Commodities Outlook (Q1 2020)

****Content reproduced from our recently released quarterly *Scotiabank's Global Outlook* (pp. 42–44).**

- **Macro sentiment is expected to continue dominating commodity price formation in 2020 before risks ease in 2021 and commodities are able to resume price paths driven by commodity-specific fundamentals.**
- **A mild easing of US-China trade tensions on the back of the soon-to-be-signed Phase I deal as well as continually worsening US-Iran relations have boosted the prospects for oil and copper prices while modestly dimming the outlook for gold in 2020.**

2020 BRINGS FAMILIAR RISKS FOR COMMODITY MARKET, THOUGH THE WORST MAY HAVE BEEN AVOIDED

The defining feature of commodity price formation through 2019 was market sentiment toward Washington and Beijing's capricious trade relationship—pushing around contracts far more than any commodity-specific fundamental news. This despite the fact that last year witnessed historic supply-side risk events, including massive protests in copper juggernaut Chile, a tragic tailings dam collapse in Brazil that idled much of the country's iron ore mines, ever-ramping Iranian regional aggression culminating in the largest-ever disruption to Saudi oil supplies, and most recently the largest shock to US-Iran relations since the 1979 hostage crisis in the targeted killing of Iran's most powerful military leader. Still, it was the on-again-off-again headlines related to this-or-that US-China trade development that packed the biggest price punch, bringing commodities higher and lower together as a pack with few exceptions.

We expect another year of trade policy dominance in 2020 before risks gradually abate following the US presidential election, regardless of who lays claim to the Oval Office. Our view remains more or less unchanged from our last quarterly forecast release, though the avoidance of additional tariffs scheduled to take effect on December 15th and the announcement of a potential Phase I trade deal to be signed on January 15th (according to the President's Twitter account, so we're taking it with healthy wallop of salt) signals the first real progress on the trade file since the trade war began in earnest in mid-2018. While we remain skeptically optimistic that trade negotiations will advance further over the coming months we are not yet committing to an outright reduction in trade risks, rather trimming our assumed probability of a worst-case trade outcome—namely the further descent into trade animosity between the world's two largest economies and ramp ups of even less predictable non-tariff barriers. Our commodity price outlook remains mostly unchanged from last quarter (chart 1), save for very modest upgrades to copper and a minor trimming to gold's price path, the two most risk-sensitive commodities, as well as an upgrade to the crude price outlook to account for increased supply risk following the US killing of Iran's most influential general.

ENERGY: OIL MARKET SPEED BUMP AHEAD, STRENGTH THEREAFTER

Oil prices rallied through December on the back of positive US-China trade developments despite widely anticipated surplus conditions in the first half of 2020 (chart 2). Crude prices are expected to ease slightly as this sentiment normalizes,

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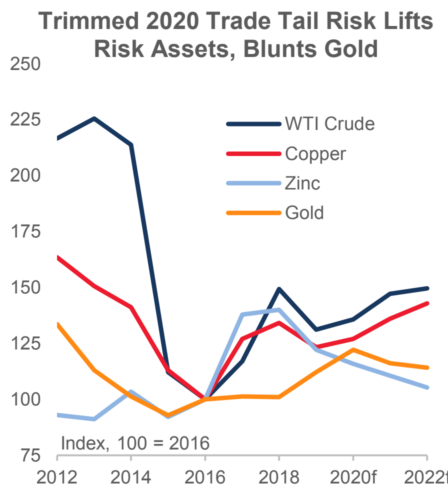
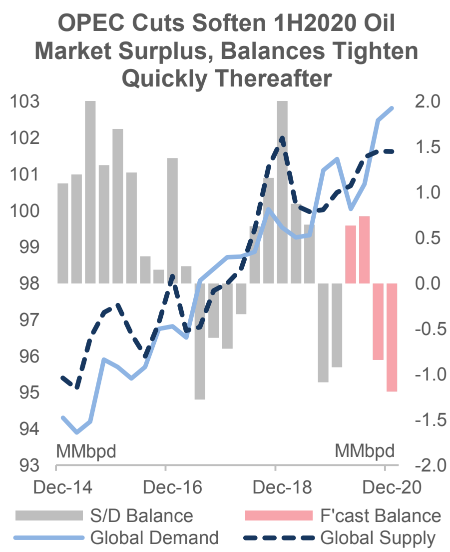
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

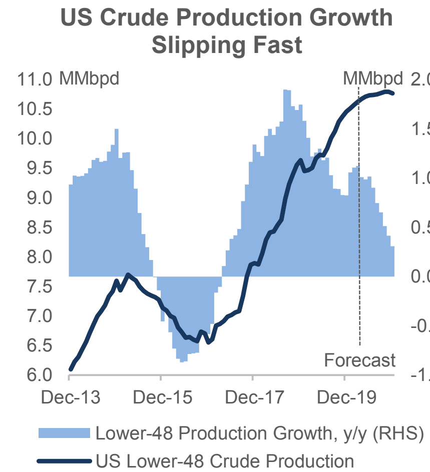


Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

forward curves flip into mild contango, and global inventories begin to rise, signalling the onset of surplus supply conditions that are anticipated to persist until the second half of the year. But this surplus reflects a different kind of supply than that which has cast a bearish cloud over crude contracts since late-2014—not a US shale surge or OPEC battle for market share, but a coincidence of timing that has three long-lead-time, offshore jurisdictions ramping new project output together in Brazil's pre-salt, a Norwegian mega-project in the North Sea, and the first-ever barrels produced in tiny Guyana, which is now expected to shift from no production to the highest per-capita production on the planet.

