A lot has changed between Q3'19 and Q4'19 as the global sentiment tone shifts to the idea that the "worst is over" for a global economic slowdown and U.S / China trade differences; but is this just a cyclical repricing in risk vs haven asset prices driven by a change in sentiment, or a structural regime shift that will continue into 2020?

CONTACTS

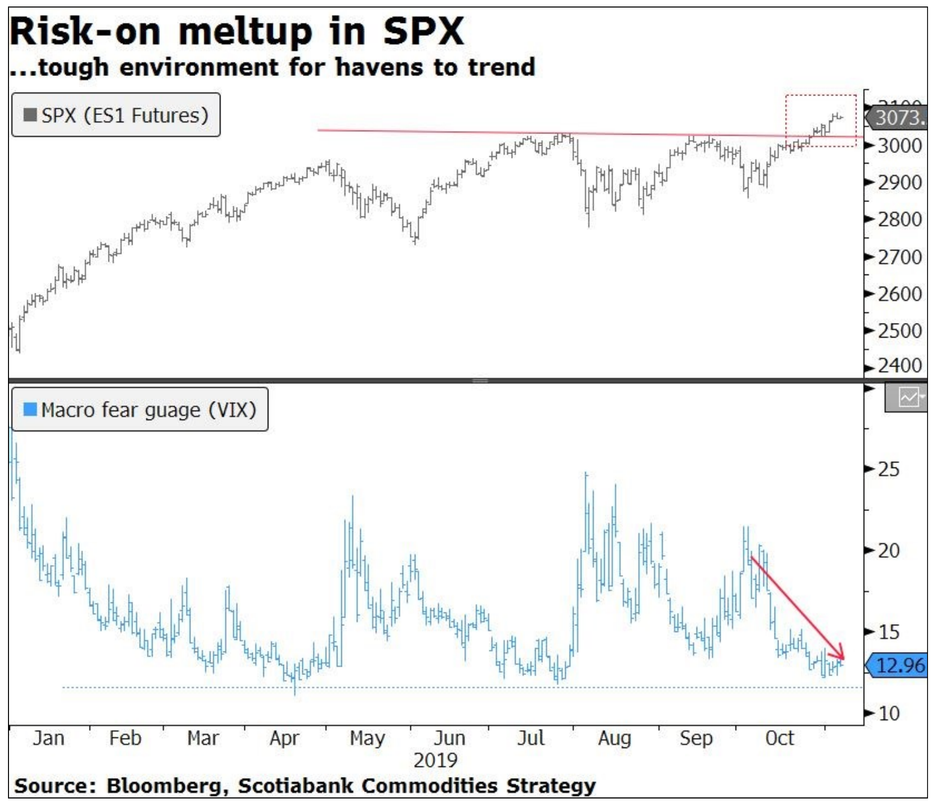
Nicky Shiels
Commodity Strategist (Metals
212-225-6724
Commodities Derivatives
nicky.shiels@scotiabank.com

Follow us on Twitter @ScotiaMetals

Theres been a mix of positive updates from trade, US data and the Fed, since recessionary fears peaked in August 2019, shown up then by the convincing repricing in havens --> Gold in multi-currencies hit record highs, US 30yr bond fell sub 2% , negative yielding debt hit $17tn and US yield curve (amongst many other indicators) flashed red. Since the announcement of some US/China 'mini' or 'phase one' deal (mid October), the momentum in 'trade hopes' has garnered a lot of support for cheap cyclical upsides into year-end, which has been the core driver for the rebound in Copper from depressing depths ($5600) and in Gold lower from recession-like peaks ($1550). Below are some big picture thoughts around this idea of a reflation reprieve into year-end, as it pertains to base (Copper) and precious metal (Gold) trends. Theres also a calendar of economic, political and trade related event risk into the final 2 months of 2019.

SUMMARY:

Theres a tangible willingness for markets to capitalize on positive data, news or trade rhetoric into year-end. However, Gold price action (a false break lower) and some other technical failures in FX (JPY at ~109.20) & rates (10yr yields still afraid of 2%), still indicates this is a tactical repricing in sentiment, and a rotation in paper positioning, not a reliable shift in fundamentals. Markets require more trade progress (phase one actually signed, clarity on auto tariff decision on Nov 17, and finalizing USMCA), further positive economic data and a clearer resolution to broader trade tensions, in order for these sentiment trends to extend.



