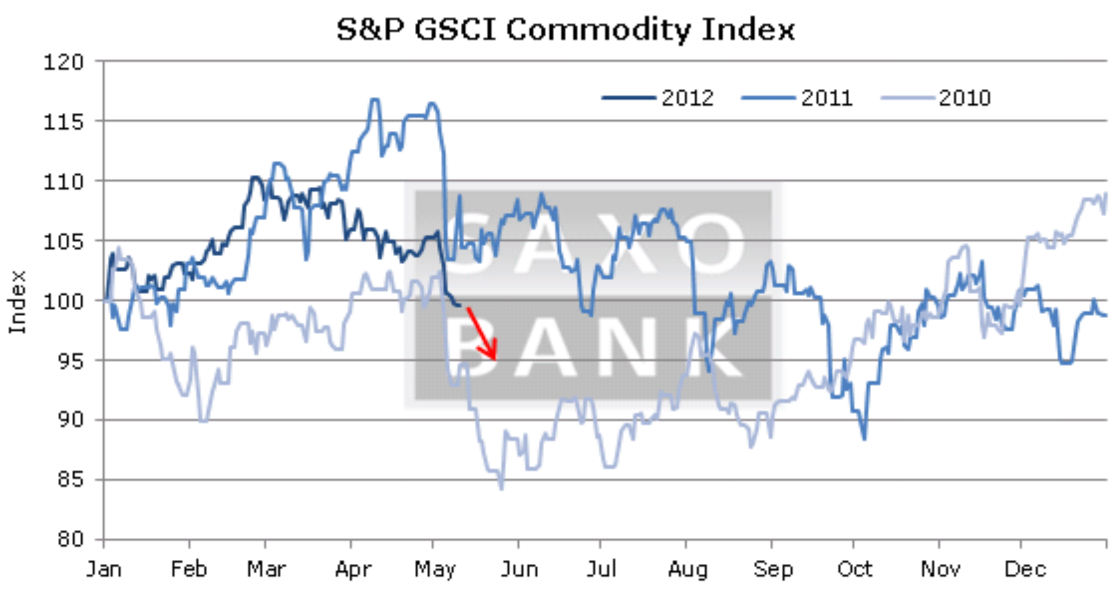
Commodities looking for support after onslaught

By Ole S. Hansen, Head of Commodity Strategy

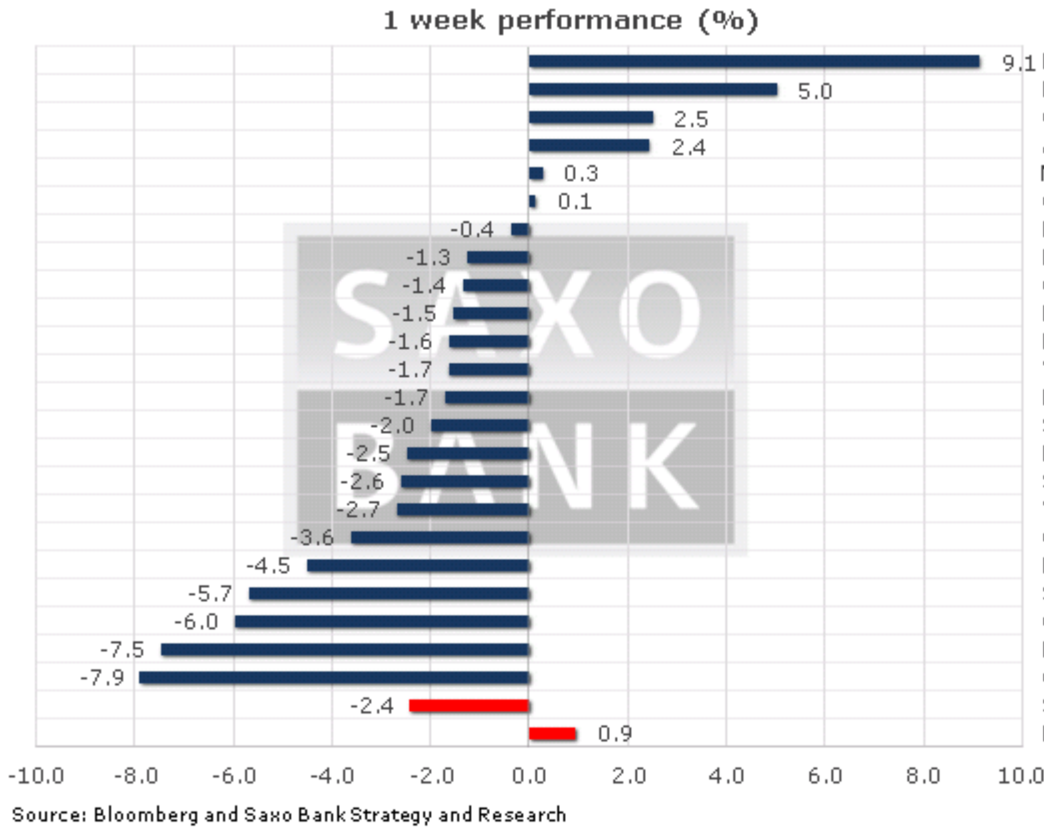
Commodity markets suffered further losses this week with all the major sectors being pressured by weaker fundamentals, a stronger dollar and investors needing to reduce exposure. India's industrial production shrank and Chinas weakened sharply in April as investments slowed to the lowest level in nearly a decade, once again raising the question whether this will signal an end to the rapid demand growth for commodities witnessed during the past decade. The Eurozone remains a source of anxiety as well for investors with continued focus on Spain and especially Greece. In such a climate the dollar advanced to the highest level versus the Euro in almost four months thereby further eroding support for dollar denominated commodities.

