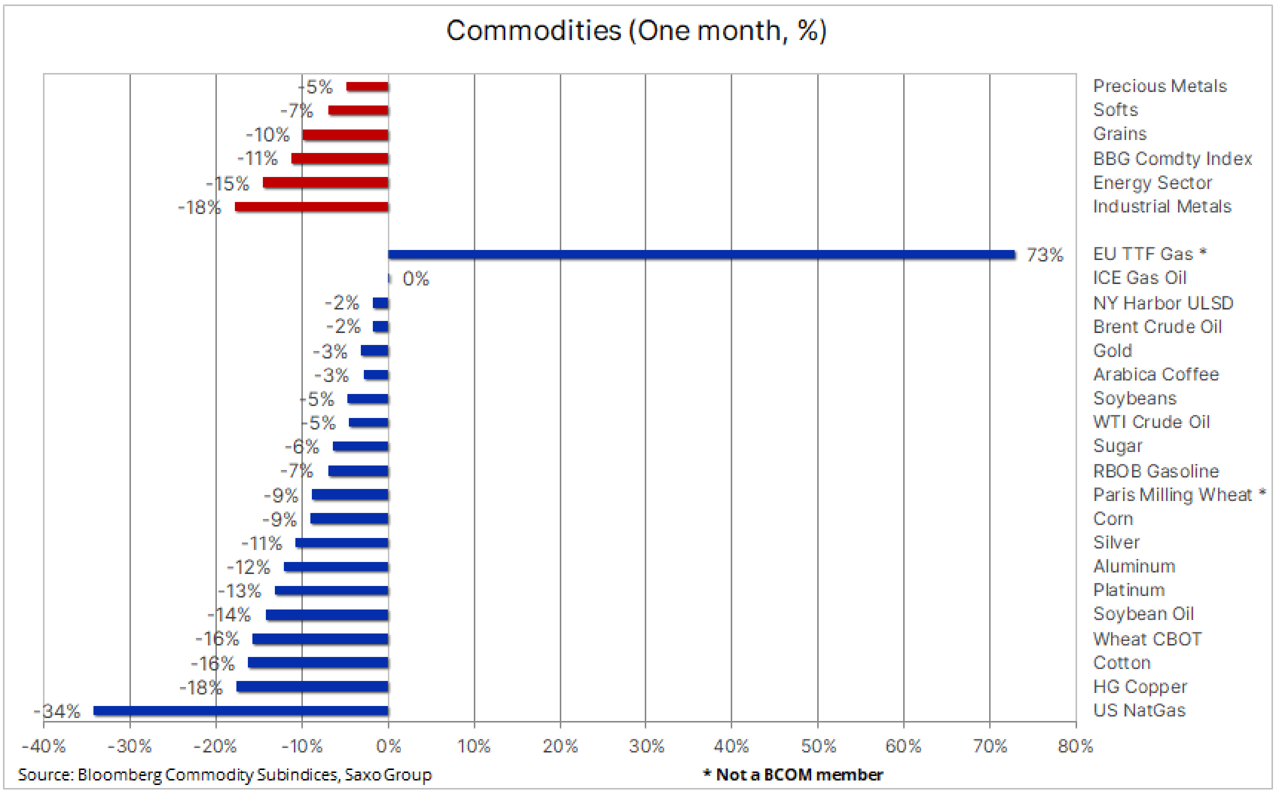
WCU: Copper and cotton crushed on galloping recession fears

By Ole S. Hansen // July 1, 2022

The month-long commodity rally hit a major obstacle during the latter part of June as the risk of recession continued to take hold in people's minds. With the war in Ukraine, China still struggling to find a growth gear amid its controversial zero tolerance approach to Covid outbreaks and the wider world, led by the US responding to the negative impact galloping inflation has on consumers' propensity to spend, the outlook has indeed worsened.

