Oil Rallies Higher, Metals Slide On Trade War Fears

- **Favourable oil market fundamentals and bullish underlying sentiment have been joined by rising political risks on the supply-side of the global ledger, as hawkish appointments to lead the US National Security Council and State Department indicate a potential hardline shift in US foreign policy disposition toward large producing states like Iran and Venezuela.**
- **Canadian heavy oil discounts have improved rapidly in the final days of March and are currently below $17/bbl; while we expected discounts to fall as oil-by-rail stepped in to fill the gap overburdened pipelines, the scale and pace of the latest retracement doesn't seem to square with current takeaway trends and we expect discounts to rise again.**
- **Kinder Morgan's decision to suspend non-essential spending on the Trans Mountain Expansion (TMX) pipeline until there is more investment certainty is a serious challenge to future Western Canadian oil production. Our long-term outlook assumes the construction of either TMX or KXL by the early 2020s; Canadian crude will have an increasingly difficult time getting to market absent this essential infrastructure, which will manifest as ever-wider WCS discounts.**
- **China's new oil futures contract enjoyed a successful first few days of trading and while the benchmark faces a few substantial hurdles, it serves a direct need and will likely become a key regional marker.**
- **Base metals prices fell back as trade war fears mount, but the outlook remains promising and the current rout is expected to be temporary.**
- **Gold prices are benefiting from rising risk perception, with triggers ranging from hawkish appointments at NSC and State to trade war flirtation between Washington and Beijing.**

OIL OUTLOOK STRONG, POSITIONING POSES NEAR-TERM HEADWIND

Oil prices rallied through March, closing the month at $65/bbl (WTI) from $61/bbl at end-February. Global fundamentals appear to be improving, inventories continue to draw down both in the US and throughout the OECD membership, and market sentiment is at near-record levels of bullishness as measured by net speculative positioning. Prices held up far better in the first quarter of 2018 than initially anticipated and the market is only expected to get tighter going forward, supporting pricing higher over the next 18–24 months.

In fact, if there is a cause for concern in the oil market at present, it is the one-sidedness of current market sentiment. Speculative short positions as a share of open interest in major oil contracts are at 7-year lows (chart 1), which leaves few remaining potential buyers and ample downside price risk in the near-term as positions are normalized. We anticipate that a rationalization of this asymmetric positioning will bring prices lower over the coming month before setting the stage for crude's next step higher on a fundamentally bullish outlook.

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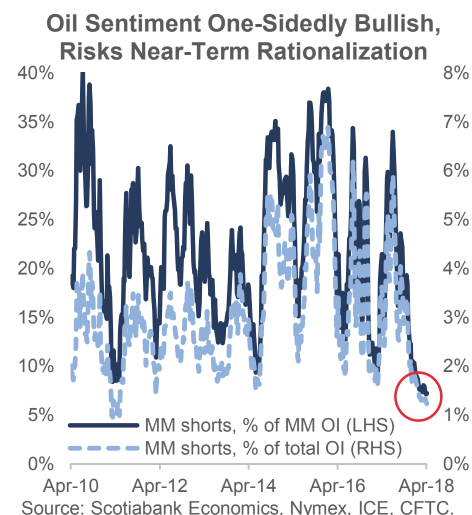
Chart 1



Source: Scotiabank Economics, Nymex, ICE, CFTC.

Table 1

Scotiabank Commodity Price Index

March 2018	(% change) M/M	Y/Y	YTD
All Commodity*	**1.5**	**10.2**	**8.6**
Industrials	**1.0**	**9.9**	**8.5**
Oil & Gas	3.6	12.6	6.5
Metal & Minerals	-2.0	-0.3	1.9
Forest Products	2.2	26.6	26.1
Agriculture	**3.7**	**11.5**	**9.4**

