

Commodities Outlook (Q1 2019)

****Content reproduced from our recently released quarterly [Scotiabank's Global Outlook](#) (p. 44–48).**

PRICES TO RISE THROUGH 2019 FOLLOWING VOLATILE 2018 FALLBACK

- The prices of industrial commodities are expected to broadly rise over the coming two years, though a slightly weaker global economic outlook slows the march higher relative to our last outlook (chart 1).
- While we are now pricing in mildly slower global growth, we do not believe that the market's trade fears will be realized and commodities are expected to receive a broad boost as the market unwinds those concerns over the coming months.
- Oil prices are currently digesting a bout of bearish sentiment and WTI is expected to rise back into the high-\$50s in 2019 and gradually toward \$65/bbl in the following years.
- The October oil price collapse reflected the repricing of Iranian production assumptions following Washington's volatile hawk-dove flip-flopping on the severity of nuclear sanctions.
- We maintain our outlook for rising industrial metals prices, though current trade concerns have pushed anticipated price increases out by about a year for most metallic commodities; gold prices are expected to remain steady, caught between rising rates and a weakening US dollar.

Well that was a bumpy sleigh ride. Markets experienced extreme volatility through December and big daily movements in the value of equities, bonds, and commodities have remained a feature of trading into the first few weeks of the New Year. The relationship between risk assets has tightened, giving the market's broad macro narrative a far greater say in commodity price formation than material-specific factors related to supply and demand. This herd behaviour is expected to pass, however, and we anticipate that fundamental factors will reassert themselves in 2019 as inventory movements provide ample reason for commodity differentiation. Slower global growth will present mild headwinds to the commodity complex, though we believe that the worst of the market's fears regarding the US-China trade war will fail to materialize. Virtually all industrial commodities are forecast to rise from recently distressed levels—WTI crude from \$45/bbl in early January to average \$58/bbl in 2019, copper from sub-\$2.55/lb to \$3.00/lb, etc.—as trade-related bearishness unwinds, speculative positioning normalizes, and physical realities like falling inventory levels highlight the need for higher prices.

SLOWING DOWN ISN'T SO BAD WHEN WE'VE BEEN SPEEDING

Make no mistake—the global economy is indeed slowing, coming off an incredibly robust and synchronized burst of economic momentum in 2017-18 (chart 2). Economies like the United States and Canada have been growing so quickly relative to their theoretical potential that central banks, fearing mounting

CONTACTS

Rory Johnston, Commodity Economist
 416.862.3908
 Scotiabank Economics
rory.johnston@scotiabank.com

Chart 1

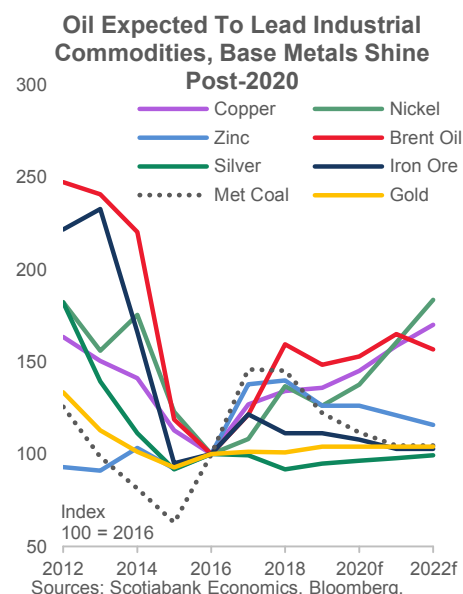
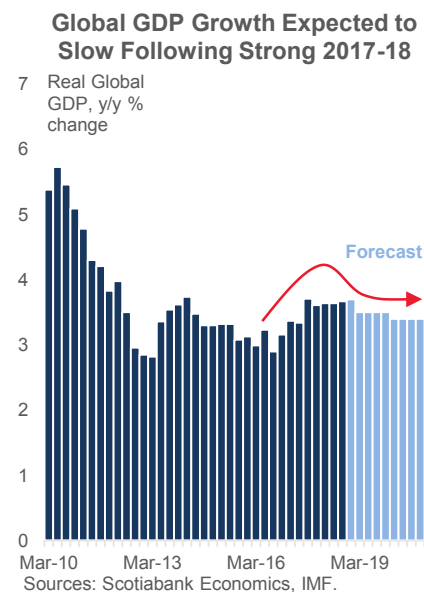


