

Economics of Pessimism Batter Industrial Commodities, Gold Boosted by Market Misfortune

- The global economic outlook continues to deteriorate and industrial commodity prices are feeling the weight of bearish macro sentiment.
- We are reversing our prior optimism and now expect the US-China trade war to steadily worsen straight through to the 2020 US presidential election, with neither Washington nor Beijing showing any willingness to deescalate tensions.
- Commensurate with this bearish slide in our outlook, risks are now to the downside of our current industrial commodity price forecasts and to the upside of our precious metals forecasts, which will be updated in October when firmer data is available.
- Canadian oil markets received a rare spot of good pipeline news in August with the Nebraska Supreme Court ruling in favour of Keystone XL and the company behind the Trans Mountain Expansion Project revving up hiring for potential construction as soon as September.
- While uncertainty is weighing on industrial commodities, precious metals have ripped higher on the back of plunging bond yields and safe haven bids, with gold reaching its highest level since the end of the eurozone crisis at nearly \$1,550 per ounce.

DETERIORATING MACRO SIGNALS

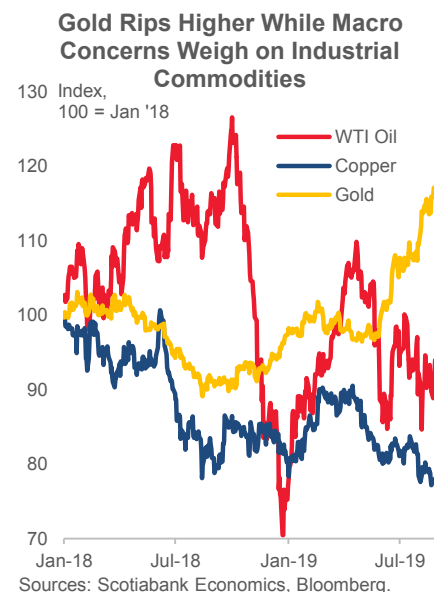
The global economic outlook continues to deteriorate and industrial commodity prices are feeling the weight of bearish macro sentiment. Numerous trade-exposed economies are showing signs of contraction and financial markets are flashing signals that portend the onset of recessionary conditions. Commodity prices are trading mostly where you'd expect given such a macro backdrop, with WTI oil prices sagging in the low-\$50s despite a litany of supply risks, copper trading at less than \$2.55/lb, and gold fetching nearly \$1,550/oz (chart 1).

While there are many risks—including but not limited to Chinese deleveraging, Hong Kong protests, disorderly Brexit, German industrial weakness, Argentinian politics, etc.—buffeting growth prospects, the US-China trade war has been the strongest driver of market sentiment and things only seem to be getting worse. We are beginning to reassess our prior cautious optimism on the trade file and are now erring on the side of pessimism. Far from our initial expectation that cooler, rational heads would prevail in the trade war, neither Washington nor Beijing has shown any willingness to deescalate tensions. Our base case has shifted to continued, steadily worsening trade tensions straight through the 2020 US presidential election. Responding to the storm clouds on the horizon, global central banks are shifting from tightening to easing monetary policy in an effort to blunt the worst of any slowdown (chart 2), boosting gold's until-now-staid prospects. Commensurate with this bearish slide in our outlook, risks are now to the downside of our current industrial commodity price forecasts and to the upside of our precious metals forecasts, which will be updated in October.

CONTACTS

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

Chart 1



Scotiabank Commodity Price Index

	July 2019 (% change)		
	MM	Y/Y	YTD
All Commodity*	2.2	-5.3	-4.7
Industrials	2.9	-5.5	-4.3
Oil & Gas	7.7	-12.0	-3.4
Metal & Minerals	1.1	12.4	1.3
Forest Products	-1.3	-20.4	-14.5
Agriculture	-1.3	-4.3	-6.6

January 2007 = 100

	2019		
	Jul	Jun	YTD avg.
All Commodity	114.7	112.2	115.6
Industrials	112.6	109.5	113.5
Oil & Gas	88.3	82.1	92.4
Metal & Minerals	132.5	131.0	127.2
Forest Products	138.0	139.8	142.8
Agriculture	125.8	127.5	127.4

* Weights: Oil & Gas (39.9%), Metal & Minerals (30.1%), Forest Products (14.7%), Agriculture (15.3%); Full technical note on page 7.

