

Trade Fear Drags on Metal Demand Expectations, Canadian Crude Discounts Swell as Rail Lags

- Commodity prices fell back broadly in August on concerns that mounting tariffs between the US and China would dent demand for industrial materials. The White House continues to ramp up its trade dispute with Beijing, slapping tariffs on another \$200B in Chinese exports in mid-September.
- Base metals felt the brunt of US-China trade dispute headwinds but Chinese physical copper premiums have reached 3-year highs despite weaker global copper contracts, indicating that global bearishness concerning Chinese demand has likely run ahead of any actual slowdown in physical purchases.
- While most of the commodity complex remains in a state of at least temporary famine, the energy complex is feasting upon renewed bullish sentiment toward oil price prospects, and global benchmark Brent crude settled above \$80/bbl for the first time since late-2014.
- Canadian oil producers are missing out on the latest surge in global crude prices and brokers in Calgary have reported to media that Canadian heavy oil contracts traded hands at all-time high discounts of more than \$40/bbl under WTI in late-September as oil-by-rail services fail to keep pace with voracious demand for non-pipeline egress out of Western Canada.

The Scotiabank Commodity Price Index retreated by 5.3% m/m in August, with all major sub-indices falling back on a combination of demand concerns stemming from the US-China trade dispute and shortcomings in North American crude oil transportation infrastructure. Losses were most acute in the Oil & Gas sub-index (-9.7%) as discounts borne by Western Canadian crude benchmarks blew out in response to ongoing pipeline bottlenecks, insufficient oil-by-rail uptake, and steeper than usual refinery maintenance in the US Midwest.

In mid-September, the White House announced that the US would impose a 10% tariff on \$200B of Chinese exports, with the rate steepening to 25% at the start of the new year. This latest salvo comes on top of the 25% tariff on \$50B of Chinese imports announced in mid-June as well as product-specific tariffs on steel, aluminium, washing machines, and solar panels rolled out this past spring. China has responded with its own suite of retaliatory levies and there is no end in sight to the dispute; even a decisive Democratic victory in the midterms is unlikely to materially change the US trade negotiation position, with uncommon bipartisan support for a tougher trade stance against Beijing.

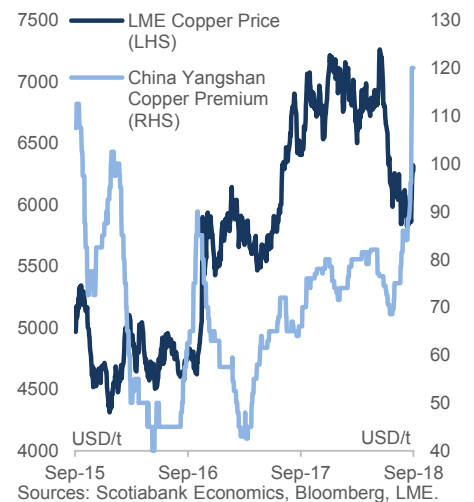
While a good deal of next year's commodity demand fundamentals will be determined by the form and intensity of policy assistance coming out of Beijing, it is notable that commodity prices appear to be holding up better within China than global benchmarks feeling the weight of speculative shorting activity from those betting that Chinese demand will falter (chart 1).

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Chart 1

Stronger Chinese Copper Market at Odds with Current LME Weakness



Scotiabank Commodity Price Index

August 2018	(% change)		
	MM	Y/Y	YTD
All Commodity*	-5.3	6.1	11.9
Industrials	-5.9	9.1	13.9
Oil & Gas	-9.7	14.4	16.6
Metal & Minerals	-1.3	-1.0	4.4
Forest Products	-6.4	18.3	26.9
Agriculture	-2.2	-6.3	3.3
	January 2007 = 100		
	2018		
	Aug	Jul	YTD avg.
All Commodity	114.5	120.9	120.5
Industrials	112.0	119.0	117.8
Oil & Gas	90.6	100.4	95.0
Metal & Minerals	115.8	117.3	124.2
Forest Products	162.3	173.4	166.5
Agriculture	128.6	131.5	135.4

* Weights: Oil & Gas (39.9%), Metal & Minerals (30.1%), Forest Products (14.7%), Agriculture (15.3%); Full technical note on page 6.

