Marketplace review

The Global Market Environment

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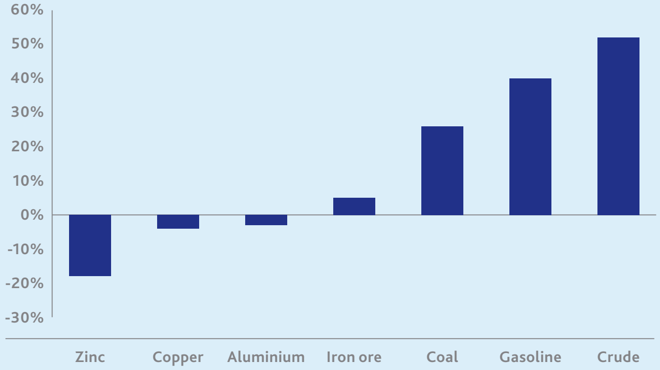
The world was a turbulent place in 2018 and commodity markets certainly reflected that. We witnessed multi-year highs for certain commodity prices followed rapidly by multi-year lows. Markets were impacted by sanctions, tariffs and waivers, and extraordinary volatility. Geopolitics also returned as a major factor affecting market volatility, as well as a rising interest rate environment for the first time in over a decade. Expected physical deficits turned into surpluses and headlines turned into fundamentals. And through it all, there were rapid shifts in trade flows, with robust demand meeting variations in supply, which created a dynamic and ever-changing trading environment.

Global macroeconomic environment

Global economic growth in 2018 generally maintained its momentum from the previous year, underpinning a decent year in terms of commodity demand growth. Despite rising interest rates, emerging market (EM) turmoil, geopolitical issues, a stronger US dollar and higher commodity prices, growth was above historic averages and was broad based across geographies and product types alike.

One-year price increase

Stated in percent change year-on-year



Source: Bloomberg, Trafigura Research

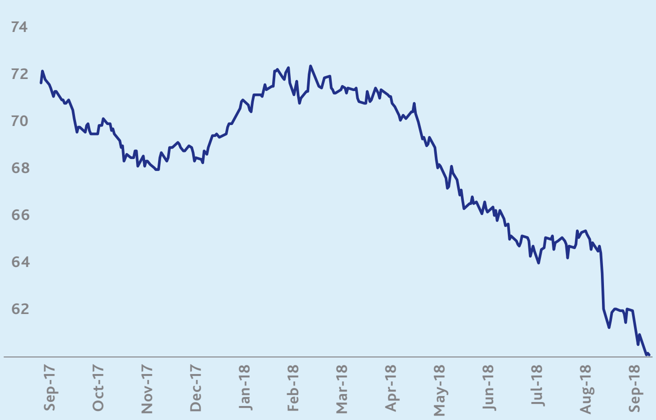
Trade conflict was the story that had the most over-arching impact on the commodity markets. In particular, the escalation of trade tensions between China and the US has created a sense of macro concern in global markets, from stocks and bonds to currencies and commodities. While fundamentals for many commodities looked relatively tight, the escalating implementation of reciprocal tariffs prompted markets to focus instead on worries about future demand growth and to discount accordingly. While such a demand effect may emerge in coming months, we did not see an impact on physical demand for most of the commodities that we traded during our fiscal year. But we did experience a reorientation of trade flows as China took less US oil and sought alternatives. Elsewhere, the announcement of tariffs on steel and aluminium imports into the US also had an impact on basis premiums and flows/sourcing, although later waivers and exceptions mitigated some of these impacts.

Sanctions were another significant influence on the market during our fiscal year. Physical trade flows in particular were affected, as buyers had to look for alternative sources for, at different points in the year, aluminium and oil. Aluminium was impacted by sanctions against Rusal, which affected nearly seven percent of global supplies and took prices from a two-year low to a seven-year high. Oil markets were roiled by the re-imposition of US sanction on Iran. Although in the final accounting the sanctions were less harsh than the US administration had proclaimed, the fact remains that over one million barrels of oil per day were removed from the market, leaving buyers to look for other sources of supply and helping drive the oil price to a four-year high, well above USD80 per barrel.

