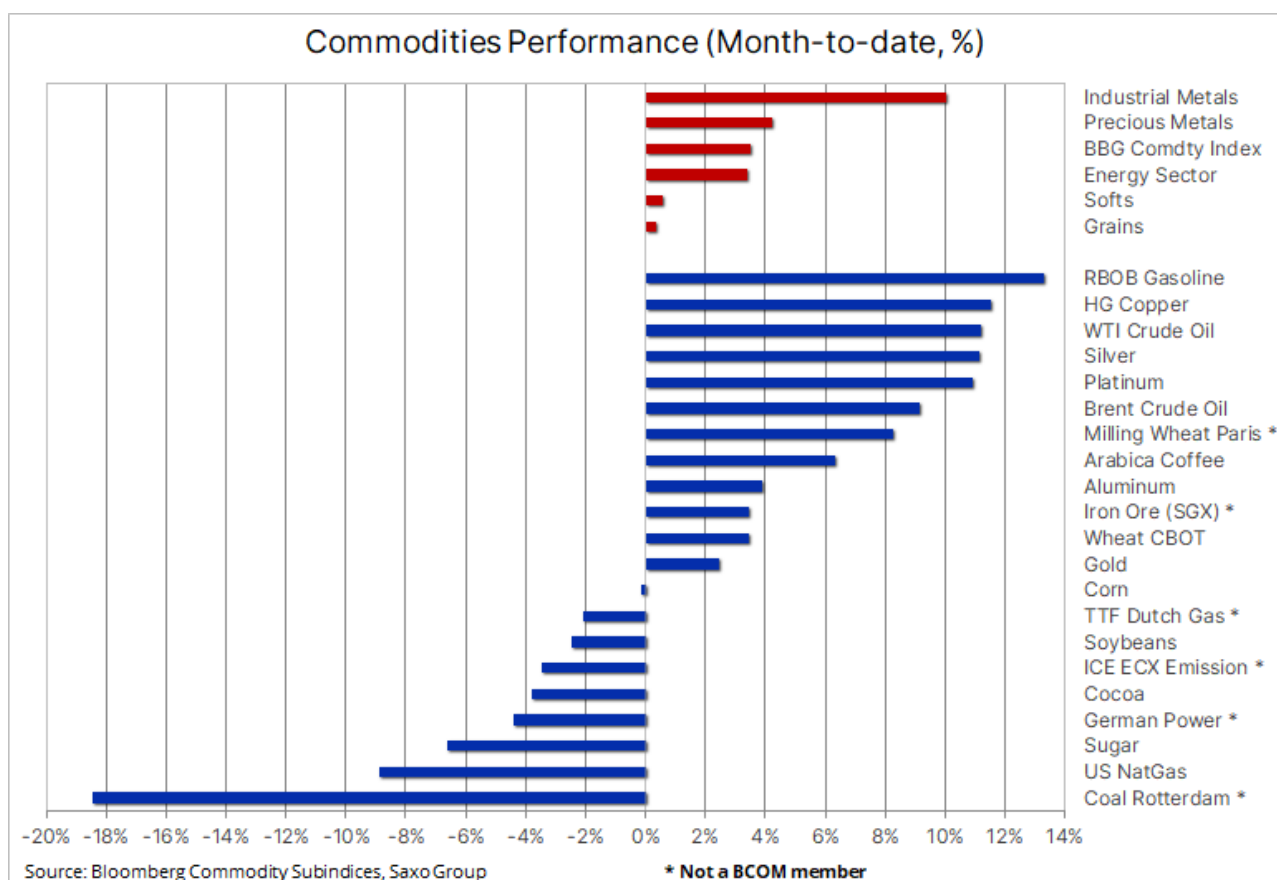


WCU: Energy crisis fuels commodity rally despite growth concerns

By Ole S. Hansen // October 22, 2021

The month-long run-up in commodity prices shows no sign of easing with the main engine continuing to be the global energy crisis and its direct impact on other sectors, not least the energy-intensive industrial metal sector. Shortages of fuel leading to record-high prices has forced reductions in metal production from China to Europe, thereby exacerbating price gains for several key metals, many of which are important components in the global push to decarbonize economies.

The continued rally has however by now also started to raise concerns about its impact on consumers and whether high prices eventually will dampen the prospect for demand, thereby supporting more balanced markets. Global growth is already seeing regular downgrades with rising energy prices acting as a direct tax on consumers. Adding to this are higher inflation and a slow resolution of supply bottlenecks around the world as well as the need for an even greater medical effort to combat a not yet under control virus.