Despite LME copper prices falling from near-\$3.30/lb to recent lows below \$2.70/lb, physical premiums in China rose to three-year highs—global speculators were bidding down copper on bets that Chinese demand would falter in the face of US tariffs, while at the same time Chinese buyers on the ground were bidding up local premiums as they took advantage of the narrative-driven discount.

In an unlikely reversal, base metals are waning just as bulk commodities are picking up steam (chart 2). At the beginning of 2018, base metal prices were strong and the outlook appeared solid while bulks—particularly iron ore—looked destined to float lower as the market made room for ample low-cost supply coming on in Brazil and Australia. Then the prices of base metals collapsed in early June as fears mounted that the escalating trade dispute between the United States and China would weigh on the latter’s demand for raw material feedstock. At the same time, Beijing’s environmental and capacity rationalization policies removed a large portion of China’s steel smelting capacity from the domestic cost curve, pushing the value of steel ever-higher and prompting further iron ore demand from Chinese smelters that avoided closure and have since experienced exceptionally high margins.

CANADIAN CRUDE DISCOUNTS SWELL AS RAIL FAILS TO KEEP PACE

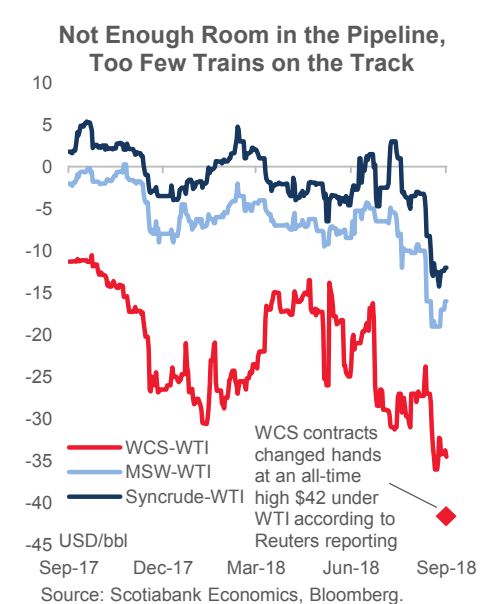
The discount borne by Canadian heavy oil blew out once again in September, reaching an all-time high of more than \$40/bbl under WTI on September 24th according to media reports quoting brokers in Calgary as the ramp-up of necessary oil-by-rail capacity clearly fell below demand for non-pipeline egress out of Western Canada (chart 3). And while pipeline bottlenecks are most visible in Western Canadian Select heavy oil discounts, Canadian light crude benchmarks like Mixed Sweet and Synthetic Crude are also seeing differentials to US crudes rise, reflecting increasingly tight takeaway capacity across all crude grades.

Canadian oil-by-rail shipments—which reached an all-time high of 204 kbpd in June—have further to climb and current commitments from major carriers like CP and CN Rail will put nearer 300 kbpd of Canadian crude on the rails by year-end. Current challenges sourcing enough rail crews, locomotives, and tank cars to satiate the rapidly rising demand for non-pipeline egress out of Western Canada are expected to abate, facilitating a gradual easing of WCS discounts back toward the \$18–22/bbl level required by oil-by-rail costs. Given the multitude of challenges currently faced by Canadian energy infrastructure projects, many in the industry increasingly see oil-by-rail as less of a temporary Band-Aid and more as a permanent, flexible component of the supply chain to a Canadian energy sector seemingly unable to push a major pipeline project to the finish line.

