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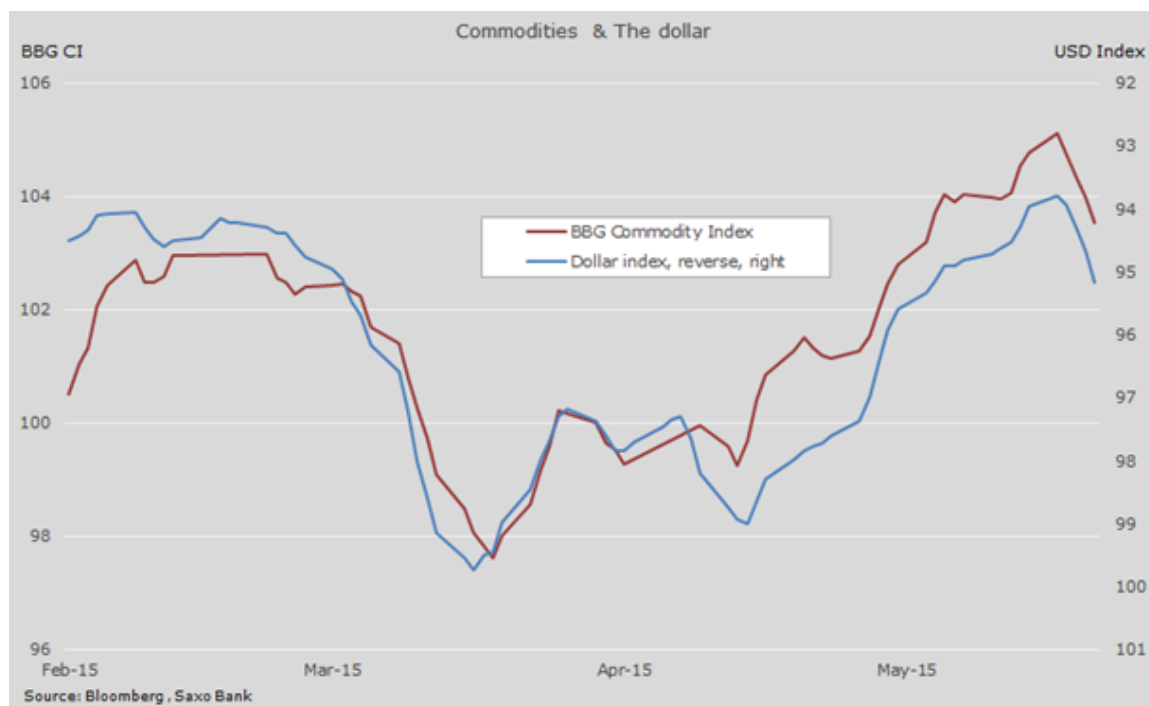
King Dollar reigns over commodities

By Ole Hansen

Three consecutive weeks of commodity gains gave way to losses this past week. The US dollar, which had been retreating since April, recovered and the impact was felt across most commodity sectors. While individual pieces of news relating to the different sectors are important, the overall direction of the market – as the chart below shows – continues to come from the dollar.

This obviously raises the question where the greenback goes from here, and we are keeping a close eye on two levels in order to determine that.

Support at 1.1050 in EURUSD and resistance at 122 in USDJPY are the two key levels which need to be broken in order for the dollar to resume the rally which began almost one year ago. Failure to do so should continue to support commodities in the near-term.



All sectors suffered losses, not least industrial metals where nickel dropped by more than 8% while copper broke lower following a period of consolidation. The agriculture sector was also lower during a week where talk of the potentially devastating return of "El Nino" continued to attract attention.