LETTERS FROM A TRADE WAR

The US-China trade war continues to rumble on—erratically, unevenly, but definitively trending ever worse. On August 1st President Trump took aim at the final \$300 billion tranche of until-now non-tariffed Chinese imports, placing a levy of 10% effective September 1st. This is a step that many believed the White House would not take given the heavy consumer tilt to this final basket of imports. Indeed, on August 13th Trump wavered and announced that more than half of those tariffs by value (mostly on electronics and other mass consumer items) would be delayed until December 15th to avoid higher-cost Christmas lists and pocketbook pain, a tacit acknowledgement that the American consumer is the ultimate payer of tariffs and contrary to Trump's general message up until this point.

As would be expected, Beijing followed suit and placed retaliatory tariffs of an equivalent magnitude on the final \$75 billion tranche of US imports, split between September 1st and December 15th to mirror the US. However, the White House viewed China's retaliatory tariffs as an affront—despite being only one-quarter the size—and responded by further ratcheting tariff rates by five percentage points effective October 1st (from 25% to 30% on the \$250 billion of previously tariffed goods and from 10% to 15% on pending tariffs on the upcoming tranche). Even actions that could potentially be interpreted as dovish regarding trade tensions, like Trump's mention of a promising phone call with the Beijing, fall flat as Chinese policymakers firmly denying that any such call took place. We anticipate a fairly steady stream of worsening trade-related headlines to keep pressure on sentiment and hold back industrial commodity prices.

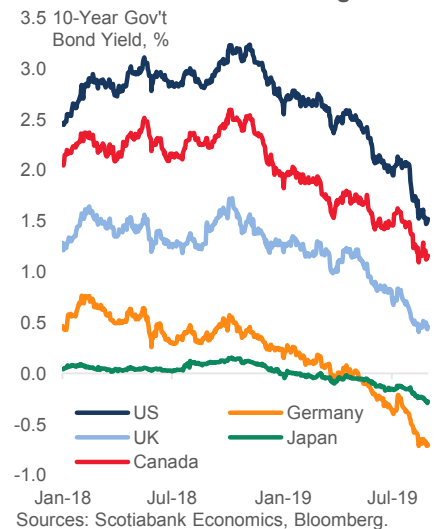
PACE OF COMMODITY RECOVERY WILL BE DECIDED IN BEIJING

All commodity roads end in China, where more than half of most industrial metals are consumed, but not all of China's challenges are trade-related. Even before the trade war began in earnest the seeds were sown for weaker Chinese growth in 2019–20 coming off the stimulus-fuelled highs of 2017–18 as Beijing focused on deleveraging the over indebted domestic economy. Historic protests in Hong Kong have thrown the future of the economic powerhouse territory's governance into question and further eroded confidence. Past Chinese slowdowns have in their own way been turned out to be an eventual boon for commodity fortunes as Beijing moved to counteract waning growth with aggressive, construction-heavy fiscal stimulus programmes.

We are likely to see some modest efforts of this variety again and it has been reported that Beijing is looking to increase the annual quota for special municipal bonds—which are typically linked to commodity-intensive local infrastructure spending—from the current level of \$305 billion after loosening the rules on what those funds could be spent on in June. However, given Beijing's ongoing efforts to deleverage the economy, any stimulus is expected to be more modest and tilted toward the consumer and service sector rather than materials-heavy industry and construction favoured in past spending splurges. The ongoing trade war could also, paradoxically, further limit Beijing's stimulus spend given that, despite the additional drag on the economy, Washington's trade policies provide an external source of blame to a slowdown that many in Beijing view as a necessary step in rebalancing financial risks.

Chart 2

Bond Markets Begin to Price In Global Central Bank Easing Trend



WESTERN CANADIAN OIL PATCH GETS POSITIVE PIPELINE NEWS, BUT DIFFERENTIALS REMAIN TOO TIGHT FOR RAIL

Global oil prices have felt the weight of global macro concerns—probably worth \$5–10/bbl at present—but a litany of supply-side challenges have provided price support and prevented WTI from falling below \$50/bbl, at least for now. Canada’s oil patch, meanwhile, experienced some rare good pipeline-related news and curtailment has kept Canadian crude differentials tighter than rail economics require.

