TD Economics

Commodity Price Report

Upward Momentum Fades as the Economic Recovery Slows

Omar Abdelrahman, Economist | 416-734-2873

October 14, 2020

Highlights

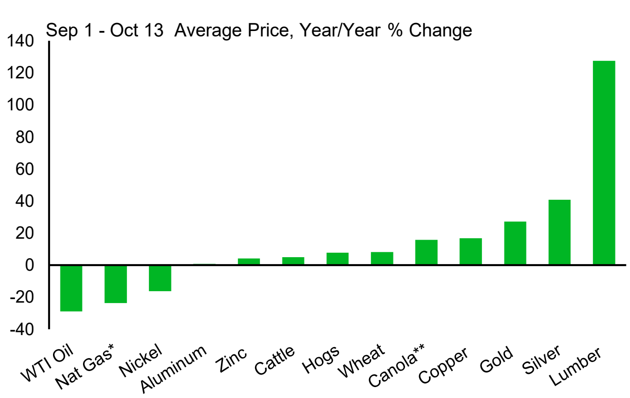
- Following a strong summer rebound, momentum in commodity prices has stalled in recent weeks in tandem with other risk assets. A levelling off in demand is coinciding with declining support from the supply side.
- Commodity prices continue to face an uphill battle. Among the major areas, oil prices have the most lost ground to make up. Crude prices will likely remain the most detached from their pre-pandemic levels well into 2021.
- The resilience of China's industrial recovery has kept base metal prices above their pre-pandemic levels. Going forward, the waning impact of stimulus measures and supply-side forces will drive a wedge between base metal performances.
- Drivers of precious metals prices remain broadly supportive. However, with these largely priced in, another strong leg up in prices is unlikely.
- Agriculture and forestry markets are facing idiosyncratic conditions. Pre-existing oversupply concerns remain in some crop markets. However, improving demand-supply fundamentals are supporting oilseed and livestock prices. Continued moderation in lumber prices is expected as North American housing activity slows to more sustainable levels.

The lifting of mobility restrictions over the summer supported a bounce-back in demand across all commodities. At the same time, supply-side curtailments in oil markets and ongoing virus-related disruptions in metal mines were also critical in partially rebalancing oversupplied markets. China's government stimulus package was more supportive for commodity demand than initially expected. The downshift in the USD and increased investor appetite for inflation-sensitive assets further bolstered these trends in the latter part of the summer.

Notwithstanding this, the commodity complex remains on shaky grounds. With the low hanging fruit already picked, price growth has stalled across most commodities. A modest uptrend is still expected as the global economy gains more traction in 2021. That said, strong summer gains will give way to a more elongated recovery going forward.

The impacts of the pandemic and subsequent recovery paths remain uneven across the commodity complex (Chart 1). Oil – the most decoupled from its pre-pandemic levels – continues to face the longest uphill battle. Emerging COVID-19 second waves and seasonal factors are limiting demand growth at a time when supply-side supports are being gradually eased. Most other commodities are now trending above their year-ago levels. However, price growth will notably moderate across most base metals as the im-

Chart 1: Oil Markets Left Behind



Note: *Natural Gas prices are cash prices **Canola prices are converted from C$ to US$.
Source: CME, Bloomberg, Random Lengths, WSJ, FT, EIA, FRB, ICE, TD Economics.

pact of stimulus measures wanes and supplies grow. In agriculture and forestry markets, lumber prices are expected to moderate after reaching record highs as housing activity slows to more sustainable levels. Livestock prices stand to modestly gain from improved supply-demand fundamentals and the African Swine Fever. Meanwhile, crop markets are mixed. Pre-existing oversupply concerns continue to cloud the outlook for wheat prices, while oilseed prices are benefitting from lower production and inventories. Elsewhere, precious metal prices are expected to be flat-to-slightly-down.

