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Investment Strategy Bulletin

Commodities: Fundamentally constructive despite moderating returns

Investment Solutions

February 2018

Commodities: Fundamentally constructive despite moderating returns

- Commodities started the year with positive momentum, led by the base metals and energy sectors (Chart I). Clearly, investors' sentiment towards the commodity complex has improved markedly as part of the global reflationary trend.
- Going forward, fundamentals are pointing in the right direction: i/ all segments are currently facing the best demand backdrop in over a decade; ii/ supply cuts by the Organisation of Petroleum Exporting Countries (OPEC) and Russia and supply-side reforms in China should help to keep inventories in check; iii/ a weaker US dollar should also bring additional support.
- **We thus reaffirm our constructive stance by raising our targets on most commodities.**
- Despite the above, we expect lower returns for the coming year.
- Our macroeconomic scenario calls for a benign environment on the demand side, but no marked acceleration. With the Chinese economy slowing down gradually, the base metals complex should be more supply-driven than in 2017. Oil might also face headwinds as the markets' focus gradually turns to the ramp-up in US shale production.
- As such, speculative positioning at multi-year highs calls for cautiousness in the short-term as better entry points may arise over the course of the year.

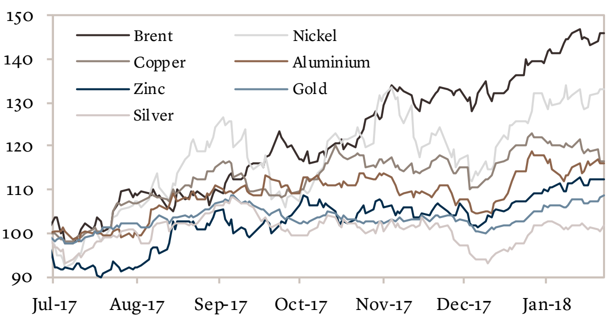
Oil markets transitioning away from oversupply to tightness: Backwardation will offer a buffer to price volatility
Target 12M: USD 64/bbl –Brent (vs spot USD 69/bbl)

We have raised our target on Brent for year-end as we expect supportive underlying dynamics and limited downside risk. Admittedly, the rally on oil might have been a little bit early, helped by infrastructure and production outages, and rising geopolitical risk. But, going forward, the strong fundamental picture should underpin prices above USD 60/bbl.

The pick-up in global activity suggests that robust demand is here to stay: we expect global GDP growth to remain slightly above its 2017 levels, supporting 1.5 Mb/d of additional demand for oil in 2018 (Chart II). Higher prices might affect US consumers at the margin but this effect should be partly offset elsewhere by a weaker US dollar. In addition, if history is a guide, curves in backwardation should generate financial demand as well.

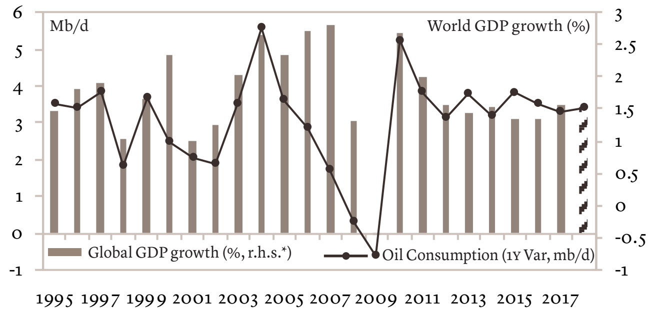
In the meantime, the OPEC and non-OPEC producers' (notably Russia) coalition met on 30 November 2017 and agreed to extend its production cuts through year-end 2018, with the goal of normalising inventories. The almost uninterrupted downward trend in US inventories (when stocks usually tend to build up in wintertime, Chart III) is already a good indication that this goal might be met over the course of the year. The group made clear that it wants to act as a market stabiliser, limiting oil price downside in

I. 2017 Performances of main commodities
100 in July-17 (spot prices)



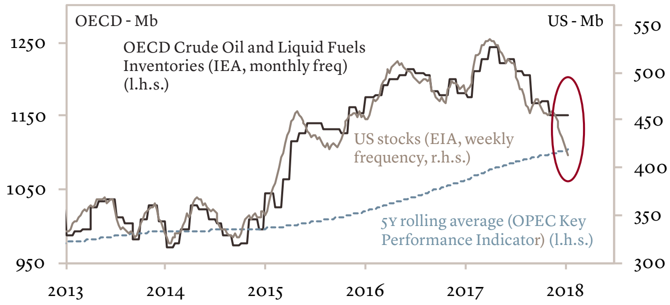
These figures refer to the past.
Past performance is not a reliable indicator of future results.

