COMMODITIES 2016 YEAR AHEAD

“Global nominal GDP in USD is contracting, and commodities are falling on weak global growth, low inflation and a strong U.S. dollar… To top it off, many commodity markets remain in surplus mode as supply is taking an awfully long time to adjust, suggesting too many commodities keep chasing too few U.S. dollars.”

– Francisco Blanch, Head of Global Commodities and Derivatives Research

Our view

Commodities face continued macro headwinds from China: As we have said in the past, a strong U.S. dollar and restrained global growth will create downward pressures on commodity prices – not just in metals, but also in energy and grains. Looking ahead to 2016, we expect emerging growth to remain below trend once again, and our FX team sees the renminbi depreciating to 6.9 against the U.S. dollar. We expect China to continue its transition from an industrial to a service economy, reducing its demand for metals and mined commodities but increasing already robust demand for transportation fuels.

Energy supply/demand dynamics are improving: In the near term, we see downside risks to Brent crude oil on a potentially weaker Chinese renminbi and generally poor macro conditions. However, the micro structure of the oil market looks much better for the second half of 2016. We expect a combination of lower non-OPEC output and robust global demand to push Brent crude oil back up to an average of $50 per barrel next year. Meanwhile, Brent-WTI differentials should stay narrow, averaging $2/bbl in 2016.

Healthy refining margins, led by gasoline: For now, a persistent crude oil surplus should provide support to refining margins. Product demand growth may again outpace crude distillation additions in 2016, and spare capacity in refining is low. Solid gasoline consumption on the back of low oil prices and a tight supply backdrop may result in higher RBOB crack spreads next summer. Diesel balances, however, look weak. For U.S. natural gas, we downgrade our 2016 average price forecast to $3/MMBtu, but remain constructive for 2017. Lastly, global thermal coal prices have yet to find a bottom and will continue to struggle.

Continued downside pressure on base metals: Manufacturing activity globally remains challenged, and modest supply cuts are unlikely to drive prices higher. Thus, we believe metals could decline further into 2016. For copper, this may lead to another round of supply cutbacks. Zinc has the strongest fundamentals in our view, with a concentrates deficit of 800kt, so it is likely that this commodity will remain an outperformer. Aluminum remains challenged unless Chinese smelters curtail output, a distinct possibility.

A hawkish Fed will weigh negatively on precious metals: We recently lowered our gold price view on an imminent start of a Fed hiking cycle. Rising nominal rates, combined with low/falling inflation rates will likely pressure the yellow metal lower. Yet, scope for global reflation in 2H16 and/or a slower Fed hiking cycle could bring about a turning point for gold.

Expect lower grain and oilseed prices on high inventories: Five consecutive years of rising stock-to-use ratios continue to exert downward pressure on corn, wheat and soybean prices, are all of which are down by more than 10 percent this year. This year's harvests are set to increase global stock-to-use ratios to some of the highest levels in more than a decade, and we see the potential for resultant impacts on supply and price.

An eventual rebound, but not yet: We see a modest acceleration in global GDP growth because of reduced commodity prices. However, this may not occur immediately. Although the central banks of China, Europe and Japan are continuing their monetary easing policies, the Federal Reserve is preparing to increase rates – in effect reversing the situation in these economies in 2007. As a result, improving micro supply/demand dynamics may not translate instantly into higher commodity prices.

Moderate optimism on a 12-month basis: The Bloomberg Commodity (BCOM) Index has declined by 22 percent year-to-date, falling well behind both equities and bonds, and many near-term headwinds remain. However, we remain more optimistic on a 12-month basis, as we believe supply curtailments, potentially stronger economic activity, and the possibility of a slower Federal Reserve rate hike path ultimately could push commodities back up again.

Key calls

- **Energy macro remains negative, but micro is improving:** We now believe Brent will average $50 per barrel in 2016, down from $55 previously. Eventually, a steadier U.S. dollar and a shrinking supply/demand imbalance could push Brent to $61 per barrel in our 2017 forecast. This is our base case for oil.

- **A de-peg of the Saudi riyal is our top black-swan event for 2016:** This is a highly unlikely, but hugely impactful, risk. If Saudi Arabia opts to cut supply modestly to push Brent crude oil prices back above $50 per barrel over the next year, emerging market growth could stabilize at these low levels and eventually recover. However, if Saudi Arabia cannot resist the forces created by a strong U.S. dollar and de-pegs the riyal to follow Russia or Brazil, oil prices could collapse to $25 per barrel.

- **Copper prices will likely drop further to force more output cuts:** Continued increases in TC/RCs suggest that the concentrates market has not tightened. With demand weakness likely spilling over into next year, we see scope for prices to decline further. Thereafter, another round of production cutbacks may finally help rebalance the copper market.