Chart 2



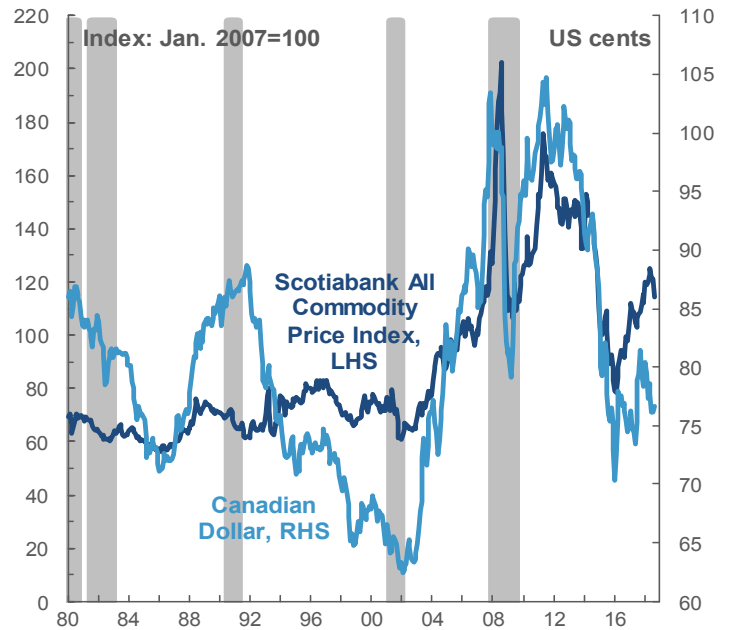
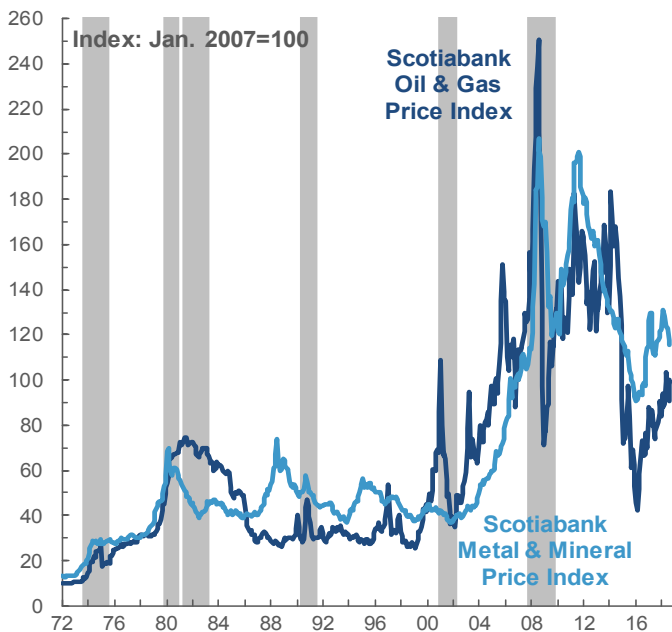
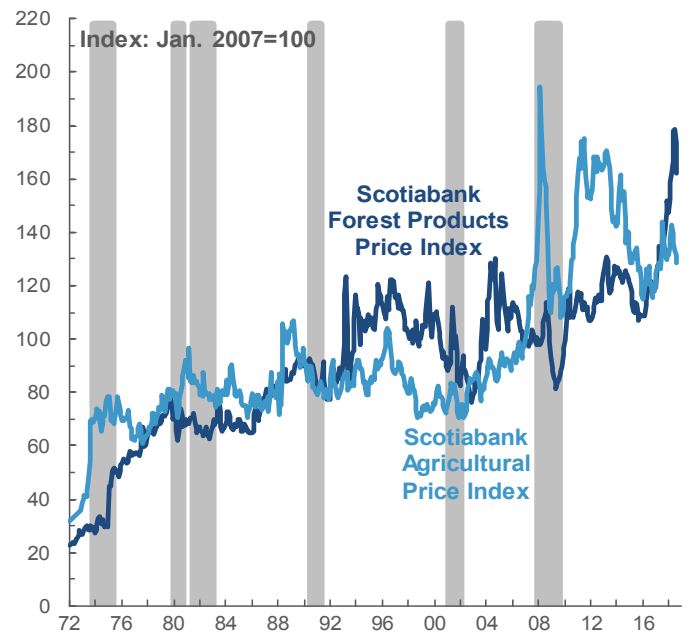
Chart 3