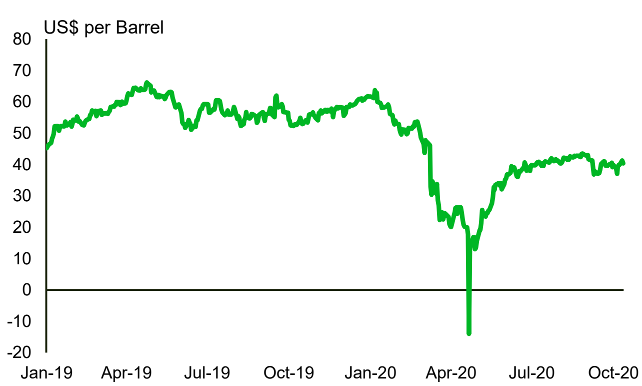
Once again – at the risk of sounding like a broken record – the outlook remains subject to heightened uncertainty. Consistent with our latest Quarterly Economic Forecast, it is predicated on a continued "swoosh-shaped" recovery and the rollout of a vaccine by the second half of 2021. Second wave restrictions are assumed to be more targeted, preventing another slump in demand. Supply-side supports will remain critical in some markets – namely oil. In light of this, risks to the commodity price outlook remain tilted to the downside.

The Marathon Begins in Global Oil Markets

As restrictions on mobility were lifted over the summer, oil demand has partially recovered from its April slump. Prices have remained stable around the US$40 mark since July (Chart 2). However, inventories remain bloated, and the journey back to pre-pandemic levels of demand is expected to be long and choppy.

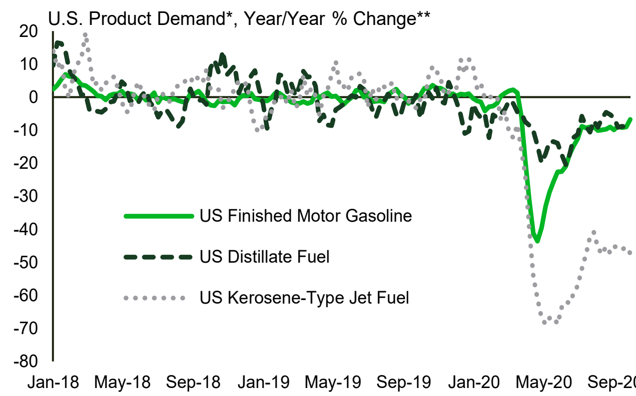
A mix of second wave restrictions and seasonal effects are putting a temporary lid on demand growth. Mobility gains

Chart 2: WTI Oil Prices Stable near the US$40 Mark



Source: Bloomberg, TD Economics. Last observation October 13, 2020.

Chart 3: A "K-Shaped" Recovery in Oil Markets



*Product supplied, used as a proxy for consumption. **4-weeks moving average.
Source: Energy Information Administration, TD Economics. Last observation October 2, 2020.

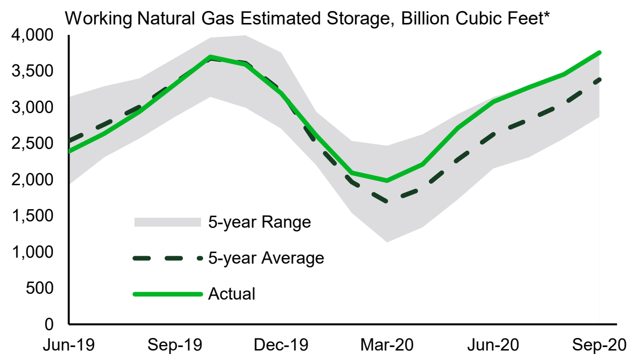
are levelling off across most major economies. At the same time, the boost from China's import surge over the past few months is unlikely to be sustained. From a product demand perspective (Chart 3), timely data on U.S. gasoline shows a plateauing following strong summer gains. Meanwhile, jet fuel remains well below pre-pandemic levels (stuck near -50% y/y). Gains in the latter are expected to remain muted until a vaccine is widely available.

Supply side curtailments have also been critical in rebalancing markets since May. Compliance with OPEC+ quotas has been high. The group's messaging also signaled a strong intent to keeping inventories on a downward trend and prices stable. Namely, it included a warning to speculators in the September JMMC meeting. In the meantime, shut-in wells in the U.S. and Canada are only slowly resuming production. With that said, support from this side of the ledger has also likely peaked. OPEC+ production quotas are set to be eased again in January. Importantly, compliance from all producers will be critical. More recently, Libya has restarted production in its oil fields, with the International Energy Agency (IEA) projecting a 400K bpd increase in its production by December.