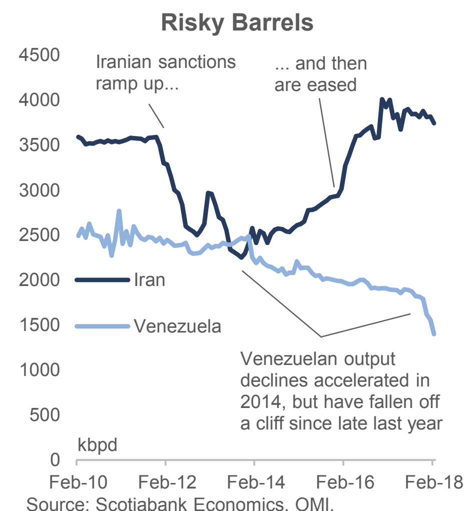
January 2007 = 100	2018 Mar	Feb	YTD avg.
All Commodity	**120.5**	**118.7**	**119.8**
Industrials	**116.5**	**115.3**	**116.4**
Oil & Gas	90.2	87.1	90.4
Metal & Minerals	129.2	131.8	130.9
Forest Products	161.9	158.4	157.5
Agriculture	**142.5**	**137.4**	**138.2**

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

Personnel changes in the US government have increased perceptions of [geo] political risk and provide modest tailwinds for oil prices. The appointment of John Bolton as US National Security Advisor and the nomination of Mike Pompeo as Secretary of State indicate a hawkish shift in US foreign policy; both men are known to hold relatively hardline foreign policy positions and have replaced moderates in two of the top foreign policy roles in the US government. The two most important vectors through which this foreign policy change could affect the oil market are a likely move by the US to change the terms of the Iran nuclear deal as well as potential sanctions against the Maduro regime in Venezuela. **The Trump administration needs decide whether to extend Iranian sanctions waivers by May 12th** and it is appears increasingly likely that the White House will begin backing away from the deal. Iranian oil production climbed 1.2 MMbpd—from 2.6 MMbpd in early-2015 to roughly 3.8 MMbpd today (chart 2)—following the conclusion of the nuclear agreement and those barrels are at risk if the US pushes for changes to the deal. Other parties to the agreement—e.g. European allies, China, and Russia—still support the deal and it is unlikely that unilateral US action would disrupt all 1.2 MMbpd of Iranian gains; however, US financial sanctions would complicate USD payment logistics, make necessary shipping insurance more difficult to secure, and generally put downward pressure on current production levels. Meanwhile, **potential economic sanctions against Venezuela could put further pressure on the country's increasingly fragile oil industry**. Venezuela's energy sector is more dependent on the US refineries along the Gulf Coast than many recognize, serving as the primary destination for heavy Venezuelan oil and as one of the only suppliers of the lighter hydrocarbons needed to dilute said heavy crude. Cutting off this supply chain would be a material blow for Venezuela's oil sector, further weakening the already beleaguered industry where production has fallen to 1.4 MMbpd as of February, down 0.4 MMbpd from as recently as November and more than 1 MMbpd since January 2014 (also chart 2).

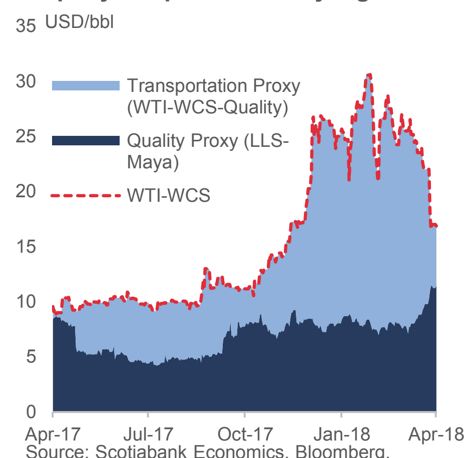
Canadian heavy oil (i.e. WCS) pricing has been surprisingly strong as WCS-WTI differentials fell rapidly from $22–27/bbl in mid-March to under $17/bbl as of writing (chart 3). While we had anticipated a gradual easing of the WCS discount as oil-by-rail shipments picked up, the latest narrowing occurred a bit too fast and took differentials a bit too low given prevailing trends in the Canadian oil patch, in our view. The narrowing makes sense as a transitory phenomenon: high discounts were expected to incentivize oil-by-rail service, which would gradually eat away at the differential as barrels rolled out of the patch, and the Sturgeon refinery has started up operations, effectively creating a 50 kbpd demand sink in Alberta. That said, we still expect 400–500 kbpd of new supply coming online through end-2019 and these barrels are going to have a difficult time finding their way to market. Line 3 is expected to enter service in the second half of 2019, but it's not outside the realm of possibility that this schedule is delayed given recent experience. National rail capacity is also stretched paper thin, with few new railcars let alone operating crews available to satisfy what could a three-fold increase over current oil-by-rail demand by this time next year. Against this precarious takeaway backdrop, we believe that today's low discounts will rise again as WCSB supply marches onward. Looking further ahead in the outlook, **the recent announcement that Kinder Morgan is suspending non-essential spending on the Trans Mountain Expansion (TMX) pipeline until there is more certainty in the investment climate is a serious challenge to future Western Canadian production**. Our current long-term outlook