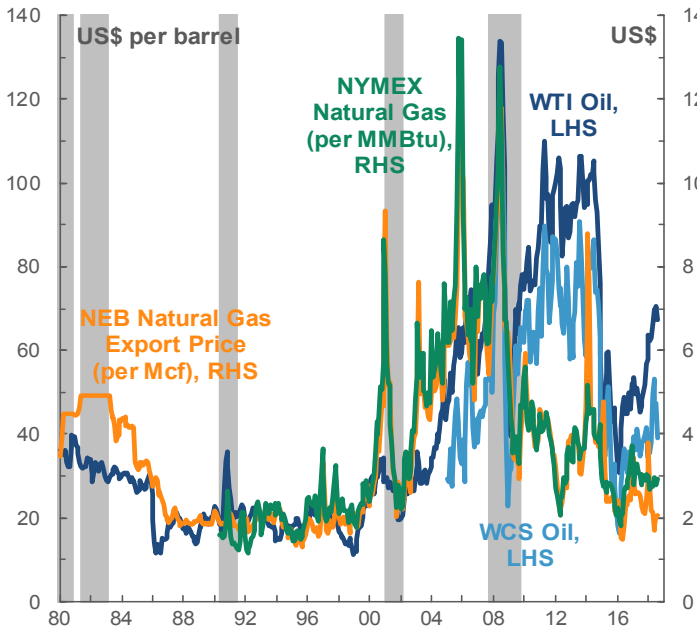
Price Outlook		2000–2016			2017	2018ytd	2018F	2019F
		Monthly Avg. Low	Period Avg.	Monthly Avg. High				
Oil & Gas								
Crude Oils								
West Texas Intermediate	USD/bbl	19.40	62.70	134.02	50.85	66.70	68	71
North Sea Brent Blend	USD/bbl	19.06	65.53	134.56	54.75	72.59	74	77
WCS - WTI Discount*	USD/bbl	-42.50	-16.85	-5.50	-12.74	-23.58	-23	-23
Natural Gas								
Nymex Henry Hub	USD/MMBtu	1.81	4.94	13.46	3.02	2.85	2.93	2.90
Metals & Minerals								
Base Metals								
Copper	USD/lb	0.62	2.35	4.48	2.80	3.02	3.10	3.25
Nickel	USD/lb	2.19	7.26	23.67	4.72	6.21	6.50	7.00
Zinc	USD/lb	0.34	0.81	2.00	1.31	1.37	1.45	1.45
Aluminium	USD/lb	0.58	0.86	1.39	0.89	0.98	0.95	1.00
Bulk Commodities								
Iron Ore	USD/t	27	108	302	72	69	63	60
Metallurgical Coal	USD/t	39	127	330	188	202	190	160
Precious Metals								
Gold	USD/toz	261	869	1,772	1,257	1,284	1,311	1,300

* 2008-16 average.

