Commodity Weekly: Offering a better insight than stocks

By Ole S. Hansen | February 7, 2020

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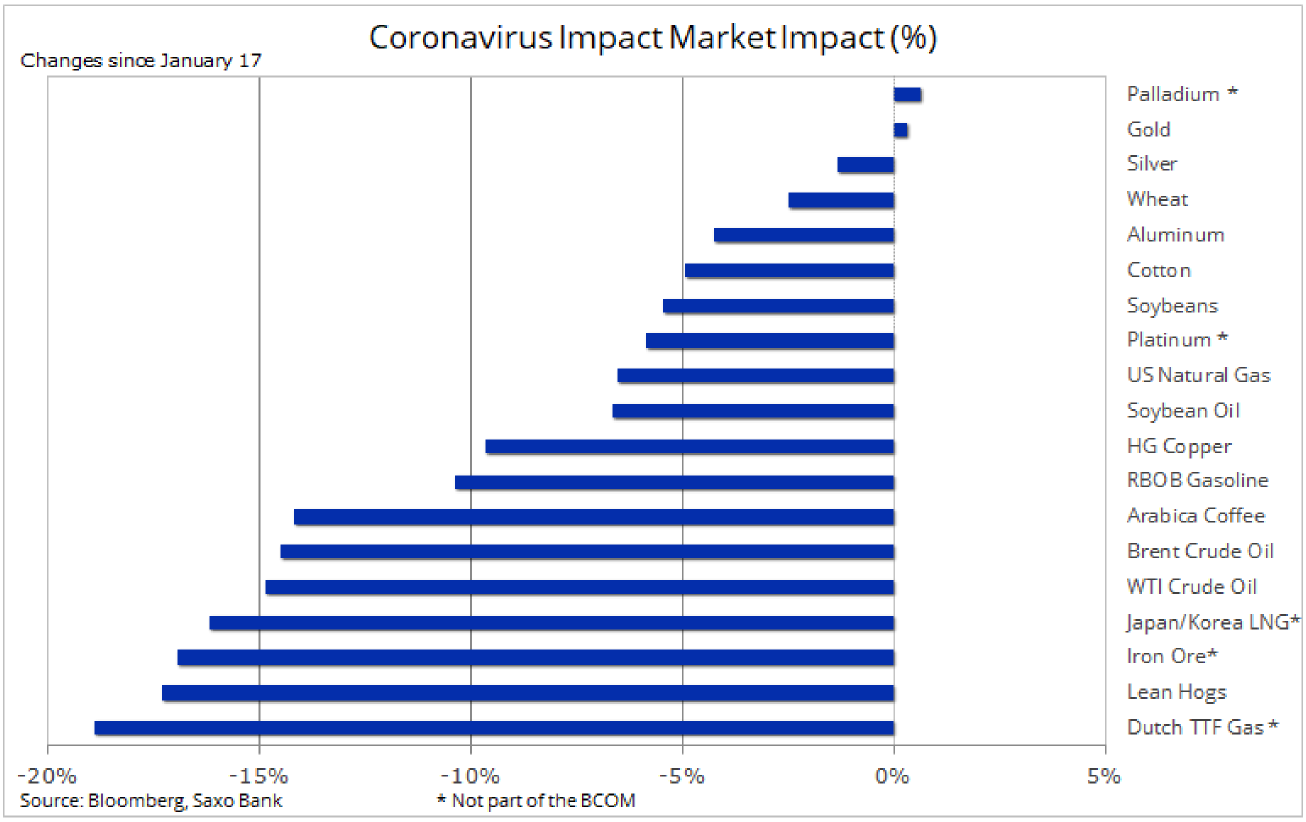
Commodity markets continue to bear the brunt of the coronavirus outbreak in China. While stocks, led by the U.S. technology sector, resumed their rally and reached new highs, the Bloomberg Commodity Index traded lower for a fifth week and down by 6.4% since January 17th when China finally alerted the world about the severity of 2019-nCoV outbreak.

We remain concerned that the full impact of the slowdown in China and abroad, with the exception of commodities, is not being properly priced in. The stock market has recovered strongly as investors have become increasingly immune to the apparent risks. Instead, focusing on the support coming from low inflation, low interest rates and central banks, led by the U.S. Federal Reserve, continuing to pump liquidity into the market.

