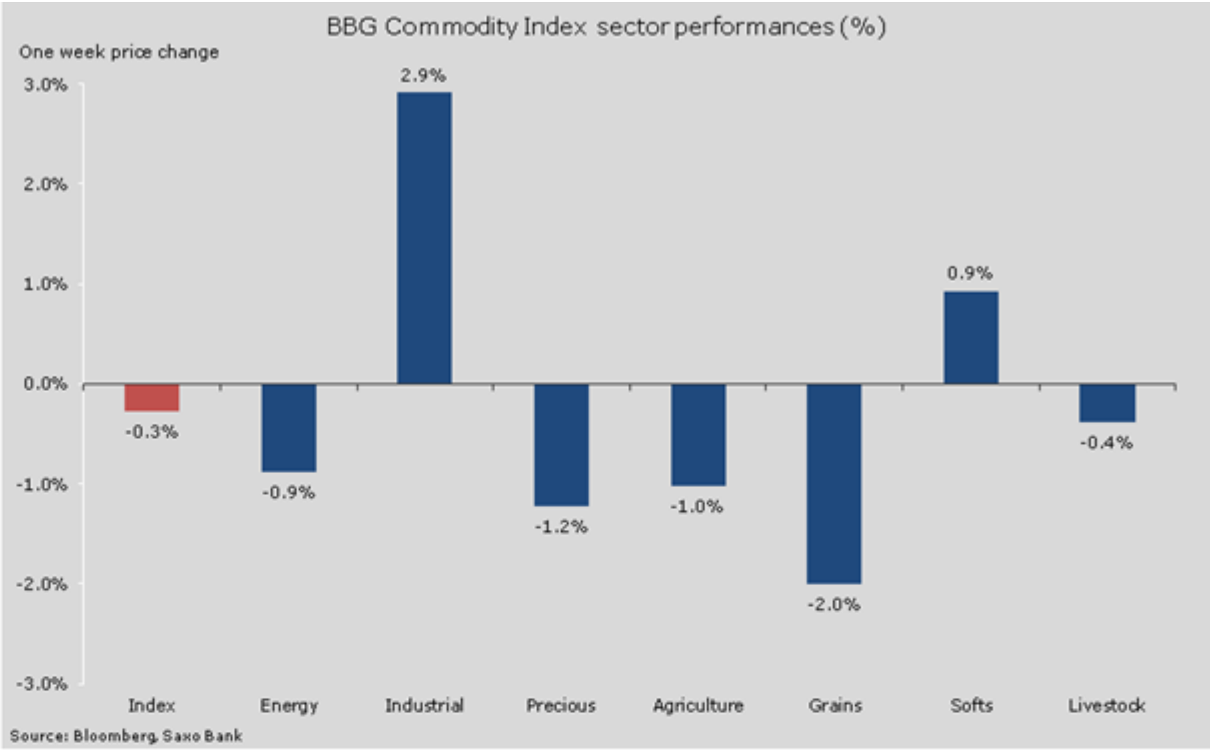
Industrial metals offset weakness in energy and precious metals