Against this backdrop, oil markets are expected to remain in deficit territory in the near term, but only narrowly. At the same time, financial market sentiment is likely to be unsupportive amid lingering uncertainty on COVID-19. As a result, prices are expected to move sideways before edging up slowly above the US$40 mark. Risks to this price trajectory are tilted to the downside in Q4.

Turning to the medium term, our Quarterly Economic Forecast embeds a moderate acceleration in global economic

Chart 4: U.S. Natural Gas Stocks Still Above Their 5-year Average



*End-of-Month Data, Except for October 2020.
Source: Bloomberg, U.S. Department of Energy, TD Economics.

growth in the second half of next year. This uptick is predicated on a vaccine becoming available. A vaccine/treatment would disproportionately benefit oil relative to other commodities. Consistent with this, we anticipate the next leg up in prices to the US$45-US$50 level to occur by the second half of 2021.

Looking beyond 2021, there are some compelling arguments that our price target is on the conservative side. The pandemic-induced slump in upstream investment, namely in the U.S., is expected to lead to lower future production. Given this, tighter markets may eventually emerge, especially if global demand continues to recover gradually. Until then, however, there is more than enough spare capacity to meet any shortages in the market.

Heavy Oil Discount Likely to Widen Only Modestly

Lower heavy oil discounts provided some modest offset to Canadian oil producers amid this year's turmoil. In the Western Canadian Sedimentary Basin (WCSB), production in May declined by 14.5% in Alberta and 26% in Saskatchewan relative to year-ago levels. The latest readings for July show production only slowly rebounding in both provinces. At the same time, exports on the more expensive crude-by-rail option continue to dive lower. This notably lower level of production has lessened transportation and storage capacity pressures. With only a gradual rebound expected in production, the WTI-WCS discount is likely to remain in US$10-US$15 range through 2021.

Natural Gas Oversupply Should Ease

Natural gas markets were already facing an unfavourable backdrop prior to COVID-19 – largely due to a spike in U.S. production in 2019. COVID-19 has hit demand for natural gas end-uses, albeit significantly less than the hit seen in oil. Yet, prices tumbled to multi-decade lows over the summer, and volatility has surged. The market continues to be characterized by high inventories, which remain above their five-year average (Chart 4).

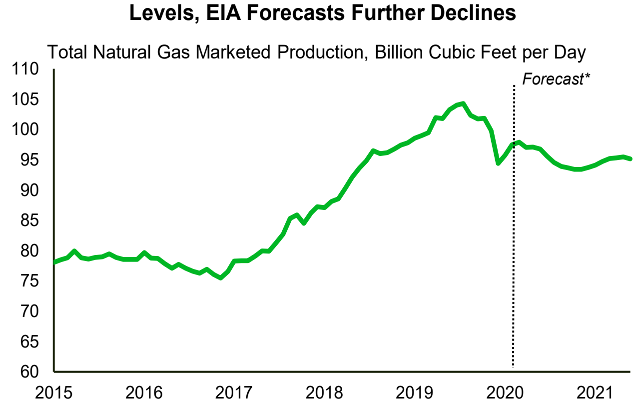
Going forward, an expected recovery in U.S. LNG exports should help reduce bloated inventories. In a similar vein to oil, U.S. natural gas rig counts have tumbled, and the Energy Information Adminstration (EIA) is also anticipating a drop in natural gas production (Chart 5). Together with the upcoming heating season, these forces point to some easing on the supply side in the upcoming months. Consequently, the price environment should gradually improve.

Base Metals Buoyed by China's Industrial Recovery, but Momentum is Slowing

Despite the steepest global economic contraction since the post-world war period, base metals have surged well above their pre-pandemic levels. The culprit here was China's stimulus, which fueled a strong industrial and manufacturing rebound. The boost in demand benefitted all metals across the spectrum, including previously oversupplied markets such as aluminum.