The Keystone XL pipeline received some promising news when Nebraska’s Supreme Court approved the project’s route on August 23rd, ending a more than decade-long permitting dispute. The approval is a good sign in Western Canada’s long-running battle to increase pipeline capacity, though far from a definitive victory. Many hurdles remain including a federal lawsuit in Montana, holdout landowners along the route that continue to refuse to grant an easement to the pipeline, in addition to the many likely avenues of additional opposition including protests and blockades. Meanwhile, the federally-owned Trans Mountain Expansion Project was also the source of positive egress news when Trans Mountain Corp, the crown corporation charged with building the expansion, issued “notice to proceed” directives to mobilize contractors and could begin construction activities as soon as September. The company expects the pipeline to ever service is mid-2022, though all timelines should be taken with a wallop of salt given the past decade of project opposition.

The flurry of pipeline headlines is great news for the future but distracts from the present, where production curtailments have kept markets tight and WCS prices too high, in our view, given the need for further rail investments. The WCS discount is currently sitting at less than \$12 per barrel under WTI, well below the level that allows producers to profitably ship crude by rail. While this discount level would have failed to cover the cost of oil-by-rail a few months ago, break-even prices are drifting higher (chart 4) as WCS’ quality-related discount widens as markets await the onset of the International Maritime Organization’s 2020 emission standards. The new shipping rules will enforce a sea-change (all puns intended) in the fuel used by the roughly 80,000 ships traversing the world’s oceans, penalizing sulphurous heavy fuel oil and boosting demand for lighter fuels like marine diesel. The shift in fuel preferences should, all else equal, increase the discounts borne by heavy, high-sulphur crudes like WCS. On the flip side, demand for the heavier nature of WCS—useful in blending with ultra-light crudes coming from the US shale patch—will continue to be supported by US sanctions against Venezuela and Iran, both of which produce oil blends that are on the heavier side of the crude slate.

GOLD SHINES AS RISKS MOUNT

While uncertainty is weighing on industrial commodities, precious metals have ripped higher on the back of plunging bond yields and safe haven bids. Sporadically inverting yield curves the world over have brought with them a flurry of recession-fearing headlines and provided market bears a firm signal with which to drive global markets lower. Central banks have responded to slowing growth and mounting political risks by abruptly reversing their prior tightening path, with the yield on US inflation-protected 10-year bonds falling more than 100 basis points since the beginning of the year into negative real yield territory (chart 4).

Gold prices are trading at their highest level since the eurozone crisis at just under \$1,550 per ounce. Plummeting inflation-adjusted US bond yields and the proliferation of negative-yielding debt across much of the OECD have improved the relative attractiveness of non-yielding bullion. Meanwhile, political risks from Hong Kong’s historic protests to London’s seeming race toward a hard Brexit have further bolstered gold through safe haven inflows. Silver, too, which has been a general laggard has been pulled higher and is up nearly 30% since the end of May to \$18.46 per ounce. Gold will continue to outperform amidst political and market uncertainty and risks are now solidly to the upside of our 2020 forecast of \$1350 per ounce.