Chart 2



inflationary pressures, have begun tightening interest rates. China, too, is seeing an organic slowdown—particularly in heavy industries like construction—as the government pivots away from stimulus-fuelled expansion toward prudent and gradual deleveraging. Even the trade war with Washington hasn't rattled Beijing off its deleveraging priorities, despite a notable slowdown in export-oriented sectors like manufacturing. China has embarked on a path of mild monetary stimulus and select infrastructure spending (e.g. recent \$125bn rail project allocation), but we don't expect to we'll see an all-out fiscal effort of the sort that supported the global economy—and particularly the industrial commodity sector—in 2008-09 and 2015-16. **Stimulative Chinese economic policy is likely to support consumer activity over industrial expansion, which means less materials-intensive spending on a smaller pool of deployed capital.**

Taken together, Beijing's commitment to its deleveraging mandate and lack of materials-intensive stimulus, coupled with gradually easing growth through the rest of the world, has prompted us to modestly downgrade the demand and thus price outlook for most industrial commodities. The direction of rebalancing, however, remains the same and metals and energy commodities are expected to embark on a gradual climb higher through the end of the decade.

ENERGY: OIL BUFFETED BY POLICY VOLATILITY, HEADING HIGHER IN 2019

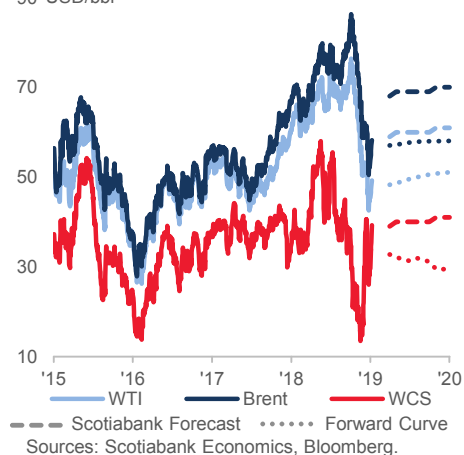
Last year saw oil markets whipped between extreme bullishness that brought Brent crude prices above \$86/bbl and a subsequent bear raid that took prices more than 40% to \$50/bbl on Christmas Eve. Despite the volatility, our structural view of the oil market remains unchanged—the US shale patch has made prices much above \$65/bbl (WTI) untenable for prolonged periods of time and Brent crude is expected to trade at roughly \$70/bbl on a long-run basis. However, US policy volatility wreaked havoc in the oil market through the latter half of 2018 as hawkish rhetoric regarding Iranian sanctions spooked the market higher and forced OPEC+ to quickly lift supply, only for the White House to back down when the November deadline passed—in large part, according to President Trump, due to those higher oil prices. The policy reversal left the market with surplus crude, which when combined with the general market sell-off resulted in a precipitous decline in spot prices, far lower than we believe is required to balance the near-term market. **WTI contracts are currently trading around \$50/bbl and we expect prices to rise to average \$58/bbl in 2019 (down from \$72/bbl in our last quarterly outlook) and \$62/bbl in 2020 (down from \$69/bbl, see Chart 3).**

The market is working through a transitory supply glut that began in the latter half of 2018 and is expected to fall away by the latter half of 2019. However, this glut is far smaller, at roughly 200 million barrels from 2Q18 to 2Q19, than the supply bulge that tanked oil prices in 2014-16, which totaled almost one billion barrels between 2Q14 and 2Q16 (chart 4). Similarly, US petroleum inventory flow data have moved mildly bearish and stocks ended the year roughly where they began relative to a 100 Mbbd draw in 2017, but remain in a far stronger position than the 350 million barrel build between April 2014 and August 2016 (chart 5).