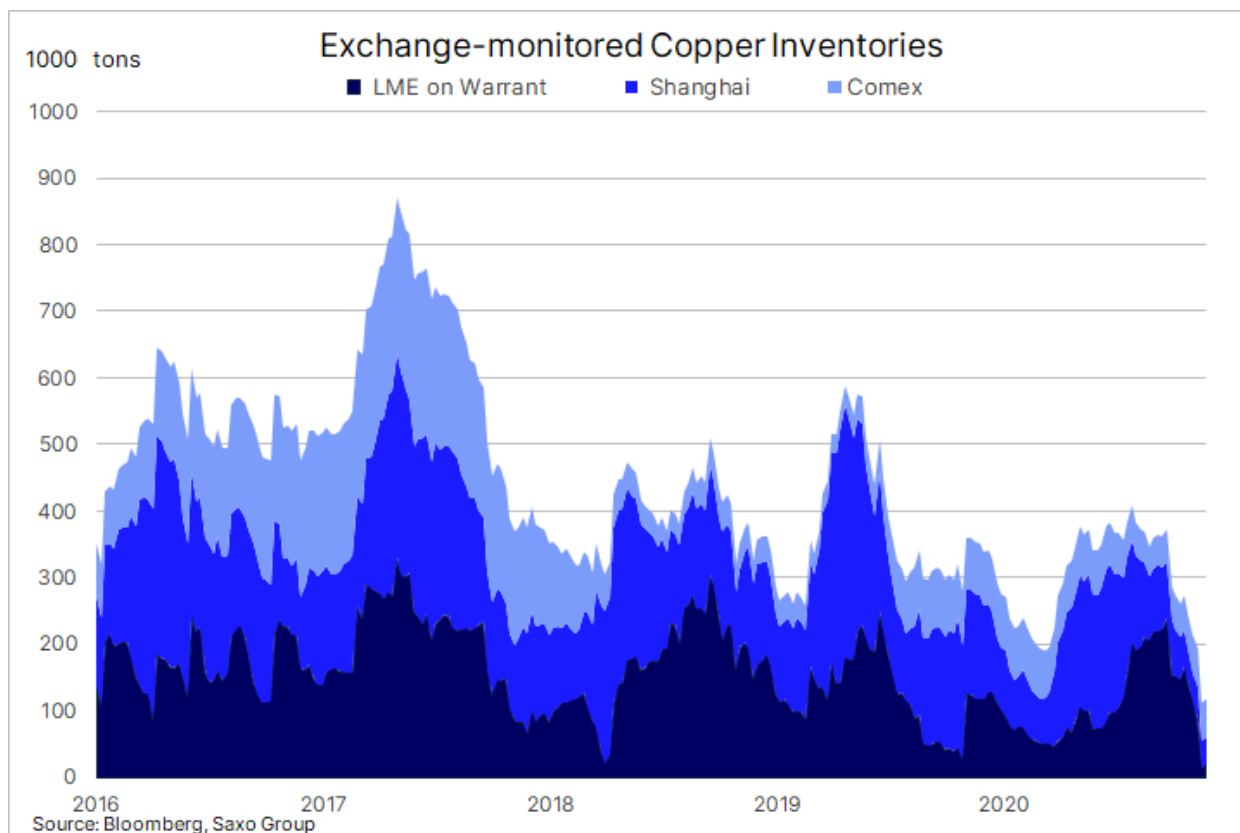
In addition to the price-induced demand destruction and the impact of energy/power cost inflation on disposable incomes, a slowdown in the Chinese property market and cuts to Chinese industrial production could be forces that in our opinion may slow but not curb further commodity gains during the coming months.

Inflation remains a hot topic and following months of range-bound trading the difference between inflation protected and normal bonds has started to move higher. The so-called breakeven yield, which reflects the markets expectations for U.S. inflation over the next five years, reached 3 percent, thereby exceeding the previous high from 2005. A rise in the ten-year breakeven yield to 2.70 percent helped keep real yields suppressed around -1 percent, thereby supporting a gold market which increasingly has been competing with cryptos, not least after this week's launch of a Bitcoin futures-linked ETF.

Industrial metals have seen the strongest gains so far this month as the global energy crunch and China's fight against pollution has curbed production at a time where demand has yet to show signs of weakness. After hitting a record high last week, the LME Metals Index, which tracks six metals, retreated this week with Chinese efforts to curb coal prices having a negative price impact on energy-intensive metals such as aluminum and zinc. However, the main story this past week has been the copper market where a rapid reduction in available stocks at LME-monitored warehouses helped drive an unprecedented surge in the cost of metals available for immediate delivery.

While the benchmark three-month forward copper contract on Monday hit a five-month high at \$10,450/ton, the spot price at one point jumped to trade at a \$1,100/ton premium over. In recent weeks big orders to withdraw stocks have seen the availability of copper sink to just 14,150 tons, the lowest since 1974. At the same time, inventories monitored by the Shanghai Futures Exchange has dropped to 40,000 tons, the lowest since 2009.

Worries about Chinese growth in generally, and specifically the health of the Chinese property market, has kept copper in a relatively tight range for several months, but the recent breakout amid tightening exchange-controlled supply could see it consolidate before eventually breaking the record highs from May. In High Grade copper we see support already emerging between \$4.45 and \$4.52 per pound.



Precious metals: The combination of rising industrial metal prices, a softer dollar and rising inflation expectations helped lift silver to a five-week high while at the same time supporting a drop in the gold-silver ratio back below 74 from above 80 at the beginning of the month. From this we can see that gold has been dragged higher instead of leading from the front. Despite Fed officials signaling no rush for rate hikes, gold has yet to find a bid strong enough to push it through key resistance at \$1835.