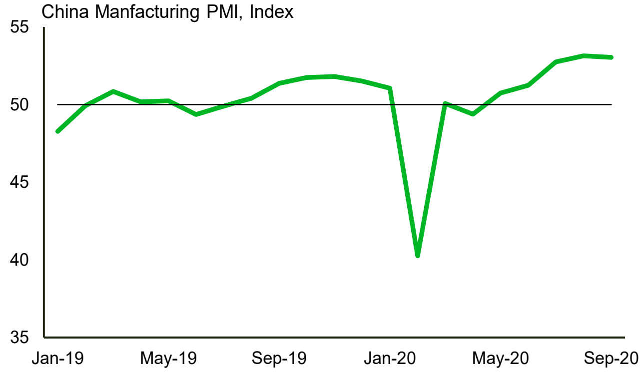
China's robust September manufacturing PMI readings (Chart 6) point to a recovery that remains intact. However, the impacts of China's stimulus on commodity prices

Chart 5: Natural Gas Production Has Dropped from 2019 Levels, EIA Forecasts Further Declines



*Forecast by EIA as of October 2020.
Source: Energy Information Adminstration (EIA), TD Economics.

Chart 6: Base Metal Prices Bolstered by China's Manufacturing and Industrial Recovery



Note: Below 50 = a majority of businesses reported a contraction.
Source: IHS Markit, TD Economics.

will likely wane as we progress into 2021. Divergences are also expected going forward. These will be largely dictated by supply-side developments. Pandemic-driven mine disruptions in Latin America (namely in Peru) weighed on copper and zinc production, temporarily improving their supply-demand fundamentals. A recent strike at Chile's Escondida Aluminum prices poses some further downside risks to production. That said, caution remains warranted as the impacts of these supply-side disruptions wanes going forward. Aluminum prices, on the other hand, appear on track to decline. The metal continues to face elevated inventories and the expectation of added production capacity in China. Nickel prices were heavily impacted by the pandemic, but prices should benefit from ramped up restrictions on Indonesian ore exports and the potential for increased battery demand.

Like oil, near-term risks to base metal prices appear to be weighted to the downside. An uneven recovery in China's economy could set the stage for bouts of significant selling pressure. Moreover, the recent flattening in consumer spending trends globally (and in China) may eventually hinder the industrial recovery and lead to a pull-back in metals prices.

Backdrop Remains Supportive for Precious Metals, but a Further Leg Up is Unlikely

The confluence of tailwinds supporting the surge in gold prices this year is almost too long to list. Demand for the yellow metal prior to COVID-19 was already on a strong footing as a result of dampened bond yields and geopolitical uncertainty. These forces were amplified by the pandemic. Real interest rates dropped further, central banks unleashed significant asset purchase programs, and economic uncertainty spiked to unprecedented levels. Over the summer, a downshift in the trade-weighted US dollar value lifted prices further to record levels. Strong investor appetite is reflected in still-high ETF holdings (Chart 7), although net inflows have recently slowed.

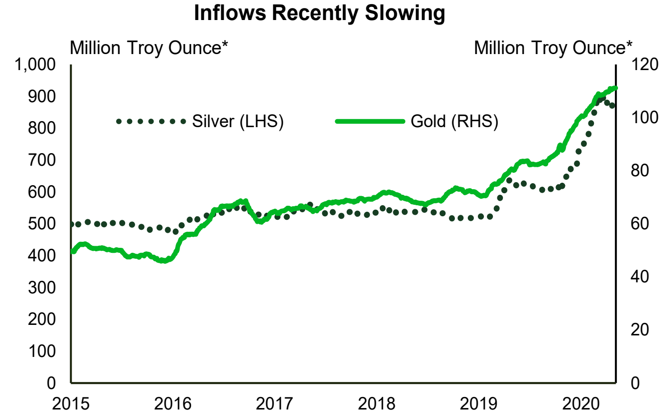
These forces should prevent a strong downshift in prices in the near term. That said, they are also arguably mostly priced in, precluding another strong price rally. Nominal interest rates have likely hit rock bottom. At the same time, expectations for a period of low-for-long rates are already priced in across treasury and federal funds futures. Central banks have already signaled a "whatever it takes" approach to support the recovery. Economic uncertainty remains high but, has ebbed since the onset of the pandemic. These developments lessen the potential for any bullish surprises that would act as a catalyst for prices.