Sanctions indirectly impacted commodity markets as well, as a dispute between Turkey and the US, and the resultant sharp devaluation in the Turkish Lira, contributed to a marked slowdown in emerging markets generally. Some of the emerging markets issues can be attributed to domestic political issues, such as in Brazil and South Africa, others to localised economic issues, as in Argentina, but others are also due to the effects of higher oil prices and higher US interest rates. India was particularly exposed to these external factors, evidenced by the fact that the country saw its currency hit all-time lows against the USD despite solid domestic growth.

Emerging market currencies

Index value



Source: JP Morgan; Trafigura Research

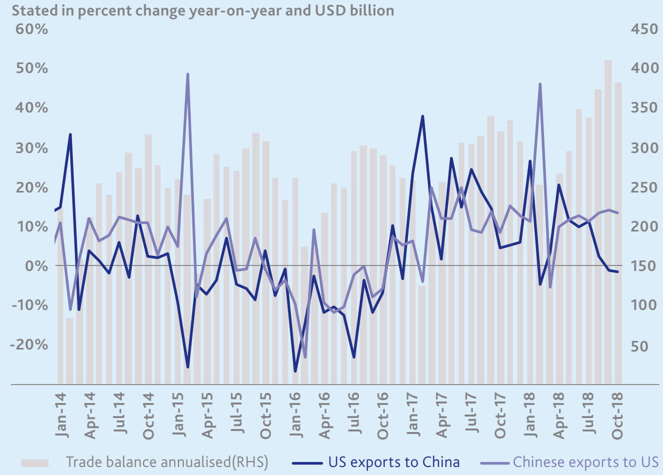
Overall, the effects of these developments on the global economy were relatively limited. The US in particular continued to grow strongly, averaging more than three percent over the year with the strongest quarterly growth rates since 2014. Some of this growth came in the form of an investment boost following the tax cut enacted in early 2018, but subsequent quarters have seen material contributions from a temporary increase in agricultural exports and inventory stockpiling. The former has already reversed and the latter will be more of a drag on growth going forward. Rising interest rates did not dampen consumer enthusiasm (and therefore spending) for most of the year, although in the closing months of our fiscal year, mortgage rates hit an eight-year high, which is clearly having a slowing impact on the US housing sector.

European growth started the year at multi-year highs, but tapered off as the year progressed amid continuing uncertainties around Brexit, Italian budget negotiations and German elections. Despite the recent slowing, Eurozone growth was a material contributor to commodity demand for the first time in some years. In particular, the net delta from a negative demand for oil to a positive one had a larger impact than simply growth alone.

Emerging markets generally had a positive year, as underlying growth remained positive, but they were buffeted by significant headwinds. Mexico had to deal with tariffs and NAFTA renegotiations, taking the currency down to near-record lows. Argentina needed an International Monetary Fund (IMF) bailout, while Turkey was hit with sanctions and tariffs. Brazil and South Africa both experienced political crises. India, now a major contributor to global oil demand growth, felt the pinch of higher oil prices and higher US interest rates. And yet, despite all of this and the moves in currency and stock markets, industrialisation, trade and urbanisation continued, and emerging markets again contributed to global demand growth.

US China goods trade

Stated in percent change year-on-year and USD billion



Source: CEIC, Trafigura Research

China remains the key economy for most commodities, at least in terms of incremental growth. Concerns over the potential impact of a trade war, plus a slowdown in lending as part of the ongoing deleveraging effort, weighed on some commodity prices despite strong fundamentals. Copper was a good example of this, as the price fell 20 percent, from a four-year high of USD7,332 per tonne to USD5,800 per tonne within two months despite unchanged fundamentals. Part of the shift can be attributed to the depreciation of the Chinese currency, which moved from RMB6.3 to the USD to close to RMB7.0, in no small part due to trade concerns. From mid-year, however, Chinese authorities began taking steps to combat the slowdown in activity, by injecting liquidity in various forms, most notably through repeated cuts to the reserve ratio requirements for banks, thereby encouraging them to lend. Furthermore, retail investors are now allowed to purchase local government bonds, new rail and electricity grid projects have been authorised, and interest rates have come down, which all points to a reversal in the recent trend of tighter credit and to increased economic activity in coming months.

