Commodity Spotlight

17 January 2014

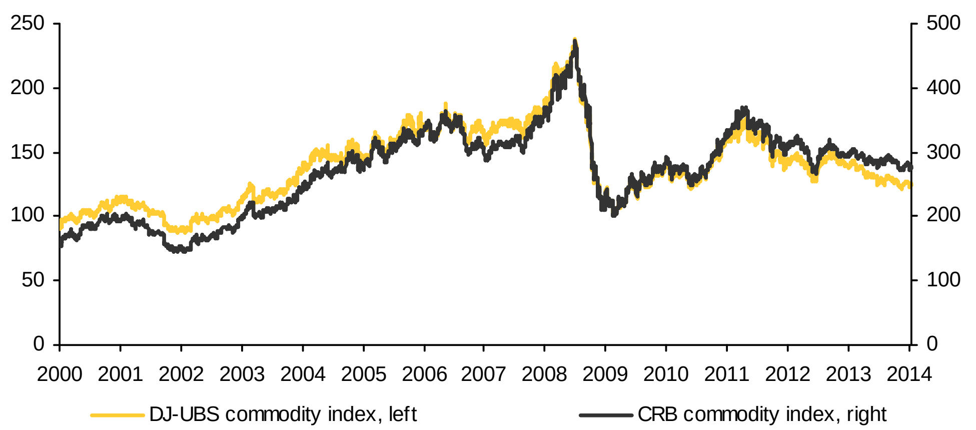
Outlook 2014: Bottoming with subsequent recovery

Following the renewed decline of broad commodity indices in 2013, we forecast a general bottoming for the first half of 2014 and a price rise, particularly in base and precious metals, by year-end. At the same time, we see only little upside potential in crude oil and most agricultural commodities. The differentiation within the commodity sector, i.e. the differences in price movements, should thus remain considerable. This is because alongside factors relevant to all commodity markets, such as economic developments in China, investor behaviour and central bank policy, sector-specific factors above all will come to the fore.

Commodity prices, measured in terms of the broad commodity indices, dropped again last year and have been in an overarching downtrend since spring 2011 (chart 1). An important question market watchers frequently asked in recent months is whether this has concluded the super cycle in commodities that started around the turn of the millennium. Our answer is "yes and no". Whilst we assume that the days of exorbitant price rises and a continuous increase across all commodities are over, we still regard the emerging markets' enormous catch-up potential on the demand side, in particular, as crucial to a gradual, long-term commodity price rise. Moreover, the differentiation within the commodity sector looks set to be high in the months and years to come, with the various commodity market segments, such as base metals, precious metals, energy and agricultural commodities, behaving differently. Medium-term, we see higher potential, especially in metals, following the loss-making previous years, because the price decline was partially attributable to excessively negative sentiment.

But before we discuss future market developments, we will look in detail at the factors that triggered and supported the partially massive price losses. We find that this time round the price weakness was accompanied by both physical surpluses and a deterioration of sentiment and the subsequent withdrawal of investors from the asset class of commodities. Also in the past year, the sometimes very heterogeneous price movements of the various commodities (chart 2, page 2) were frequently attributable to the different aspects and influences of monetary and economic policies as well as geopolitics. Whilst rising real interest rates and the prospect of monetary tightening by the Federal Reserve caused the gold price to fall by as much as 30% over the past year, the price slump in base metals was in our view mainly owed to softer economic growth in China (compared to the previous years). Oil prices, in contrast, were primarily supported by geopolitical factors and fears and were rather stable over the year despite ample supply.

CHART 1**: Commodity prices in a consolidation phase of more than two years**



Source: DJ-UBS, Thomson Reuters/Jefferies, Bloomberg, Commerzbank Corporates & Markets

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Influential factors vary according to commodity segment and over time

A fact that often fascinates many commodity market watchers is that most price movements can be explained, at least in hindsight, by simple logical developments, factors and aspects of the physical and/or speculative supply/demand situation. In many cases these factors have emerged and proved decisive over several years, such as physical lack of supply, the development of stocks or Chinese imports, or investor sentiment. But the interplay in commodity markets is often more complex and complicated than it appears at first sight. For instance, expectations often prove more important than reality, and the influence of many factors changes over time. For example, the Fed's unconventional policy, which had given strong support to commodity prices over the period between 2009 and 2011, supported western equity markets, but not commodity markets, in the past two years. And the US dollar, which over the past decade was one of the most important drivers of changes in commodity and gold prices, has recently lost much of its influence (chart 3). For this reason we will initially look at the physical aspects of what went on in the commodity markets in recent years before discussing the somewhat softer factors such as monetary policy and investor behaviour.