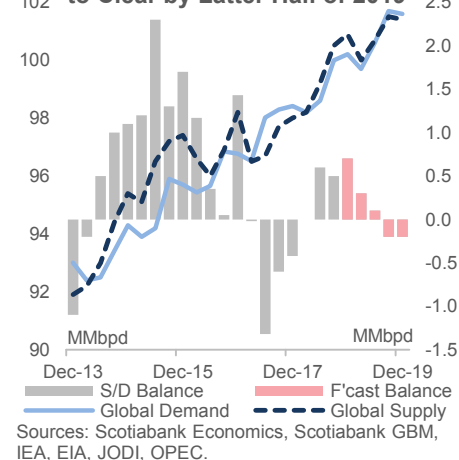
Oil demand is expected to remain healthy and advance by 1.6 MMbpd y/y in 2019, though the market's current economic concerns likely have spot contracts pricing in slower demand growth in the 1.2-1.3 MMbpd range. Most of the economic anxiety is directed toward Asian markets, where the China-US trade dispute looms large. Oil

Chart 3

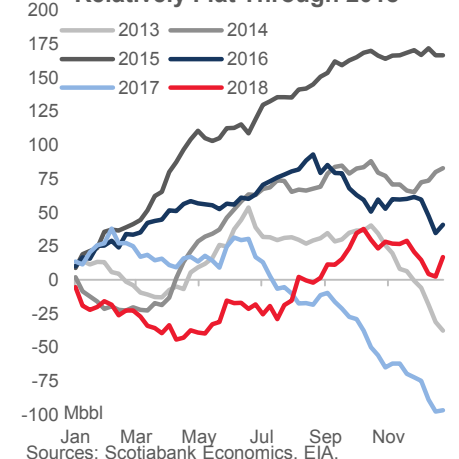
Oil Prices Heading Higher From Here


Chart 4

Oil Market's Transitory Supply Glut to Clear by Latter Half of 2019


Chart 5

US Total Petroleum Inventories Relatively Flat Through 2018



demand growth in China is now tilted heavily toward consumer fuels like gasoline and jet fuel rather than industrial-favourite diesel, which has been the traditional driver of rising Chinese petroleum use. A weaker Chinese consumer is thus a key risk to the oil demand outlook, made more acute by Apple's recent announcement that blamed the "magnitude of [China's] economic deterioration" for faltering sales forecasts in the world's largest smartphone market. Car sales are also contracting for the first time in nearly 30 years, which could have a more direct impact on fuel demand. The rest of Asia also appears to be feeling the weight of the pain in the region's largest economy—the combined oil demand growth in India and China, which are expected to account for roughly half of the world's increased consumption in 2019 and 2020, fell from more than 1 MMbpd y/y around the end of 2017 to the less than 200 kbpd y/y a year later (chart 6). Global demand growth, on a 12-month moving basis, has fallen from around 1.9 MMbpd this past spring to less than 1.3 MMbpd by the end of 2018. We expect that a reacceleration of Asian petroleum demand will lift combined Chinese-Indian consumption growth to around 700 kbpd and global demand growth back around 1.6 MMbpd.

While the late-2018 selloff began in large part on concerns about surging US shale supply and higher-than-needed OPEC output, we expect that 2019 will see a return to supply concerns. Supply growth over the coming year will be primarily driven by the pace of US shale expansion in a sub-\$60/bbl WTI price environment, OPEC+'s return to supply discipline, and developments in Canada's oil sands—where mandatory output cuts took effect on January 1st—as well as Brazil, where perennial production optimism has frequently been revised lower.

Case in point, the US shale patch, where 2019 supply growth was forecast to exceed 1.5 MMbpd y/y as global oil prices hovered in the mid-\$80s, is beginning to worry about cash flow once again. While most shale players are in a far better position today than when prices last dipped below \$50/bbl, the growth strategy prompted by high oil prices is looking precarious and a renewed focus on costs and competitiveness is expected. Fit-for-50 capex budgets that were rapidly falling out of fashion six months ago are being dusted off once again.