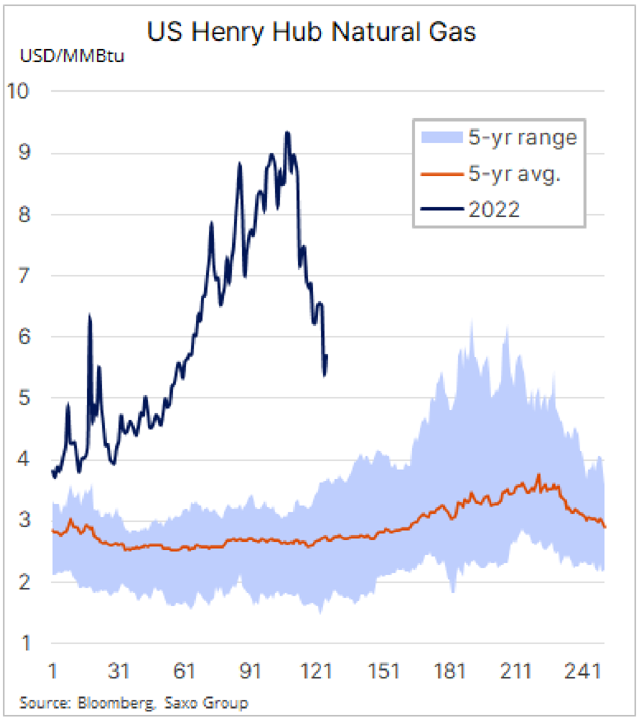
During the past month, the Bloomberg Commodity Index has given back 12%, thereby in month giving back close to half the gains the sector had delivered since last December. As per the table below, steep declines have been seen across all three sectors of energy, primarily due to natural gas, metals, and agriculture. At this point, the level of potential demand destruction remains very unclear. However, there is no doubt that some of the recent froth is currently being taken out of the market. This is partly driven by macro-orientated funds who bought the rally but now are having second thoughts as the risk of an economic slowdown looms ever larger.

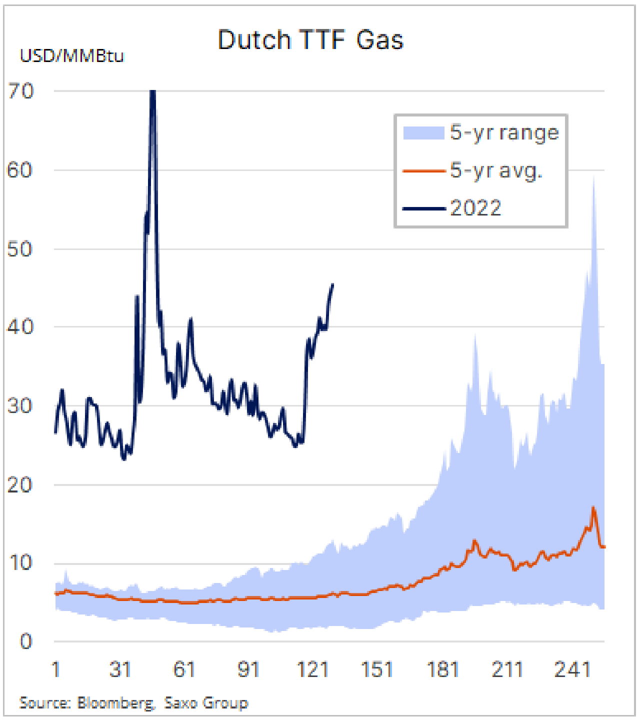


What happened in June that would justify such a major short or even medium-term reversal of the markets? It all began with the higher-than-expected US inflation print on 10 June leading to the first 75 basis point rate hike in decades. With several additional rate hikes to follow, the market has increasingly started to worry that central banks around the world will continue to raise rates. This will be either until inflation is brought under control or something breaks – the latter being the risk of economies buckling under pressure with recession the consequence. For now, at least one element of inflation, i.e., rising input costs through elevated commodity prices, has started to retreat, thereby supporting a 1.1% drop in two-year forward inflation expectations to 3.6% during the past two weeks alone.

A spate of weaker-than-expected economic data from US and signs consumers have started to scale back consumption has resulted in the Atlanta Fed GDPnow model tracking an economic contraction of 1.0% in Q2, which would imply a US "technical" recession of two consecutive quarters of negative real GDP growth. Still, we do not think that the US is heading into a broad-based recession, even as the Fed will likely continue to chase inflation.

Natural gas:
The two major performance outliers this past month are natural gas in the US and Europe. Stateside, the Henry Hub natural gas contract has slumped by 34% to $5.7/MMBtu as the prolonged shutdown of the Freeport LNG export terminal keeps more gas at home, thereby supporting a faster-than-expected inventory build ahead of the winter peak demand season. The latest twist came after a federal agency said the terminal, accounting for around 20% of US exports, can't restart without written permission from the Biden administration. Last week, some 82 bcf (billion cubic feet) of gas was injected into underground caverns against expectations of 75 bcf.