Chart 2



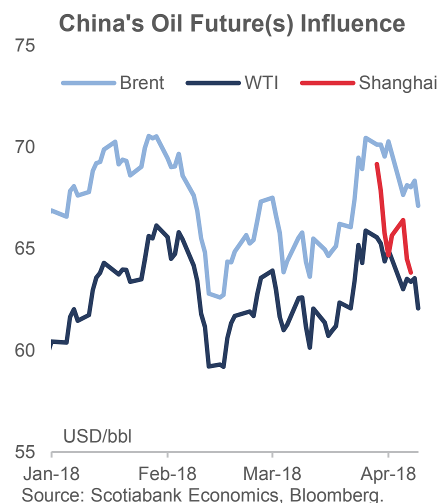
Source: Scotiabank Economics, OMI.

Chart 3



Source: Scotiabank Economics, Bloomberg.

Chart 4



Source: Scotiabank Economics, Bloomberg.

assumes that either TMX or KXL are completed in the early 2020s; absent these major pipeline additions, Canadian crude discounts will expand ever-wider to compensate the stranded nature of Canadian crude on global markets.

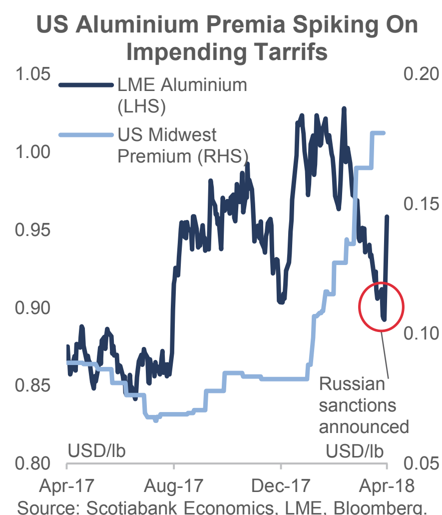
China's new oil futures contract began trading on March 26 after many delays (chart 4). The launch of the new instrument was a success by most measures despite some initial skepticism that the yuan-denominated contract would simply end up a currency trade against USD benchmarks like WTI and Brent. The Shanghai contract still has many hurdles to overcomes—mostly related to the China's closed capital account and nascent financial market development in this area—but it serves a legitimate need as China overcomes the United States as the world's largest importer of foreign crude. **Three aspects of the new contract make it notably different than WTI and Brent**, the two primary global crude benchmarks and what most people mean when they refer to the "price of oil". First, geography: the contract is physical settled on the Shanghai futures exchange, which allows buyers and sellers operating in China to better hedge risk based on local supply and demand conditions rather than on conditions around the North Sea (Brent) or at tank farms in Oklahoma (WTI). Second, quality: the Shanghai contract is linked to a medium sour grade of crude oil that better reflects the refinery slate of regional refineries than Brent or WTI, which are light sweet crudes. This allows for better management of risks related to the relative value of crudes based on their gravity (i.e. light vs heavy) and their sulphur content (i.e. sweet vs sour). Finally, currency: the contract is denominated in yuan rather than US dollars. While in the long-term we could see a move toward settling crude purchases in currencies beyond the USD, in the near term this has two interrelated impacts: first, it will limit interest in the contract due to China's closed capital account and the associated illiquidity in offshore yuan markets; second, the contract could increase external yuan demand, which would facilitate an opening of said capital account—one of the main hurdles to opening China's capital account is the pent-up domestic demand for higher yielding investments outside the mainland.

METALS: PRICES DOWN ON TRADE WAR FEARS, OUTLOOK REMAINS FIRM

Metals prices benefitted greatly from the strong industrial activity that accompanied the synchronized burst of global economic growth. Unfortunately, those same metal prices also fell back together as fears began to mount that the beating of the trade war drums and mounting rhetorical volleys between Washington and Beijing would bring that metals-intensive activity to a halt. Looking through the current headlines, we expect base metal prices to resume a gradual upward trajectory on a combination of steady demand and an emptying pipeline of new mine projects.

