Commodities Outlook (Q4 2018)

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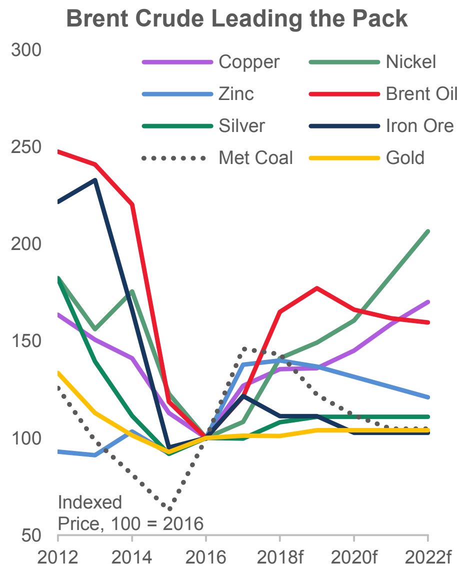
US-CHINA TRADE HEAT SETTLES TO FRUSTRATING SIMMER, DIMMING METALS PRICE PROSPECTS

- **While NAFTA worries look to be in the rear-view mirror, US-China trade concerns remain front-and-centre for commodity markets with no obvious end in sight; we now believe that the US-China trade dispute will remain a slow-burn drag on industrial commodity sentiment through to the 2020 US presidential election.**
- **Chinese counter-stimulus will help offset trade-related headwinds, but we expect Beijing's policy package to be primarily targeted at domestic services industries and thus less metals-supportive than in the past.**
- **Our less constructive view on the tumultuous cross-Pacific trade environment leads to slower demand growth and thus lower forecasted prices for metals like copper, nickel, zinc, and aluminium through the end of 2020 (chart 1).**
- **Oil price prospects have been bolstered by tightening supply conditions and uncertainty regarding Saudi Arabia's capacity to fill in for production losses in Iran and Venezuela.**
- **Unfortunately for Canadian oil producers, pipeline constraints and sluggish oil-by-rail pickup have prompted discounts to blow out once again and differentials are expected to remain volatile until Line 3 enters service in early 2020.**

FROM TRADE WAR FOOTING TO UNCOMFORTABLE UNPLEASANTNESS

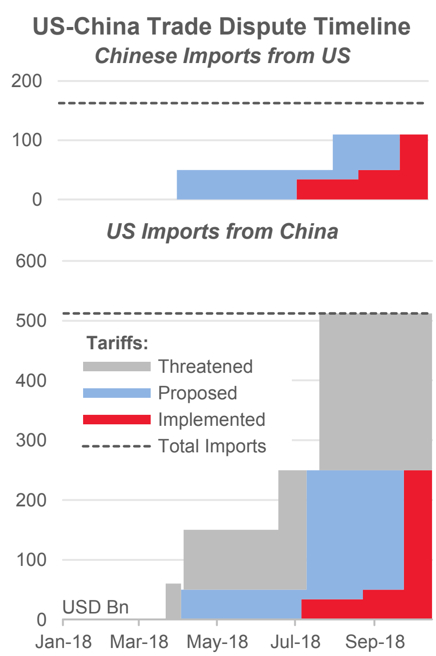
The Great US-China Trade War—or as we're choosing the think of it, the protracted US-China unpleasantness—looks like it's going to be a long-lived annoyance to the global economy and commodities producers need to get used to a few more years of slower-than-anticipated demand and tepid market sentiment. In mid-September, the White House announced that the US would impose a 10% tariff on $200B of imports from China (chart 2), 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 shipments announced in mid-June as well as product-specific tariffs on steel, aluminium, washing machines, and solar panels rolled out earlier in the year. We expect US tariffs on $250B in Chinese goods to remain in place at a rate of 25% through to the 2020 US presidential election, presenting broad but relatively mild headwinds to the Chinese economy. Standing up to China on trade enjoys uncommon bipartisan support in Washington and even a decisive Democratic victory in Congressional mid-term elections is unlikely to materially change the current policy course. However, we believe that the White House will ultimately decline to impose further so-called Phase III tariffs on the remaining $267B in imports from China, primarily because this final list of goods is

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, PIIE.

far more consumer-oriented (e.g. iPhones) and thus likely to prompt negative political sticker-shock.