Reduced US export capabilities could not have come at a worse time for Europe where reduced flows on the NordSteam 1 pipeline to Europe has further uprooted the market and driven prices to a demand destructive territory just below €150/MWh ($46.5/MMBtu), around a ten-fold higher price than seen in the run up to last year's surge. The economic impact on European utilities not receiving the gas they bought under long-term contracts with Gazprom at much lower prices is currently being felt the hardest in Germany, a country whose failed strategy to depend almost exclusively on Russian gas has left many high energy consuming industries exposed.

This past week Uniper, a major energy company, was the first to ask for state help after receiving only 40% of the contractual agreed gas volumes from Gazprom since June 16. In order to make up the shortfall they are forced to buy the gas in the spot market at the mentioned very high levels. With the cost on winter gas already trading close to €150/MWh and with storage injections slowing, only an aggressive reduction in demand, either through voluntary or government intervention will prevent the risk of blackouts this winter.

Crude oil:
Crude oil and fuel products remain rangebound and after recording their first, albeit small, monthly loss since last November, and some questions are being raised about the sector’s ability to withstand additional recession-focused selling. We still believe – and fear – that worries about demand destruction will be more than offset by supply constraints. OPEC+ met this week and agreed another small production hike at a time where the group is already trailing their own production target by 2.7 million barrels per day. Having completed the reversal of output cuts made at the start of the pandemic in 2020, the market will focus on what lies ahead, but with most producers being close to maxed out, we are unlikely to see a surprise additional supply response.

The weekly inventory report from the US Energy Information Administration showed US crude stockpiles, despite massive injections from Strategic Petroleum Reserves (SPR), falling to their lowest seasonal level since 2014 while stocks at Cushing, the important delivery hub for WTI crude oil futures dropped to 21.3 million barrels, are also the lowest since 2014. The negative market impact, however, came from finished motor gasoline supplied data which showed that US demand for gasoline is succumbing in a more substantial way to record-high gasoline prices after showing a counter-seasonal decline.

In the short term, we will see a battle between macroeconomic focused traders selling “paper” oil through futures and other financial products as a hedge against recession, and the physical market where price supportive tightness remains. A battle that for now and during the upcoming peak summer holiday period when liquidity dries out may see Brent crude oil trade within the established range between $100 and $125.

Gold and silver
Gold traded below $1800 for the first time in six weeks with focus now on key support around $1780. The weakness being driven by a combination of a stronger dollar, the market pricing in lower forward inflation driven by rate hikes, recession worries reducing the overall appetite for commodity exposure, and after India, the world’s number 2 consumer, increased import taxes. In addition, silver has slumped below $20, dragged lower by continued weakness across industrial metals, especially copper. Faced with these multiple headwinds, investors are reducing their exposure in ETFs while speculators are adding short positions through futures. Reasons for holding gold, such as the hedge against stagflation, geopolitical and financial market risks, have not gone away, but for now with the summer holiday and low liquidity season upon us, investors are scaling back more than gearing up.

Copper and cotton crushed
Behind the mentioned big drop in US natural gas we find copper and cotton as the biggest losers in June. These two commodities from a different sectors are often used as barometers of the health of the global economy. The level of demand for copper given its use in electrical wiring and cotton in clothing are two key components that drive global growth, and with rising concerns about a global recession, both have been attacked by sellers, either getting out of long or into short positions as a hedge against further macroeconomic deterioration. While copper crashed below levels not seen since early 2021, cotton hit a nine-month low, some 32% below the May peak, with Covid-hit China seeing lower demand. Against these challenging demand developments, the outlook for supply also worsened after the percentage of US crops being rated good to excellent dropped to just 37% versus 52% a year ago.

Once the dust settles, copper is likely to attract fresh demand, not least because China is showing fresh attempts to ease lockdowns while the level of available stocks held at warehouses monitored by the two major exchanges in London and Shanghai remain near the lowest in decades. Not a healthy starting point from any signs of a renewed pickup in demand.

HG Copper extended its slump following the recent break below support at $3.95/lb with the focus now on the next key level of support at $3.50/lb.

Source: Saxo Group

Ole. Hansen
Head of Commodity Strategy

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