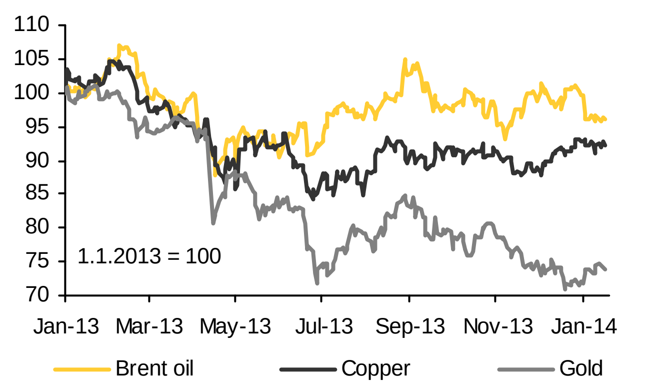
Commodity boom caused by slow supply-side response …

Not only temporary price leaps but also longer-term up and down cycles in commodities are mainly caused by the occurrence of unexpected factors and less by normal economic cycles. This could be the formation of a production cartel, for example, or the introduction of an improved production technology such as "fracking" on the supply side. On the demand side, this could be a more efficient handing of commodities or, alternatively, the development of a commodity-intensive technology and commodities establishing themselves as an asset class. We therefore do not regard the fact that China has become the biggest commodities buyer in the past decade as the sole trigger of the "super cycle". We believe the main factor was the surprise on the supply side, which had evidently not been expected on such a scale especially after the severe Asian crisis at the end of the 1990s and is why sufficient production capacities were not developed. Coupled with the strong increase in investment demand, this production deficit caused a sharp rise in commodity prices.

… resulting in some cases in familiar "hog cycle"

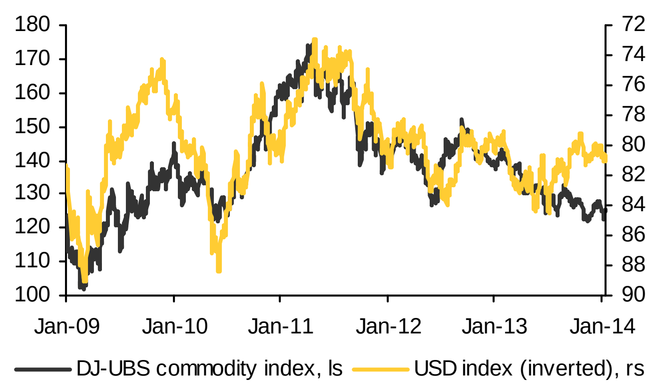
That said, the price rises would have also led to the famous "hog cycle", whereby new production facilities had often already been planned at the much higher prices of recent years. In short, some commodity markets currently show a structural oversupply, the reasons for which can be found in exaggerated expectations and investments beforehand. A sustained price rise is less realistic alongside production overcapacities, especially as demand prospects have not improved accordingly and much of these capacities can be put into operation in due course. The situation for producers is additionally being made more difficult by the entry of many new producers, resulting in a lower concentration in part on the supply side; this lowers the discipline of commodities producers because the major companies often no longer control marginal production and therefore no longer have pricing power. Prices on commodity markets where only a few producers control marginal production, such as on the oil market or on the platinum and palladium market, have proven much more stable recently.

CHART 2: **Commodity price movements mirror economic and monetary policies and geopolitics (indexed)**



Source: Bloomberg, Commerzbank Corporates & Markets

CHART 3: **Weak US dollar and QE3 have recently given no support to commodity prices**



Source: DJ-UBS, Bloomberg, Commerzbank Corporates & Markets

Production expectations partly exaggerated, scope for revisions

Assuming that especially surprising developments are having a significant impact on prices, it should also be asked to what extent present and future rises in production are already expected by market participants and priced in. Generally speaking, the successes on the production side of most commodities in past years have blown up the expectations of independent research agencies and government authorities. If we compare this with the hard data for certain periods of time, we find that these expectations were exaggerated to some extent, especially in the case of base metals, and predicted production surpluses have therefore proven too high.