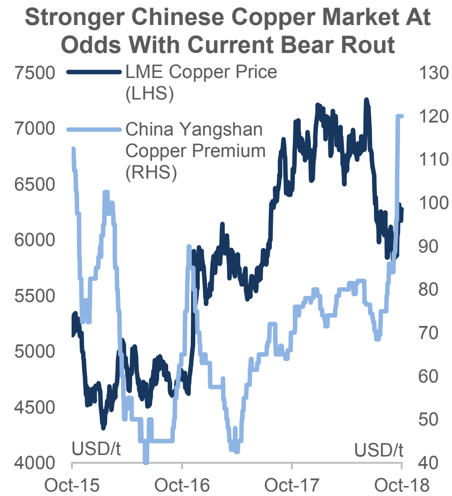
Beijing has retaliated with counter-tariffs to the extent that it can given that China imports less than $250B from the US, though non-tariff measures remain a future option should relations sour further. **More important for raw commodities demand are the steps that Chinese policymakers take to offset the drag of US tariffs on the Chinese economy.** Chinese Premier Li addressed some of the speculation around potential stimulus responses, stating that Beijing is not looking to engage in currency devaluation nor would it embark on the same kind of economic stimulus that helped China's economy avoid the worst of the 2008 financial crisis. Instead, Li stressed that Beijing would take "pre-emptive measures" and would use other macroeconomic policies to help industries hit by the mounting tariffs, with the vague pronouncement leaving considerable room for interpretation. We believe that while the Chinese government is likely to fast-track infrastructure projects that have been slow to break ground, Beijing is unlikely to kick off billions of dollars in new infrastructure projects as seen in previous stimulus efforts. This time around, we expect that the primary target of monetary and fiscal measures will be services-oriented sectors that China believes have significant growth potential, meaning that this policy package is likely to be less metals-supportive than previous efforts. Accordingly, we have softened our demand and price outlook across the base metals complex, reflecting the impacts of trade-related drag and unsupportive sentiment.

While a good deal of next year's commodity demand fundamentals will be determined by the type and intensity of policy assistance coming out of Beijing, it is notable that current spot prices are richer within China than global benchmarks would suggest. 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 (chart 3). While we believe that Chinese demand will gradually slow through next year, LME prices are at least currently reflecting an overreaction to the US-China trade dispute.

ENERGY: TIGHTENING CRUDE BALANCES AND LARGE IRANIAN EXPORT LOSSES PUT SAUDI ARABIAN SPARE CAPACITY IN THE SPOTLIGHT

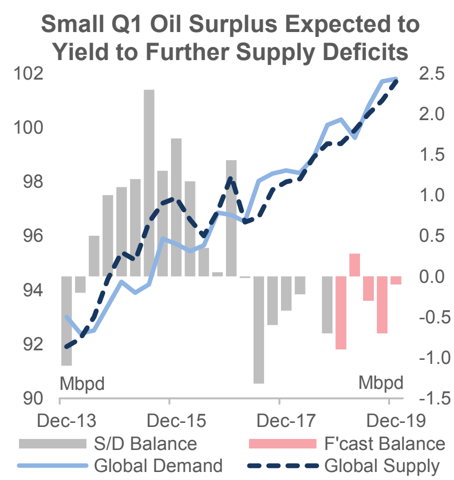
The oil market is getting tight and Brent crude breached $85/bbl in early October for the first time since 2014. Demand growth has been robust at 1.5 MMbpd y/y through the first half of 2018 and is expected to grow by a strong 1.6 MMbpd next year. The US shale patch satiated nearly all this new demand—pumping 1.8 MMbpd more through the first half of 2018—but looks set to slow to nearer 1 MMbpd in 2019 as drilling drifts into less prolific acreage and infrastructure constraints limit profitability. Within OPEC, Venezuelan production continues to collapse (-650 kbpd y/y) and Iranian exports are rapidly falling off (-1 MMbpd by year-end) in the face of renewed US sanctions. All this leaves considerable weight on the shoulders of Saudi Arabia, which holds virtually all of the OPEC's spare capacity. We expect Saudi Arabia to largely rise to the challenge, contributing enough supply to maintain market stability but not as many barrels are needed to close the supply gap completely. Global oil balances are expected to remain in a mild deficit of 200 kbpd in 2019 (chart 4), slightly less than the 500–600 kbpd deficits averaged over 2017–18 but with less of an inventory cushion (chart 5). Prices are expected to remain well-supported through 2020, though a forecast surplus in 1Q19 and an anticipated rebalancing of over-extended bullish positioning are expected to keep us from sustainably breaking above