Chart 3

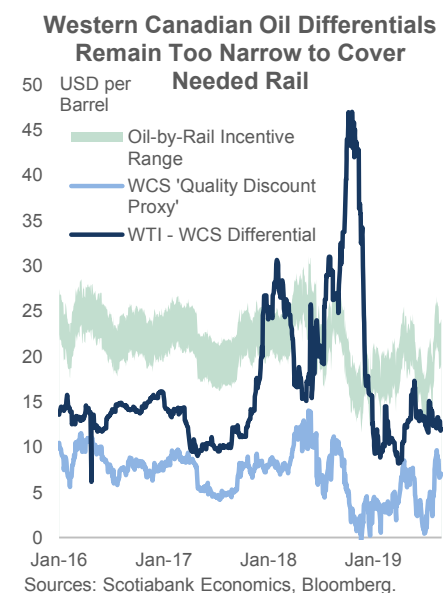
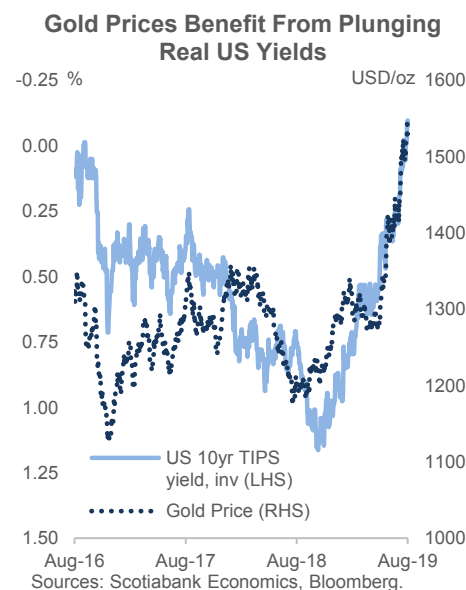
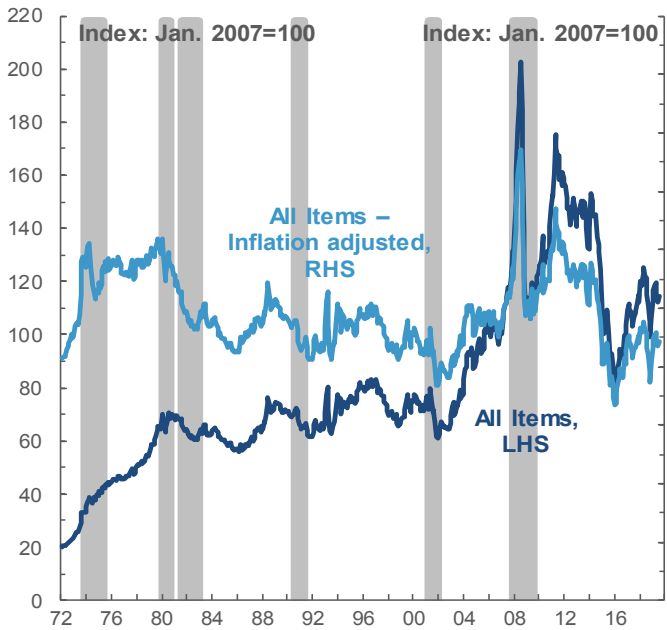
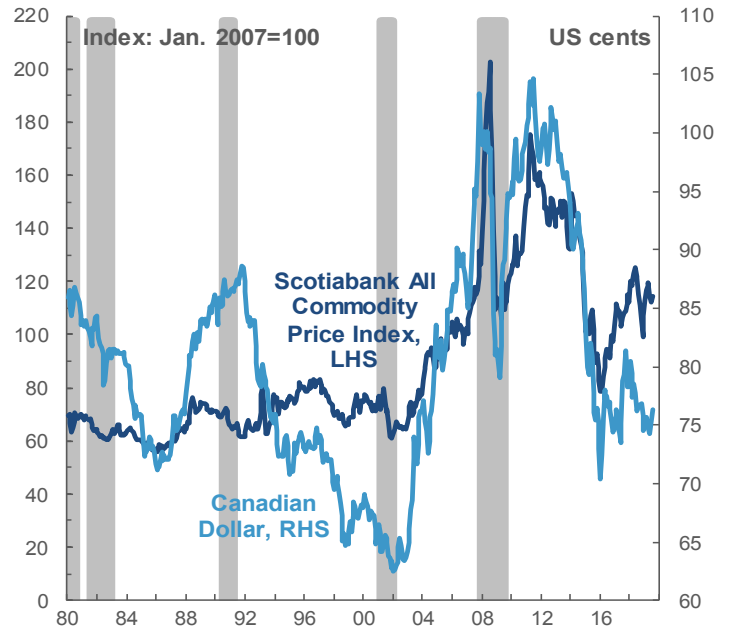