Higher demand thanks to global economy picking up

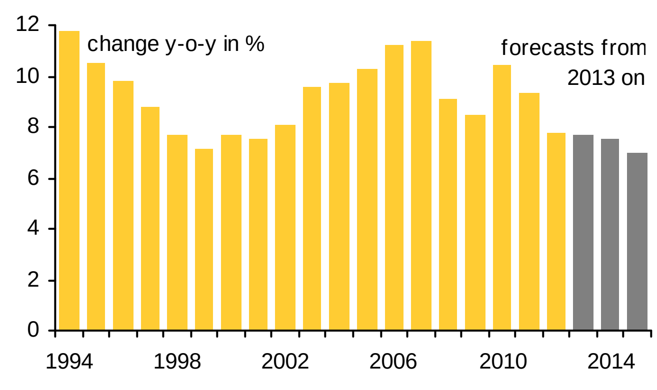
Price trends are always an interplay of supply and demand. The supply side is often influenced by medium-term price movements and external shocks such as strikes, severe weather conditions or operating problems. On the other hand, the demand side is often largely price-inelastic, meaning it reacts only marginally to price movements. Demand estimates often prove more accurate because they normally depend on general economic trends. We expect a revival of the global economy in 2014. Firstly, the industrialized countries should show relatively robust growth, especially the US, where our economists envisage 2.8% GDP growth. Japan should expand by 1.8% and the eurozone by 0.9% after two years of a shrinking economy. Secondly, the emerging countries should also return to a growth path in the later stages of the year after struggling with huge capital outflows and anaemic growth by their standards in the year before. We expect China to achieve 7.5% GDP growth in 2014 (chart 4). While this would be the weakest growth rate since 1990, it must be remembered that China is meanwhile the world's second biggest economy after three decades of approximately 10% growth per annum. A substantial revival of the global economy – we expect a rise in global GDP of about 3.5% in 2014 – should support the commodity market this year.

Commodity markets should stabilise following strong investment outflows

In past years, commodities have also established themselves as a separate asset class. The growth prospects of emerging countries, positive price trends and often a low correlation with other asset classes such as equities or bonds have led to inflows of some hundred billion USD into commodities futures markets and ETPs. However, amid a somewhat gloomier outlook for commodities markets in recent years, many investors have exited commodities investments. We estimate that commodity investments in futures markets, commodity funds, ETPs etc fell by over 50 billion USD last year. Outflows from gold ETPs alone came to around 40 billion USD last year (chart 5). These outflows, i.e. additional supply on commodity markets, probably accelerated the fall of many commodity prices. Even so, we are convinced that commodities should remain part of a diversified portfolio. We expect to see a revival or at least stabilisation of investment demand for commodities this year.

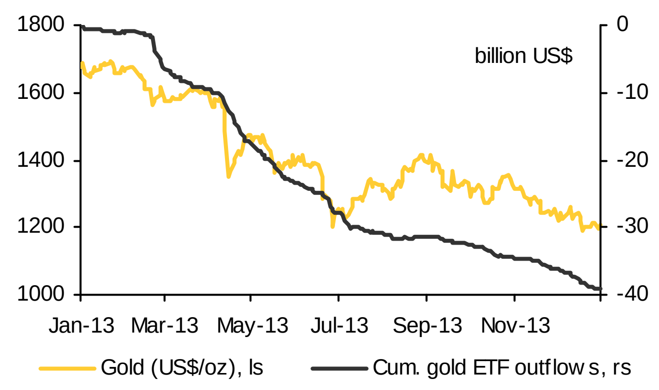
We distributed a more detailed outlook for all commodity market segments in 2014 in December. Below we have merely considered the most important developments in the various sectors on the basis of a number of major significant examples.