Are we currently seeing a repeat performance of the past two years with a strong first quarter being followed by weakness in the second? Looking at the chart below it certainly seems that way with the energy heavy S&P GSCI moving into negative territory on the year after falling eight days in a row in its worst run since December 2008. Libya drove oil prices higher in 2011 and this year we have seen a repeat, this time driven by tension in the Persian Gulf. By this time last year however we were seeing the beginning to the end of the Libyan crisis while the Iranian tensions this year have only eased but not yet gone away, which raises the question whether oil prices should find support soon - we think they will.



Source: Saxo Bank Strategy and Research, Bloomberg

The individual performances among some of the major commodities are mostly showing losses on the week with only natural gas rallying strongly as confidence continues to build that a low has now been established. This strong performance in natural gas resulted in the energy sector suffering a relative small loss while precious metals, especially silver and palladium, for the second week have borne the brunt of investor selling.



China slowing and so does its oil demand
China's implied oil demand fell in April to the lowest level in six months and showed the first year-on-year decline in at least three years, primarily due to refineries scaling back demand to perform annual maintenance. This exacerbates the sentiment that global oil demand is going though a soft patch which could last another couple of months. But with both the Organization of the Petroleum Exporting Countries (OPEC) and the International Energy Agency (IEA) expecting global oil demand to pick up later in the year, as growing emerging market demand more than off-sets declining consumption in developed economies, further downside seems limited.

OPEC still pumping at record levels
Saudi Arabia and OPEC once again repeated their call for lower oil prices this week in order to help steer the global economy away from a slowdown. So far, this verbal intervention combined with record output from the organisation have eased the pressure on oil prices with WTI sinking below 100 dollars and moving close to its 2011 average. The IEA in its monthly report said that oil prices are likely to stay high due to unresolved geo-political tensions, despite a dramatic improvement in world supply resulting in a big build in stocks.

Oil speculators brought down to earth
The elevated speculative long positions in WTI and Brent that we have touched upon several times as representing the biggest downside risk to oil have now been dramatically reduced.

Since May 1, the price of WTI crude has fallen by 10 dollars and this may have reduced the speculative net long position down towards 200 million barrels, which co-incidentally corresponds with the average during the last three years. From that perspective, further long liquidation should begin to meet fresh buying, as the speculative overhang now seems to have been brought back to manageable levels. The main driver for higher oil prices during Q1 was the geo-political risk stemming from Iran, and with this situation still unresolved, the risk premium in oil will not go away for now and should help prices stabilize soon.

Brent crude, the global benchmark for physical oil transactions, has spent most of the week consolidating following its sharp move lower after the recent US jobs report. Having seen the price drop by 16 dollars from the March peak, support will begin to emerge, especially ahead of the trend-line support from the 2008 nadir, currently at 109.50.

Brent Crude – Source: Bloomberg

Gold looks towards physical buyers for support

Following two months of trading sideways, gold made a strong move lower this week. With several key technical indicators broken during the last few days and a dollar moving higher, gold, in the end, only had one way to go. With cash and secure government bonds once again attracting interest, highly liquid investments like gold are very easy to exit and this helps to explain why it has been hurt more than other markets – especially considering the market driver at the moment predominately stems from political anxieties in Europe.