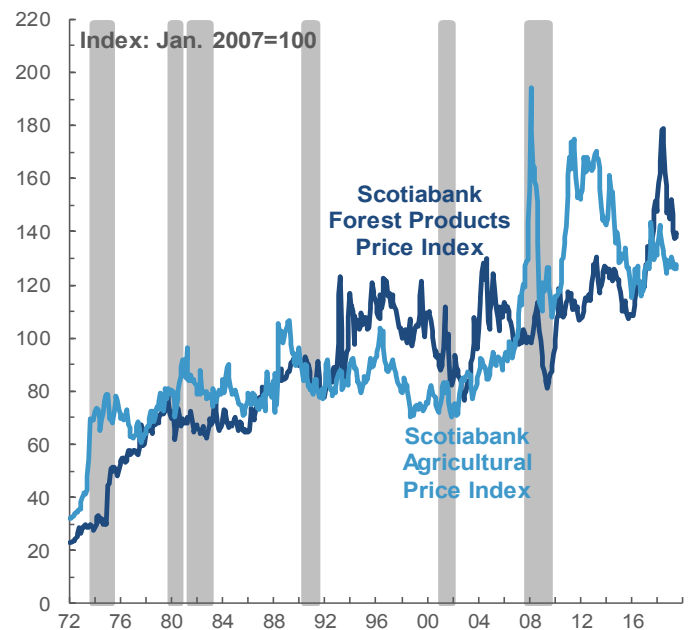
Chart 4

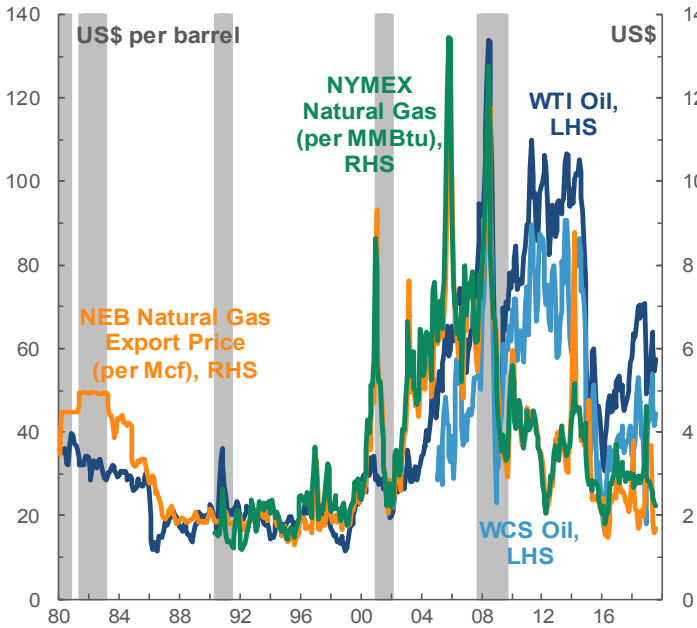
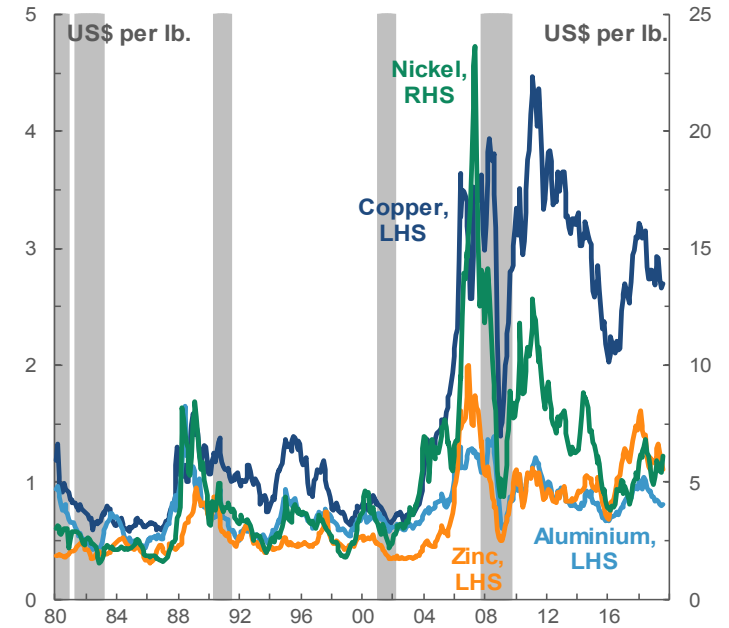
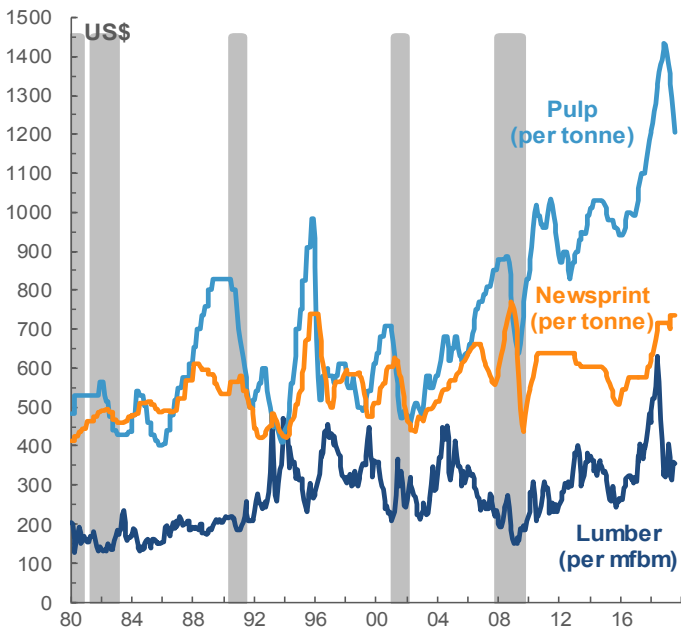
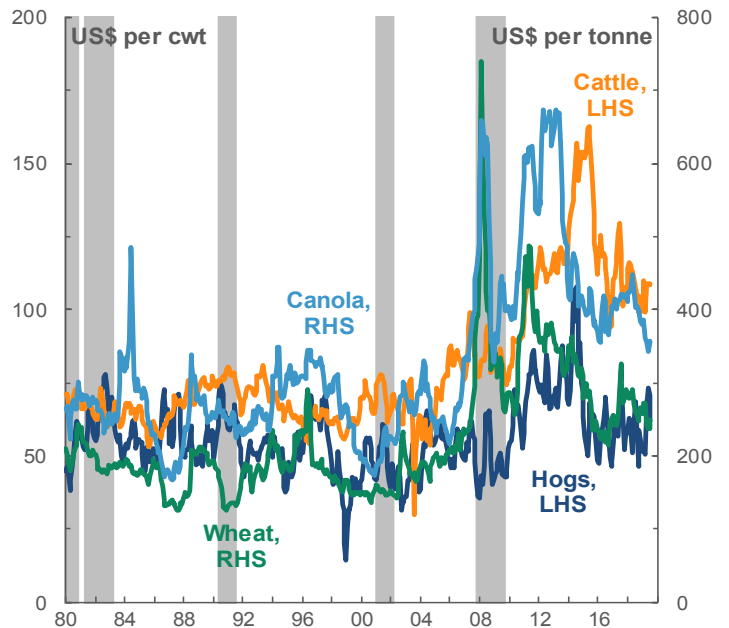