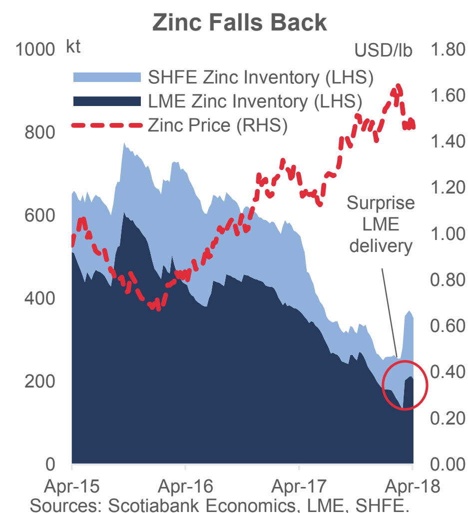
As part of the mounting trade-war rhetoric, the US moved to impose tariffs on aluminium imports—first from all countries, now only counties that were unable to get an exemption from the administration. While global aluminium prices fell back with the rest of the base metals complex in March, markets responded to the tariff news by pushing up US Midwest premiums, which more than doubled from $0.08/lb (roughly 8% of the LME contract) in January to $0.18/lb (20% of LME) as of writing (chart 5). The US maintains a structural dependence on imported aluminium and the tariff burden is expected to largely fall on American aluminium consuming industries. The latest round of sanctions levied by Washington against seven Russian oligarchs caused an acute spike in aluminium prices (chart 5) given uncertainty surrounding

Chart 5



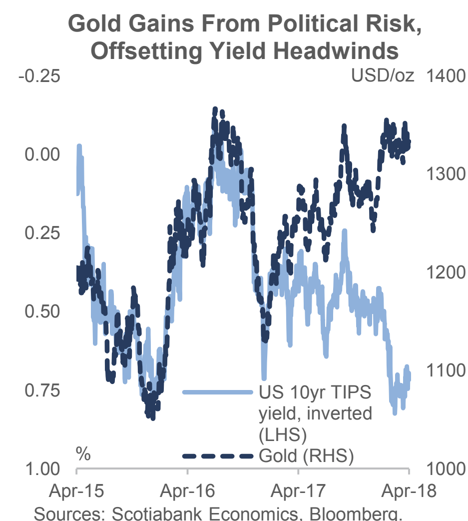
Source: Scotiabank Economics, LME, Bloomberg.

Chart 6



Sources: Scotiabank Economics, LME, SHFE.

Chart 7



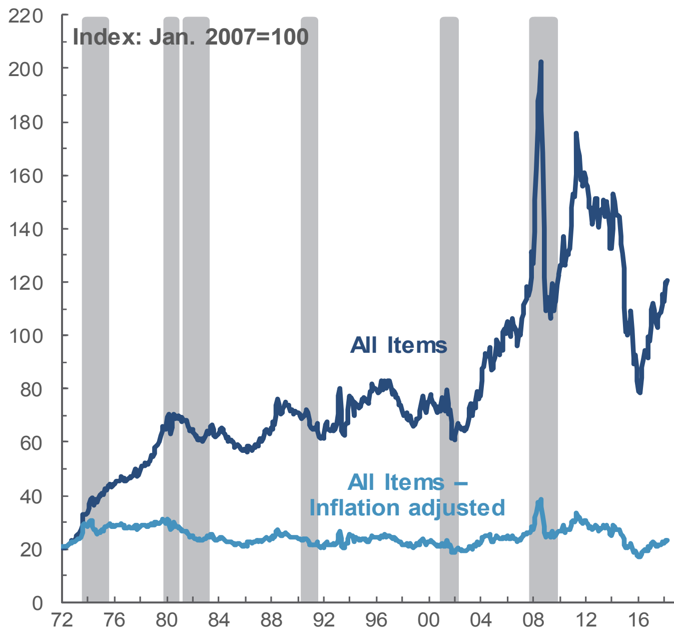
Sources: Scotiabank Economics, Bloomberg.

future shipments from Rusal, which produces 7% of global aluminium supply and was previously led by one of the seven individuals named in the sanctions.

