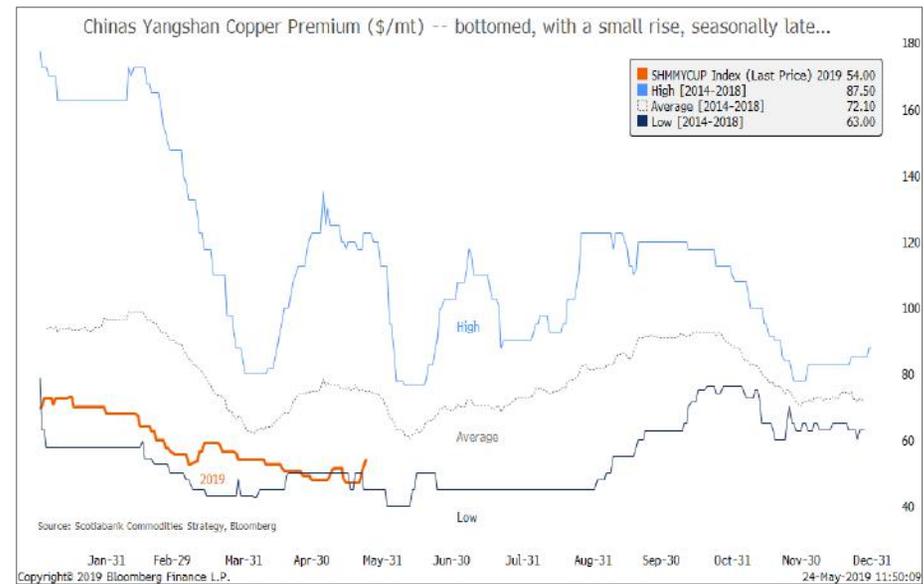
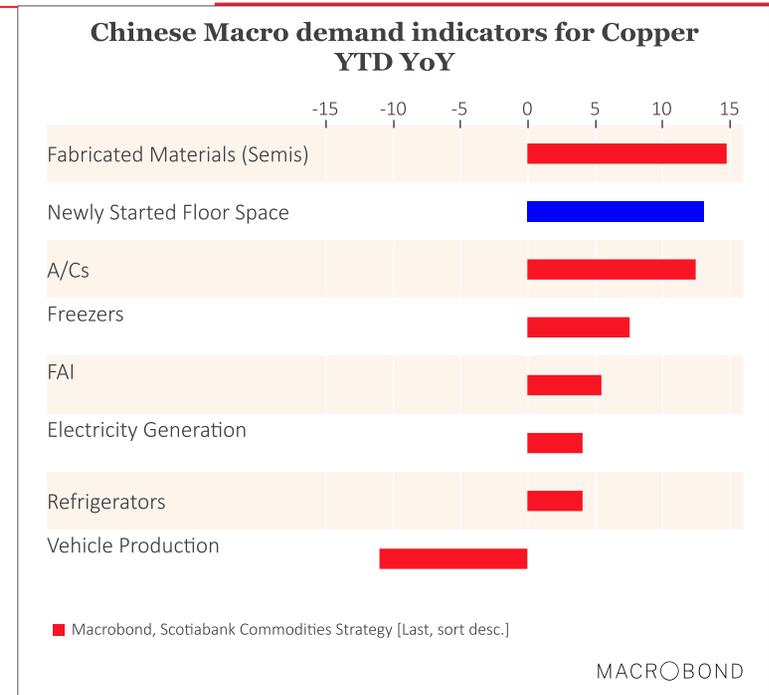
* Falling national output levels (Chile confirming Copper production in February fell to its lowest in 2 years), Weather/rainfall & v community protests in Chile & Peru (MMGs Las Bambas), ramp-up issues at Chilean operations (Caserones, Sierra Gorda, Codelco), announced production cutbacks in Africa (Glencore) and the transition losses to underground operations (Freeport/Grasberg) are some notable supply developments we mentioned in our previous note.

- The deliveries into both European and Asia warehouses in March & April, brought total global inventories up to 6 month highs, loosening spreads back and helping to sour post-CESCO week positive sentiment.
- However there's been a noted reversal in these inflows, starting in April (with SHFE falling ~90K mt, to 172K mt so) and more recently in May (with LME joining and drawing down 42K mt), while CME stocks remain on their historical lows. This has taken a gauge of global stock down below 400K mt, a key threshold we referenced in an October 2018 note which showed that spreads (cash-3s) have historically averaged \$22 back when global stocks are so low (<400k mt)
- There's been some talk of European consumers looking to maintain low inventories, which is a common (and understated) theme that can be applied to Asian consumers if the macro uncertainty persists due to trade escalation.
- Overall, but unless the conspiracy theorists are correct (there's significant above ground unknown stocks) what's visible is low (not super low), drawing and below 5 year average.



