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Commodity update: All eyes on energy

The first full trading week of 2015 kicked off with a lot of focus on the continued fall in energy markets (as this is helping to destabilise other asset classes).

Stocks were initially pulled lower by the steep fall in crude and its negative impact on the energy sector, while government bond yields fell further on the prospect of falling inflation, and — in the case of the Eurozone — a return to deflation for the first time since October 2009.

The mid-week bounce in oil markets may have been shallow, but it proved very supportive for stocks. It also took some of the shine off the bond markets' rally. It's no wonder that it's not just oil traders who are paying close attention to what happens to black gold at the moment.



It's a commodity that can easily come to occupy your time. Photo: iStock

Yellow gold, meanwhile, continues to defy gravity, rising despite what should be negative impact from the rising dollar. This dislocation has given the metal a new lease on life since the beginning of December.

Instead of focusing on the continuing dollar rally, traders instead turned their attention to worries about the Greek election later this month. A win for the anti-austerity Syriza party carries some potentially wide-ranging implications for the Eurozone and the euro. Falling US bond yields have also been lending support, as this reduces the opportunity cost of holding precious metals.

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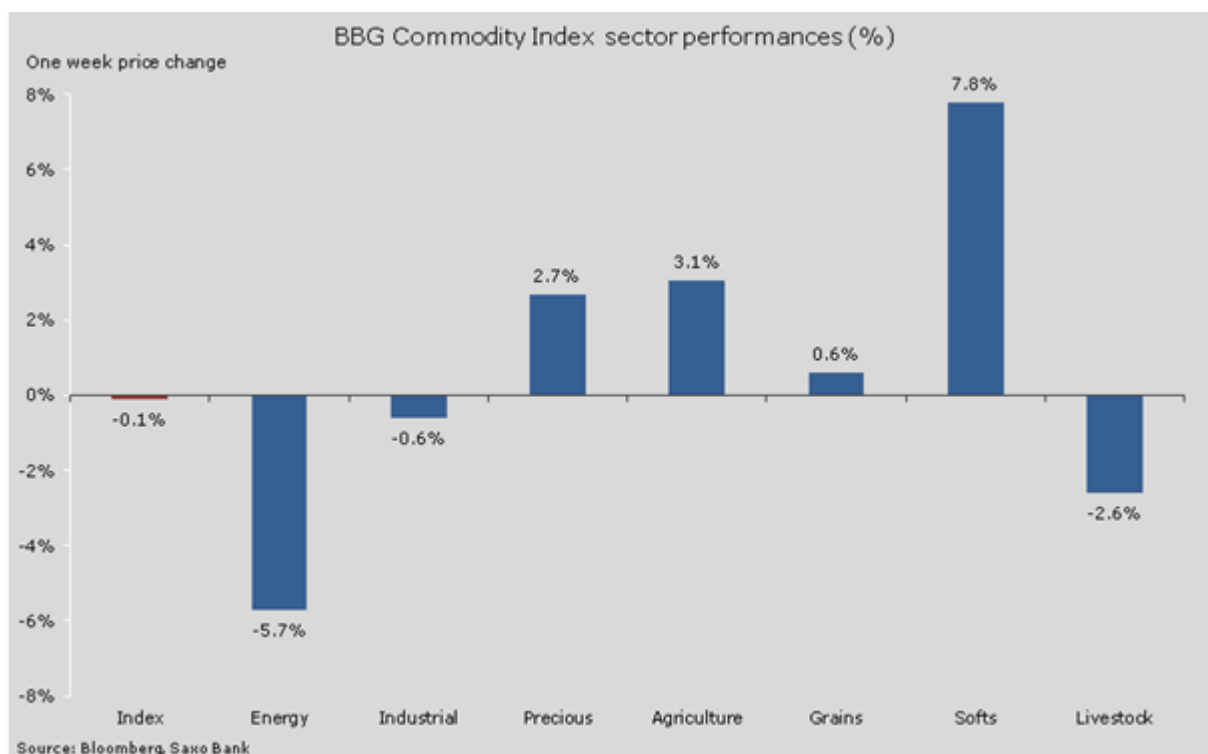
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Gold remains stuck in a wide \$1170 to \$1240 range while XAUEUR has broken above 1,000 euros to reach its highest level since September 2013 as it benefits from the continued dislocation between the dollar and gold.



Overall, it was a mixed week for commodities with the Bloomberg commodity index finishing almost where it started. Significant losses across the energy sector were offset by gains in precious metals and agriculture, most noticeably in the soft sector where coffee and sugar flew out of the starting block on dry weather concerns in Brazil.