Prices are expected to remain flat-to-slightly down over the next few quarters. Nevertheless, there are some scenarios whereby bullion significantly overshoots our prediction. Appetite for the metal as a hedge against inflation has resurfaced amid spiking government expenditures and money supply. While not our base case, a spike in inflation would also add further downward pressure on real interest rates, supporting the metal further.

Agricultural Prices Mixed, but Oversupply Concerns are Easing

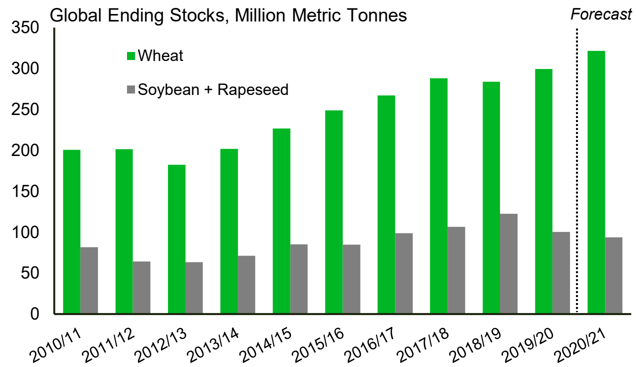
During the pandemic, food and agricultural demand has held up well compared that of other commodities. Notwithstanding this relative advantage, longstanding oversupply is-

Chart 7: Precious Metals ETF Holdings Still High, but Inflows Recently Slowing



*Total known ETF holdings.
Source: Bloomberg, TD Economics.

Chart 8: Wheat Supplies Still Plentiful, Oilseed Inventories Dropping



Source: USDA, TD Economics. Forecast by USDA as of September 2020.

sues remain front and center. Wheat prices have spiked in the past few weeks on dry weather concerns, but a further leg up appears unlikely to be sustained amid high global stocks and rising global production. Indeed, estimates from the USDA point to a strong year for wheat production and higher ending stocks (Chart 8). This is driven by strong increases in Russian production. The surge in China's soybean imports from the U.S. to fulfill its Phase 1 trade commitments has lifted the oilseeds complex higher. With this, canola prices have surged to their highest level in more than two years. In contrast to its wheat counterpart, lower production and ending stocks this year are supporting oilseed prices. Additionally, slowly recovering pig herds in China should revive demand for soybean feed. Price strength should remain in the near and medium term. However, a flattening or even some pullback is possible going forward as production and acreage respond to higher demand and prices.

In contrast to crops, livestock commodities were more impacted by pandemic-induced shutdowns in meat-processing plans. These shutdowns created a backlog in herds, pressuring prices downwards. As the impact of transitory processing plant shutdowns fades, prices should continue to recover. Hog prices have already bounced back above pre-pandemic levels, supported by increased U.S. exports. While herd sizes are recovering, the African Swine Fever has left a sizeable hole to fill in China's markets. Hog prices should remain resilient near current levels, but a strong acceleration is unlikely amid still-high U.S. inventories.

Lumber's Rally Cooling

Lumber's pandemic-driven slump in April was short-lived, as U.S. and Canadian housing demand rebounded promptly in V-shaped fashion. This came against supply shortages driven by Canadian mill shutdowns.

The resulting market tightness lifted lumber prices to record levels in August. Prices have since retreated but remain far above their pre-pandemic levels. Our latest Quarterly Economic Forecast embeds a near-term slowdown in U.S. and Canadian homebuilding. Likewise, seasonality and exhaustion of pent-up demand will likely weigh on growth in renovation activity. Given this backdrop, we see further room for prices to recede. However, the recently-improved market balance should keep prices from slipping below their pre-pandemic levels.