Marketplace review

The Global Market Environment

Global energy markets

Oil moved in a dramatic fashion over the course of our 2018 fiscal year. From an all-time high starting point, crude oil inventories declined steadily throughout 2017, until by the start of our 2018 fiscal year, they were back to a five-year-average level. They continued to decline during the year as the combination of robust demand growth and a cut to OPEC-plus supply helped the market rebalance and brought stocks down to below historical averages. The structure of the curve moved from contango to backwardation; this was indicative of tighter supply and demand fundamentals in the front, and incentivised market participants to draw down stocks rather than keep them in storage to gain the uplift of higher prices later.

Oil price

Stated in USD per barrel

Source: Bloomberg, Trafigura Research

Despite the tariff headwinds, sanctions and rising interest rates, global oil demand in 2018 remained healthy. We estimate that global liquids (crude, condensate and natural gas liquids) demand increased by close to 1.7 million barrels per day last year, one of the stronger performances recorded in recent years. The growth was widespread, both in terms of geography and product type.

As has often been the case in recent years, China took the lead, recording growth in demand of approximately 400,000 barrels per day. Diesel consumption remained strong in China and gasoline use also increased as consumers purchased more vehicles. There was also growth in liquefied petroleum gas (LPG) use, thanks to a rise in petrochemical and residential consumption. The US witnessed a robust increase in demand, with consumer spending contributing to a rise in demand for gasoline. Globally, gasoline demand grew by over 400,000 barrels per day. We also saw surprisingly strong growth in demand for diesel. The latter was most likely due to increased movement of goods as companies ramped up exports ahead of the imposition of tariffs, and also to increased oil and gas drilling activity as prices picked up.

Indian demand for refined liquids recovered in the 2018 fiscal year, returning to a rate well above 200,000 barrels per day. This level is still below a recent peak, but nonetheless represents a decent increment for global demand growth and indicates that the country continued to perform in the face of demonetisation, sales tax reform and external headwinds. Other emerging markets also saw demand growth returning. As commodity prices picked up, so did accompanying mining, production and trade activity, which led to a healthy increase in demand in Africa, Latin America and the Middle East.

On the supply side, the main driver was US growth. Estimates for US production were repeatedly overtaken as the productivity gains in the shale sector continued to surprise. The Permian Basin alone saw growth of 1.2 million barrels per day in 2018, meaning that if it were a standalone country, it would be the world's eighth largest producer. In 2018, the US became the largest producer of oil globally, a dramatic turnaround from the start of the decade. Although productivity gains have slowed somewhat from the breakneck speed of recent years, we still expect production to grow at a healthy rate for some years.

A key component of this growth will be the development of domestic oil infrastructure in the US. Permian growth is in danger of being constrained as production currently exceeds pipeline capacity, leading to movement of crude by rail or even by truck, a more expensive and logistically challenging process. As a result, the differential between prices in Midland (the main Permian delivery hub) and Cushing (normally the key US benchmark) was as wide as USD18 per barrel at times, challenging the economics for some producers and leading to a steady increase in 'drilled but uncompleted' wells (DUCs). As the name suggests, these are wells that have completed first-stage drilling but have not yet been fracked and connected to the pipeline network. However, as new pipelines and port expansions are completed in 2019, we expect the growth in Permian to accelerate again.

Elsewhere, OPEC+ (OPEC plus Russia and others) had a more challenging year. After deciding to cut production in 2016 to support prices and offset rising US production, OPEC+, specifically Saudi Arabia and Russia, reversed course in mid-2018 and started to increase production. This decision was driven in large part by expectations that US sanctions would reduce Iranian oil exports by an amount that would significantly tighten global supplies if OPEC+ continued with their cut. Structural declines in Venezuela and other countries also pointed towards a tightening market, and as a result, Saudi Arabia and Russia look to have increased production by over 700,000 barrels per day between them. Whether or not Russia and Saudi Arabia maintain these production levels remains to be seen, as a price correction of over 20 percent since the end of our fiscal year means that OPEC+ is discussing the possibility of cutting output once again.