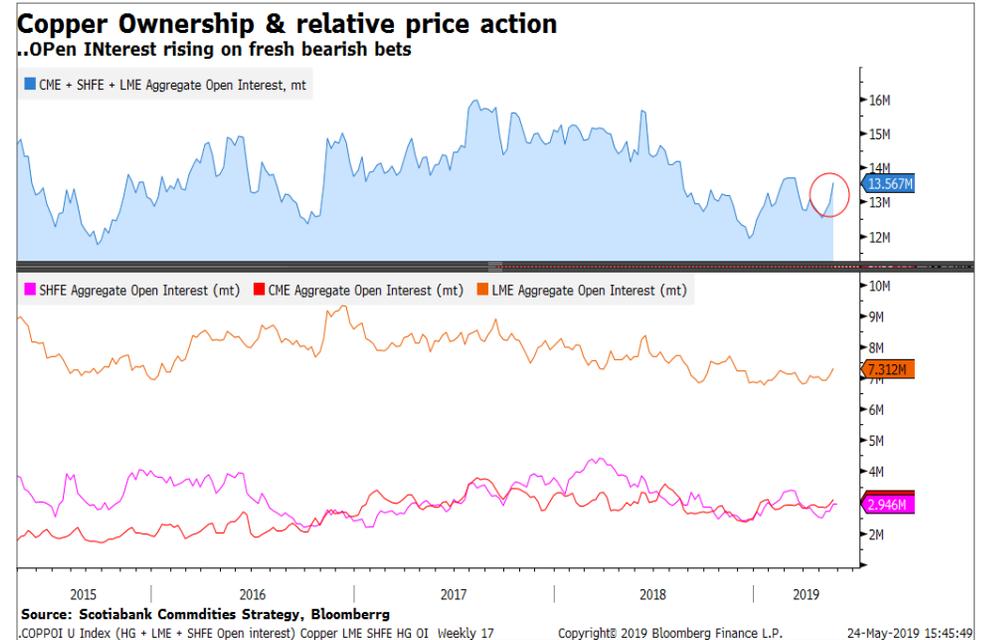
DEMAND UPDATE:

- While the market has welcomed a rebound in China's Manufacturing PMI, back up above the 50-handle (after a 3-year low of 49.2 in February), softer than expected manufacturing PMIs in the US (for May falling to 50.6) and Europe (especially Germany) suggest a fall-back in manufacturing in DM heavyweights. The repricing in oil (*why does it always take so long to take cues from Copper?*) this week highlights this concurrent roll-over in PMIs theme that plaguing macro markets
- Recent soft fundamental negative pricing in China such as persistently falling premiums & rising stocks, have started to bottom (Yangshan premiums bottoming under \$50/mt currently at \$54) or reverse (SHFE warehouse stocks have fallen ~90K mt, to 172K mt so far in Q2), as expected during seasonally stronger Q2.
- Pricing in the bulks space is booming (Iron Ore is hovering around \$100/mt) due to strong steel demand in China thanks largely to the PBOCs recent stimulus package, which targeted the old-economy of infrastructure and property. Floor space starts are up strongly (YTD up 13.1%, see graph) which is currently supporting bulk metals (they're used in 1st stage of construction) but have yet to impact Copper (and Ali) which are used toward the end of the construction cycle. That's because new property completions have been lagging starts - the construction sector will begin to impact copper demand (watch for a turn in new property completion rates) and can potentially turn into a *net* positive for Copper (offsetting the terrible weakness in the automotive sector).
- Overall, macro demand indicators range from mildly supportive (single digit growth in FAI, Electricity generation & refrigeration production) to quite constructive (double-digit growth in Freezer & AC production, production of semis and newly started floor space) - growth rates that seem out of sync with a 5-handle, so long as DM demand doesn't really roll over



POSITIONING AND TECHNICALS UPDATE:

- Since there's been a lot of focus on systematic/programmatic paper short-sellers in Copper, it's useful to very simply quantify their firepower. Over the last 2 weeks, 1m mt was added to Copper positioning across all 3 major exchanges (SHFE, CME & LME). Presumably much of this positioning is fresh shorts, given (weakening) price action.
- The majority of the bearish bets stemmed from CME/ HG participants! The smaller market (total OI is only 3m mt, more than half the size of LME) is making the biggest splash... They added 444K mt to Aggregate OI, followed by LME participants (OI increased by 384K mt), and then by SHFE (OI increased by 244K mt). That highlights and confirms how macro and systematic in the nature this repricing has been.
- A deeper dive into updated COT data (as of May 21st 2019) shows that gross speculative shorts have continued to expand bets toward historical highs. Gross short positioning now stands at 84K contracts, a triple top peak (around 90K contracts) mirroring similar 'inflows' seen in the summer of 2018 and in Jan 2019. This selling pressure was enough back then to driver HG through \$2.60; a somewhat constructive takeaway in that current HG prices (under similar firepower) have held over 4% higher.
- Technically, Copper has rolled over all key moving indicators (the 50, 100 & 200 all are converging between \$6200 & \$6300). Series of physical demand is slowly emerging around the \$5800-5900 region, but it would probably take a few closes above \$6000 to reinstall confidence and only above \$6110 (23.6% Fib retracement of the past years range) will begin to force out some last weak shorts (LME & SHFE). Note CME shorts are still well ITM, being short at an average of \$6300 since they began accumulating their positioning mid March.



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