Table 1: Commodity Price Forecast Summary									
	Spot Price October 13	Q4				Annual Average			
		2019	2020F	2021F	2022F	2019	2020F	2021F	2022F
Energy*									
WTI Oil	40	57	41	49	53	57	39	46	52
Natural Gas	2.12	2.39	2.60	3.10	3.16	2.57	2.05	2.86	3.00
Precious Metals*									
Gold	1891	1482	1950	1850	1750	1392	1787	1895	1788
Silver	24.20	17.34	25.00	23.00	22.00	16.21	20.65	23.75	22.38
Non-Precious Metals**									
Aluminum	84	80	78	74	73	81	75	75	73
Copper	304	267	298	310	313	272	273	304	312
Nickel	6.87	6.99	6.81	6.92	7.06	6.30	6.14	6.90	7.01
Zinc	110	108	108	110	110	116	100	109	110
Agriculture & Forestry*									
Lumber	629	391	600	425	415	360	508	446	419
Wheat	6.84	6.77	6.81	6.84	6.75	6.59	6.56	6.84	6.78
Canola	420	362	410	406	403	361	379	408	404
Cattle	109	117	110	118	122	116	106	116	119
Hogs	78	65	70	72	74	70	60	73	75
Source: *Forecasts by TD Economics as of October 2020 ** forecasts by TD Securities and TD Economics as of October 2020									

MEASURES & QUOTED PRICES

($ is US$ unless stated otherwise; C$ prices converted to US$ using daily C$/US$ exchange rate).

FORESTRY

Lumber: Random Lengths' Framing Lumber Composite ($/1000 Bd Ft)

ENERGY

Oil: Domestic Spot Market Price: West Texas Intermediate, Cushing ($/Barrel); **Natural Gas:** Henry Hub, LA ($/mmbtu)

PRECIOUS METALS

Silver: Cash price: Silver, Troy Oz, Handy & Harman Base Price ($/Troy oz); **Gold:** Cash Price: London Gold Bullion, PM Fix ($/Troy oz)

NON-PRECIOUS METALS & MINERALS

Aluminum: LME Aluminum, 99.7% Purity: Closing Cash Price (Cents/lb); **Copper:** LME Copper, Grade A: Closing Cash Price (Cents/lb); **Nickel:** LME Nickel: Closing Cash Price ($/lb); **Zinc:** LME Zinc: Closing Cash Price (Cents/lb)

AGRICULTURE

Wheat: Spring,14%Protein: Minneapolis ($/bu); **Canola**: Canada: Cash Pr: Canola: Instore Vancouver: Grade 1 Canada NCC (C$/mt); **Cattle:** Live Cattle Futures Price: 1st Expiring Contract Open (Cents/lb); **Hogs**: Lean Hogs Futures Price: 1st Expiring Contract Open (Cents/lb)

Sources: WSJ, FT, Random Lenghts, CME, FRBNY / Haver Analytics, Bloomberg.

Table 2: Commodity Price Forecast Summary % Change								
	Q4				Annual Average			
	2019	2020F	2021F	2022F	2019	2020F	2021F	2022F
Energy*								
WTI Oil	-3.6	-27.9	19.5	8.2	-12.2	-31.8	17.7	12.6
Natural Gas	-36.6	8.6	19.2	1.9	-18.5	-20.1	39.5	4.9
Precious Metals*								
Gold	20.6	31.6	-5.1	-5.4	9.6	28.4	6.0	-5.7
Silver	19.0	44.2	-8.0	-4.3	3.1	27.4	15.0	-5.8
Non-Precious Metals**								
Aluminum	-10.9	-1.9	-5.1	-1.4	-15.1	-7.8	-0.6	-2.0
Copper	-4.5	11.5	4.0	1.0	-8.0	0.2	11.5	2.5
Nickel	34.1	-2.5	1.6	2.0	5.9	-2.6	12.4	1.6
Zinc	-9.3	-0.1	1.9	0.0	-12.8	-13.7	8.8	1.4
Agriculture & Forestry*								
Lumber	11.1	53.6	-29.2	-2.4	-22.0	41.0	-12.1	-6.0
Wheat	-1.2	0.6	0.4	-1.3	-7.4	-0.4	4.3	-0.8
Canola	-6.7	13.3	-1.0	-0.6	-12.6	5.0	7.6	-0.9
Cattle	0.4	-5.8	7.3	3.4	1.2	-8.6	9.3	2.5
Hogs	9.4	8.0	2.9	2.8	7.3	-14.0	21.6	2.4

Source: * Forecasts by TD Economics as of October 2020 ** forecasts by TD Securities and TD Economics as of October 2020