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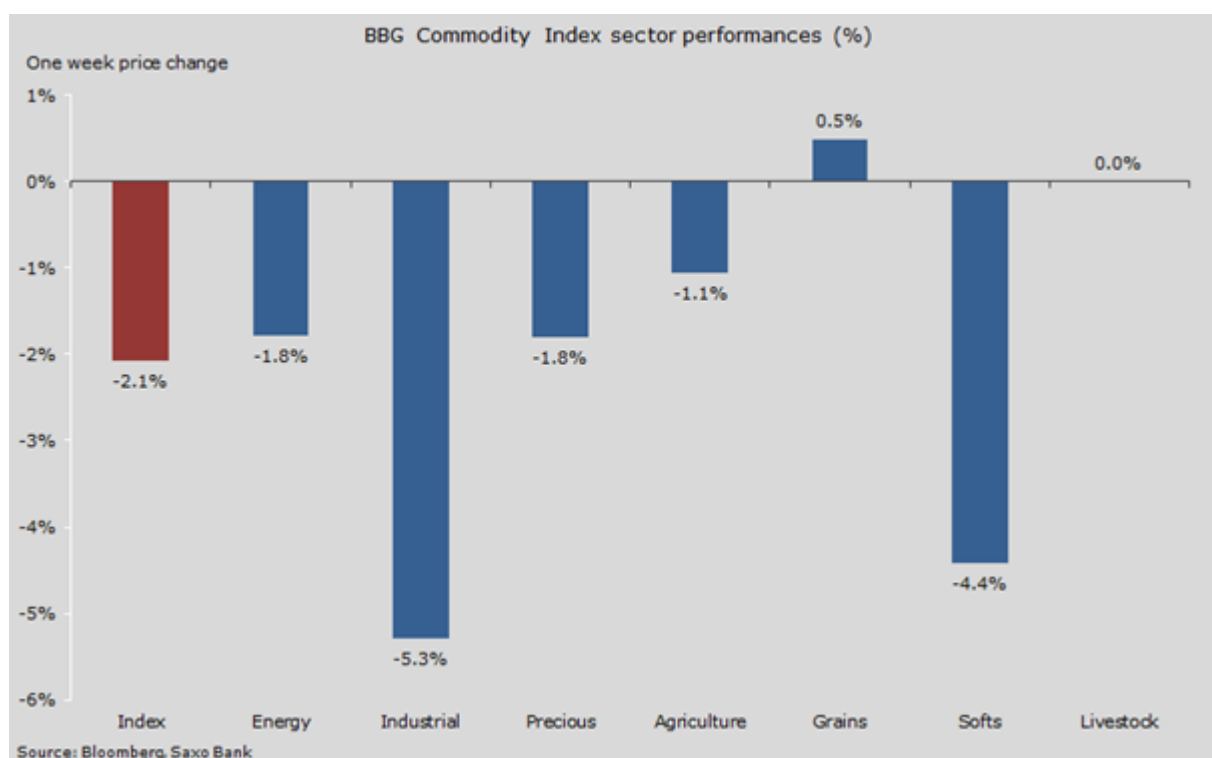
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The softs sector was hit with both coffee and cotton falling out of favour on news of increased supply. These losses more than offset gains in cocoa, which received a lift from worries that Ghanaian production could suffer a 25% reduction due to the emergence of black pod fungal disease.

The grain sector was mixed with the diverging outlook for wheat and soybeans attracting some attention after the ratio dropped to the lowest since January. Wheat found support from too-wet conditions in the US and too-dry conditions in Russia and Canada while soybeans fell on the outlook for a bumper harvest in South America.



The energy sector maintained its recent strength after a selloff related to the stronger dollar partly reversed on news that US inventories and production continue to slow as the US gears up for the biggest opening of the driving season in a decade.

Middle East tensions also added some support, thereby more than offsetting news that major Opec members such as Saudi Arabia and Iraq both continue to increase production while a return of Iranian oil cannot be ruled out.

Precious metals suffered a greenback-related setback but quickly stabilised, helped by gold which managed to find support at \$1200/oz (which is the middle of the range that has now prevailed for the past couple of months).