Global non-ferrous metals markets

Copper

The copper market tends to be the base metals market that is most exposed to global macro conditions and sentiment, and this impact was visible in 2018 as factors outside of the market buffeted prices. Copper started the 2018 fiscal year strongly, with prices rising to a high of USD7,200 per tonne, a level not seen since 2014. Positive global macro conditions buoyed market sentiment, encouraging financial sector participation, but fundamentals were strong as well, with global demand remaining robust and most regions seeing upward movements in premiums.

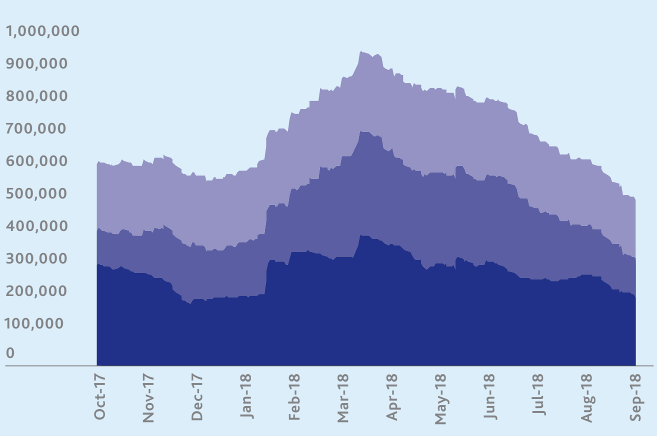
In China, despite concerns about slowing macro conditions, demand remained healthy and imports of cathode were strong. Partly the result of a ban on the import of low-quality scrap metal, which left Chinese consumers turning to cathode to fill the gap.

Sentiment shifted in June as concerns over an economic slowdown in China and the impact of deteriorating trade relations with the US led to a broad sell-off in commodities. Copper prices dipped below USD6,000 per tonne for a short time before recovering to between USD6,200 and USD6,400 per tonne. While clearly lower than at the start of 2018, prices are still comfortably above the 90th percentile of the mining cost curve. Therefore, we do not expect mine cuts to take place. We are also seeing signs of increased liquidity in China filtering through into increased infrastructure and real estate, albeit at a pace that will not see the bulk of impact until sometime in 2019.

Mine supply appeared to be tightening for most of 2018, with spot treatment and refining charges dropping to five-year lows in April. However, unexpected smelter outages and generally stronger mine supply led to the market softening into the summer months. On the mining side, expected disruptions due to labour disputes failed to materialise, allowing the concentrates side to stay fairly well supplied and mitigating some of the upside price risk.

Copper stocks

In tonnes



Source: BBG, Trafigura Research

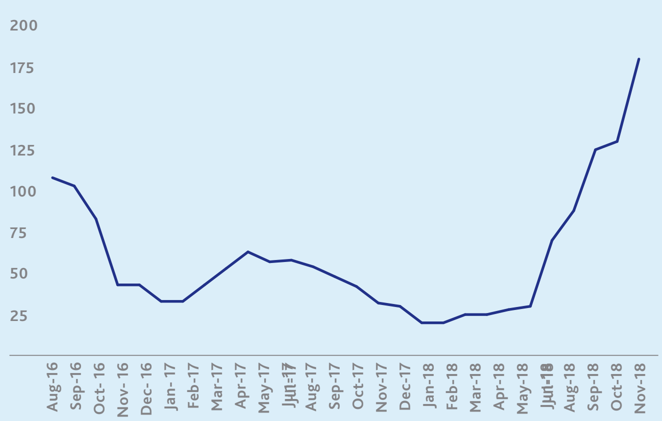
Zinc and Lead

The zinc mine supply shortage that became apparent in early 2017 caused the market to tighten over the course of the year, with visible inventory drawing continuously and London Metals Exchange stocks hitting a 10-year low in December.

As the market tightened, prices surged to almost USD3,600 per tonne in February 2018 but from then on it became clear that mine supply was recovering. As treatment charges rose from a low of USD15 per tonne to USD70 per tonne by the end of September 2018, prices dropped all the way back to USD2,500 per tonne, although inventory of metal has yet to move meaningfully higher. Weakness in Chinese construction, which impacts steel and demand for the iron ore and zinc that go into galvanized steel, also helped to put downward pressure on zinc demand and prices.