Chart 3



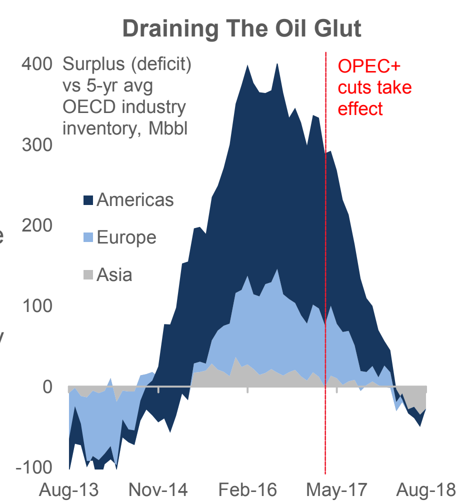
Sources: Scotiabank Economics, Bloomberg, LME.

Chart 4



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

Chart 5



Sources: Scotiabank Economics, IEA, OMI.

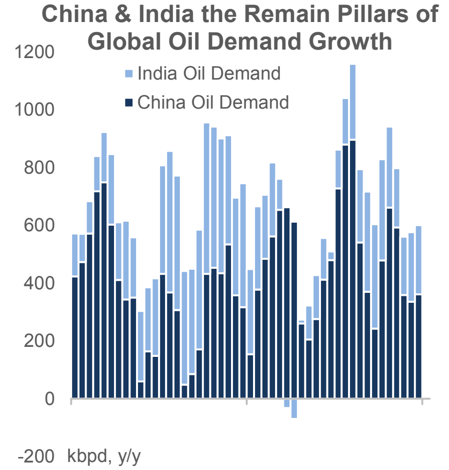
$90/bbl. Brent oil prices are forecast to average $80/bbl in 2019 before gradually falling back to $75/bbl in 2020. WTI differentials are expected to remain wide given chronic infrastructure bottlenecks, averaging $72/bbl in 2019 and $69/bbl in 2020. On top of WTI's challenges, Canadian heavy crude is forecast to trade at a wider discount through 2020, with WCS contracts expected to average $24/bbl under WTI in 2019 as oil-by-rail services ramp up before narrowing to $21/bbl in 2020 as Line 3 enters service.

Despite trade uncertainty the global economic backdrop remains robust and supportive of continued gains in oil demand. Going into 2019, we expect global demand to advance by 1.6 MMbpd before slowing slightly in 2020 on the back of high prices. Emerging Asia remains the engine of global oil demand growth (chart 6), expected to advance 850 kbpd in 2019 with China accounting for just more than half that sum. While metals are going to miss out on Beijing's stimulus, services-targeted spending is likely to further support already strong Chinese demand growth. Indian demand is also picking up, averaging nearly 300 kbpd year-to-date following growth of only 100 kbpd in 2017 due to headwinds related to the late-2016 demonetization policy. High prices are expected to weigh on demand growth through the latter part of 2019 into 2020, and slower demand stemming from higher-than-anticipated oil prices could contribute to a smaller supply deficit in the latter half of 2019.

Growth in the US shale patch will continue to march ahead in 2019, though at a noticeably slower pace than producers enjoyed in 2018. From a breakneck pace of more then 1.7 MMbpd in 2018 (chart 7), shale's contribution to global balances looks to slow to nearer 1.0–1.2 MMbpd in 2019. Infrastructure bottlenecks present the first drag on shale growth as 2018's production gains overwhelmed the capacity of midstream assets—particularly around West Texas' Permian Basin and en route to export facilities on the US Gulf Coast—and enflamed discounts, which rose to nearly $20/bbl under WTI for many Permian producers and to more than $10/bbl under global Brent for WTI at Cushing, the primary US crude benchmark. These differentials are preventing US producers from receiving the full investment impulse that $85/bbl Brent would normally provide, though infrastructure buildouts are expected to mitigate this challenge through the end of 2019 and into 2020. The other, more structural challenge facing shale producers is the gradual shift into less prolific acreage. Many firms "high-graded" their drilling, focusing on the sweet spots in each play as a means of staying afloat amidst the post-2014 downturn in oil prices. These producers are now venturing further afield, which means that average well productivity is likely to decline slightly and leave much of the work of increasing production levels to higher drilling rates.

