

Commodities Outlook (Q2 2019)

**Content reproduced from our recently released quarterly [Scotiabank's Global Outlook](#) (p. 46–49).

- Healthy global economic growth provides a solid demand backdrop for commodities through 2020, allowing fundamentals to reassert commodity-specific price paths over the coming years (chart 1).
- After reversing the late-2018 bear route in risk assets through the first quarter of 2019, most major commodity prices—oil, copper, gold—are expected to trade around current levels through the remainder of the year.
- Policy and event-driven developments have modestly shifted the outlook for Western Canadian Select (WCS) crude due to challenges surrounding the Alberta government's production curtailment plan and iron ore following a crackdown on tailings dams in Brazil.

FUNDAMENTALS TO RETURN AS COMMODITIES DRIVER AS NEGATIVE MACRO SENTIMENT NORMALIZES

Industrial commodity prices rallied through the first quarter of 2019 as markets reversed the bearish speculative sentiment that drove a sell-off of equity and commodity prices in the closing months of 2018. Oil and copper contracts are up 37% and 11%, respectively, from late-December lows while the S&P500—which also collapsed through December as sentiment toward risk assets soured—is up 22%. This rally occurred despite relatively weak industrial data (e.g. three months of contracting Chinese manufacturing activity) and falling trade flows on the back of the US-China trade war (global trade volume fell 1.7% y/y in December, chart 2), which primes commodities—particularly metals like copper—for further gains through 2019 as those trends normalize. The global economy's ongoing rebound is progressing largely along our prior forecast path and thus our major commodity price forecasts are largely unchanged on the quarter beyond policy-driven revisions to the WCS and iron ore outlooks. WTI oil prices are expected to average \$59/bbl in 2019 (+\$1/bbl versus our last quarterly outlook) and \$61/bbl in 2020 (-\$1/bbl), copper is forecast to average \$3.00/3.20 per pound in 2019/2020 (unchanged), and we continue to anticipate that gold will remain range bound around \$1,300 per ounce (unchanged).

Global growth is uneven, but largely tilting in the right direction. Industrial activity indicators are split between major markets, with the US showing continued strength while European activity looks soft and Chinese surveys finally showing a rebound from three consecutive months of contraction. Despite this mixed picture, we maintain our view that global growth remains on a solid footing and that the current slowdown is a natural deceleration off an artificially high stimulus-fueled base; large fiscal outlays from US and Chinese authorities in late-2016 provided the impulse that lifted all boats through the synchronized global acceleration of 2017–1H2018. Uncertainty related to the US-China trade war, US monetary policy, and the end-2018 fallback in global equity markets, all contributed lacklustre industrial performance in the first quarter of 2019 but we believe that activity will bounce back over the coming months and provide a steady demand backdrop for commodity markets going forward.

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Chart 1

Commodity Price Trending Higher Through 2020

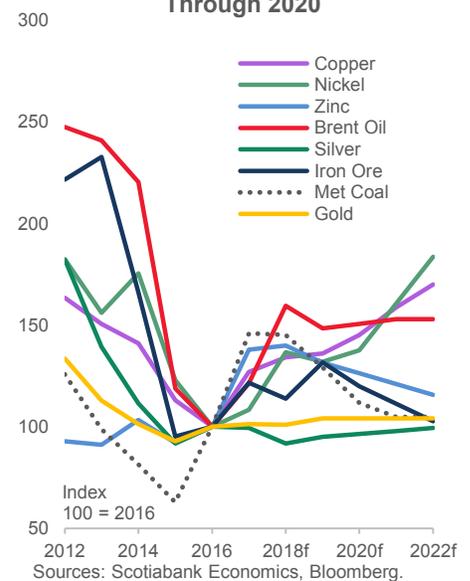
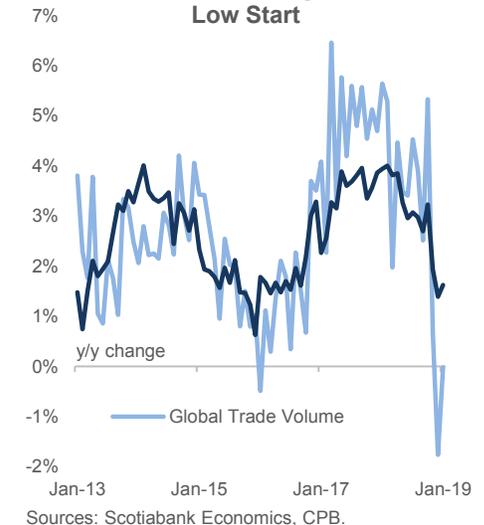