OPEC and allied producers, meanwhile, have stepped on the brakes and begun winding back production. The volatility of OPEC policy-making reflects the volatility of US foreign policy, and pressure on OPEC has shifted from "more supply, now" when prices were nearing \$90/bbl in early-October to "cuts are necessary for market balance" today. OPEC only agreed to begin lifting production after many cried out for the Saudis and the Russians to step in to fill a supply gap caused by US sanctions against Iran and a lagging shale rebound. Less than a month later the oil price had collapsed and the Kingdom pulled an abrupt 180-degree-turn after efforts to jawbone the price higher failed to stop the bleeding—the latest comments out of Riyadh indicate that the OPEC kingpin still desires Brent prices around \$80/bbl. Following the policy turnaround, OPEC production fell roughly 0.5 MMbpd m/m in December representing the producer group's largest monthly decline since its last agreed-upon cut took effect in January 2017 (chart 7). US, Russian, and Saudi Arabian oil wells were pushing out all-time record volumes of crude in the closing quarter of 2018, which was seen as necessary to offset declines in Venezuelan output and soon-to-be-cratering production in Iran as US sanctions block the purchase of Iranian crude.

Albertan oil production cuts totalling 325 kbpd (8.7%) took effect on January 1st, quickly addressing the glut of oil trying to leave the province on bottlenecked

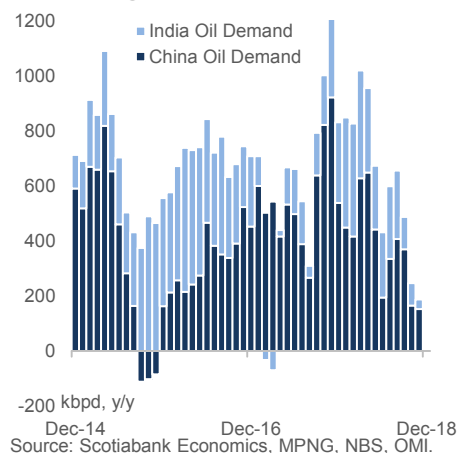
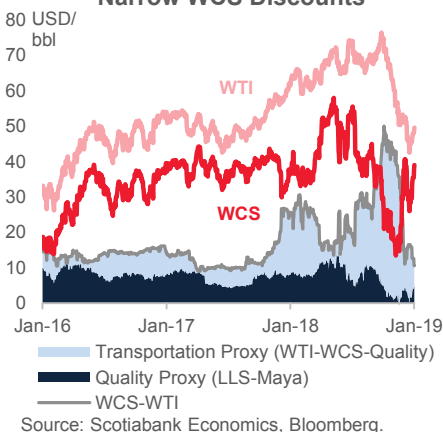
Chart 6
Chinese & Indian Oil Demand Wanes, Leaving Room for Reacceleration

Chart 7
OPEC+ Production Bounce Erased, Returns to Output Restraint for Now

Chart 8
Alberta Production Curtailment, Stronger Heavy Oil Prices Help Narrow WCS Discounts


pipelines and helping bring WCS discounts from a peak of more than \$50/bbl under WTI a few months ago to around \$10/bbl today (chart 8). Discounts collapsed below the \$20/bbl level that many associated with oil-by-rail breakeven costs, assisted by a much-narrower quality discount witnessed around the US Gulf Coast—less than \$3/bbl relative to a typical discount of nearer \$10/bbl. Production is expected to remain constrained around current levels through late-Spring, when inventory declines are expected to trigger a gradual loosening of output restrictions. Oil-by-rail shipments continue to rise and future capacity will be aided by the Alberta Government’s 120 kbpd oil-by-rail capacity purchase commitment, likely surpassing a half-million barrels per day of throughput by year-end up from the record-setting 327 kbpd of Western Canadian crude that exited the country in October. **WCS discounts are expected to average \$20/bbl in 2019-20, materially tighter to WTI following the rollout of the Alberta government’s production curtailment policy.** The risk to this outlook is for spreads to remain tighter, in the mid-teens, given the current favourable heavy oil pricing environment around the US Gulf Coast.