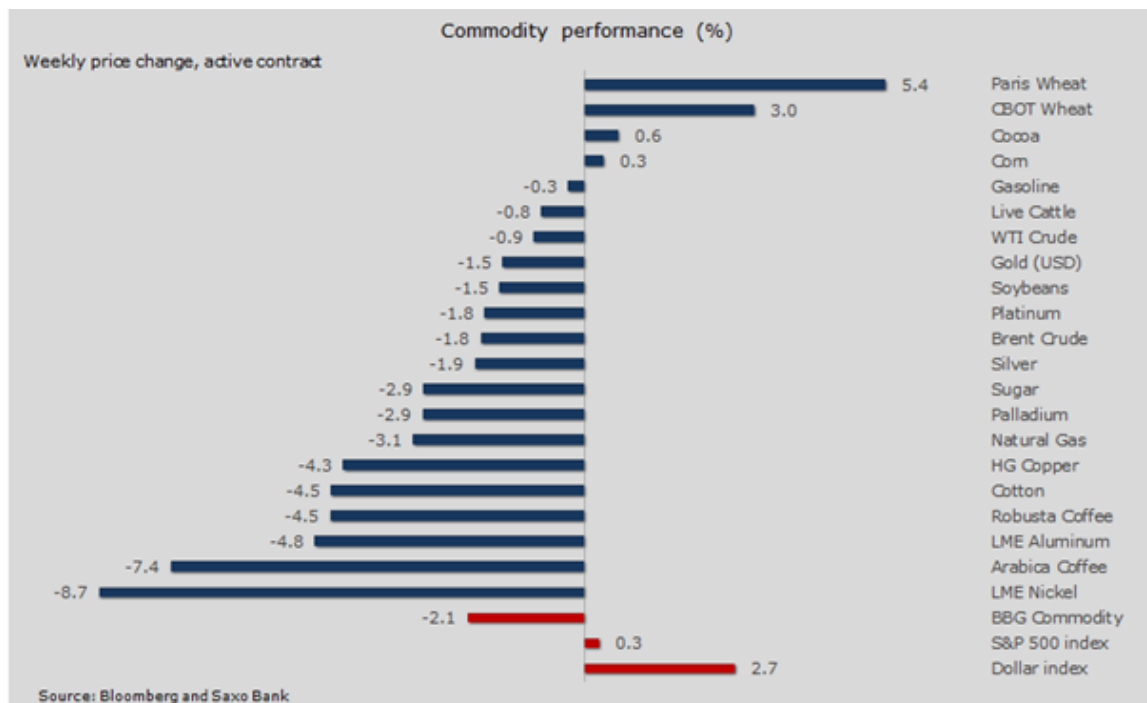
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Gold and the other precious metals are desperately looking for a driver or an event to give the sector a new lease on life. Looking at gold, we have seen several failed attempts in both directions over the last couple of months as uncertainty with regards to the timing of the first interest rate hike in the US, the movements of the dollar and gyrations in bond markets have all left gold going nowhere.

Investment demand through exchange-traded products has slowed further this month as investors used the early May uptick to reduce exposure. With total holdings once again close to a six-year low, it can be argued that most of the reduction has taken place by now given the resilience seen among existing investors the last time this level of participation was observed back in January.

Money managers – who are often the trend-setters – have also found little to cheer about and are currently holding a net-long futures position close to the lowest since 2013 – the year of the big selloff.

A relatively large short position (last seen at 75,000 lots) is not far from the 80,000 level. On several occasions since 2013 we have seen the number of short positions contract sharply every time this level was reached.

The speculative position is in other words very light, especially to the upside, which leaves money managers with plenty of room to engage should we see a change in sentiment. So far, however, many are happy to sit on the fence and wait for the break out of the current \$1170/oz to \$1230/oz range. We see the biggest chance of a break being skewed to the upside.

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Crude oil markets remain range-bound close to a five-month high after an attempted selloff earlier in the week when the dollar rise failed to succeed. Renewed dollar strength as the weekend approached however led to another round long liquidation. For a third week running, the US inventory report provided the market with the support needed to challenge newly established short position and the price of WTI crude oil returned to \$60/barrel – a level around which it has been trading for the past month.

In a delayed response to the rapid reduction in the number of US rigs since last October, crude production has now fallen by 157,000 b/day since the March peak but still remains up by more than 800,000 barrels compared with a year ago.