Chart 2

Global Trade and Industrial Production Headed Higher From A Low Start



OIL PRICES UP SHARPLY AS OPEC CUTS OUTPUT, US SHALE'S PACE MODERATES

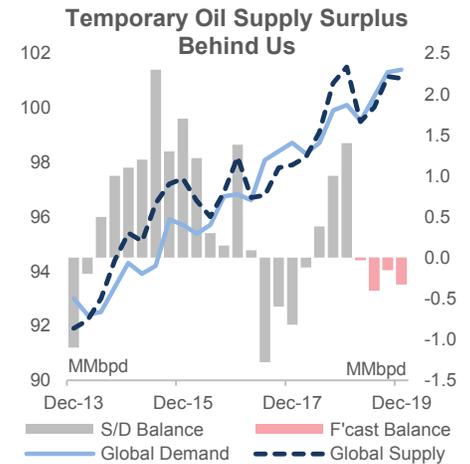
Global crude oil prices have rebounded and WTI contracts are up by more than a third from 2018's close. Demand growth remains healthy while supply is tightening on the back of a notable reduction in OPEC production—both voluntary and involuntary—as well as slowing momentum in the US shale patch. We expect oil markets to remain in mild deficit through 2019 (chart 3), which is forecast to maintain WTI prices around \$59/bbl in 2019 and \$61/bbl in 2020, with Brent trading at a \$7–8/bbl premium to WTI through the forecast horizon on continued bottlenecks en route to the US Gulf Coast.

Global oil demand growth remains healthy and is expected to come in at around 1.4 MMbpd y/y in 2019—nothing to write home about but steady enough to keep the market more-or-less in balance through 2020. Emerging Asia continues to drive this growth, with China and India expected to contribute just more than half that total. More than the overall demand for crude by the world's refineries, the coming years will bring far larger changes to the *relative* demand for finished products as new fuel emissions standards from International Marine Organization (IMO2020) come into effect. The IMO2020 regulatory shift reduces the allowable sulphur concentration in the heavy fuel oil consumed by the roughly 80,000-strong global shipping fleet, which will reduce the demand for high-sulphur fuel oil (HSFO) and boost the demand for middle distillates—products like diesel or marine gas oil (MGO) that are either consumed directly or blended with traditional fuels to reduce the sulphur content of bunker fuels. This paradoxically increases the demand for heavy crudes like WCS, which can be blended with lighter crudes like those coming out of the US shale patch to increase middle distillate yields at refineries along the US gulf coast. Coupled with the declining supply of heavy crudes from Venezuela and Mexico, this tight market for heavy crudes has been a boon for the price of WCS, Canada's primary export benchmark.

Global oil supply growth is slowing from the remarkably strong gains witnessed in late-2018 as OPEC+ cuts production and the pace of growth in the US shale patch moderates. OPEC+ production fell in the opening months of 2019 between organized cuts taken to defend prices and steep involuntary losses in Venezuelan supply (chart 4). Venezuelan production difficulties ramped up considerably in March after weeks of intermittent days-long blackouts roil the country's oil production and export systems in addition to the vast majority of Venezuela's citizens. Problems with the electrical grid will continue to plague the production, blending, and export of Venezuelan crude, and the government lacks the capital and expertise to make any meaningful repairs to the system. In the US shale patch, supply growth continues to lead the world (chart 5) but the pace of gains is slowing as producers continue to move away from sweet-spots and the number rigs in the field flat lines.