METALS & MINERALS:

Metals prices were the first casualties of the market’s soured macro sentiment— as is so often the case—and the value of metals like copper, nickel, and zinc fell back in June on the back of heightened trade war rhetoric, well ahead of oil’s October rout. Some of this fallback was justified—copper prices, for instance had run ahead of what we believe was fundamentally justified, and the price of zinc was returning to earth from a rally that had lifted prices to the highest level in a decade. However, as with crude oil, industrial metals prices have also fallen below where commodity-specific fundamentals would justify.

The unexpectedly strong growth of 2017-18 pushed commodities into overdrive and prices outperformed our initial expectations on frothy market sentiment.

Copper, for instance, leapt from sub-\$2.20/lb in 2016 to more than \$3.30/lb by the end of 2017 as investors betting on a faster global economy channeled their thesis through speculative copper bets (chart 9). These gains were well ahead of the gradual climb toward \$3/lb that we believed was fundamentally justified, and we expected some of that froth to fall away. The latest price collapse, however, brought copper contracts sharply lower to the mid-\$2 range; this too far, too fast price route occurred just as

Chart 9

Speculative Copper Positioning Remains Relatively Bearish

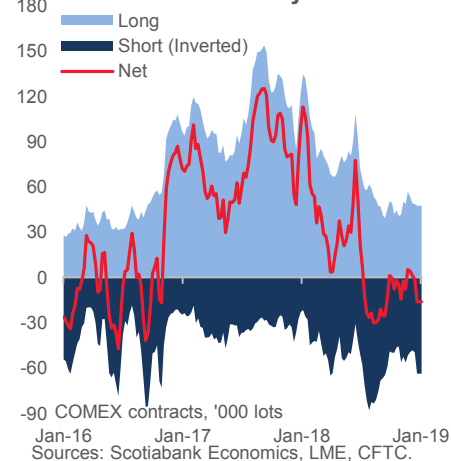


Chart 10

Base Metal Inventories Slide Lower

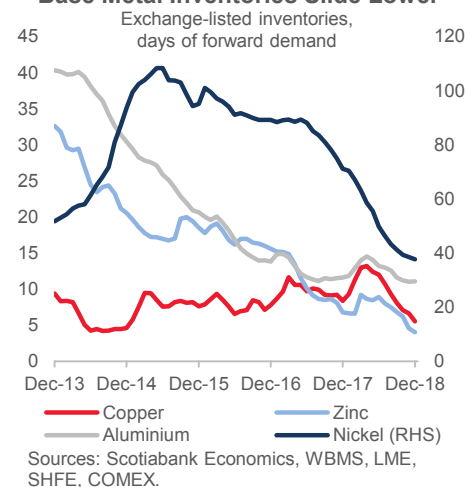


Table 1

| Commodities | 2000–2017 | | | Annual Average | | | |
|--------------------------------|-----------|-------|-------|----------------|-------|-------|-------|
| | Low | Avg. | High | 2017 | 2018 | 2019f | 2020f |
| WTI Oil (USD/bbl) | 17 | 62 | 145 | 51 | 65 | 58 | 62 |
| Brent Oil (USD/bbl) | 18 | 65 | 146 | 55 | 72 | 67 | 69 |
| WCS - WTI Discount* (USD/bbl) | -43 | -16 | -6 | -13 | -26 | -20 | -20 |
| Nymex Natural Gas (USD/mmbtu) | 1.64 | 4.83 | 15.38 | 3.02 | 3.07 | 3.25 | 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 | 1.20 | 1.20 |
| Nickel (USD/lb) | 2.00 | 7.12 | 24.58 | 4.72 | 5.95 | 5.50 | 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 | 65 | 63 |
| Metallurgical Coal (USD/tonne) | 39 | 131 | 330 | 187 | 206 | 175 | 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 | 16.25 | 16.50 |

* 2008–16 average.

Sources: Scotiabank Economics, Bloomberg.

mounting supply deficits over the next few years call for a price above \$3/lb to incentivize much-needed mine investment. Many other industrial commodities—most notably crude oil—have followed a similar pattern: overshooting fundamentals through mid-2018 before sentiment shifted and prices fell into fundamentally oversold territory.