By Ole Hansen

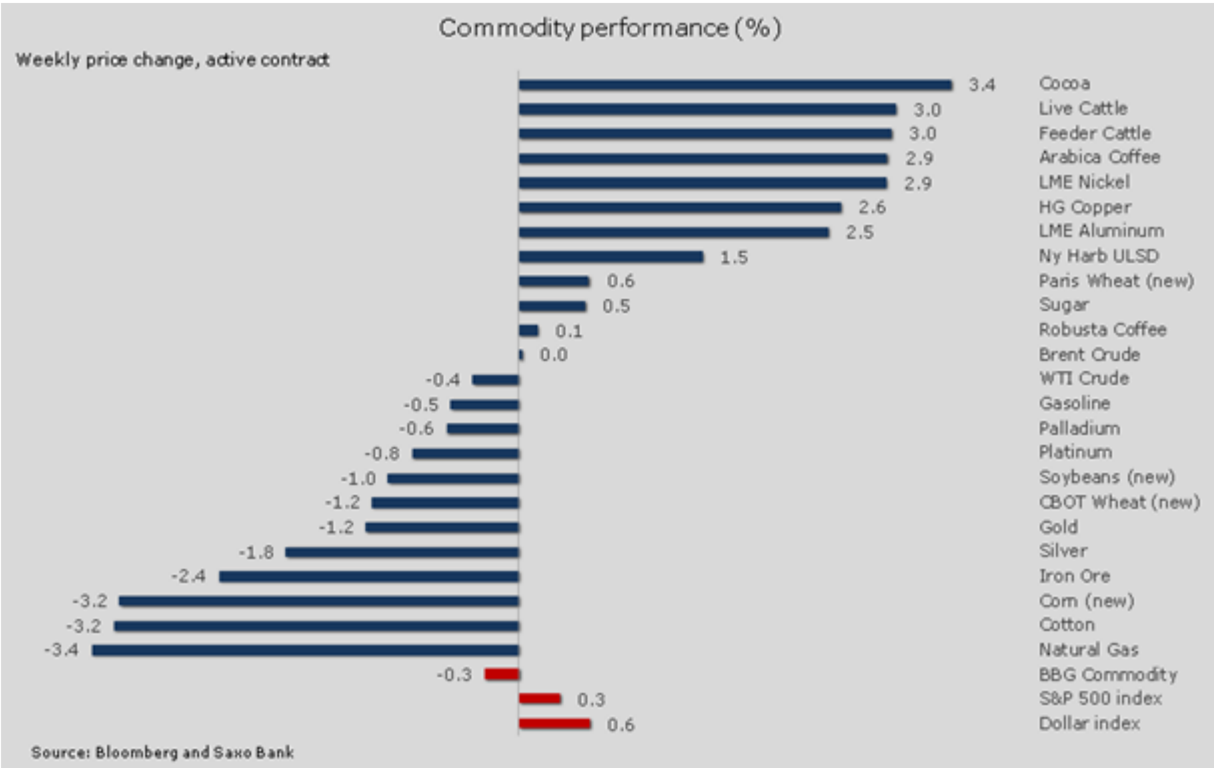
The diversified BBG Commodity Index was almost unchanged on the week with strong gains in industrial metals, not least zinc and aluminium, helping to offset losses in energy and precious metals. The agriculture sector was mixed with continued weakness seen among the key crops, especially corn while the soft sector led by coffee and cocoa made a solid gains.



Arabica coffee and cocoa was found at the top of the leader board this past week. Coffee prices jumped sharply during the first quarter as drought in Brazil, the world's largest producer of the high quality bean, led to a reduction in production. Following a 50 percent correction of that rally the price is once again moving higher, this time due to reports that the drought may have caused irreversible damage to Brazilian coffee trees which could lead to a downwards revision of future production estimates.

Cocoa, meanwhile, reached a three-year high after the September future broke out of a six-week consolidation range. The catalyst for the move higher apart from technical buying once the recent high was broken came from news about a pick up in demand from processors in North America and Asia. We are entering a period of peak demand as processors ramp up production ahead of the December festive season when consumption is high. Supplies out of West Africa remains healthy but any change in that outlook may give prices an additional boost unless we see demand begin to be affected by recent price rises, most noticeably by Mars Candy Company and Hershey.

The price of US natural gas was heading for a sixth consecutive weekly loss triggered by a continued strong pace of inventory rebuilding which were left depleted in January following a very cold winter. The weekly growth in inventories has been running above the five-year average for the past fourteen weeks on a combination of strong production and weaker demand from utilities due to milder than normal weather. As a result, the price has fallen to an eight month low but with stockpiles still 23.5 percent below the five-year average high, weekly injections into underground storage need to be maintained to ensure a healthy level of stocks before winter demand kick off in late October.