Zinc spot treatment charges

Stated in USD per tonne



Source: Metal Bulletin, Trafigura Research

The decline of zinc took lead down with it, although market dynamics have generally been very different for lead. There has been limited mine supply recovery and treatment charges have not shown the same upward movement as for zinc.

Meanwhile, environmental pressure on lead smelters in China has resulted in a severe lead shortage, which has caused stocks on the Shanghai Futures Exchange to drop to historical lows and the opening of import arbitrage.

Marketplace review

The Global Market Environment

Aluminium

Aluminium market conditions were nothing if not volatile. The much-anticipated environmental closures over the winter of 2017/2018 turned out to have very muted impact on overall production, resulting in a sell-off and a widening of the Chinese export arbitrage, as a solution was sought for winding down the large stock pile of metal built up in the country.

Further disruptions followed, with the US applying tariffs on the import of aluminium from March, which sent US premiums soaring, and later applying sanctions on the largest shareholder of Russian smelting giant Rusal, which potentially could have left a significant gap in global supply. However, an extended timeline for implementation of the sanctions and lack of follow-through in terms of implementation meant that markets did not feel the full effect of the sanctions and so most of the initial gains were reversed in due course.

Volatility came from raw materials as well, with the world's largest alumina refinery in Brazil having to curtail output following an environmental incident. While this put upward pressure on alumina prices, the raw material cost increase did not fully pass through to smelters, leading to margin contraction. This has been felt in China in particular, where curtailed output is finally allowing stocks to draw back towards more normalised levels.

Overall demand is holding up well as aluminium continues to see increased use in vehicle light-weighting and in transmission grid build-outs. Unusually, aluminium growth is beginning to be driven more by demand outside China rather than in it, providing a solid base for future growth.

Aluminium LME price and Midwest premium

Stated in USD per tonne

Source: LME, Platts and Trafigura Research

Nickel

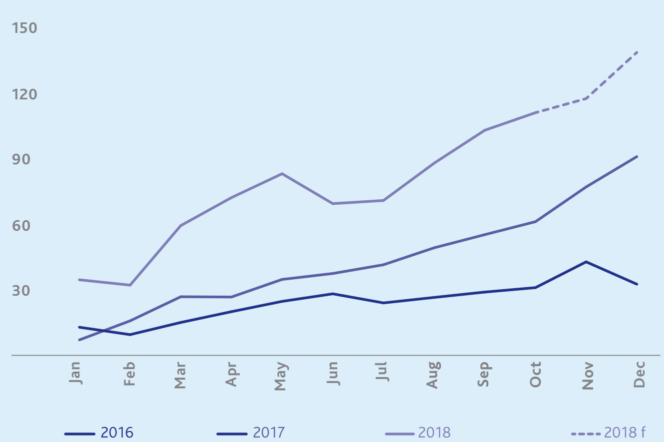
The nickel market saw its third consecutive year of significant deficit, with exchange stocks down by 350,000 tonnes from their peak in Q4 2015. Supply growth in China has been constrained by environmental policy-related restrictions, leaving Indonesia as the main source of new nickel units, almost exclusively in the form of nickel pig iron. Longer-term concerns over the availability of supply were tempered somewhat by the announcement of low-cost, Chinese-led, high pressure acid leach projects. The feasibility of these plans remains is uncertain and the speculative community has turned against nickel for now.

On the demand side, stainless steel production was strong over the year, although worries about an economic slowdown in China hurt consumption and prices later in the year. Asian stainless steel markets felt the pressure of rising low-cost Indonesian exports more broadly and the further addition of Filipino and Indonesian stainless steel capacity remains a key risk factor.

Battery demand continued to grow at a healthy rate. Electric vehicle production and sales beat consensus expectations yet again, with China leading the increase in adoption rates. Electric vehicle production and sales beat expectations yet again, with China leading the increase in adoption rates.