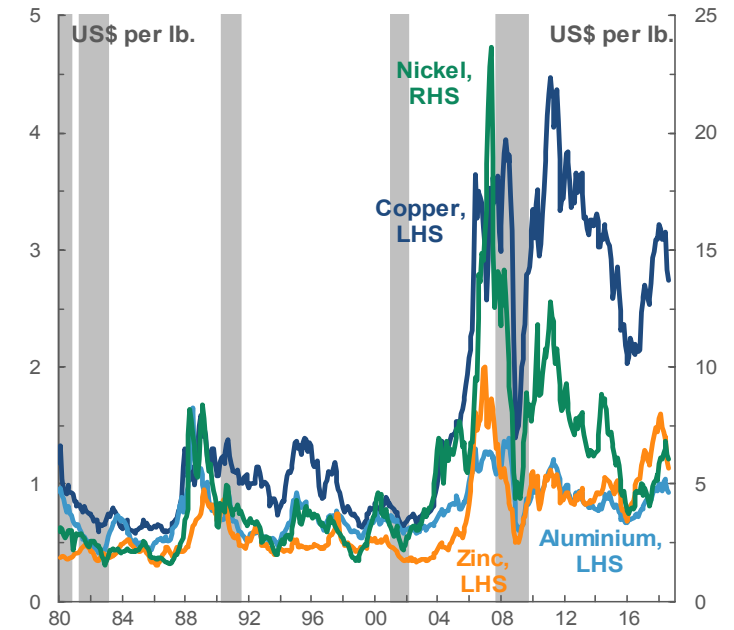
Scotiabank All Commodity Price Index

Canadian Dollar vs. Commodity Prices

Scotiabank Oil & Gas and Metal & Mineral Indices

Scotiabank Forest Products & Agricultural Indices


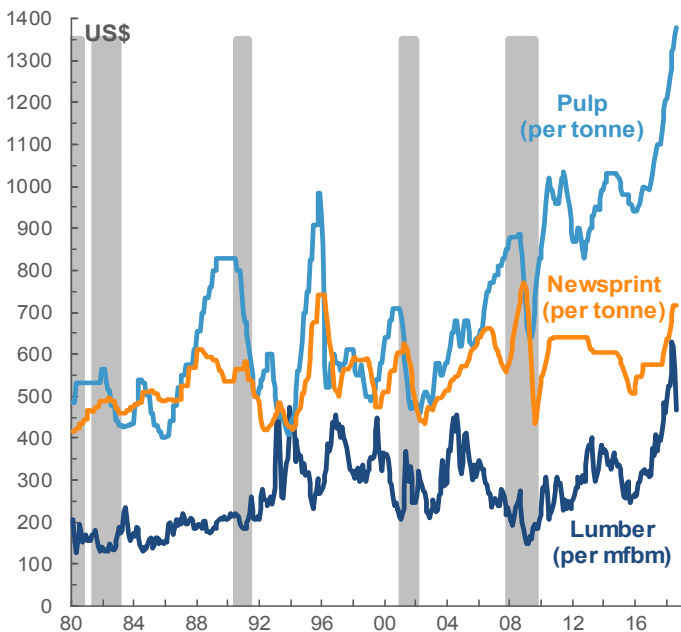
Oil & Gas Prices



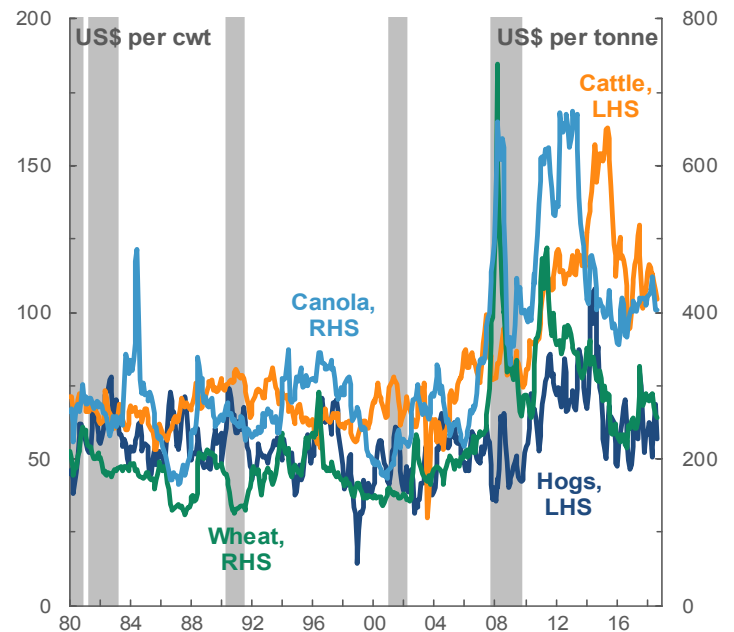
Metals Prices



Forest Products Prices



Agricultural Prices



Technical Note
**Scotiabank Commodity Price Index — Principal Canadian Exports
January 2007 = 100**

This Index has been designed to track the spot or transactions prices paid in U.S. dollars for key Canadian commodities and resource-based manufactured goods in export markets. The weight of each component is based upon its net export value in 2010. Prior to January 2007, the weight of each component was based on its export value in 1995-97, except for crude oil & refined petroleum products, uncoated freesheet paper and linerboard, where net exports were used. Canada imports a significant quantity of these products, and use of their export value alone would have overstated the importance in Canada's trade performance.

The following prices are included:
OIL & GAS

Crude Oil & Refined Petroleum Products (US\$ per bbl) MSW light sweet crude oil at Edmonton (previously Edmonton Par crude) and Western Canadian Select heavy oil at Hardisty, Alberta; price differentials off WTI near-by futures from Bloomberg.

Natural Gas (US\$ per mcf) Average export price quoted by the National Energy Board.

Natural Gas Liquids (NGLs – Propane, Butane, Ethane & Pentanes-Plus) (US\$ per bbl), Propane at Edmonton & Sarnia.

METALS & MINERALS

Copper & Products (US\$ per lb) LME official cash settlement price for grade A copper.