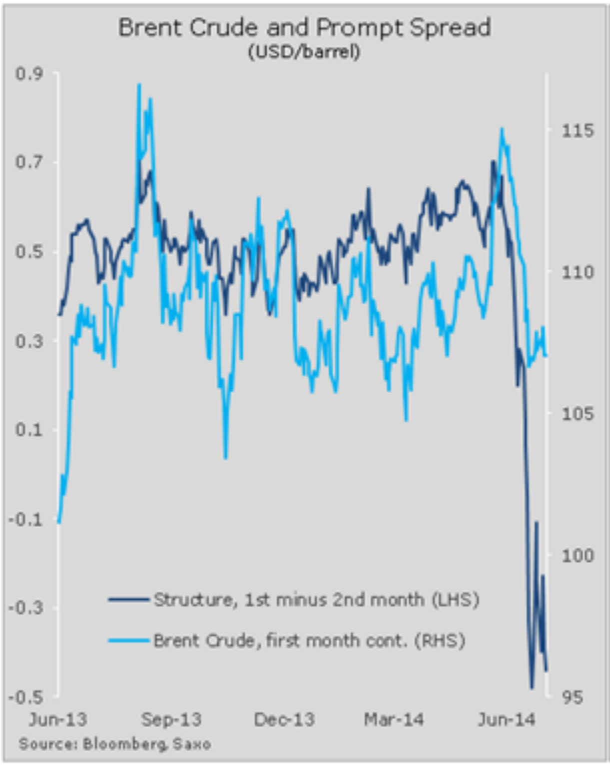


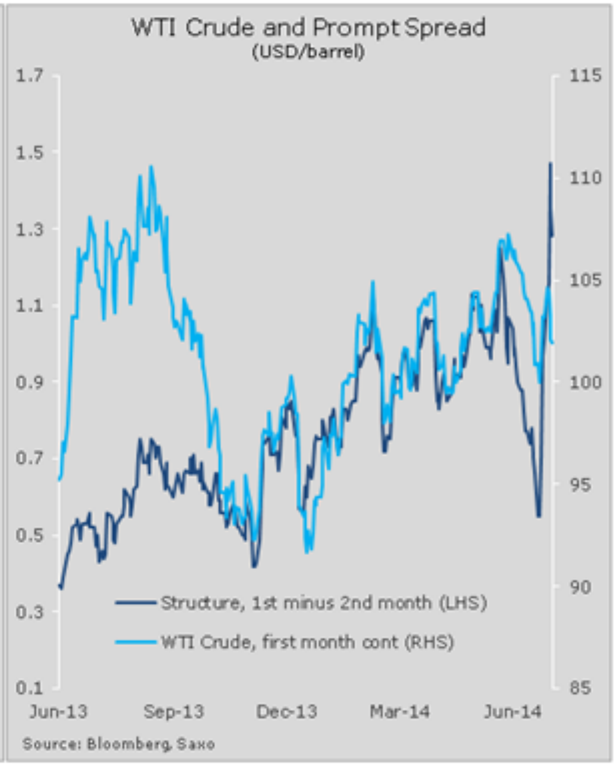
Industrial metals have overtaken both energy and precious metals as the strongest sector so far this year. The recent gains has been driven by increased speculation about a rising supply deficit in aluminum over the coming two years as demand keeps rising at a time where some of the major producers outside Chine have reduced production. A production cutback was triggered by a price slump that began in 2011, and following the recent gains, only one-third of that sell-off has been recovered so far. The general improvement in economic data out of China and the US, the world's two biggest consumers by far, has also helped improve sentiment during the past couple of months. HG Copper, which has established a new trading range between USD 3.18 and 3.30/lb, does not currently have the same supporting characteristics as aluminum and zinc. So for now, that range is expected to hold with the upside potential currently assessed as limited.

The energy sector was mostly flat with geopolitical worries being offset by weak demand for Brent crude where the prompt spread has moved deeper into contango. This signals an improved supply situation at a time of weak refinery demand. WTI crude has been supported by the continued fall in inventories at the delivery hub at Cushing, but at the same time, a strong rise in gasoline inventories as a result of strong refinery activity in recent weeks is now pointing towards a potential slowdown in crude oil demand as we approach the end of the US motoring season which normally runs until Labor day in early September.