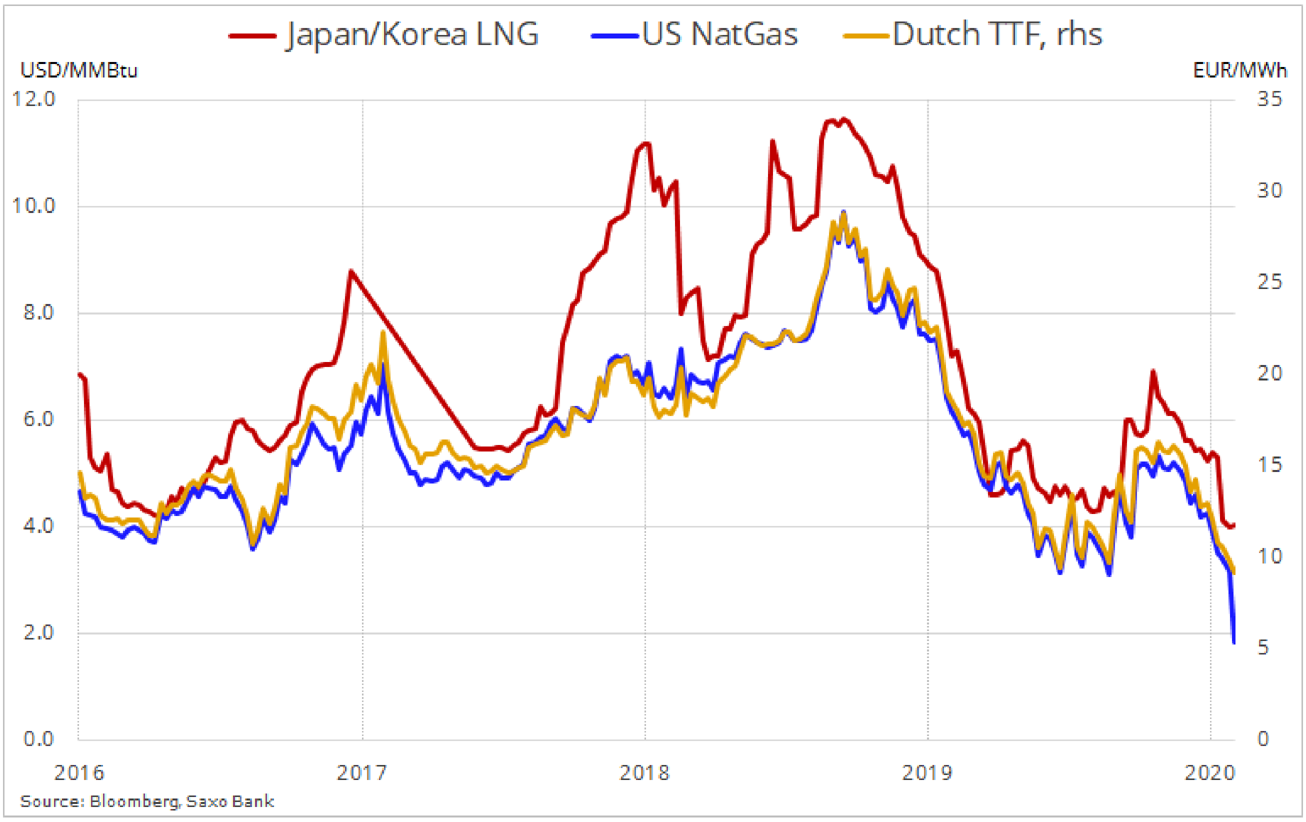
With China being the world's most dominant consumer of raw materials, the impact has been felt strongly across key commodities and the world is facing the biggest demand shock since the 2008-09 global financial crisis. Despite some attempts to recover this past week, the losses since January 17th are significant as highlighted in the table below.



Chinese demand will undoubtedly take a hit during the first half of 2020 and the risk was highlighted this past week when some gas and copper importers began declaring force majeure on shipments. The prolonged lockdown of parts of the country in order to prevent further spreading of the virus has not only hurt demand but in the short-term also reduced China's ability to take deliveries.

For natural gas producers this could not happen at a worse time with global inventories already elevated following a mild Northern Hemisphere winter. In Europe, the Dutch TTF contract dropped to the lowest since August 2009 while in Asia the Japan/Korea LNG (Liquified Natural Gas) contract hit a record low at $3/MMBtu.

All of this being bad news for an already depressed U.S. natural gas market where robust production growth has increasingly been relying on exports through LNG to curb inventories.



Copper managed to claw back some of its steep losses after finding support at $2.50/lb on High Grade and $5800/t on LME. The temporary recovery was supported by robust action from the People's Bank of China who returned from the Lunar New Year holiday to add liquidity and cut rates. News that China would cut tariffs on American imports also helped sentiment. While these developments are likely to support a recovery in copper once China returns to work, the short-term outlook remains very challenging with half of global copper supply being consumed by China. We keep a close eye on the mentioned levels with a break signaling a potentially even bigger sell-off.

Reports here and here that Chinese demand for crude oil has been cut by more than 3 million barrels/day has kept prices under pressure and once again the market is looking to the OPEC+ group of producers for support through additional production cuts on top of those announce just two months ago. According to a survey from Bloomberg, OPEC's production dropped to 28.4 million barrels/day in January, the lowest since 2009. Since the peak in late 2016, the group has now cut production by 5.8 million barrels/day with more than half coming from involuntary cuts from Venezuela, Iran and Libya.

Saudi Arabia, who needs oil closer to $80/b than the current $50/b, has shown an interest in yielding further market share in order to support and prevent the price from collapsing any further. The OPEC+ technical committee has proposed an additional cut of 600,000 barrels/day. Russia has once again shown resistance against cutting production and has promised an answer soon as to whether it will join.

Five weeks of selling has taken Brent crude oil down by 25% to a one-year low and the sudden shift from tightening supply to oversupply is reflected in the forward curve. In just three weeks the spread between the prompt April and the September futures contracts has gone from a healthy backwardation of $3/b, signaling tight supply, to a contango (oversupply) of -$0.85/b.

Source: Saxo Bank

While the virus tsunami hit pro-cyclical commodities, gold has spent the past three weeks trading within a relatively tight range. During the early stages of the virus breakout its lack of performance raised a few eyebrows of concern. Following a brief correction to support at $1550/oz it nevertheless managed to recover despite headwinds from rising stocks, yields and the dollar.

These developments highlight gold's continued safe haven despite a weaker inflation outlook – as raw materials tumble – and the risk of softer demand from China. Investors have, despite the lack of price performance, continued to accumulate gold through exchange-traded funds backed by bullion. Total holdings have, during the past three weeks, risen by 65 tons to 2585 tons, thereby breaking the previous record from 2012.

Renewed dollar strength may presents another challenge but overall we maintain our bullish outlook for gold. This given our concerns that the stock markets, as opposed to commodities, are sending a wrong signal with the regards to the direction of growth and with that companies earnings potential. At this stage however there is no point in chasing the market until the stock markets and yields turn lower again.

Source: Saxo Bank

Ole S. Hansen
Head of Commodity Strategy

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