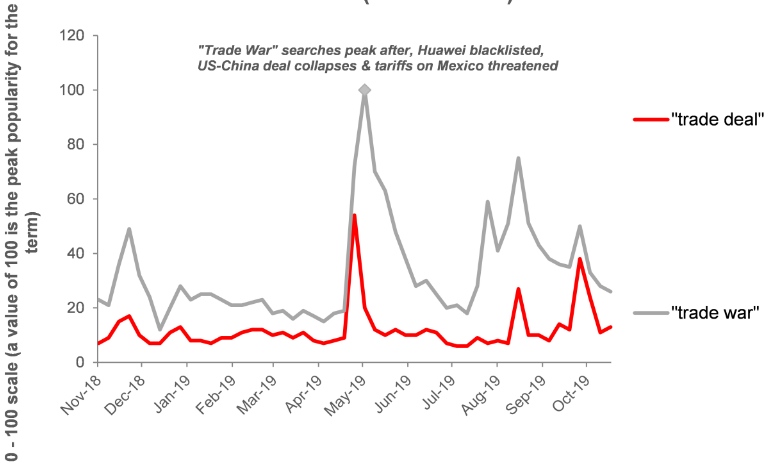
SENTIMENT & EVENT RISK: there's palpable hope and belief in a window of opportunity for a reflation bounce, especially given that event risk is either:

- Behind us: October was jam-packed with data, CB and trade event risk but risk markets emerged unscathed, with SPX having the ability to overcome major worries such as trade tariffs, a global manufacturing recession, the dead money in Big Tech / Silicon Valley disappointments, impeachment risk , repo stresses, Brexit, a Fed policy change, etc. The strong technical repricing in US stocks through an old ceiling, despite these headwinds, is being respected with markets calling for a further melt-up as complacency rolls on and macro fear remains subdued (graph 1)
- Rolled out: the Brexit deadline was extended and a friendlier divorce now more likely, with a phase one trade deal in the works (and thus potential tariffs delayed), while the Fed remains on hold. 'Deadline risk' has been extended, removing the uncertainty/fear overhanging risk markets/stocks for now.

Source: Bloomberg, Scotiabank Commodities Strategy

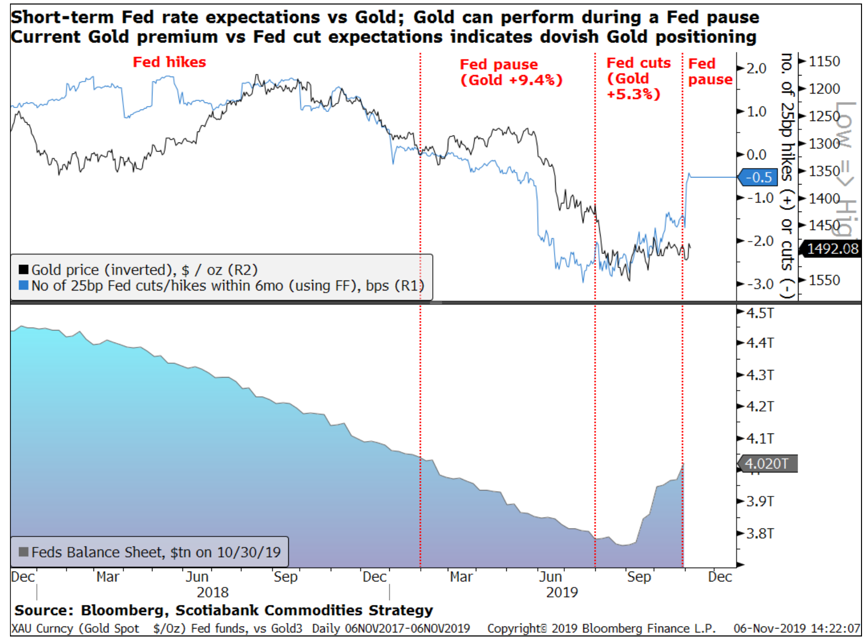
TRADE: trade optimism has swelled around persistent rhetoric for weeks now around a 'phase one' deal that is expected to be signed in mid November (news today is that the deal signing is delayed until December because discussions over both terms and venue continue). China is reportedly proposing the U.S. remove the tariffs imposed in September, theres talk of a planned US/ China opioid bust and China may issue more tariff waivers and restore agricultural purchases - efforts that would help sell the phase one deal. What has NOT yet been addressed is 1) an agreement **from both** on the location, timing and terms of the signing (after the APEC summit in Chile slated for Nov 16/17, was canceled), 2) whether trade talks will continue toward a comprehensive agreement including national security and IP issues (*i.e: phase one of how many phases?).* Overall, given the structural differences between the two sides, the base case is to expect a series of 'mini-wins' / 'mini-battles' within a broader framework of global protectionism, where theres perhaps little aggressive trade escalation into 2020 US elections, but no respite either. The tail risks --> 1) outright trade war, or 2) trade peace-- is not impossible, given 1) past top -level talks (Buenos Aires end 2018 & Osaka in summer 2019) ended with pledges of progress, but broke down immediately afterwards. 2) despite the very high unlikelihood of a comprehensive deal including intellectual property protection, markets are well aware that trade talks can take unexpected u-turns and even the very unexpected needs to be priced in.

