2018 GLOBAL COMMODITIES OUTLOOK

"This year has been a tale of two markets in commodities, with prices declining in the first half and rebounding in the second. The second-half rebound provides momentum headed into 2018, especially given the tailwinds of firmer global growth and easy financial conditions."

– **Francisco Blanch, head of Commodities and Derivatives**

Our view

Global growth is a tailwind for commodities going into 2018

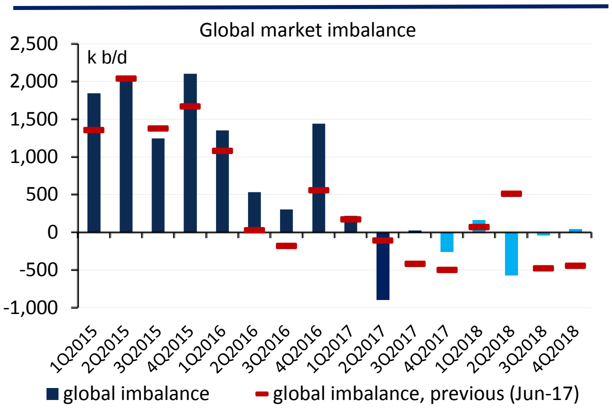
A nearly 9 percent decline in the DXY (U.S. dollar index) in 2017 proved to be a tailwind for oil and other commodities, along with a cyclical acceleration in global growth that has pushed prices higher. Moreover, OPEC supply cuts and China supply-side reforms have reduced oversupply.

Looking into 2018, commodity prices face some headwinds. Global growth and inflation are picking up, however, so financial conditions remain easy, and rising real rates support commodity roll returns. Most significantly, the higher real interest rates we are seeing are linked to shifts from "contango" (when the futures price of a commodity is higher than the projected future spot price) to "backwardation" (when the futures price is lower than the spot price), as the incentive to store commodities falls when the cost of funding them rises. The result is a decline in commodity inventories. Moreover, with geopolitical risks on the rise, commodities remain a hedge against unexpected inflation.

Crude oil: Robust global demand/tight supply for oil in 2018

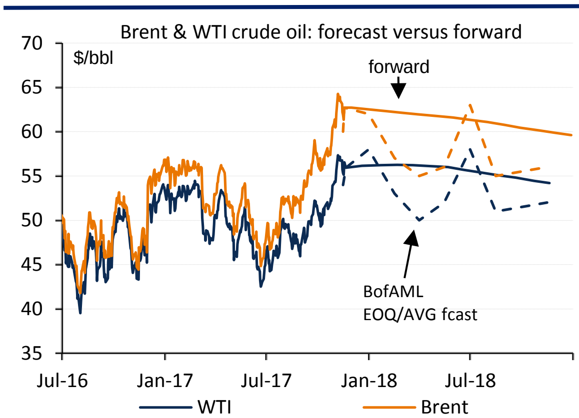
The global oil market experienced a clear turning point in 2017, with balances tightening on the back of robust 1.5 million barrel per day growth average in demand and a supply cut deal of 1.8 million barrels per day. Next year likely will see global oil demand expand again by 1.5 million barrels per day and U.S. supply rise by 870,000 barrels per day – although OPEC likely will at best maintain the cuts implemented in 2017, resulting in a balanced market. On these assumptions, Brent crude should average $56 per barrel in 2018 and hit a high point of $70 per barrel at the peak of the U.S. driving season.

Our revised global oil supply and demand forecasts point to a sizeable deficit in 2017 and a more balanced market in 2018



Source: IEA, BofA Merrill Lynch Global Research estimates

Global crude oil prices, particularly Brent, have firmed up more than we expected and we are adjusting our numbers higher



Source: Bloomberg, BofA Merrill Lynch Global Research estimates

Positives for U.S. natural gas: Fundamentals for U.S. natural gas are more positive than current forwards imply, and prices could reach $3.30/million BTU in 2018, with U.S. household natural gas prices briefly breaking through $4 per million BTU this winter. For 2018, we expect a tightening in balances on strong structural demand growth in 2018, especially from liquid natural gas (LNG export facilities), outpacing production growth. Returns at current prices are only marginal for producers; the forward would have to come up by at least 30 cents to justify drilling.

Diesel may hit $90 a barrel: A strong diesel crack spread gives refiners in the Atlantic Basic reason to continue to run hard. The capacity to increase crude oil distillation (CDU) is limited, however, so diesel could hit $90 a barrel in 2018. The spread between gasoline and diesel prices is also likely to fluctuate in a wider-than-normal range on seasonal demand. In short, we see a wider gasoline discount to diesel through the winter and a wider premium 2018 summer than what the forward curve is currently pricing.

Key theme: Miners vs. refiners – who wins in the electric vehicle transition?

The advent of the electric vehicle (EV) will likely remain one of the most defining themes for commodities in 2018. The speed and effects of the transition to EV are hard to project, creating uncertainties for commodity markets.

With annual capital expenditures in mining and energy falling in the past four years from around $900 billion to $500 billion, we are concerned that bottlenecks may emerge. Crude distillation capacity, for instance, has fallen short of fuel demand for years, yet refiners remain reluctant to invest given the risk of a peak demand scenario in the next five to seven years. Similarly, miners have shied away from new copper and nickel investments, despite these being crucial raw materials for electric vehicles. Uncertainty around EV penetration rates, coupled with a major timing gap, should continue to create opportunities for investors in 2018 and beyond.

Remarkable rally in copper: Copper has long been the laggard in the base metals complex, yet prices rallied in the second half of 2017, and copper has remarkably outperformed all other metals. Despite a slowdown in demand from China, we think there is scope for copper prices to reach $7,700/t (or $3.50/lb) by mid-2018.

Cautious gold but buy on dips to position for policy shift: We see only limited upside to gold prices in 2018, as the macro-economic backdrop remains challenging. Gold is correlated with the U.S. dollar, and volatility (in rates, oil prices, FX) is one of the key variables influencing gold prices in the year ahead. While the 2018 forecast for gold isn't bullish, an inflation surprise could bring buyers into the market because gold is frequently held as an inflation hedge.

Key calls

- Brent crude to average $56/barrel, WTI averages $52/barrel
- U.S. natural gas prices to average $3.30/million BTU, reach $4/million BTU
- Price per ounce: Gold $1,326; silver $17.41; platinum $950; palladium $850
- Price per ton: Aluminium $2,375; copper $6,525; lead $2,488; nickel $13,500; zinc $3,213
- Favor value and momentum strategies in commodities over carry or curve placement as inventories continue to drop and curves push into backwardation
- Sector preferences:
    - Energy: Overweight Brent crude oil, natural gas and gasoil
    - Precious Metals: Underweight gold and silver
    - Base Metals: Overweight aluminium and nickel; neutral copper and zinc
    - Grains & Oilseeds: Overweight corn and wheat