GLOBAL COMMODITIES 2019 OUTLOOK: MOSTLY POSITIVE, BUT DISPERSION AHEAD

"While we remain modestly positive on commodities, differentiation is essential, and three macro downside risks stand out: a collapse of the U.S.-China trade relationship, Fed monetary policy tightening, and a worsening credit cycle. On the positive side, commodities tend to perform well during late business-cycle phases."

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

<u>**Our view**</u>

Commodities face three key macro challenges:

1) **U.S. monetary policy could tighten a lot further.** The Fed, and potentially other central banks, seem keen on reducing the size of their balance sheets, and we project a meaningful increase in the Fed funds' rate in the next 12 months.
2) **U.S.-China trade war could intensify.** This could lead to a materially different USD/CNY exchange rate if no agreement is reached, and commodities will likely move with the Chinese currency if the CNY moves from 7 to 8.
3) **The emerging market credit cycle could materially worsen.** Financial markets are struggling to cope with the reversal of years of easy monetary and tight fiscal policy in advanced economies, and the emerging markets are facing meaningful headwinds.

Oil diverges from the pack: The strong U.S. dollar in 2018 has been a drag on energy, metals, and agriculture, but the correlation between currencies and commodities did break when oil prices rallied earlier in the year, thanks to oil supply disruptions in Venezuela and Iran. We see world oil demand growth holding up over the coming quarters, as we project global GDP to be relatively robust.

Strong U.S. crude growth in 2019: Total U.S. volumes have exceeded our initial expectations, and we now forecast U.S. crude oil production to average more than 12mn b/d next year.

Low inventory for natural gas: Despite enormous production growth this year, natural gas inventories are their lowest since 2003, and cold weather could create a difficult situation for total gas inventories.

Aluminum market could rally: While fundamentals in China have strengthened, sanctions on Rusal have been in place since April, and prices will likely trade in a tight range until there is more clarity over whether trade restrictions will be removed. Given China's production curtailments, aluminum is in deficit, which should ultimately support prices, and we see scope for a rally should Rusal sanctions be removed as pent-up demand is released.

Cautious on copper: Prices have been under pressure, and the macro environment remains challenging, with the U.S. economy set to weaken in 2019, activity in Europe expected to remain subdued, and China slowing as well.

PMIs point to continued expansion: With PMIs in key emerging markets continuing to expand, commodity consumption should hold relatively firm over the coming quarters, unless EM fragilities reappear. Emerging markets remain a relatively diverse group, but financial conditions are easing in China, potentially providing some support to commodity prices.

Key calls

- We expect Brent crude and WTI to average $70/bbl and $59/bbl, respectively, in 2019, and $65/bbl and $60/bbl in 2020.
- For U.S. natural gas, we expect weather-induced volatility in the near term, as cold weather could propel winter natural gas over $5/MMbtu, but mild weather could lead to a steep sell-off.
- As the coal shortages are alleviated with supplies from the U.S., we expect Newcastle thermal coal to average $95/mt in 2019 and $90 in 2020, $5 below the forward.
- Aluminum fundamentals are steady on smelter cuts in China while output has also underperformed in the Americas and Europe.
- Zinc had been the outperformer in the base metal complex in 2016, but mine supply has been rising since 2017 and should increasingly push the market into surplus, so upside to prices is capped.
- A weaker dollar is prerequisite for a gold rally, and the golden triplets – U.S. twin deficits and Chinese stimulus – could push gold to $1,400/oz high; our 2019 forecast is for an average price of $1,296/oz.
- In 2019, we are bullish on corn and mildly bullish on wheat, while bearish on soybeans and sugar.