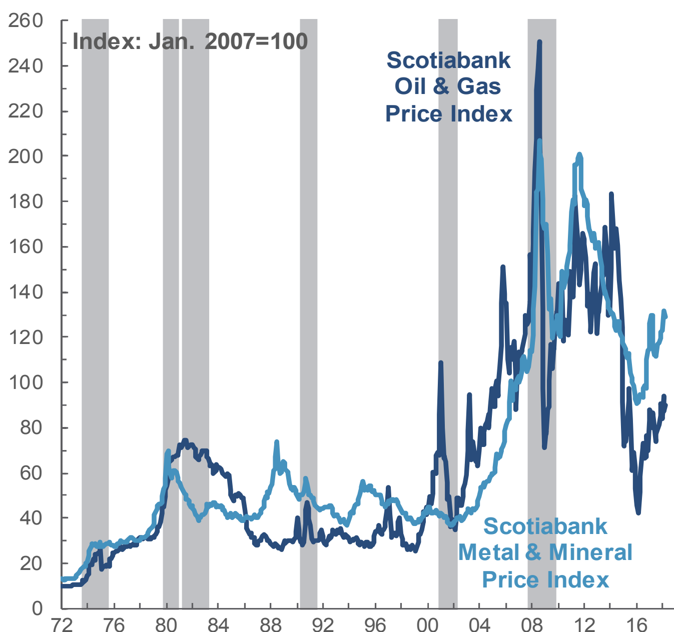
Zinc prices also took a dive along with the rest of the base metals market after breaking above $1.60/lb for the first time in more than a decade. Sentiment wasn't helped by a surprise delivery into exchange-listed inventories, which rose 45% from the beginning to end of March (chart 6). However, we believe that this tonnage reflects nothing more than the final, less visible stocks finally making their way though the LME warehousing system, and that extremely favourable fundamentals will help prompt zinc prices higher again through the end of 2018.

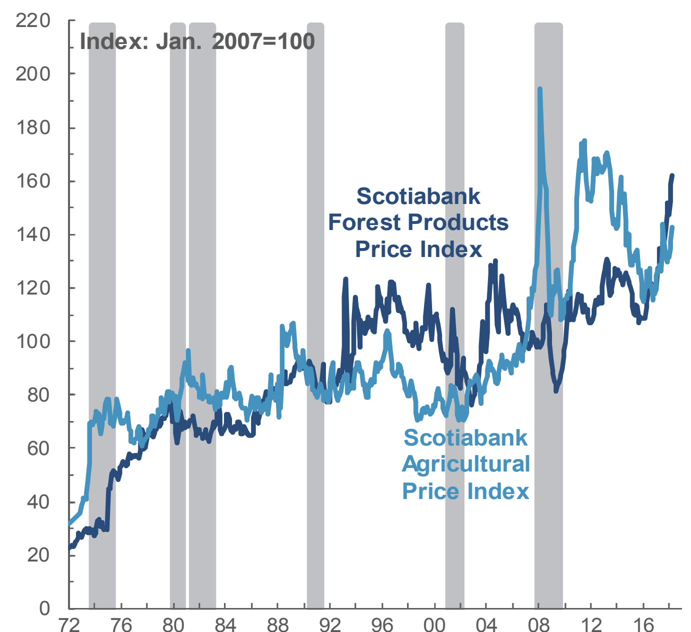
Finally, with all this talk of political risks—both from a hawkish US foreign policy shift as well as the beating of the trade war drums—the risk premium enjoyed by gold appears to be helping the precious metal withstand headwinds related to rising interest rate policy (chart 7). The price of gold is strongly and negatively associated with rising interest rates, which increase the opportunity cost of holding the non-yielding yellow metal. While the relationship between gold prices and real yields had weakened through 2017, we saw a sharp dislocation occur at the end of January that has persisted through the beginning of April, indicating a rise in market risk perception and safe haven buying.