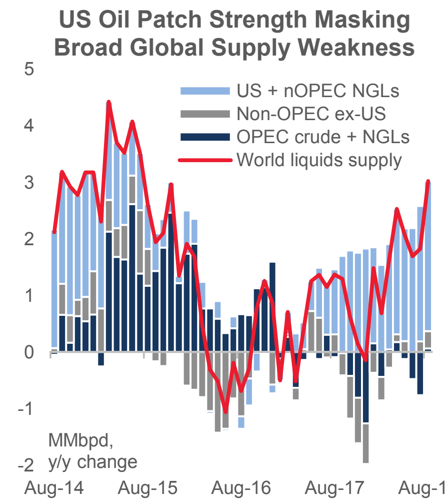
A slower US shale patch shifts the marginal spotlight to OPEC where losses in Venezuela and Iran will put a lot of pressure on producers like Saudi Arabia to make up the difference. Venezuelan production is down 642 kbpd y/y as years of mismanagement and underinvestment take their toll (chart 8). In Iran, US nuclear sanctions are having a much larger impact than initially forecast and an anticipated loss of 300–400 kbpd is now expected to exceed 1 MMbpd by the end of the year. Former purchasers of Iranian crude are taking no chances when it comes to US sanctions for fear of being locked out of the US financial system. This ground-level corporate aversion to Iranian oil is dramatically increasing the effectiveness of the US sanctions regime, negating the broad global government-level opposition which we originally believed would blunt their impact. The task of making up most of this shortfall will fall to Saudi Arabia, which isn't likely to receive much production assistance from the rest of OPEC, where six of fifteen members are experiencing chronic production declines.

Chart 6



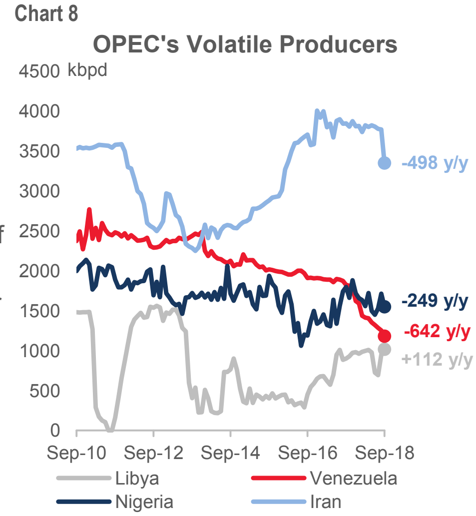
Sources: Scotiabank Economics, MPNG, NBS, OMI.

Chart 7



Sources: Scotiabank Economics, OMI.

Chart 8



Sources: Scotiabank Economics, OMI.

Saudi Arabia typically holds back 1.5–2.0 MMbpd or more of its supply as a emergency cushion for potential shortfalls elsewhere in the world. To keep up with demands on its production next year, we expect that Saudi Arabia will need to push its fields to more than 11 MMbpd for the first time in the country's history—a feat that many in the market are betting Riyadh can't pull off. We expect they'll succeed and maintain a reasonably well-supplied market in 2019, but it'll be a delicate balance and the oil industry isn't typically a delicate one. Two key areas to watch are Libya and Nigeria, where production statistics have been calm relative to recent militancy-fueled export volatility. A pipeline attack in Nigeria or a port seizure in Libya would quickly take 200–400 kbpd off the market and provide the propellant for a march into the $90s. Conversely, prior forecasts for slowing US shale growth have been consistently confounded and global crude prices comfortably in the $80s could derail recently strong demand growth, allowing us to drift back into the low $70s.