At the same time, inventories have also begun to draw but are still 100 million barrels above the five-year average for this time of year.

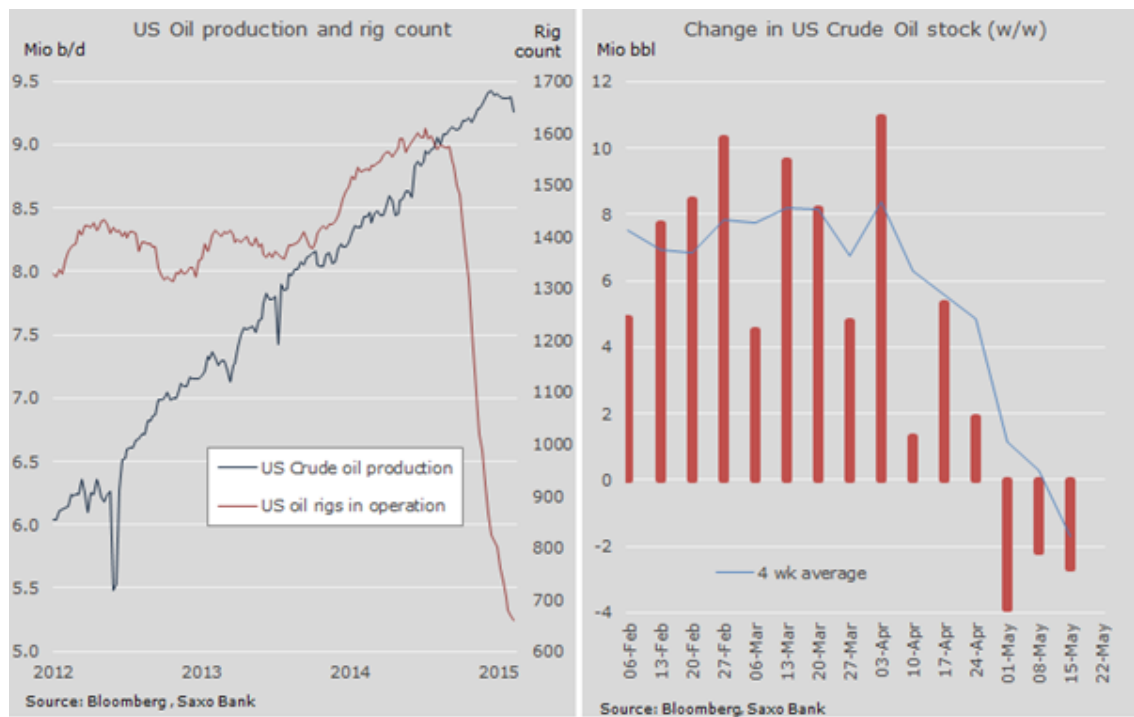
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Goldman Sachs led the chorus of forecasters predicting that the current rally was not supported by fundamentals and as a consequence the price of WTI crude could revisit the \$45/b low by October. What is very clear is that a rally much above \$60 at this stage could unravel Opec's current efforts to stifle non-Opec production.

This came on the back of recent comments from US shale producers that a return to \$65/b would trigger an increase in production. Break-even levels have come sharply lower in recent months due to the price deflation that has hit the whole sector.

Traders holding long positions in the oil market are currently betting on a continued rise in demand from a busy US driving season which could further help reduce the overhang of supply.

In addition, the forecasted pick-up in Saudi Arabia's wasteful use of crude during its summer period of peak demand has raised expectations that this will help remove substantial quantities of crude oil from the international market.

Given the fact that Opec is unlikely to cut production at its June meeting (and that much higher prices from here will trigger a supply response), we see the price of WTI crude continuing to struggle, with the upside above \$60/b very limited at this stage. The rapid reduction in US rigs slowed to just 8 last week and a potential rise would be taken badly by the bulls.

A break below \$58 could trigger a deeper correction, not least considering the continued elevated bullish position held by money managers in the futures market.

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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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