Price Outlook		2000–2017			2018	2019ytd	2019F	2020F
		Low	Period Avg.	High				
Oil & Gas								
Crude Oils								
West Texas Intermediate	USD/bbl	17.45	62.05	145.29	64.90	57.15	56	55
North Sea Brent Blend	USD/bbl	17.68	64.93	146.08	71.69	65.14	65	62
WCS - WTI Discount*	USD/bbl	-42.50	-16.43	-5.50	-26.29	-11.80	-14	-21
Natural Gas								
Nymex Henry Hub	USD/MMBtu	1.64	4.83	15.38	3.07	2.58	2.71	2.75
Metals & Minerals								
Base Metals								
Copper	USD/lb	0.60	2.38	4.60	2.96	2.76	2.80	3.00
Nickel	USD/lb	2.00	7.12	24.58	5.95	5.82	5.70	6.00
Zinc	USD/lb	0.33	0.84	2.10	1.33	1.20	1.22	1.20
Aluminium	USD/lb	0.56	0.87	1.49	0.96	0.82	0.90	0.90
Bulk Commodities								
Iron Ore	USD/t	27	108	302	70	96	90	72
Metallurgical Coal	USD/t	39	131	330	208	196	195	170
Precious Metals								
Gold	USD/toz	256	890	1,895	1,268	1,342	1,350	1,350

* 2008-17 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, 45 grams, 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), Saskatchewan aggregate spot price; historical data 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

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.