Gauging trade sentiment through Google Trends: trade escalation (search term: "trade war") vs trade de-escalation ("trade deal")

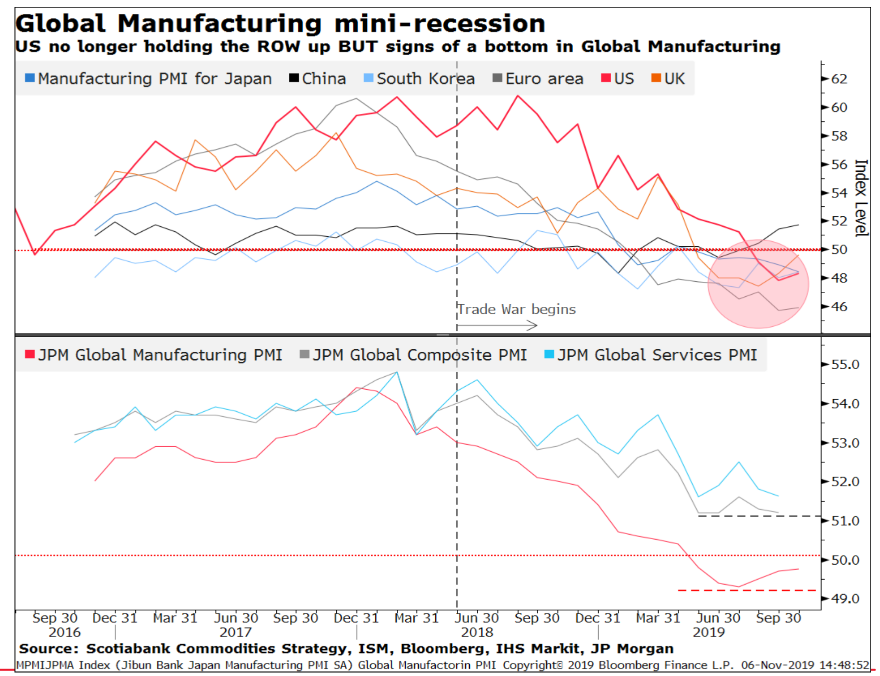


Source: Scotiabank Commodities Strategy, Bloomberg, Google

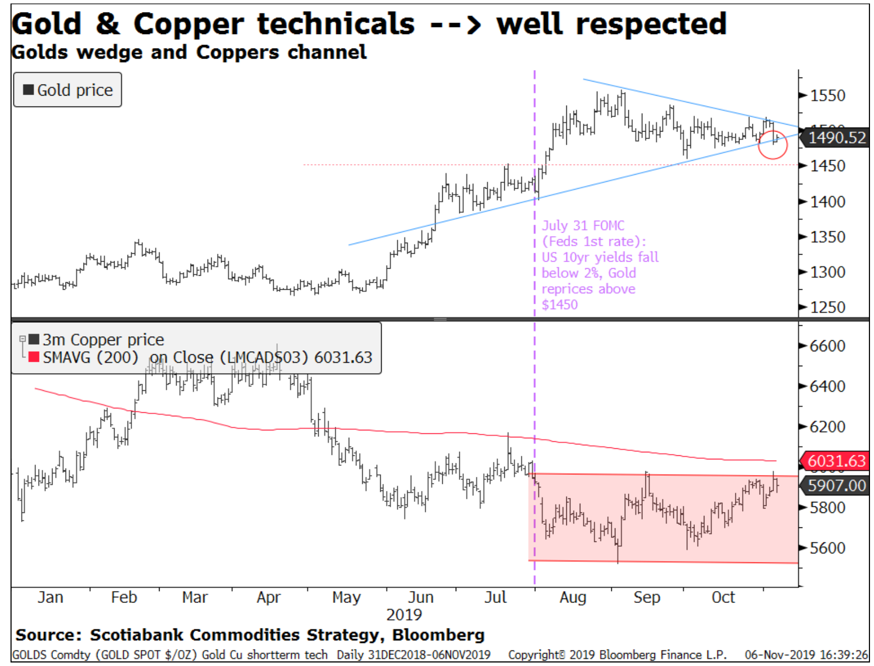
FED & PEAK CB DOVISHNESS: After 3 Fed cuts over the past ~3 months, Powell said last week policy had reached an “appropriate” level, ultimately leading the CB (pack) in the thinking that they’ve done enough to avoid a recession. Subsequent other CB policy action will be important in whether they collectively pause (likely), ultimately signaling that the global cutting phase is over, for now, and focus will swing to what fiscal coordination can do. While peak dovishness is behind us, note that: 1) the shift in the Fed is from a series of 'hawkish cuts' to a 'dovish pause', 2) they have set the bar very high for rate hikes, citing a sustained and significant up-tick in inflation - unlikely, and 3) theres a persistent (Fed) liquidity provision with re-pos requiring billions of US$ in daily balancing transactions, which some have lik-ened to QE-lite given the continued expansion of the Balance Sheet. Thus, their shift doesn't spell the reversal of the (early) Gold bull market; it merely signals Gold should re-calibrate to a less bullish trajectory (all else equal), given that *some* probability of cuts restarting needs to be priced in; Gold is increasingly forward looking in its expectations of a Fed cycle shift (i.e: a stronger Gold rally in June/July 2019 well ahead of the first Fed cut on July 31st). Overall, with the 3 core risks—-Fed, event (Brexit) and trade (US/China deal roll-out) — taking a backseat, US data should become the dominant driver of macro markets and sentiment going forward.