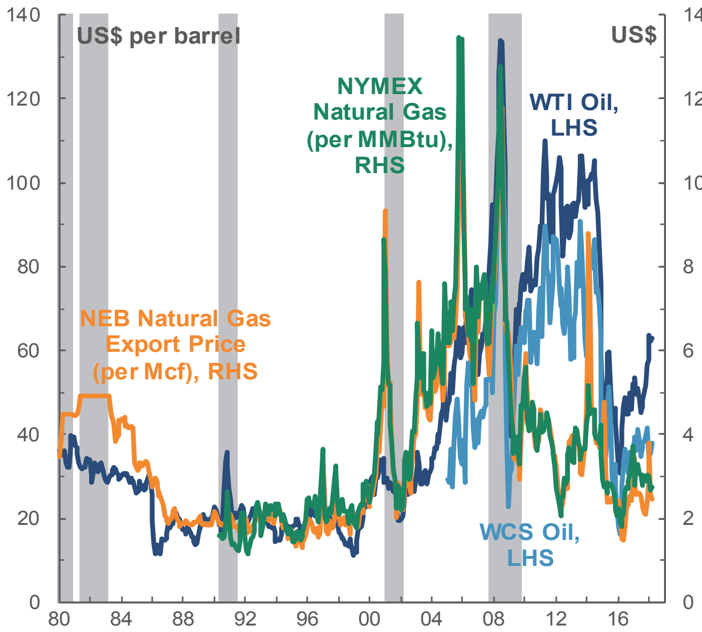
Price Outlook		2000–2016			2018YTD	2017	2018F	2019F
Oil & Gas		Monthly Avg. Low	Period Avg.	Monthly Avg. High				
Crude Oils								
West Texas Intermediate	USD/bbl	19.40	62.70	134.02	62.87	50.85	57	60
North Sea Brent Blend	USD/bbl	19.06	65.53	134.56	67.33	54.75	62	65
Natural Gas								
Nymex Henry Hub	USD/MMBtu	1.81	4.94	13.46	2.91	3.02	2.95	2.95
Metals & Minerals								
Base Metals								
Copper	USD/lb	0.62	2.35	4.48	3.19	2.80	3.05	3.25
Nickel	USD/lb	2.19	7.26	23.67	6.00	4.72	6.00	6.50
Zinc	USD/lb	0.34	0.81	2.00	1.58	1.31	1.60	1.60
Aluminium	USD/lb	0.58	0.86	1.39	1.00	0.89	0.95	1.00
Bulk Commodities								
Iron Ore	USD/t	27	108	302	77	72	60	60
Metallurgical Coal	USD/t	39	127	330	235	187	170	150
Precious Metals								
Gold	USD/toz	261	869	1,772	1,331	1,257	1,300	1,300

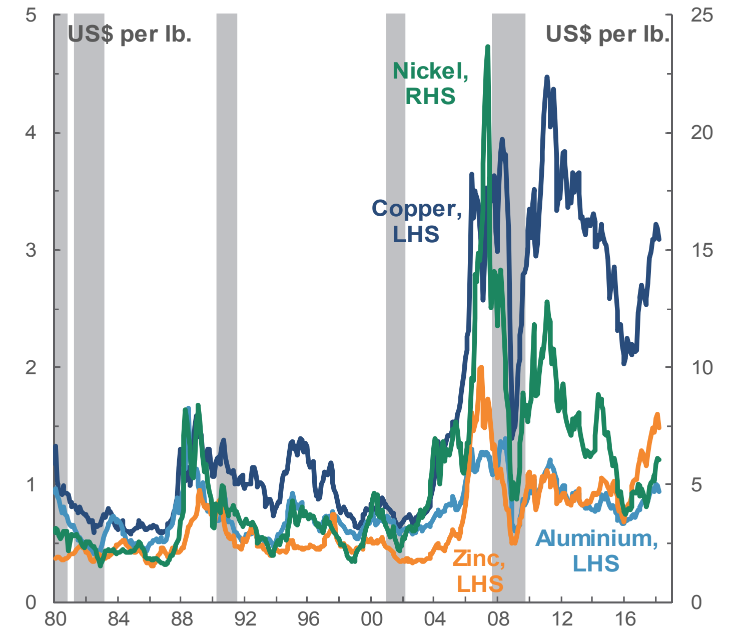

Scotiabank All Commodity Price Index
Index: Jan. 2007=100
All Items
All Items – Inflation adjusted