CHART 4: **Weaker growth ahead in China, but from a significantly higher level**



Source: NBS, Bloomberg, Commerzbank Corporates & Markets

CHART 5: **Huge outflows of investor money knock commodity prices (gold price shown here)**



Source: Bloomberg, Commerzbank Corporates & Markets

Supply-side trends decisive on oil market

Non-OPEC supplies to outpace global demand

The focus on the oil market this year will once more be on supplies. Continuing success with shale oil production in the US will again keep prices in check. Within the last three years, US crude output has risen by 50%. At the start of this year, US output passed the 8.1 million barrels a day mark for the first time in 25 years. The US Energy Information Agency expects this sharp upturn to continue, so that by the end of the year production should have hit almost 9 million barrels a days. And it will be thanks largely to this rise in production in the US that mounting non-OPEC supplies should be sufficient to meet increasing global demand. This latter can be expected to expand somewhat more than in 2013, but even in the US Energy Information Agency's optimistic scenario which shows demand rising this year by 1.2 million barrels a day – slightly higher than the average of the past 10 years – growth in demand will not exceed the growth in non-OPEC supplies (chart 6).

High production losses lead to lower OPEC supplies

However, this also means a drop in demand for OPEC oil, and OPEC has in fact experienced lower output recently. Reuters estimate that production in December amounted to 29.5 million barrels a day, down more than 2 million barrels on summer 2012 and the lowest level for two and a half years. This decline was not a voluntary one, though, as it resulted primarily from unscheduled shortfalls in output. These totalled 2.5 million barrels a day among OPEC producers in December (chart 7). Continuing strikes and protests in Libya over several months, for example, cut output to a fraction of the usual volume.

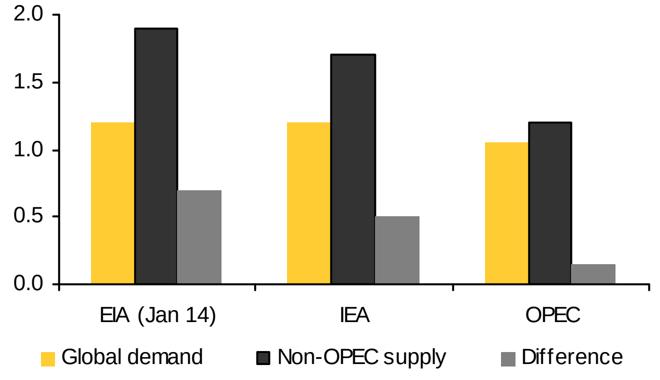
Iran and Libya could increase output

Now, though, the situation in Libya appears to be improving: Output has meanwhile been more than doubled from the December level to 600,000 barrels a day. Moreover, in mid-year we could see the oil sanctions imposed on Iran being relaxed or even dropped altogether. Since a first agreement on this issue was reached in late November following years of dispute over the nuclear question, the chance of this happening has improved. European insurance companies are meanwhile once again allowed to make contractual commitments for oil supplies from Iran. In the coming months, this will no doubt translate into stronger purchases on the part of Asian buyers, especially since they have been exempted by the US for a further six months from the sanctions imposed.

(OPEC) supply determines prices

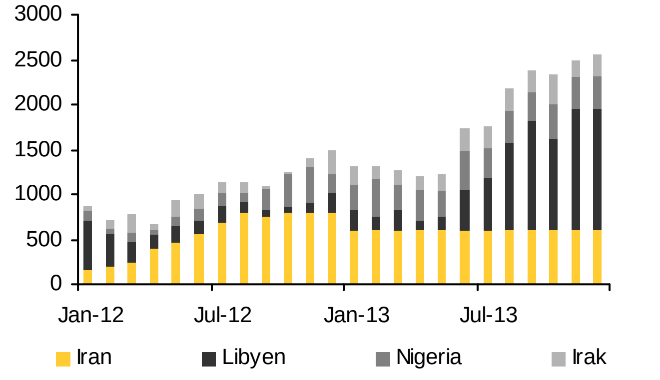
If Libya and/or Iran expand their production, there would undoubtedly be a risk of a huge glut on the oil market. However, we expect swing producer Saudi Arabia to scale down its production, which it can afford to do with a healthy budget situation at home, thus preventing an excessive price slide. Over the year on average, we envisage a Brent oil price of $106 a barrel. All in all, the market will again be focusing on the supply side this year. But nor can the reverse situation be ruled out, since if geopolitical tensions grew more severe again in the Middle East, triggering concerns about supplies, oil prices could also rocket.