China electric vehicle sales

Stated in 000 vehicles



Source: Macquarie Strategy, Bloomberg NEF, Trafigura Research

Cobalt

Cobalt prices were less volatile but nonetheless moved substantially, the first part of our 2018 fiscal year, before moving back down in the second half. Essentially, the market moved from concern over impending shortages to realising that short-term production can and had been ramped up, specifically in the Democratic Republic of the Congo. We witnessed a move in the price of cobalt from USD60,000 per tonne to USD95,000 per tonne between September 2017 and March 2018, and then a retracement from USD95,000 per tonne to USD60,000 per tonne between March 2018 and September 2018, as a result of higher supply and macroeconomic concerns. Prices are likely come under pressure in the short term as new supply continues to come online. However, in the longer-term, cobalt still looks to be undersupplied given the expected growth in electric vehicles and other uses. As such, we expect prices to recover at some point.

Global bulk markets

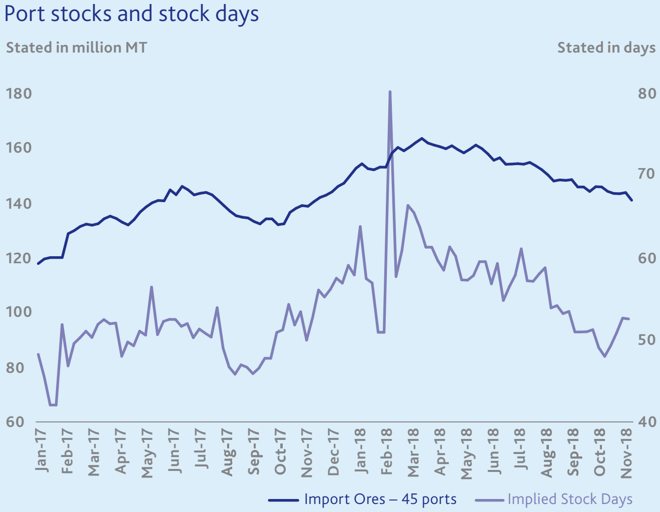
Iron ore

Iron ore saw its usual seasonal ups and downs over the winter of 2017-2018. Prices rose into February as mills restocked ahead of a spring production ramp-up. Then with restocking complete, prices sank and from there, benchmark prices saw a period of historically low volatility.

However, more interesting moves were observed outside of the benchmark grades. Very strong levels of steel mill profitability drove up premiums for high-grade ore, particularly lumps and pellets. These products allow mills to increase productivity while avoiding the sintering process that has been the target of a number of government environmental clampdowns.

While mill profitability has been strong, China's iron ore imports ended up being weaker in 2018. Part of the shortfall was filled by running down stocks of ore that had built up at ports, but 2018 also saw a large increase in the use of scrap steel as a raw material in China.

Port stocks and stock days



Source: Mystl, Trafigura Research

Scrap metal offset is likely to remain a long-term theme in iron ore and steel markets in China. However, with rising consolidation and structurally higher capacity use in the global blast furnace fleet, demand for productive iron ore looks set to remain strong.

Coal

The coal markets remained tight, a situation shaped by little incremental supply growth outside of Indonesia and the adverse effect of ongoing safety and environmental inspections on domestic Chinese production.

Demand for coal grew further for the two largest emerging economies, China and India. This resulted in strong seasonal price movements, with sharp increases over the winter period and ahead of the summer season. In addition, with supply growth limited to low-to-mid calorific qualities, the premiums for higher-quality coal widened sharply.

Furthermore, efforts on the part of the Chinese to limit coal imports and continuing rail logistic issues in India added brought uncertainty and volatility to the markets.

Conclusion

In a year beset by turbulence and volatility, the core business of global trade continued to grow apace. Demand for the key commodities Trafigura sources, transports and delivers continues to expand globally, across product types and geographies. The global commodity market is moving from reliance for growth on one critical market, China, to broader support across regions, providing a more stable and robust underpinning for future growth.

However, in the short-term we do see increasing headwinds – both of a political nature, in the form of tariffs and economic sanctions, and in the macroeconomic sphere from rising interest rates. While there was some considerable relief at the truce agreed by the US and China at the G20 summit in Buenos Aires, the risk remains that this will prove temporary. Either way, geopolitical uncertainty looks set to remain a given, with the constant potential to disrupt markets – and to create trading opportunities.