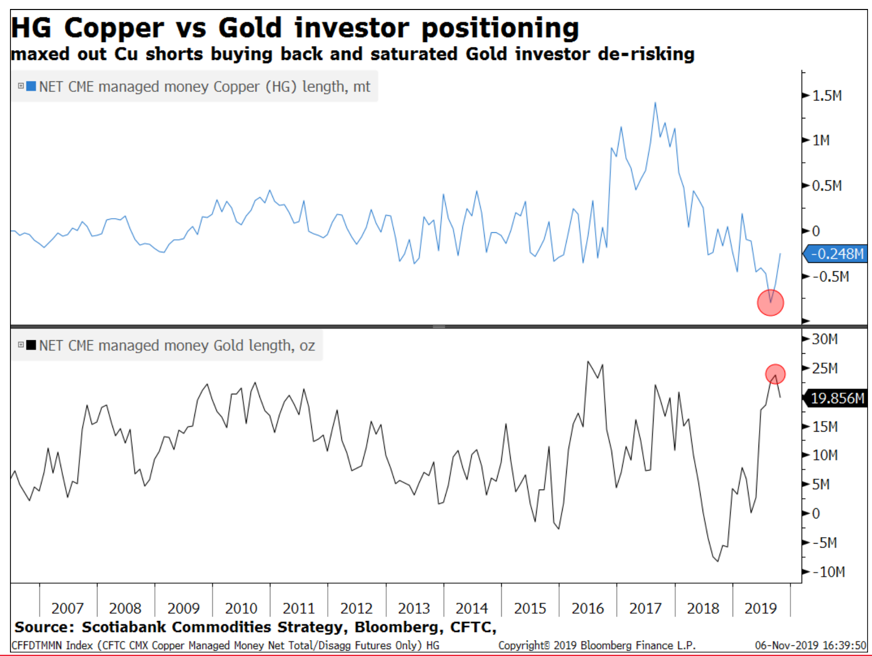
DATA: as highlighted above, data - particularly data points that are either trade sen-sitive (Global manufacturing figures) and/or bright spots (US consumer related) - will become increasingly important into year-end. Inflation data should, in theory, help drive the narrative around the Fed, but overall inflation remains well below the target of what many CBs including the Fed are mandated to deliver. Most of Octobers PMI data is out, and while the manufacturing slowdown remains in tact (most regions are still in sub-50 contractionary mode), JPMs Global Manufacturing PMI was up slightly for the 2nd month hinting at some green shoots/stabilization in the decline due to trade war / uncertainties. However, perhaps more importantly, the global composite PMI is holding above 51, defying expectations of a manufacturing softness that in-fects the rest of the economy and spreads to services. The worst fears in base met-als, especially in macro-centric copper (i.e: a revisit of $5600), should be put to rest.