CHART 6: **Non-OPEC supply to outpace demand this year**
Agencies forecasts, million barrels a day



Source: EIA, IEA, OPEC, Commerzbank Corporates & Markets

CHART 7: **High unscheduled OPEC production losses**
Thousand barrels a day



Source: EIA, Commerzbank Corporates & Markets

Global copper market more strained than apparent at first glance

Copper supply disappointing

In contrast with the oil market, players on the copper market will no doubt be disappointed by the latest supply trend. So far the prevailing view has been that in 2013 the global copper market was in surplus for the first time in four years, and that this glut would expand considerably in the new year. However, the data provided by the International Copper Study Group (ICSG) present a different picture. According to these, there was a seasonally adjusted supply-side deficit of 66 thousand tons from January to September. One major contributor will have been difficulties in getting new projects up and running, e.g. in Mongolia. The serious depletion of copper inventories registered on the exchanges also suggests that the situation is strained (chart 8). It is therefore far from certain that supply exceeded demand last year. Moreover, the surplus expected this year seems too high. In addition, copper prices are currently low, making it unattractive to commission new mining projects.

Strong demand in China driving global demand for copper

At the same time, demand is robust. The ICSG envisages a rise in the global demand for copper this year of 4.4%, thanks largely to China. As the urbanisation process continues, copper is needed for example in electronics, power cables and other infrastructural developments. In order to meet the country's requirements, China depends heavily on imports. During the second half of last year, 2.5 million tons of copper were imported, 18% more than in the prior-year period (chart 9). The state research institute Antaike envisages demand rising 6.5% in China this year.

Short-term potential for correction, but price rises expected in medium term

Since the market is over-estimating supplies, and this factor has not yet been priced in, while demand can be expected to rise quite substantially once the global economy picks up speed again, we expect copper prices to rise to $8,000 a ton by the end of the year. There is a risk of brief setbacks, though, as the year-end price surge was largely driven by speculative financial investors. The net long positions held by speculative financial investors then, for example, were at their highest level since February 2011. At the beginning of December, most of these investors bet on falling prices.

Demand decisive on gold market

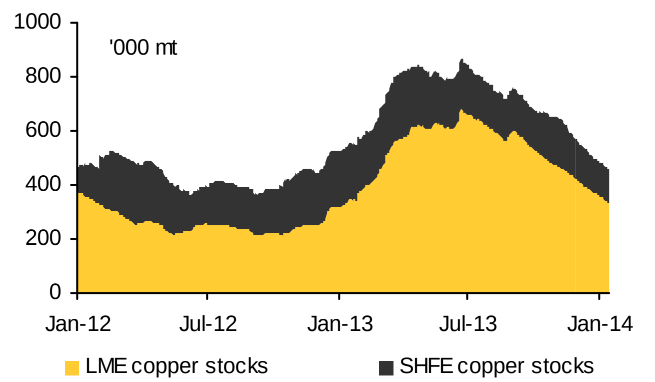
Slight price recovery at start of year

The historic slump in gold prices last year was due mainly to the sharp drop in investment demand. At the end of 2013, gold was only marginally above its 3½-year low of just under $1,200 per troy ounce (chart 10, page 6). There has been something of a recovery since the start of the year, though. As yet it has been mainly short-term oriented investors who have been playing the market on a grander scale, but there is no sign so far of a shift in mood among ETF investors. On the contrary, ETFs have experienced a continuing exodus since the start of the year.

Headwind of real interest rates and stock market should lessen

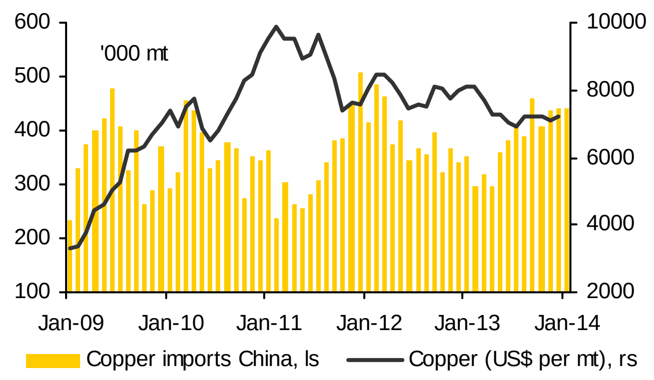
The trend should be reversed later in the year, though, as the two main factors posing a strain on investment demand, namely higher real interest rates and rising equity markets, are likely to become less significant. For one thing, the Fed should be able to keep expectations of rate hikes in check despite its tapering, thus ensuring that long-term interest rates do not rise excessively.

