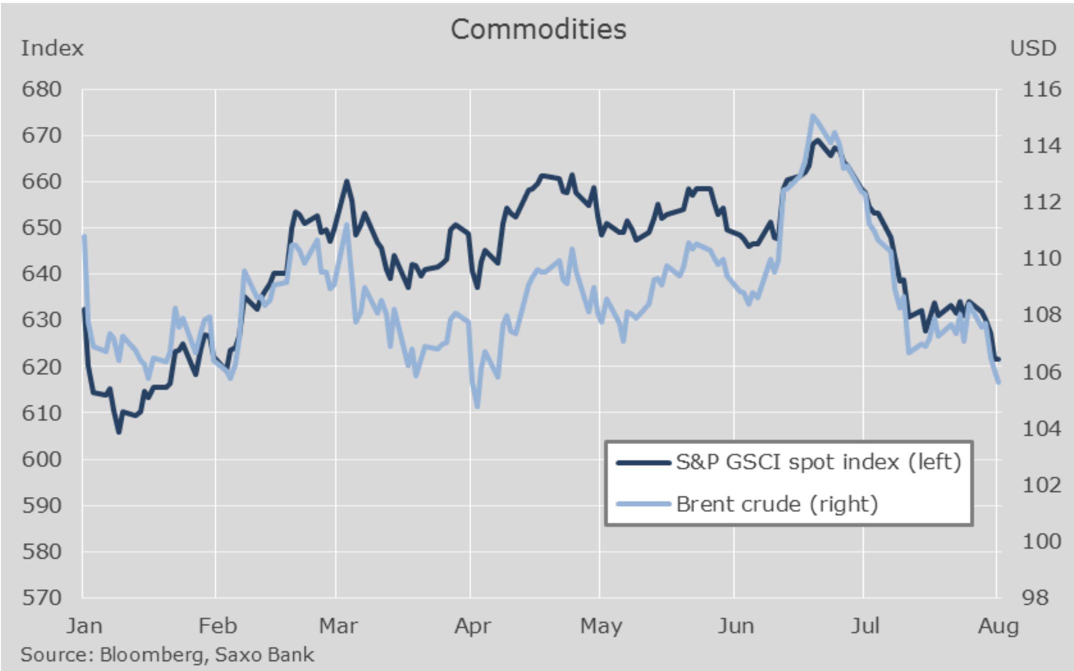
Weekly Commodity Outlook: Geopolitical risk fatigue

Iraqi insurgencies, repeated clashes between Western powers and Russia first over Crimea, then Ukraine, while another bloody conflict raged in Gaza. The cocktail of high explosives for commodities is there, but 2014 has nevertheless been rather uneventful from a market perspective (so far at least).

Like the forex market, commodities are struggling to make meaningful moves. Now, as August begins, we're looking at severely low commodity volatility the like of which has not been seen this side of the millennium. Using the S&P GSCI index to gauge the commodity spectrum, we find that annual volatility is currently running below 10 percent at 9.3 percent, less than half the annual average since 2000 at around 22 percent - even 2013 was more volatile.



With five months to go in 2014, commodities are broadly 1.7 percent lower from January 1, having been up for most of the year and peaking at 5.8 percent ahead in June. This week, commodities have weakened by around 2 percent.

Crude oil

Crude oil has been a key driver behind the fall in S&P GSCI since June. Brent crude oil is down 7.9 percent from the June 19 top and down roughly 2.5 percent for the week, trading around USD 106. Brent crude is displaying the same volatility characteristic as that of the broad commodity spectrum. Volatility has trended steadily down ever since 2008 and is on track for a new record low, currently at 12.6 percent.