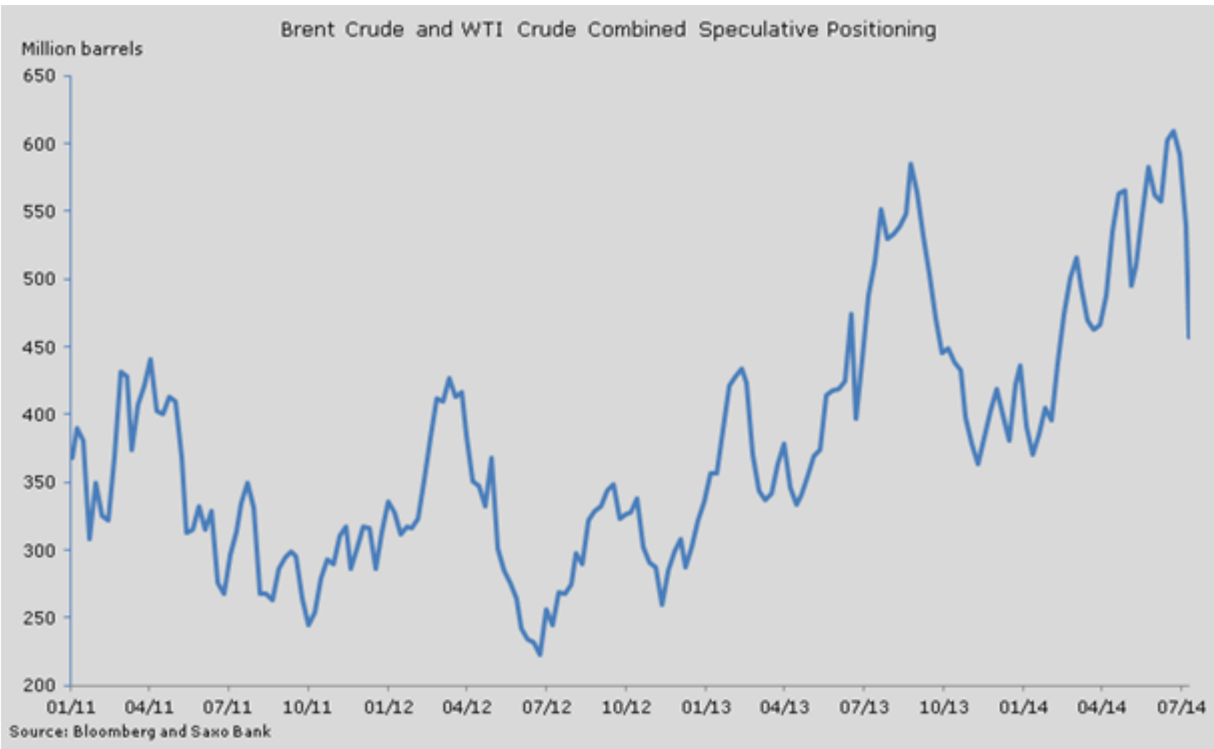
The two charts below show the diverging supply situation between Brent and WTI crude. Reduced refinery demand and increased supply in Europe has resulted in the futures spread between the first and the second futures contract on Brent having moved from a backwardation of 60 cents per barrel to a current contango of more than 40 cents. Such a collapse in prompt spreads has not been seen for a while, especially not this time of year where demand normally remains robust. The upcoming maintenance in the North Sea will reduce supply and thereby help reduce the current supply glut and help stabilise the spreads. In WTI crude strong refinery demand and a continued inventory reduction at Cushing, the delivery hub for WTI crude futures, has resulted in a sharp rise in the backwardation which is normally a sign of tightness in the spot market.

The opposing developments in refinery demand and availability of oil on either side of the Atlantic have now resulted in the discount between WTI crude and Brent crude narrowing to just 5 dollars per barrel compared with 12 dollars at the beginning of the year.





As a result of the recent weakness, which was most noticeable in Brent but also seen in WTI crude, tactical investors such as hedge funds and large money managers have once again been running for cover and over the past three weeks the combined net-long position of Brent and WTI crude has been cut by 25 percent after reaching a record of 610 million barrels in late June. Some additional long liquidation cannot be ruled out but much hinges on Brent's ability to hold above 106.75 USD/barrel and WTI crude's ability to shrug of rising gasoline inventories.



Geopolitical concerns will continue to play an important part when trying to determine a correct price for crude oil, but as we have now seen during several such incidents, the impact on markets tend to be short-lived, not least considering the increased diversification in oil production witnessed over the past few years where production from less volatile regions has provided most of the supply growth. At current levels, Brent crude probably still prices in a risk premium of at least five dollars but with so many uncertainties still existing across the world, it will be a struggle to remove that completely.

Both gold and silver were heading for a second week of straight losses after failing to hold onto the gains that was established following the tragic downing of MH17 over East Ukraine. Both metals reached their 200-day moving averages at USD 1286/oz and USD 20.27/oz respectively, but have not yet managed to breach them . Gold's 200-day moving average has been a focal point on numerous occasions these past few months, providing both support and resistance.

A stronger dollar and reduced geo-political risks have once again turned the focus in the market towards the timing of when the US Federal Reserve will move from taper to tightening. Upcoming FOMC meeting and US job report may provide some answers to this and until then the potential for a return to the upside on both metals seems limited. Not least in silver where bullish bets recently almost reached the record levels from 2010, just before the price exploded higher towards USD 50/oz. A potential driver for a renewed "explosion" is simply not there at the moment so while we still favour silver over gold considering its dual use as an investment vehicle and an industrial metal, the near-term outlook looks less supportive than what has been seen during the past month.