Standard Chartered

Commodities – signs are looking up

Although gold prices are continuing to fall in the short-term, oil prices are volatile and base metals demand growth is moderating in China, many commodities are beginning to reverse their downtrend, and recovery – although modest – is becoming evident. Standard Chartered Bank provides a forecast of what we can expect for 2014 and beyond

Commodities have had a roller-coaster ride this year. For the first time in more than a decade, gold prices are expected to end the year lower than they started. Oil prices, although ranging within a band for the third year in a row, have been volatile, while base metals have been hit by a slowdown in China since last year.

As we enter the fourth quarter of the year, commodities – and especially some base metals – are finally reversing their medium-term downtrend, established since the second quarter of 2011. They should continue to recover modestly through the rest of the year, before seeing a stronger upside move in 2014. This is for two main reasons:

1. A gradually improving global economy; and
2. Balanced demand and supply in key industrial commodities.

However, do not expect all commodities to rise in tandem. Divergence among various commodities is here to stay, as fundamentals reassert themselves and supply-side factors become dominant. For example, iron ore and coal are likely to weaken in 2014, while we are bullish on most base metals.

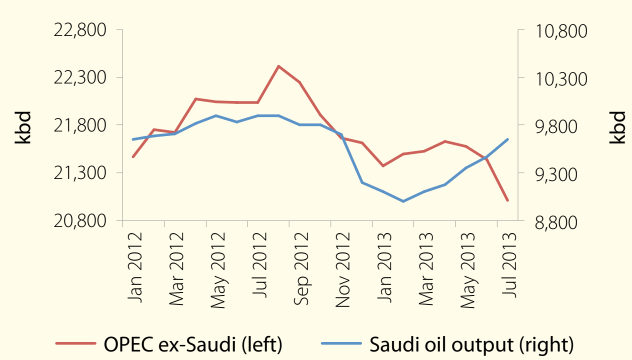
Looking at the two major industrial commodities – crude oil and copper – these are likely to be most affected in an environment of improving macroeconomic fundamentals.

Oil – a supply-side story

Demand and supply for crude oil is likely to be balanced throughout 2014. Until now, it has taken both rapid growth in US output and record Saudi production to maintain the market balance – and at relatively high prices. Oilfield shutdowns in a number of oil-producing countries in the Middle East and North Africa – whether because of maintenance and accidents or due to political unrest – are keeping markets tight. Our base case assumes that most of the lost production will not resume before the end of 2014, as the return to full production from stoppage generally takes more than 12 months.

Saudi Arabia's production discipline and recent actions suggest the country is keen to keep prices elevated, but not so high that they cause major headwinds to the global economic recovery. Production in Saudi Arabia was cut to a low of 9.0 million barrels per day in February, in response to strong US output growth from its shale discoveries, and has rapidly increased in recent months to offset Libya's production outage (figure 1).

1. Saudi Arabia is the world's swing oil producer

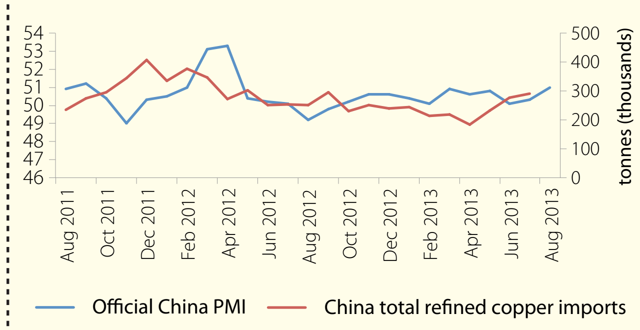


Source: Bloomberg, Standard Chartered Research

At the same time, global demand is on the rise, primarily because of strong take-up from the emerging markets. The US is the world's biggest oil consumer, accounting for around 20% of global demand. China is next and accounts for about 11%. Its share is gradually growing – we expect China's demand will account for around 40% of global demand growth this year.

Although supply-side issues will dominate oil markets into 2014, US consumption will remain an important factor, even as the US materially increases its supply and reduces imports. US demand is likely to remain constant on an annual basis in 2013 and 2014, after two years of decline since 2010.

2. China's copper imports and Purchasing Managers' Index*



*Demand has been improving since April 2013

Source: Bloomberg, Standard Chartered Research

Copper – underpinned by China

Copper is the other commodity that has traditionally reflected the health of the global economy. We forecast a modest upturn in copper prices heading into end-2013, followed by a stronger 2014. Demand is in reasonably good shape, and China's macroeconomic upturn is boosting sentiment.

The authorities in China, which consumes around 40% of world copper output, are likely to provide more industry-specific 'mini-stimulus' measures over the course of this year – unblocking the logjam in rail investment, allocating funds to slum redevelopment and quietly relaxing some of the controls that have suppressed home buying. China's actual demand for industrial metals in general, and copper in particular, has improved in the past six months. This is shown by increasing copper imports since April, and readings of the China Purchasing Managers' Index (PMI) above 50 since October 2012 (figure 2). An expanding manufacturing economy, signalled by the PMI exceeding the 50 mark, generally means greater demand for industrial metals and copper, which are used in home appliances, telecoms and construction.

China is critical to the copper market. Its consumption of the base metal is close to 10 million tonnes per year, or about four to five times US demand. Its demand for the metal grew around 12% between 2011 and 2012, while US demand has remained generally flat during the same period, and will likely grow less than 2% this year and 3% in 2014. In 2013, China accounted for 65% of global growth in copper demand. Hence, it will remain the biggest driver of copper prices in the medium term. We still see an essentially balanced market in 2014, but supply growth looks set to accelerate as major new mines ramp up production between 2014 and 2017 – the biggest capacity increases will come from Chile, Peru and Indonesia. While demand growth is also picking up, this is unlikely to be enough to prevent stock build-up heading into 2015.

Risks

The biggest risk to our bullish view on commodities in 2014 is slower-than-expected gross domestic product growth in China (we forecast 7.2% growth) or the US (2.7%). Commodity markets are not overextended now, but they have priced in stable growth in US and China. The introduction of quantitative easing in the US had no positive impact on commodity prices, and any tapering is unlikely to have a medium-term negative impact. Instead, commodity fundamentals – supply and demand – are likely to dictate price trends. In China, some sectors, such as steel, aluminium and solar, clearly have overcapacity, while others are likely to see greater liberalisation and are opening up to private investment. Some macroeconomic volatility is likely as policy-makers in Beijing pursue reforms.

Darren Baker/Shutterstock

Saudi Arabia has increased oil output in response to outages elsewhere

Meanwhile, the US economy is set to pick up materially in 2014, boosted by robust business investment, a continued housing recovery, moderating fiscal headwinds and increased bank lending. The need to increase the debt ceiling is a near-term risk. Congress may tighten fiscal policy more than we expect, which could affect future growth. Overall, however, China has a greater impact on industrial commodities than the US – with the exception of oil – and it is China's stable growth outlook that is likely to fuel the ongoing uptrend in commodity prices well into next year.