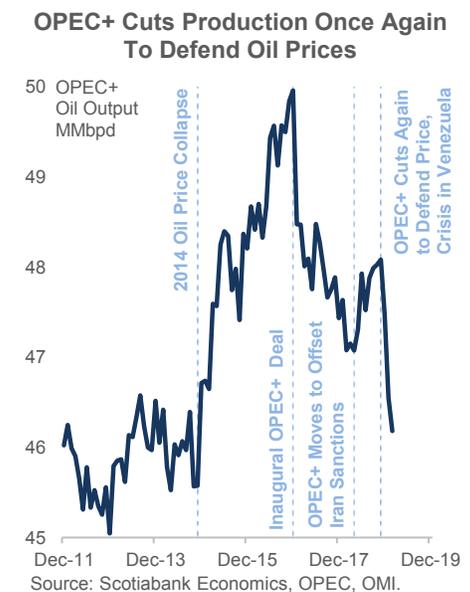
Closer to home, Western Canadian oil prices continue to trade at abnormally low discounts to US-based WTI of less than \$10/bbl, relative to the last autumn's blowout above \$50/bbl and oil-by-rail breakeven levels of around \$15/bbl. While higher prices for Canadian crude would in normal times be cause for celebration, we unfortunately believe that today's differentials are artificially narrow and a concrete sign that too much crude production remains curtailed relative to the pace at which inventories can effectively be drawn down. Too few barrels are chasing available takeaway capacity, which has bid local barrels up (meaning a narrower discount to WTI) and priced much of the industries' newly acquired oil-by-rail capacity

Chart 3



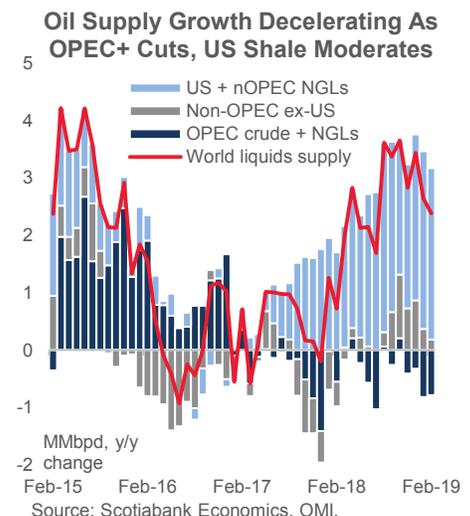
Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

Chart 4



Source: Scotiabank Economics, OPEC, OMI.

Chart 5



Source: Scotiabank Economics, OMI.

out of the market. Oil-by-rail shipments slipped roughly 30 kbpd in January from all time highs in December and higher-frequency CN and CP Rail data indicate that volumes fell steeply through February before eventually stabilizing (chart 6).

Unfortunately we are going to need as many rail cars in service as we can get through the end of 2020, particularly now that the start-up of Line 3 has been delayed until the latter half of next year. While current light/heavy differentials around the US Gulf Coast implies that oil-by-rail could technically break even at less than \$15/bbl under WTI, sub-\$10/bbl discounts appear safely out of the money and differentials likely need to rise above simple breakeven levels and into the \$15–20/bbl range to provide enough of an incentive to purchase additional rail cars (chart 7). Given the pace of expected oil sands production growth, we see the call on oil-by-rail services reaching 500–600 kbpd by late-2020 prior to the start-up of Line 3, well above the 355 kbpd record reached in December (see our [full report](#) on the Line 3 delay). In response to the narrower-than-anticipated differentials, Alberta's provincial government has announced an increase in allowable production under the curtailment every month since the program began—75 kbpd in Feb–March, and 25 kbpd in each of April, May, and June for a total easing for 150 kbpd through the first half of 2019 versus an initial cut of 325 kbpd. We anticipate that rising production capacity and easing output curtailment will facilitate the WCS discount's return to the \$15–20/bbl oil-by-rail sweet spot, but our 2019 forecast has been revised to reflect the abnormal tightening in the first half of the year. **We now expect WCS discounts to average \$15/bbl in 2019 and \$21/bbl in 2020.**