Closer to home, the discount borne by Canadian heavy oil blew out to crisis levels once again in September, reaching an all-time high of more than $40/bbl under WTI as the ramp-up of necessary oil-by-rail capacity clearly fell below demand for non-pipeline egress out of Western Canada. 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 put nearer 300 kbpd of Canadian crude on the rails by year-end. Current challenges sourcing sufficient volumes of 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 (chart 9). Given the multitude of challenges currently faced by Canadian energy infrastructure projects, many in the industry increasingly see oil-by-rail less as 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.

The early-October confirmation of a positive final investment decision from the consortium behind the LNG Canada export facility on the BC coast is a major boost for Canada energy investment sentiment following years of project delays hampering the prospects of other large energy projects. This success follows the high-profile abandonment of the similarly massive Pacific NorthWest LNG facility last year as well as the cancellation of much-needed pipelines like Northern Gateway and Energy East. The project is expected to enter service in 2024 and cost C$30–40B—depending on if and when the third and fourth of the initially proposed LNG trains are approved. But beyond the immediate impact to the BC economy, the most important factor in our view is the project's size—tens of billions of dollars with a multi-decade operating horizon, in many ways the first such investment since before oil prices collapsed in 2014. The post-2014 trend toward shorter-cycle investments like US shale helped firms manage uncertainty through the oil rout, but higher prices are helping those same firms extend their sights over a longer investment horizon. The LNG Canada facility will connect low-cost Montney Formation gas in north-eastern BC and north-western Alberta to rapidly growing demand and higher prices in Asian markets.

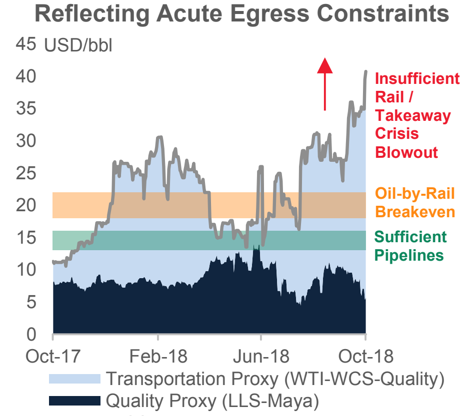
Table 1

Commodities	2000–2017			Annual Average			
	Low	Avg.	High	2017	2018f	2019f	2020f
WTI Oil (USD/bbl)	17	62	145	51	68	72	69
Brent Oil (USD/bbl)	18	65	146	55	74	80	75
WCS - WTI Discount* (USD/bbl)	-43	-16	-6	-13	-27	-24	-21
Nymex Natural Gas (USD/mmbtu)	1.64	4.83	15.38	3.02	2.93	2.93	3.00
Copper (USD/lb)	0.60	2.38	4.60	2.80	2.99	3.00	3.20
Zinc (USD/lb)	0.33	0.84	2.10	1.31	1.33	1.30	1.25
Nickel (USD/lb)	2.00	7.12	24.58	4.72	6.15	6.50	7.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.89	0.95	1.00	1.00
Iron Ore (USD/tonne)	17	67	187	72	65	65	60
Metallurgical Coal (USD/tonne)	39	131	330	187	205	175	160
Gold, London PM Fix (USD/oz)	256	890	1,895	1,257	1,262	1,300	1,300
Silver, London PM Fix (USD/oz)	4.07	14.80	48.70	17.05	15.70	17.00	17.00

* 2008–16 average.
Sources: Scotiabank Economics, Bloomberg.

Chart 9

Western Canadian Heavy Oil Discount Blows Out Again to Levels Reflecting Acute Egress Constraints



Sources: Scotiabank Economics, Bloomberg.

METALS: A REVERSAL OF FORTUNES AS BASE METALS WANE, BULKS OUTPERFORM

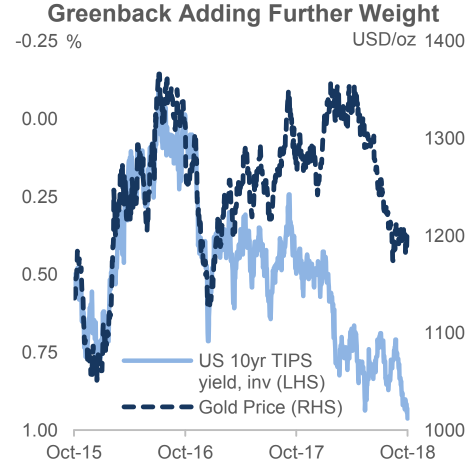
The metals complex has experienced a stark reversal from where we stood last quarter, with base metals in retreat, precious metal prices easing, and previously-battered bulks outperforming. Much of this shift can be explained by policy choices made in Beijing and Washington: the US-China trade dispute has dented the outlook for base metals demand, a stronger US dollar removed a key support and allowed higher interest rates to depress gold prices, and Chinese capacity rationalization policies have bolstered demand for high-quality steel ingredients.