This isn't to say that prices can't stay this low—most producers are still making money at these prices so there is no immediate need for higher prices—but we forecast that these markets will experience growing supply deficits over the coming years and prices need to rise to incentivize necessary future production capacity. Commodity price cycles—particularly on the metals front—move on long timescales and prices can remain below where they would optimally clear until impossible-to-ignore supply deficits force prices higher. Given that it typically takes a half-decade or more for a planned mine to move from the drawing board to production-ready, lower-than-necessary prices today will result in a period of higher-than-ideal prices in the hope of more quickly incenting needed metal onto the market.

In spite of the metals price rout, base metals continue to experience falling inventories. The volume of copper held in the storage sheds of major exchanges has fallen from 13 days of forward consumption in the first quarter of 2018 to 5 days today, zinc inventories remain extremely low at less than 4 days vs a recent high of 15 days in 1Q17, and acute supply deficits in nickel markets have allowed inventories to fall to 36 days from an unheard of 108 days in mid-2015 (chart 10).

Zinc prices are certainly justified in their initial fallback after a rally earlier this year took contracts to their highest level since 2007, though the extent and rapidity of the price decline does not seem to reflect the pace of supply rebalancing that has thus far taken place. While high prices did their job and brought significant volumes of new mine supply to the market, that concentrate—i.e. precursor to refined metal—tonnage has yet to work its way into the refined metal market. Physical market indicators continue to reflect this reality and the degree of backwardation—the premium of prompt shipments to deliveries for three months from now—in the zinc market reached all-time highs in December (chart 11) despite weaker spot pricing. We believe that zinc prices have fundamental support for one more bounce, likely in the first half of 2019, before new mine supply finally begins working its way into the refined market and zinc begins its gradual fall back to long-term incentive pricing, currently pegged at roughly \$1.00/lb.

Gold prices recovered through the end of 2018 as the outlook for the global economy darkened. Risk bids returned to bullion as equity price volatility rose and interest rate hike expectations began to fall. Speculators had built up a historically large short position in gold contracts into the beginning of 4Q18 (chart 12), betting that bullion would fall amid soaring equity returns, robust global growth, and a stubbornly strong US dollar. This shorting helped pull gold prices below \$1,200/oz before the rapid unwinding of those bets helped propel bullion back toward \$1,300/oz in the opening weeks of 2019. We expect that gold will trade flat around \$1,300/oz over the next two years as the market's interest rate expectations begin to rise and the US dollar falls back along our longer-term forecast path for the greenback.

Chart 11

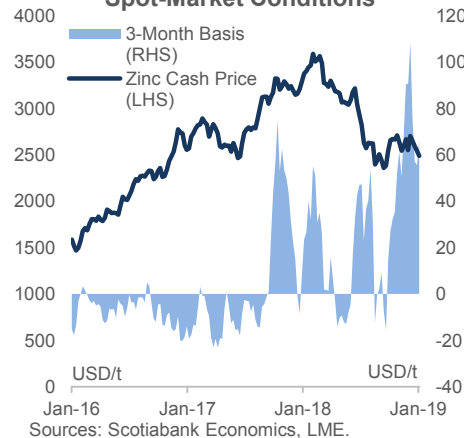
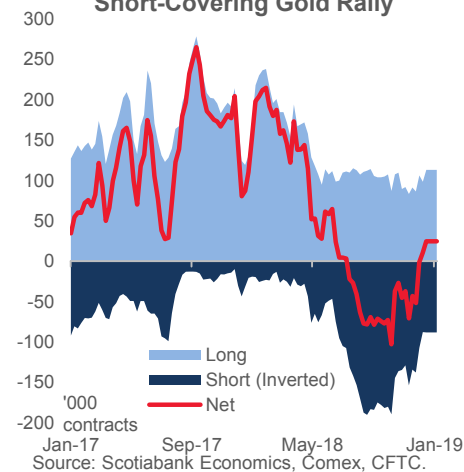
Zinc Contracts Hit Record-Setting Backwardation, Signaling Tight Spot-Market Conditions


Chart 12

Market Volatility Spurs Speculative Short-Covering Gold Rally


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