CHART 8: **Depletion of copper stocks for some months now**



Source: LME, SHFE, Bloomberg, Commerzbank Corporates & Markets

CHART 9: **Chinese imports established at high level**



Source: China Customs, Bloomberg, Commerzbank Corporates & Markets

At the same time, inflation rates will no doubt rise from their current very low level, thus preventing a further increase in real interest rates. In addition, it is hardly likely that the US stock market will again see growth of 25% this year in a less expansionary monetary climate.

Return of speculative investors likely

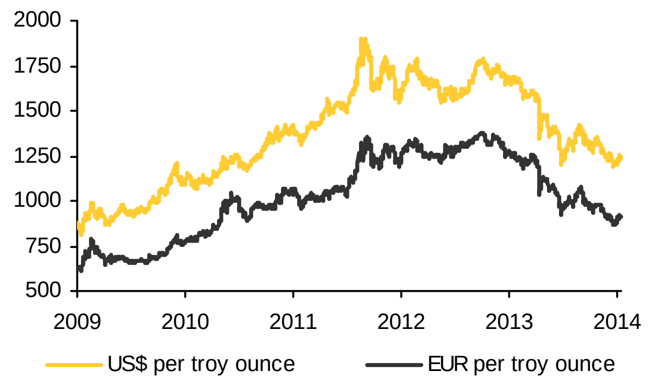
Any boost to gold prices will probably have to come from speculative investors, however. They were also the first who in summer 2011, shortly before gold reached an all-time high, started to scale down their bets on rising prices, thus signalling the end of gold's steady gains. At the end of last year, these investors had largely withdrawn from the gold market, as evident from net long positions reaching a seven-year low. As already stated, speculative investors started to build up some positions at the start of the year, and the chance of a turnaround over the course of the year is basically a good one. The negative market attitude to gold was also reflected in negative reporting in the media and largely pessimistic price forecasts, which is also an indicator of an early reversal of the trend.

Strong demand in Asia

However, even if investment demand in the west is probably the decisive factor behind gold prices, strong demand in Asia comes a close second and should not be overlooked. China is the main source of support here (chart 11). The country's demand amounts to over 1,000 tons, which means that last year China will probably have overtaken India as the biggest global consumer, although this will be due in part to Indian demand being hit drastically by restrictions on gold imports and higher import duties. The important thing is that Asian demand for gold is increasing for very different reasons for those in the west: in Asia, gold is viewed as a long-term investment and as a means of protecting assets from a loss of purchasing power occasioned by inflation and currency depreciation. This means that the gold which has moved from west to east has probably been taken off the market for good.

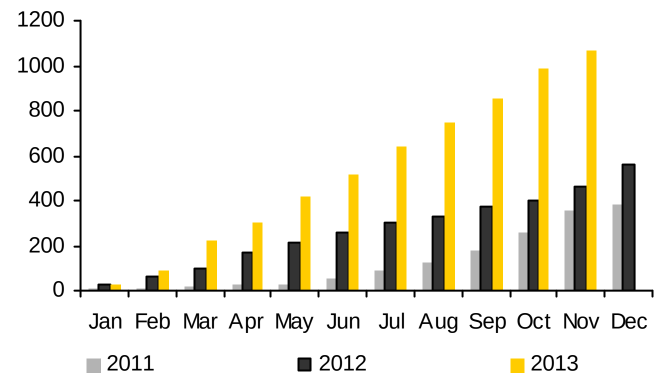
All in all, we expect that once the exodus from ETFs comes to a halt, unbroken strong demand in Asia, reinforced by greater speculative interest, will lead to higher prices. In a climate of continuing expansionary monetary policy, gold should then come to be seen again as a means of hedging against loss of purchasing power caused by inflation and currency depreciation also in industrialized countries. By year-end we envisage a gold price of $1,400 per troy ounce.