Speculative investors are holding much smaller long positions than during previous corrections, especially compared with the two "flash crashes" back in December and February. Traders will therefore be keeping a close eye on the behaviour of physical buyers who supported the market on both previous occasions and investors in exchange traded products which have only seen a limited outflow during the last month. My suspicion is that they will only begin to get worried should gold move into negative territory on the year and take out the December low at 1,522.

Looking for support towards USD 1,550

For now, everyone is talking about support at 1,550 which either means we will find support ahead of that level or get another leg down to test the December low. The move down has been necessary in order to re-ignite some interest from the leveraged investors who have been losing interest as of late. The big question is obviously if these investors view the downside as more attractive and subsequently begin to build short positions instead. Potential buyers should probably stay on the fence and wait and see how this unfolds. A move back above 1,610 will be viewed positively and could signal the end of this down move.

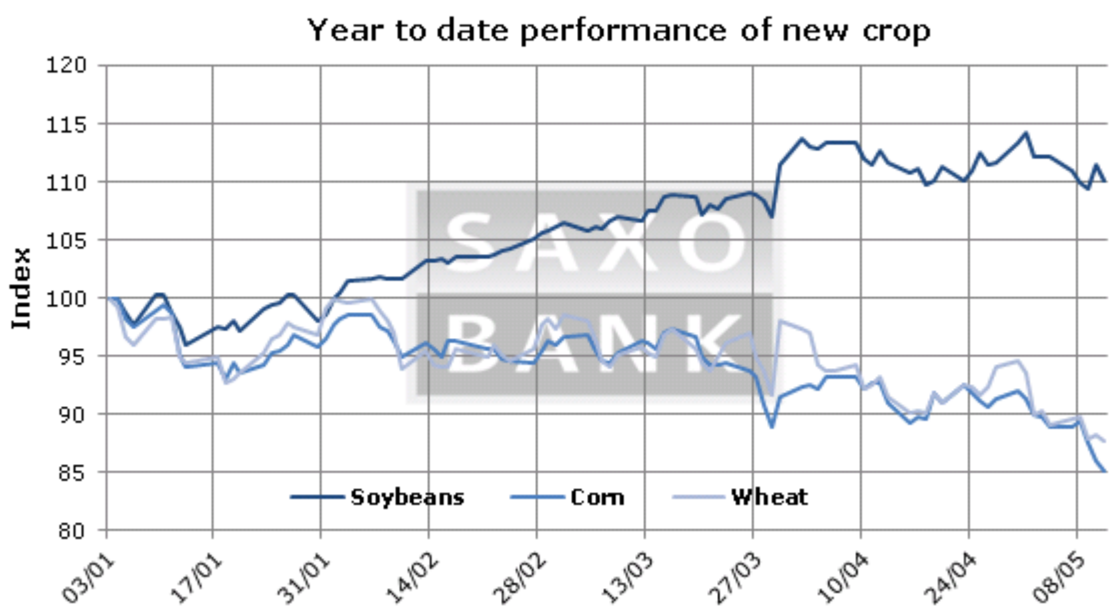
Spot Gold – Source: Bloomberg

Contrasting outlooks for corn and soybeans

US corn production this year is expected to reach a new record with previously low stock levels expected to rise to the highest in six years. According to the monthly crop report from the United States Department of Agriculture (USDA) US farmers will this planting season, assuming normal weather conditions, plant the most in 75 years, triggering a potential 20 percent rise in production which should help to stabilize prices further in the months ahead.

The price of soybeans meanwhile should remain supported as supplies this year will be tight despite a large production. This is due to the significant loss of South American production caused by adverse weather and strong exports to China and it will make it difficult to raise stock levels above the current critical low levels. Wheat prices will, just like corn, find it difficult to make much progress over the coming months but may find some support on more bullish fundamentals on expectations of an increase in global wheat feed demand over the next year.

Traders, consumers and producers have already spent most of this year pricing in these differences in the outlook for the three main crops with the price of new crop soybeans having outperformed corn and wheat with similar maturities by around 25 percent so far this year. Soybeans initially rallied on the bullish USDA report but later succumbed to a two percent correction. The soybean complex is the only commodity sector that has seen increased investor involvement over the last two months. The speculative net long positions held by hedge funds and large investors are at record levels raising the risk of a bubble emerging. Positive price fundamentals may therefore not be enough to prevent a temporary correction as the temptation to book profits will have increased, especially considering the current overall health of the commodity sector.



Source: Bloomberg and Saxo Bank Strategy & Research

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