Conditions begin to tighten quickly in the second half of 2020 into 2021 after the oil market progresses past these one-time boosts to global supply. US shale supply growth is expected to exit 2020 at less than 1 MMbpd y/y down from more than 2 MMbpd in 2018 as drilling activity continues to stagnate and productivity plateaus—US production growth is expected to stabilize in the early-2020s at around 300–500 kbpd annually (chart 3), which will leave room for OPEC+ to finally begin returning withheld barrels to the market and still have enough additional demand buffer for other non-OPEC countries outside the US (Canada as curtailment is lifted, Brazilian offshore, etc.) to organically grow output as well. Demand growth is expected to begin accelerating again in 2021 as trade uncertainly rolls off and the global economy makes up for lost time amidst delayed investment decisions in 2019–2020—demand growth of only roughly 1 MMbpd last year was well below the market's trend growth rate.

Chart 3



Sources: Scotiabank Economics, EIA.

Crude prices received an additional, classic geopolitical risk boost following news that US air strikes on Baghdad airport killed Iran's Major General Qassim Suleimani, head of the elite Quds force within the Islamic Revolutionary Guards Corps and effectively the second most powerful individual in the Iranian government behind only the Supreme Leader. How Iran decides to retaliate for the assassination of one of their upper most leaders remains to be seen, but all else equal this event considerably increases the risk of further escalation between Washington and Iran and potential spillovers to oil supply assets in the region. Factoring for this increased downside supply risk, WTI oil prices are now forecast to average $59/bbl in 2020 with prices weakening in 1H2020 alongside the supply glut and rising thereafter as conditions tighten to average $64/bbl in 2021.

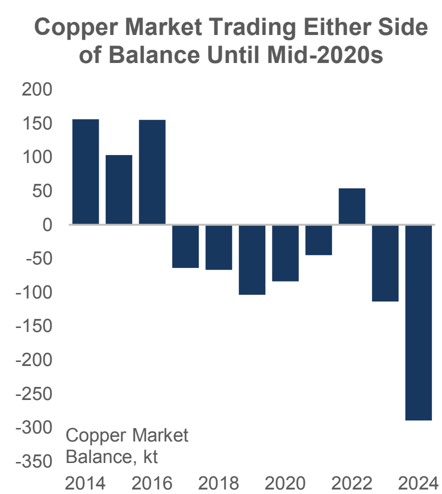
The differential borne by barrels of Canadian heavy crude (WCS) is forecast to rise to $19/bbl under WTI in 2020 and $24/bbl in 2021 as the Alberta government continues to ease its curtailment policy, pipeline capacity remains insufficient even after the assumed end-2020 start-up of Line 3, and necessary oil-by-rail economics persist as a requirement to balance the Western Canadian oil market.

INDUSTRIAL METALS: STEADY SENTIMENT TO HOLD PRICES UNTIL FUNDAMENTALS REASSERT THEMSELVES IN 2021

The trade policy narrative tugging around commodity prices last year was most evident in the base metals complex and we expect another year of relatively tight metals performance in 2020, while steel complex inputs like iron ore and coking coal are expected to better track Chinese domestic policy. Global PMI readings appear to have bottomed out in the latter months of 2019 and look to be rebounding—even as trade uncertainty remains elevated heading into the 2020 US presidential election industrial activity is expected to present stronger than last year's anemic showing.

Part of the reason that sentiment has been able to direct copper prices to this extent is that copper's physical balances aren't particularly extreme (chart 4) Demand growth was relatively steady but weak last year and we expect more of the same over the coming quarters, balanced between weak manufacturing demand in China on the back of, among other things, the drawdown of air condition inventory following the implementation of new efficiency standards, and the likely upswing of grid investment related to stronger stimulus efforts from Beijing. Despite relatively even physical balances, exchange-listed copper inventories are down 60% from early-2018 and 37% since late-3Q19. Speculative

Chart 4



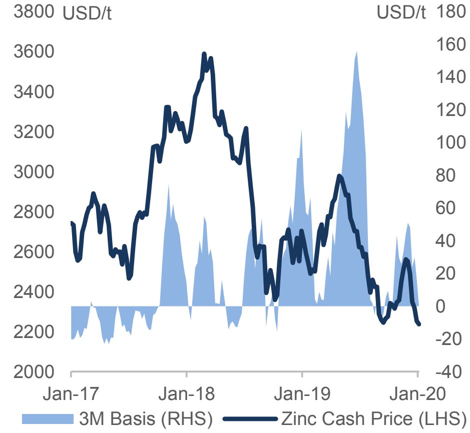
Sources: Scotiabank Economics, Wood Mackenzie.

positioning in Comex and LME futures contracts remains well below early-2018 levels before the US-China trade dispute really gained steam but has steadily improved over the past few months as hope for some kind of agreement between Washington and Beijing approaches validation in the signing of a Phase I deal scheduled for mid-2020. Commensurate with the tail-risk trimming mentioned above, we have mildly upgraded our copper price forecast for 2020 to $2.80/lb (from $2.75/lb last quarter) and 2021 at $3.00/lb.