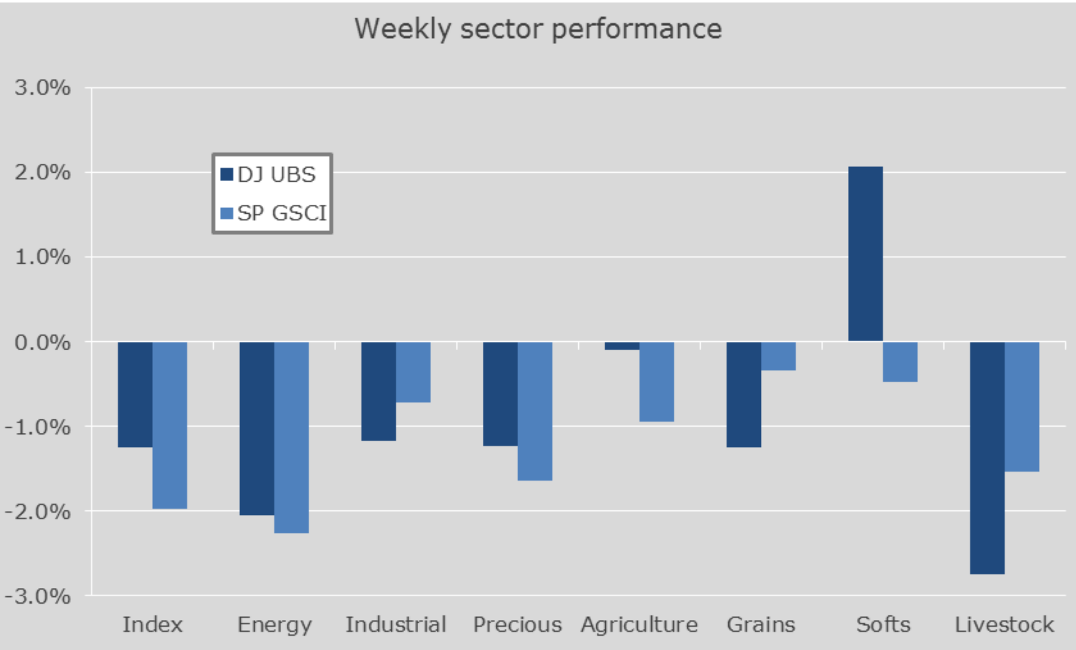
The muted reaction in oil to the multiple geopolitical events we are seeing shows that market participants are currently unconcerned that these will curtail aggregate oil supply. Regional disruptions may be making an impact locally, but that other suppliers could step in to satisfy global demand, seems to be the thinking behind the market's failure to react. Remember that OPEC did indeed step on the accelerator in July by boosting oil production compared to the previous month.

In Iran, oil exports are rising even though the administration is disputing that a nuclear deal between the country and six Western powers has been agreed. In spite of Tehran's insistence that no deal has been made, there are pointers that the two sides are inching closer to each other. The six-month intermittent agreement from January 20 was extend just a couple of weeks ago on July 19 and now runs until November 24.

However, oil concerns did resurface this week. The price of WTI crude oil has been falling fairly steadily following a flirt with USD 107 in mid-June. The decline accelerated this week to around 4.5 percent as a report from the Energy Information Administration (EIA) showed that crude inventories fell by 3.7 million barrels last week, the fifth straight weekly decline.

However, while inventories for crude are going down, the EIA also noted that gasoline and crude derivatives' inventories rose, sparking concern that demand may be fading. Supply issues hit the news again on Thursday with the prospect of a refinery shutdown in Kansas. This looks like the final straw that broke the camel's back. WTI was sent reeling below USD 100 for the first time since early May and currently trades just south of USD 98, the lowest since March.

We remain committed to our call for a stronger global economy this year and into 2015 and hence expect demand for oil to reflect such a view. This should keep a hand under oil prices even if the market maintains its current stance vis-à-vis geopolitical risks — indifference.



Source: Bloomberg, Saxo Bank

Gold

Turning to the metals space, gold lost a bit of its mojo in the second quarter, and this continued in July when it declined 3.4 percent. Silver, too, struggled slightly, shedding 3 percent. During the past week, the two precious metals dropped 1.7 percent as stronger-than-expected growth in the world's largest economy, the US, added to Chinese numbers, released earlier, in which Q2 GDP also beat consensus expectations. The US economy grew 4 percent (quarter-on-quarter, annualised) in the second quarter while the Chinese economy advanced twice as fast.

Gold remains up for the year, but its recent weakness despite escalating violence in the Gaza strip and elsewhere suggests that the yellow metal are also suffering from a touch of geopolitical risk fatigue. In addition, the 10-year US treasury yield has climbed a tad to 2.58 percent this week and the June inflation report for the US for June was underwhelming, if mostly expected. Headline inflation was unchanged in June at 2.1 percent while core consumer prices came in slightly below expectations at 1.9 percent year-on-year vs. 2 percent expected and prior.

Our call for stronger US – and global – growth includes higher US government bond yields even if they have drifted lower since the New Year. The Federal Open Market Committee will continue to taper its third round of quantitative easing, concluding with a final USD 15 billion reduction come the October meeting.

While the FOMC continues to stress that rates will not be rising in the immediate aftermath, the likelihood of a hike in the first half of 2015 has increased with the flow of strong data from the US, in particular from the labour market. Nonfarm payroll gains have averaged 230,000 this year compared with 194,000 in 2013.

And since Q1 they have been stronger still at 260,000. Furthermore, the rather solid Q2 GDP report underlines that the first quarter really was a one-off. Personal spending rebounded by more than expected and public spending also rose. Furthermore, both exports and imports point to a pick-up in global trade.