CHART 10: **Historic slump in gold prices in 2013**



Source: Bloomberg, Commerzbank Corporates & Markets

CHART 11: **Sharp rise in Chinese gold imports in 2013**
Cumulated net imports from Hong Kong in tons



Source: HK Statistics Department, Bloomberg, Coba Corporates & Markets

Our forecasts at one glance

		Quarterly averages								Yearly averages		
Energy	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
Brent Blend [1)]	107.1	108	105	105	107	107	109	111	113	109	106.25	110
WTI [1)]	94.2	97	99	100	102	102	106	108	108	98	99.6667	106
Diesel [2)]	922	960	920	910	960	970	960	970	1010	939	940	980
Gasoline [2)]	935	940	950	970	940	940	980	1020	980	987	950	980
Jet fuel [2)]	978	1000	970	960	1000	1010	1010	1020	1050	987	980	1020
Nat gas ($ per mmBtu)	4.33	4.0	3.5	4.0	4.5	4.0	4.0	4.5	5.0	3.7	4	4.5
Coal [2)]	83.3	85	85	90	90	90	95	95	100	82	88	95
EUA (€ per ton)	4.90	5.0	5.5	6.0	6.5	6.5	6.5	7.0	7.0	4.5	6	6.75
Base metals (US$ per metric ton)	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
Copper	7353	7150	7500	7800	8000	8150	8250	8350	8500	7353	7600	8300
Aluminium	1784	1750	1825	1900	1950	2000	2050	2050	2100	1888	1850	2050
Lead	2223	2125	2175	2250	2325	2400	2450	2450	2500	2156	2225	2450
Tin	22400	22800	23300	23900	24350	24750	24900	25150	25400	22309	23600	25100
Zinc	2081	1900	1950	2025	2100	2150	2200	2200	2250	1940	2000	2200
Nickel	14535	13550	13950	14350	14550	14900	15050	15300	15550	15098	14100	15200
Precious metals (US$ per troy ounce)	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
Gold	1241.9	1200	1250	1300	1400	1400	1350	1400	1500	1413	1300	1425
Silver	20.2	19.5	21.0	22.0	24.0	24.0	22.5	24.0	27.0	23.9	21.5	24.5
Platinum	1430.0	1350	1400	1500	1600	1600	1550	1600	1700	1487.25	1475	1625
Palladium	742.2	700	725	775	825	825	800	850	900	726	760	840
Crop	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
Wheat (CBOT) [4)]	568	680	690	670	650	650	640	630	620	690	670	640
Wheat (Paris; EUR)	193	205	200	190	185	185	180	180	175	210	195	180
Corn (CBOT) [4)]	426	430	460	480	480	490	500	510	520	570	460	510
Corn (Paris; EUR)	173	175	175	175	175	175	180	180	180	205	175	180
Soybeans [4)]	1318	1275	1250	1200	1150	1150	1150	1200	1200	1400	1220	1180
Rapeseed [3)]	363	370	360	360	350	350	360	360	370	415	360	360
Cotton [5)]	85	78	75	72	70	72	74	76	78	84	74	75
Softs	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
Coffee (Arabica) [5)]	117.2	105	100	105	110	110	115	115	120	125	105	115
Coffee (Robusta) [2)]	1706	1550	1500	1550	1600	1600	1650	1700	1750	1850	1550	1700
Cocoa (GBP per ton) [2)]	1765	1775	1800	1800	1850	1900	1950	1950	2000	1600	1800	1950
Sugar [5)]	15.2	17.5	18.5	19.0	19.5	19.5	20.0	20.5	21.0	17.5	18.5	20.5
Livestock	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
Live cattle [5)]	139	130	128	130	132	128	126	128	130	128	130	128
Feeder cattle [5)]	168	160	155	150	155	158	153	148	153	153	155	153
Lean hogs [5)]	92	85	93	88	83	83	91	86	81	89	87	85
Currencies	**01/15/14**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**2013**	**2014**	**2015**
EUR/USD [6)]	1.3605	1.33	1.31	1.29	1.28	1.26	1.24	1.22	1.21	1.32	1.31	1.24

If not specified otherwise, price forecasts are in US$ (quarterly averages). [1)] per barrel, [2)] per ton, [3)] EUR per ton, [4)] US cents per bushel, [5)] US cents per pound, [6)] end of quarter

In the case of agricultural commodities the current price of the most-active forward contract is being displayed. It can be different in terms of the particular maturities.

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