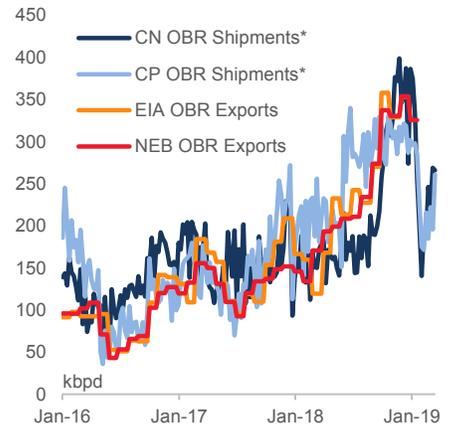
METALS: CHINA BEARISHNESS MOSTLY UNWOUND, FUNDAMENTALS IN THE DRIVER'S SEAT GOING FORWARD

Industrial metals have mostly unwound the negative sentiment that was weighing on pricing through the latter half of 2018 and individual metals are expected to resume a more fundamental-based price path over the coming years. The base metals complex slipped from last summer through the end of 2018, in large part due to negative macro sentiment enflamed by the first major volley of broad-based tariffs from the US in its trade dispute with China. The unwinding of this sentiment will allow metals prices to track metal-specific supply and demand considerations and facilitate a divergence between metals with plenty of long-term support (i.e. copper) and metals where the most acute tightness is behind us for now (i.e. zinc). Most metals forecasts remain unchanged on the quarter given our continued expectation for a steady global economic activity, while the outlook for iron ore has been revised to reflect the anticipated loss of Brazilian production following a crackdown on tailings dams in the country.

Given its outsized role in global commodity trade, particularly its more than 50% share of demand for most industrial metals, all eyes have been on China where the question of Beijing's stimulus efforts have been top of mind. Chinese manufacturing activity appeared to be contracting from December through February, but the latest PMI readings show that activity roared back to growth in March (chart 8). Some of this bounce-back can be attributed to seasonal factors coming out of Lunar New Year celebrations in February, but the jump in PMI readings is about double the typical seasonal retracement.

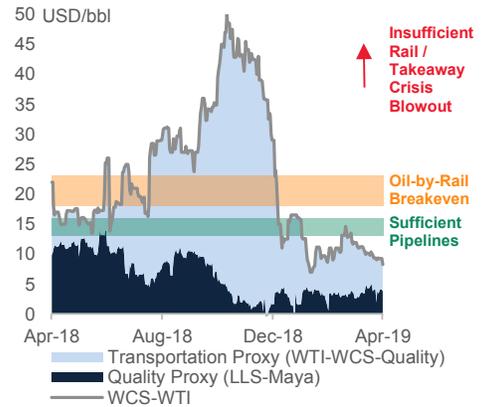
Beijing's modest stimulus efforts have begun to bear fruit, but policy-makers continue to stress that this isn't 2008 or 2016—both moments where China leaned

Chart 6
Oil-by-Rail Shipments Fell in January, Likely to Slip Further in February



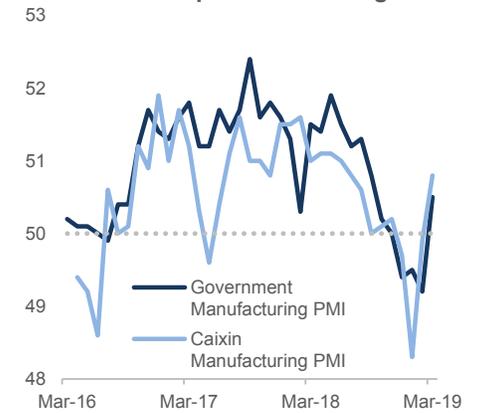
*CN/CP Rail shipments are less 300 kbpd to adjust for estimated structural/intrabasin volume.
Sources: Scotiabank Economics, NEB, EIA, CP, CN.

Chart 7
Canadian Crude Differentials Still Likely Too Low to Incentivize Necessary Oil-by-Rail Capacity



Source: Scotiabank Economics, Bloomberg.