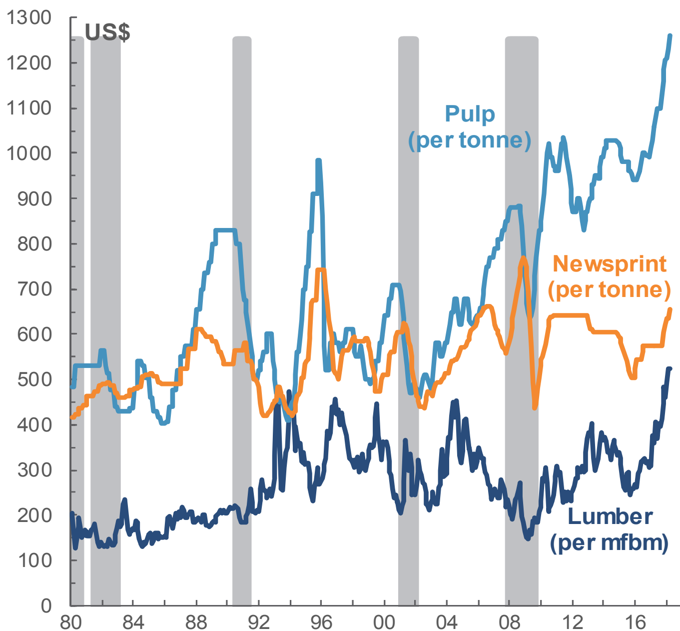
Canadian Dollar vs. Commodity Prices
Index: Jan. 2007=100
US cents
Scotiabank All Commodity Price Index, LHS
Canadian Dollar, RHS

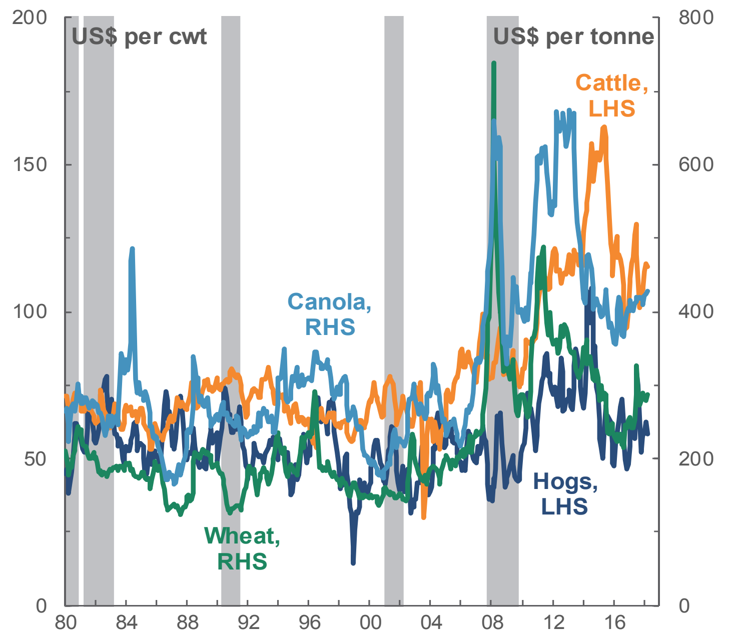

Scotiabank Oil & Gas and Metal & Mineral Indices
Index: Jan. 2007=100
Scotiabank Oil & Gas Price Index
Scotiabank Metal & Mineral Price Index


Scotiabank Forest Products & Agricultural Indices
Index: Jan. 2007=100
Scotiabank Forest Products Price Index
Scotiabank Agricultural Price Index


Oil & Gas Prices
US$ per barrel
US$
NYMEX Natural Gas (per MMBtu), RHS
WTI Oil, LHS
NEB Natural Gas Export Price (per Mcf), RHS
WCS Oil, LHS
140
120
100
80
60
40
20
0
14
12
10
8
6
4
2
0
80 84 88 92 96 00 04 08 12 16


Metals Prices
US$ per lb.
US$ per lb.
Nickel, RHS
Copper, LHS
Zinc, LHS
Aluminium, LHS
5
4
3
2
1
0
25
20
15
10
5
0
80 84 88 92 96 00 04 08 12 16


Forest Products Prices
US$
Pulp (per tonne)
Newsprint (per tonne)
Lumber (per mfbm)
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
80 84 88 92 96 00 04 08 12 16


Agricultural Prices
US$ per cwt
US$ per tonne
Cattle, LHS
Canola, RHS
Hogs, LHS
Wheat, RHS
200
150
100
50
0
800
600
400
200
0
80 84 88 92 96 00 04 08 12 16

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 TMX/Shorcan Energy Brokers.

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) Spot price for U3O8.

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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