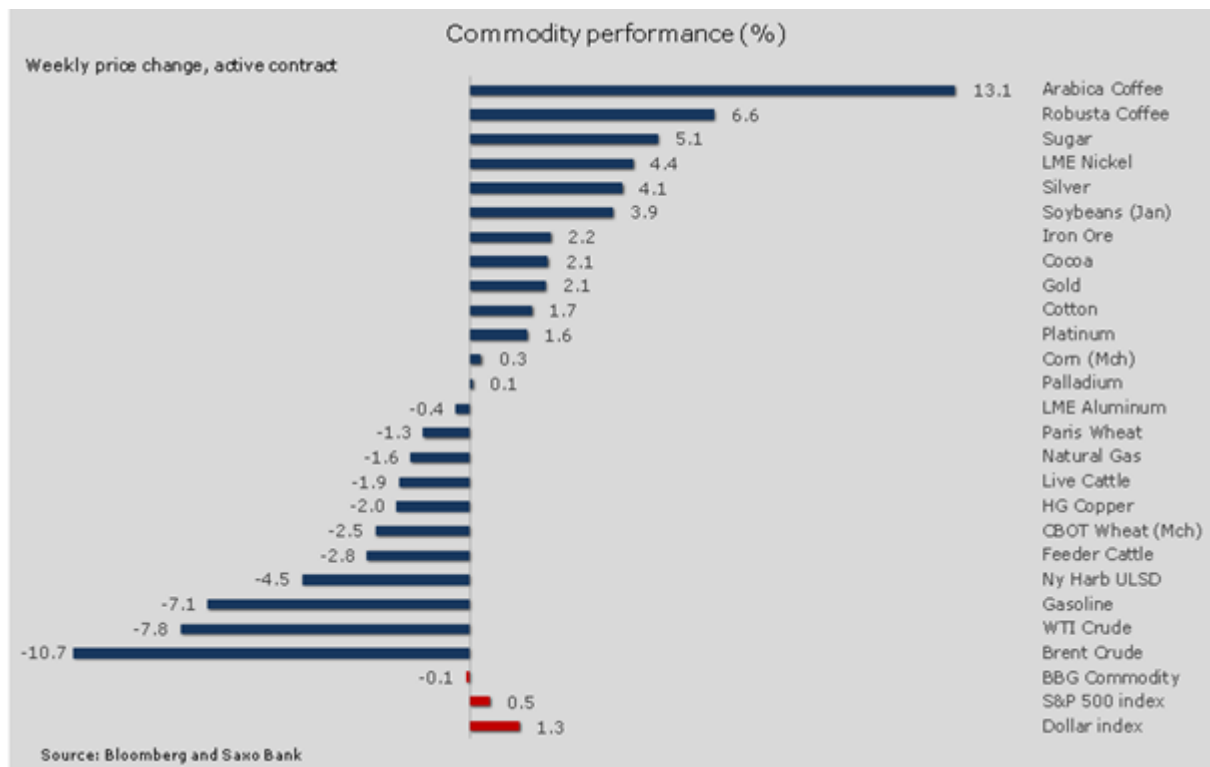
Industrial metals were driven lower by copper, which fell to a four-year low on concerns about economic activity in China as producer prices extended a record run of declines. The rising dollar also created strong headwinds and if it hadn't been for a supply concern driven rally in nickel, the sector loss would have been even more noticeable.

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As the table above highlights, energy remains the hardest-hit of the different commodity sectors. The current global supply glut of crude oil — estimated at close to 2 million barrels per day — continues to exert a lot of pressure on the spot market. So much so, in fact, that "super contango" has returned for the first time since the recession days of early 2009.

Super contango occurs when the gap between a low spot price and a higher forward price reaches a level where it makes economic sense to buy spot crude, rent a supertanker and put it into floating storage while selling the crude back at the higher future price at the same time.

Last time this occurred was following the demand collapse in 2008 and early 2009, when spot Brent crude oil slumped to a discount of more than \$10 dollars compared to its delivery-date price six months hence.