Chart 8
Chinese Stimulus Efforts Beginning To Show Up In PMI Readings

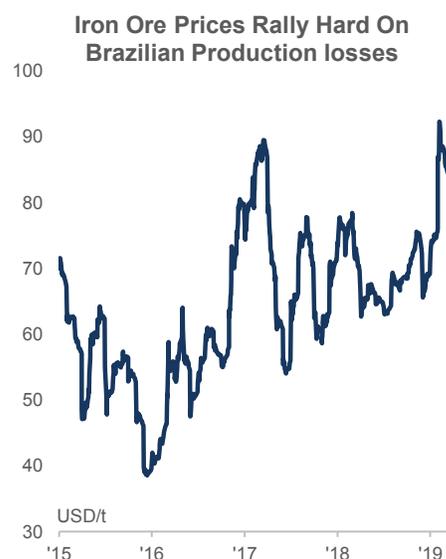


Sources: Scotiabank Economics, Bloomberg.

heavily on credit injections to stimulate the domestic, and in turn global, economy—and that China isn't falling back on its old habit of juicing traditional construction-heavy sectors. Nonetheless, the tension between Beijing's previously touted deleveraging goal and the political necessity of stable economic growth is evident in the course this particular bout of stimulus has taken; at the end of 2018 a Chinese government working group estimated that stimulus would amount to roughly 1.2T RMB, a number that was later revised upward to nearer 2T RMB. This lends at least some credit to the notion that the Beijing put—the idea that China will backstop any weakness in global industrial demand through stimulus injections—remains alive and well. Chinese policymakers are likely holding back on further stimulus until they receive additional macroeconomic data through the second quarter, to see how far the first stimulus kick lifted the economy.

Beyond the demand-driven considerations unwinding in base metals markets, Iron ore has shifted from a staid market defined by surplus supply and falling prices to a rollercoaster of production uncertainty following Brazil's fatal Brumadinho tailings dam collapse in January. Contracts for 62% iron content ore delivered to Northern China remain elevated at more than \$90 per tonne up from less than \$70/t at the end of 2018 and far above our prior forecast of \$65/t for 2019–20 (chart 9). Work stoppages ordered by Brazilian regulators and courts are expected to reduce Vale's iron ore output by 75 Mt relative to prior guidance of 400 Mt and a total seaborne iron ore trade of roughly 1,600 Mt. While we expect to see supply offsets from higher production at other Brazilian mines—Vale's technical capacity is nearer 450 Mt, leaving ~50 Mt of theoretical slack—the disruption and adjustment costs have prompted us to lift our iron ore price forecast to \$77/t in 2019 and \$70/t in 2020.

Chart 9



Source: Scotiabank Economics, Bloomberg.

Table 1

Commodities	2000–2017			Annual Average			
	Low	Avg.	High	2017	2018	2019f	2020f
WTI Oil (USD/bbl)	17	62	145	51	65	59	61
Brent Oil (USD/bbl)	18	65	146	55	72	67	68
WCS - WTI Discount* (USD/bbl)	-43	-16	-6	-13	-26	-15	-21
Nymex Natural Gas (USD/mmbtu)	1.64	4.83	15.38	3.02	3.07	2.90	2.80
Copper (USD/lb)	0.60	2.38	4.60	2.80	2.96	3.00	3.20
Zinc (USD/lb)	0.33	0.84	2.10	1.31	1.33	1.25	1.20
Nickel (USD/lb)	2.00	7.12	24.58	4.72	5.95	5.75	6.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.89	0.96	0.90	0.90
Iron Ore (USD/tonne)	17	67	187	72	70	77	70
Metallurgical Coal (USD/tonne)	39	131	330	187	206	185	160
Gold, London PM Fix (USD/oz)	256	890	1,895	1,257	1,268	1,300	1,300
Silver, London PM Fix (USD/oz)	4.07	14.80	48.70	17.05	15.71	16.00	17.00

* 2008–16 average.

Sources: Scotiabank Economics, Bloomberg.

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