Zinc (US\$ per lb) LME SHG cash settlement: prior to Sept 1990, U.S. producers' price for high-grade zinc delivered.

Lead (US\$ per lb) LME official cash settlement price; prior to Jan. 1991, U.S. producers' price for common grade delivered.

Aluminium & Products (US\$ per lb) since 1979, LME official cash settlement price.

Nickel (US\$ per lb) since 1980, LME official cash settlement price.

Gold (US\$ per oz) 'LBMA Gold Price PM' as of March 20, 2015.

Potash (US\$ per tonne) Standard potassium chloride, spot price, FOB Vancouver.

Sulphur (US\$ per tonne) Solid, spot price, FOB Vancouver.

Metallurgical Coal (US\$ per tonne) Contract price for premium-grade hard coking coal, FOB Vancouver.

Iron Ore (US cents per dmtu) Spot price fines 62% Fe, CFR Qingdao, China; prior to Jan 2011, term-contract price for concentrates 66% Fe from Labrador/Quebec to Northern Europe (FOB Sept-Iles).

Uranium (US\$ per lb) U₃O₈ near-by-futures from Bloomberg.

Molybdenum (US\$ per lb) since March 1992, MW dealer oxide.

Cobalt (US\$ per lb) MW dealer price.

FOREST PRODUCTS

Lumber & Wood Products, Western Spruce-Pine-Fir 2x4 No.2 & Btr (US\$ per mfbm) FOB mill.

Oriented Strandboard (US\$ per thousand sq. ft.), U.S. North Central region, 7/16 inch.

Pulp, Bleached Northern Softwood Kraft (US\$ per tonne) Transactions price, delivery USA.

Newsprint (US\$ per tonne) Average transactions price, 48.8 gsm, delivery Eastern USA.

Groundwood Specialty Papers (US\$ per ton) Supercalendered-A paper, 35 lb., delivery USA.

Linerboard (US\$ per ton), delivery Eastern USA with zone discounts.

AGRICULTURE

Wheat & Flour (US\$ per tonne), DNS No 1 14% protein Duluth, Minn; prior to April 2011 No.1 CWRS, 13.5% protein at St. Lawrence.

Barley (US\$ per tonne), since Dec.1994, No.1 at Lethbridge, Alberta.

Canola & Oilseeds (US\$ per tonne) No.1 Canada, in store Vancouver.

Cattle & Beef (US\$ per cwt) Steers over 1,051 pounds at Toronto; from Jan 1993, Ontario average.

Hogs & Pork (US\$ per cwt) 100 Index Hogs at Toronto; from Jan 1993, Ontario average.

Fish & Seafood (US\$ per lb) West Coast silver coho salmon; Atlantic lobster prices; prior to 1986 cod fillets & blocks.

**Scotiabank Commodity Price Index —
Components And Weights**

Index Components	Net Export Value In 2010 (millions of dollars)	Index Weight (per cent)
OIL & GAS INDEX	46,537	39.90
Crude Oil & Refined Products	33,231	28.49
Natural Gas & LNG	11,741	10.07
NGLs	1,565	1.34
METAL & MINERAL INDEX	35,109	30.10
Copper	3,160	2.71
Zinc	1,255	1.08
Lead	579	0.50
Aluminium	6,045	5.18
Nickel	4,246	3.64
Gold	4,678	4.01
Coal	4,757	4.08
Iron Ore	3,346	2.87
Potash	5,161	4.42
Sulphur	457	0.39
Uranium	891	0.76
Cobalt	288	0.25
Molybdenum	246	0.21
FOREST PRODUCTS INDEX	17,081	14.66
Lumber & Wood Products	4,673	4.01
OSB	812	0.70
Pulp	6,818	5.85
Newsprint	2,734	2.34
Groundwood Spec. Papers	1,971	1.69
Linerboard	87	0.07
AGRICULTURAL INDEX	17,901	15.35
Wheat & Flour	4,693	4.02
Barley & Feedgrains	1,088	0.93
Canola & Oilseeds	5,398	4.63
Cattle & Beef	1,640	1.41
Hogs & Pork	2,378	2.04
Fish & Seafood	2,704	2.32
TOTAL INDEX	116,643	100.00

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