GEOPOLITICS/POLITICS: Macro markets continue to be focused on the more tangible short term trade/geopolitical risks, and less so on the growing no. of political protests globally (Hong Kong, Chile, Lebanon etc), domestic politics (Trumps impeachment inquiry, Elizabeth Warren and her $52tn 'Medicare-for-all' plan, another US government shutdown etc), or simmering / unresolved Middle East tensions. Overall, while business and investor confidence took a big hit with the uncertainty around trade and Brexit in Q3'19, policy risk *(while still present with trade and Brexit still needing to be resolved)* has retreated, given that 1) time has been bought / deadlines extended, 2) a friendlier divorce (pullback from hard-Brexit) between the EU and UK is more probably vs months ago, 3) US/China 'phase one' deal is deemed to be a matter of 'when' not 'if'. Even with the repricing of Fed expectations, and the shift into high beta / risk assets with US equities making record highs, our model shows Gold is still currently pricing in a $170 "fear"/geopolitical premium* and doesn't seem to be buying into the reflation reprieve and market complacency. That is fair and understandable, given the fickle nature of policy decisions and unpredictability of geopolitical events witnessed the past year; theres an acceptance that even small tail risks require a hedge



TECHNICALS, POSITIONING & S/T OUTLOOK: there's no surprise there was a stark divergence between Gold & Copper investor positioning, with the former reaching peak holdings and the latter hitting peak short in Q3'19. Gold has become a respected trade on/off proxy (after the Fed broadened its reaction function to include trade developments) while Copper continues to adhere to macro (e.g PMI data) and trade headlines driven by systematic participation. However, the synchronized unwind from extreme levels in both assets has clearly begun with Gold investors de-risking and selling out of 1/6th of the buildup in positioning since March 2019, while Copper shorts have bought back 5/9th of their bearish bets over the same time frame. Clearly theres relatively more downside potential in Gold (vs copper upside), but technically, very steady demand has created a false break at a key trend line support in Gold. **Thus, Silver and Platinum are probably most vulnerable to the downside given that both haven't shown signs of adhering to industrial/ stronger growth signals (and trade as a precious/gold proxy), both are saturated and in a large surplus, and both don't garner key Central Bank demand. That makes a investor rotation out of the precious asset class, if the reflation trade gathers momentum into Nov 17th 'deadline', a key threat for both Platinum & Silver into year-end.** In base metals, Copper (as opposed to other shorted metals like Ali and Zinc) earns the preferred upside, given that Global inventories (CME+LME+SHFE) have drawn down consistently over the past 2 months, theres still another 300-400k mt of potential buybacks from shorts, Copper is the known and favored macro/top down asset for reflation and its sitting just beneath an appetizing technical break/handle.



Q4'19 Calendar of Economic, Political and trade related event risk.

Note, this this will likely change and evolve with time

November

- Nov 17th: numerous trade deadlines:
- for Trump to decide on whether to impose auto tariffs on Europe
- for US/China to find (and agree on!) an alternate venue to Chile to sign a US-China ‘phase one’ trade agreement after the cancellation of the APEC Summit
-
- Nov 21st: The need for a new Continuing Resolution to fund the US government past then and thus avoid another shutdown.
- Nov 28th: soft deadline / goal of the US admin to ratify the USMCA before US Thanksgiving, which is becoming increasingly unlikely
- Thanksgiving: liquidity risk, but Black Friday sales should be monitored as it provides insight on the health of the core driver of US growth (the con-sumer).

December

- Sometime in early December: Aramco IPO: its been closely-anticipated the last few years (potentially the largest share sale in history) but has been delayed due to valuation uncertainty, oil volatility, share listing location and geopolitical events/attacks. Parallels drawn with other major commodity IPOs that not coincidentally marked a top (e.g.: Glencores 2011 IPO and metals market)
- Dec 3-4th: NATO summit. Trade deal touted to be signed after this IF it isn’t signed in mid Nov.
- Dec 5th – 6th: OPEC/non-OPEC meeting
- Dec 11th: FOMC: theres still some expectation (~11% as per Fed Funds) of a Fed cut at the December meet, with Gold arguably pricing in more (~2cuts within 6mo).
- Dec 12: UK general election
- Dec 12th: ECB Meeting: Christine Lagarde is largely expected to press European leaders for more fiscal expansion, relying less on rate cuts (than Draghi did) and could resort to emphasizing the strength of EZ economy (vs playing up weakness). Together with a combo of more spending, looser monetary policy and easing of global trade tensions (into US election year), that could be bullish the EUR.
- Dec 15th: Tariffs deadline with China.
- Trump delayed them for 'Christmas season' effectively shielding more than $100bn in Chinese imports from tariffs until Dec. 15. If theres no formal signing in mid Nov, these can be instated
-
- Christmas: liquidity risk (as last year harshly reminded us of)
- End Dece,ber: Year-end dollar funding issues; a likely repeat of recent quarter-end issues