The dollar, which provided a great deal of headwind during September, has stopped rising and following weeks of speculative buying which lifted the dollar long against a G7 basket of IMM currency futures to a two-year high, the greenback is showing signs of reversing. If realized, the rise in breakeven yields and deeply-negative real yields should provide enough ammunition to trigger a break and with that renewed buying from technically-orientated funds.

Real money managers meanwhile continue to show limited appetite with the recent drop in stock market volatility once again reducing the short-term focus on and need for diversification. The reduced sentiment towards gold can be best measured by watching the miners versus the spot price of gold. When investors are more bullish gold, they tend to buy the miners (GDX ETF as an example) for leverage. When the opposite is true, they prefer to own physical gold or ETF's tracking spot gold prices. The ratio is currently just 13% above the all-time bearish lows from 2015, and 87% below the all-time peak exuberance high from 2006.

Stagflation, which is defining a period of inflation combined with slowing growth, tends to support the price of gold. It is worth noting that during each of two previous periods of stagflation, gold prices went higher while the Fed Funds Rate was also rising. With monetary policy on track to be tightened, the market may eventually have to rethink the negative impact on gold that many are currently pricing in.



Source: Saxo Group

EU gas and power prices traded mostly sideways following the early October spike, but at five times the seasonal average gas prices are still well above levels that will cause economic hardship across the region while at the same time hurting growth as heavy energy-consuming industries scale back their production. As temperatures continue to cool across the northern hemisphere, the market remains exposed to price spikes in the event of a colder winter. A 25% tumble in coal prices following intervention from several branches of the Chinese government helped, at least temporary, to alleviate some of the fears of runaway prices.

With the power crunch in China showing signs of easing as coal powered plants are incentivized to produce more power, the prospect for more LNG shipments reaching Europe has also received some attention. Overall, however, Europe is still facing a grim winter unless high prices kill demand, the winter turns out to be mild and windy, and most

importantly Russia decides to ship more gas. Unfortunately, such a decision increasingly looks like it's being linked to a swift approval by Germany of the controversial Nord Stream 2 pipeline. With this in mind, global energy prices look set to remain elevated with gas-to-oil substitution adding an additional layer of support for several fuel products from heating oil and diesel to propane.

Crude oil's six-week rally showed signs of running out of steam in response to lower US gas prices and the slump in coal prices. From a technical perspective, the combination of Brent and WTI crude oil both reaching overbought territory and hedge funds turning net sellers into the rally helped trigger some long overdue profit taking. According to the latest [Commitments of Traders report](#) covering the week to October 12, hedge funds cut their exposure in Brent crude oil, the global benchmark, by 10% to 300 million barrels, less than half the record 632 million barrels recorded back in 2018, the last time the price traded above \$80/b.

WTI crude oil meanwhile rallied to the highest level since 2014 with stocks at Cushing, the important delivery hub for WTI crude oil futures, rapidly draining to a 2018 low and well below average levels. As a result, the futures curve has moved deeper into backwardation, a formation where market tightness drives the spot price higher than the deferred prices. An example being the \$10.4/b spread between the two nearest December futures contracts, a level that was last seen in 2013.



Source: Saxo Group

In our [Q4-2021 outlook](#) published on October 5, we raised our target range for Brent crude oil by 10 dollars to a \$75 to \$85 range. Having reached the upper end of this range already, and well before winter developments and a lack of additional OPEC+ action potentially tightens the market further, the risk to our forecast remains clearly skewed to the upside. Continued selling by hedge funds, however, needs to be watched as it removes a key source of demand in the “paper” market.

Arabica coffee has settled into a range around \$2/lb which is 75% above the average price seen during the previous five years. Rising global demand, a smaller Brazil harvest due to adverse weather and not least dislocated supply chains have all supported a strong recovery in recent months. Brazil's coffee exports recorded their weakest month in September in four years as the intense battle for containers and ship capacity helped keep prices elevated while at the same time driving down stocks monitored by the ICE exchanges, especially at European warehouses as the lack of shipments forced roasters to turn elsewhere for supplies.

With global port and container congestion expected to last well into 2022, the short-term prospect for prices will once again turn to weather developments in South America. Warnings about another La Nina event like the one that hit the continent last year may provide enough support to sustain and perhaps even build on current elevated prices.

Iron Ore, which halved in value between July and September, has since managed to stabilize around \$120 per tons. The short-term outlook given Chinese efforts to reduce pollution through curbing steel production and worries about the health of the property sector are likely to keep prices suppressed during the coming months. With the demand outlook challenged, the short-term outlook depends on supply discipline from the three largest producers Vale, BHP and Rio Tinto who combined control around a 60% seaborne market share. So far, they have all responded by trimming their shipment guidance, a step that should help avoid a collapse to cost price, currently somewhere in the region just below \$50 per tons.

Press contact

Wim Heirbaut, Senior PR Consultant, Befirm
T +32 475 74 17 52
E wim.heirbaut@bepublicgroup.be



Ole. Hansen
Head of Commodity Strategy

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