The base metals complex has gotten caught up in the macro headwinds of the US-China trade dispute and most metals have temporarily ceased trading on commodity-specific fundamentals, with the LME index down 15% from where the complex stood before tariffs were announced in early-June. This rout occurred despite signals of tighter markets as inventories continue to draw— copper inventories are down 50% in the past six months, nickel inventories have fallen to five-year lows, and aluminium, zinc, and lead stocks have fallen to their lowest level in a decade. Copper demonstrated an indicative fundamental ambivalence to major supply news—the resolution of high-profile labour negotiations at a number large Latin American mines—by barely moving to what would typically be worth a few percentage points on the contract, but later that week reacted noticeably to a cooling of US-China trade rhetoric. Copper prices have stabilized around $2.80/lb, down 15% from before the US-China trade dispute heated up in early-June but up slightly from the depths to which speculators pushed the red metal in September. As stated earlier in the report, physical copper premia in China are at three-year highs despite the fallback in global LME prices as Chinese purchasers capitalize on lower prices, despite the fact that those prices are lower precisely because speculators were concerned about Chinese demand. This indicates that, at the very least, metals bearishness is running ahead of any realized demand loss. Unfortunately for base metals, negative macro sentiment can be a powerful drag on pricing and the expectation that US-China trade uncertainty will persist through 2020 is a large factor behind our near-term downgrade to the base metals price forecast. We now expect copper prices to average $3/lb in 2019 (down from $3.25/lb in our last outlook) and $3.25/lb in 2020 (from $3.40/lb).

Bulk prices, meanwhile, have experienced a mild renaissance following Chinese capacity rationalisation policies aimed at the bloated domestic steel industry. Beijing's policy actions have cut out a large piece of the domestic Chinese supply curve, inflated margins for remaining smelters, and pushed steel smelter capacity utilization higher across the board. Given the high value of steel products at present, Chinese smelters are running all-out and are prioritizing higher quality iron ore, which increases steel yield for a given volume of ore feedstock; premia for 65% fe ore vs 62% fe ore have risen to more than 50% while discounts for lower quality 58% fe ore sit around 25%. Premium hard coking coal shipments have also benefitted from Chinese buying and prices remain elevated at around $200/t. While steel throughput is currently supporting heady bulks prices, it is likely that environmental winter run cuts in China—set to begin in late-October—will be steeper than the market experienced last year, which will weigh on Chinese import demand for both iron ore and coking coal. Completing the bulks-base metal rotation, we expect that base metal prices will rebound through year-end as trade fears subside, Beijing provides further visibility on its policy response to US protectionism, and metal balances continue to tighten on insufficient mine supply.

Gold prices have fallen to trade around $1,200/oz on the back of rising real yields, a stronger greenback, and an accumulation of bearish precious metals sentiment. Gold prices finally gave way to the weight of stronger real yields (chart 10) in the US following the third interest rate hike out of the US Federal Reserve this year. Rising interest rates will continue to present the harshest headwinds for bullion through 2020, with US interest rates expected to rise by one more full percentage point by 3Q19. The US dollar provided an additional headwind, strengthening through the year when it was broadly expected to fall back and provide support to bullion. We believe that stronger US growth and tighter monetary policy are now mostly priced into current dollar strength, and speculative dollar positioning is relatively stretched to the upside. Going forward, USD risk appears broadly biased to the downside in both the short-term as sentiment normalizes and the long-term on widening US fiscal and current account deficits. We believe that a rapid covering of large speculative short positions will magnify any bounce from the dollar's reversal, bringing us back toward our $1,300 forecast for next year.

Chart 10 Yields Drag on Gold, Stronger Greenback Adding Further Weight



Sources: Scotiabank Economics, Bloomberg.

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