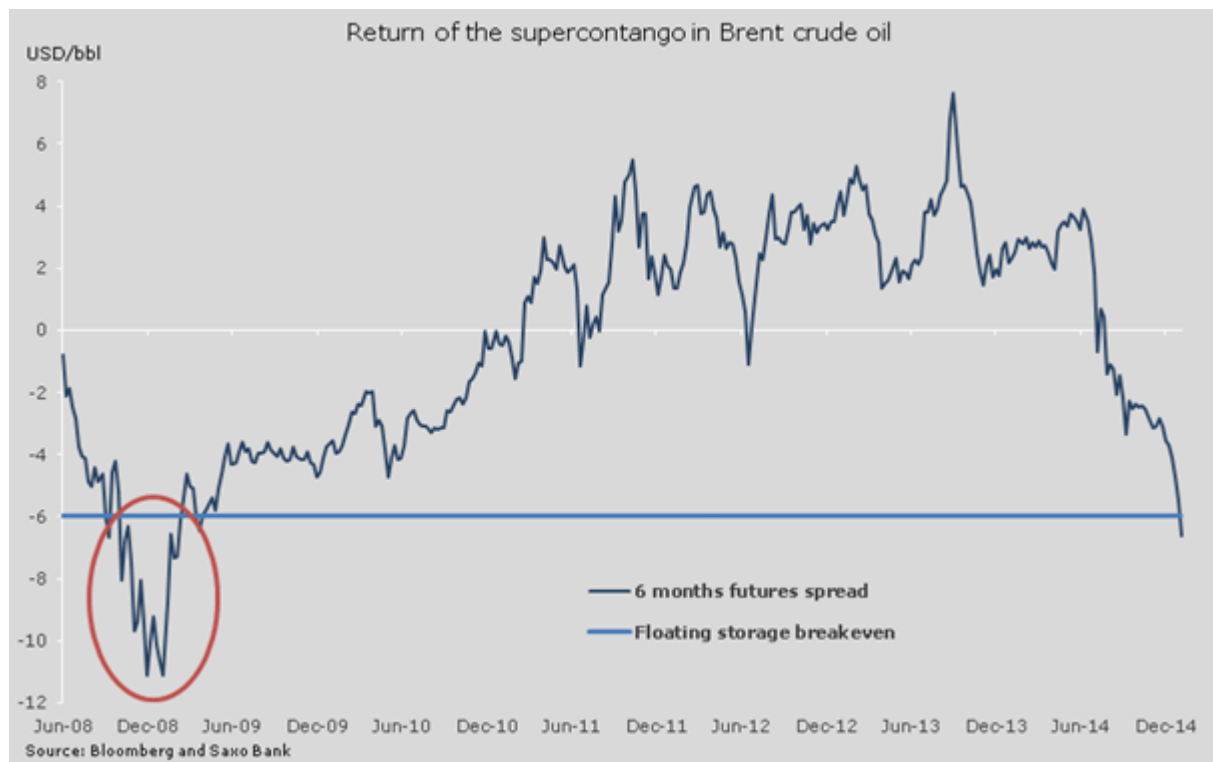
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At its peak, global volumes of fuels in floating storage topped 100 million barrels in late 2009 and while this highlights the current supply glut, it could also help ease price pressures as trading houses with access to storage facilities will remove crude from the market so long as this opportunity exists.

As far as this goes, we will only say "ease" because it would take more than floating storage to stop the current uncertainty in oil markets. The current supply glut will require some actual supply destruction before it is safe to call a bottom in the market.

With Opec not willing to reduce production and Russia producing the most oil since the Soviet Union era, traders will keep a close eye on developments among oil producers in the US and Canada.

So far we have seen an 8% reduction in active US oil rigs since October; in Canada, the number has fallen by more than half. We have also heard news of small drilling companies going bust and drilling contracts being torn up.

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The Calgary, Alberta skyline; as Canadian tar sands production slows, the booming economy of the oil-rich province will likely contract as well. Photo: iStock

These types of reports will help slow the selloff, but until we see actual reductions and/or a rise in demand, the search for equilibrium will continue (as will uncertainty and high volatility).

A significant chunk of US shale producers are likely producing at a loss already, but due to hedging programmes, many are currently able to offset these losses against financial gains on futures contracts sold at much higher levels.

Others may just simply have to pump away and generate cash in order to service loans.

So long as the the risk of revisiting 2008 lows exists, we favour trading a potential surprise recovery through options. During the past week, two-thirds of the 30 most traded options were puts, but at the top of this table we have also seen increased interest for \$65 and \$70 calls on the June WTI crude futures contract.

At a current futures price in June around \$51 per barrel, these are trading at \$1.05/b and \$0.65/b respectively.

Head of Commodity Strategy at Saxo Bank **Ole Sloth Hansen**

Email: olh@saxobank.com

Phone: +45 3977 4810

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Ole Sloth Hansen is a specialist in all traded Futures, with over 20 years' experience both on the buy and sell side. Hansen joined Saxo Bank in 2008 and is today Head of Commodity Strategy focusing on a diversified range of products from fixed income to commodities. He previously worked for 15 years in London, most recently for a multi-asset Futures and Forex Hedge fund, where he was in charge of the trade execution team. He is available for comments on most commodities, especially energies and precious metals.

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