Zinc offered a telling illustration of how powerful trade war sentiment effects have been on metals prices, with contracts falling by one-third since mid-2018 at the same time that all evidence continued to suggest extremely tight physical markets (chart 5). Despite the surge in mine supply brought on by decade-high prices last year, the surplus of concentrates have thus-far failed to materialize in refined metal balances due to tightness and bottlenecks in the smelting sector; environmental regulations in China are further straining the domestic smelting sector that would otherwise be ramping up utilization at their plants to capture the favourable difference between loose concentrate markets and tight metal markets. This tightness in metal markets is vividly evident in the exaggerated backwardation zinc contracts have experienced over the past few years; even if that backwardation is easing, it looks like we're still at least a few months out before the market reaches any meaningful near-term balance. Zinc metal inventories remain perilously low and will take time to re-accumulate after the market enters a surplus period. While we continue to expect that this concentrate surplus will work its way through into the finished metal market this year, smelting sector tightness is expected to keep prices more or less around current levels ($1.08/lb in 2020, $1.05/lb in 2021) until metal surpluses can replenish anemic inventory levels.

Chart 5

Zinc Remains Tight, Backwardated Despite Outright Price Weakness



Sources: Scotiabank Economics, LME.

PRECIOUS METALS: GOLD FORECAST TRIMMED IN LINE WITH REDUCED TAIL RISK, DEATH OF IRANIAN GENERAL PROVIDES TEMPORARY BOOST

Bullion prices received a fresh risk bid following the targeted killing of Iran's Major General Qassim Suleimani (fuller analysis above in Energy section), nearing a 7-year high of $1,600/oz (chart 6). While we expect these recent heights to be fleeting as the prospect of outright military confrontation between Washington and Tehran diminishes over the coming weeks, we continue to believe that 2020 will be a good year for gold pricing given lingering US-Iran concerns, a particularly contentious US presidential election, currently-frothy equity prices with mounting downside risks, and still-hesitant central banks waiting for more political certainty before resuming their prior tightening path.

Gold prices are forecast to average a near-term annual peak of $1525/oz in 2020 before declining to $1450/oz in 2021 and further in the early 2020s on the back of falling political uncertainty and an eventual resumption of global monetary policy tightening.

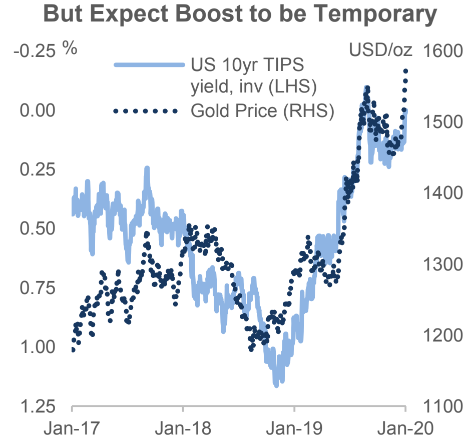
Table 1

Commodities	2010–2018			Annual Average		
	Low	Avg.	High	2019	2020f	2021f
WTI Oil (USD/bbl)	26	74	114	57	59	64
Brent Oil (USD/bbl)	28	82	127	64	63	67
WCS - WTI Discount (USD/bbl)	-50	-18	-7	-14	-20	-24
Nymex Natural Gas (USD/mmbtu)	1.64	3.39	6.15	2.53	2.39	2.63
Copper (USD/lb)	1.96	3.10	4.60	2.72	2.80	3.00
Zinc (USD/lb)	0.66	1.02	1.64	1.16	1.10	1.05
Nickel (USD/lb)	3.50	7.00	13.17	6.32	6.50	7.00
Aluminium (USD/lb)	0.65	0.89	1.26	0.81	0.90	0.90
Iron Ore (USD/tonne)	39	101	194	94	78	70
Metallurgical Coal (USD/tonne)	81	179	330	184	145	150
Gold (USD/oz)	1,049	1,342	1,895	1,393	1,525	1,450
Silver (USD/oz)	13.58	21.64	48.70	16.21	18.75	17.75

Sources: Scotiabank Economics, Bloomberg.

Chart 6

Killing of Iranian General Stokes Gold's Risk Premium Once Again, But Expect Boost to be Temporary



Sources: Scotiabank Economics, Bloomberg.