II. World oil consumption vs GDP growth
(LO estimates for 2018)

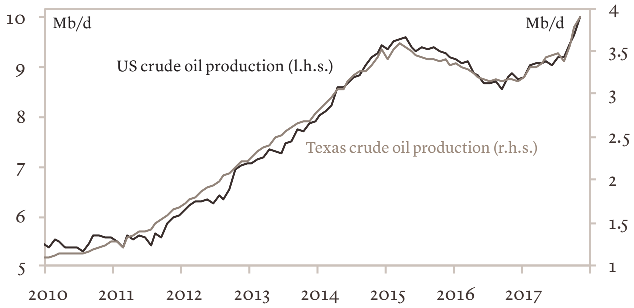


Sources: DataStream, Lombard Odier calculations
*r.h.s.: right hand scale; **l.h.s.: left hand scale

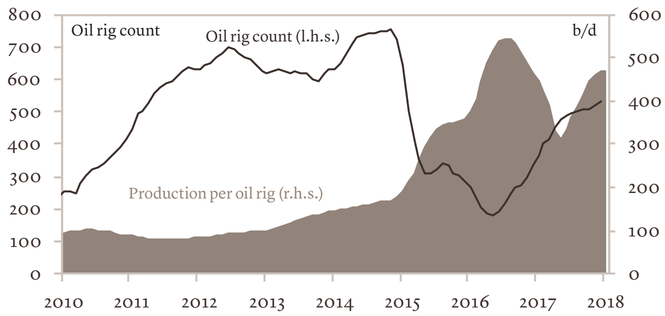
III. Counter-seasonal fall in inventories



IV. US shale production recovers strongly

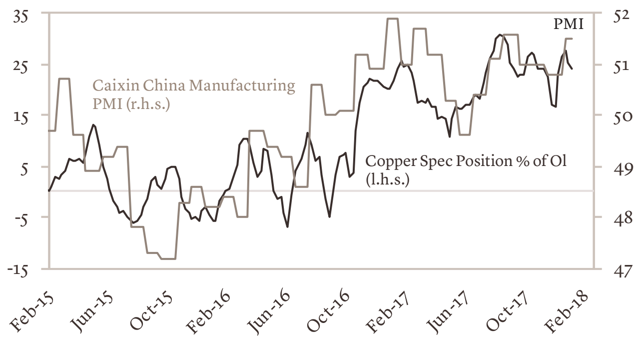


V. Stable oil rig count but higher productivity in the Permian basin



VI. Positioning is fully aligned with Chinese activity

Speculative positioning (% open interests)



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the short to medium term. **Financial constraints within OPEC (we estimate a production-weighted fiscal breakeven for OPEC around USD 65/bbl) and the need for a stable oil price for the Russian recovery to extend in an electoral year are likely to ensure high compliance among the main participants.**

Turning to the US, latest datapoints showed that shale production surged beyond the peak of 2015 (Chart IV). Admittedly, these strong figures may be partly attributable to a catch-up following weeks of post-hurricane shutdowns. Most of the additional supply came from a rise in rigs productivity (in the Permian basin for instance, Chart V) rather than from an increase in rig count. **We believe the US shale production will exceed 1Mb/d in 2018** – well above the 2011-2017 average (0.5 Mb/d), but below the 2014-2015 peak (1.4 Mb/d). It is worth mentioning that US shale companies hedge their output at a 12- to 24-month horizon and despite the current backwardation, futures contract levels are now close or above their marginal costs[1] – likely to prompt additional production. However, with US shale producers asked by shareholders to focus on free cash flow generation, financial discipline is key to the strategy of most US E&P, ultimately containing capex for the coming quarters.

As a result, our supply/demand estimates suggest that we are beginning the transition away from market oversupply, with the physical market moving into deficit (or at least being balanced) in 2018. Still, robust fundamentals are already priced-in to the extent that we do not see any catalysts for a well-entrenched upward trend (absent a sharp cut-off of Venezuelan production but for now a continued decline offset by other OPEC members' output seems the most likely scenario). Besides, the market seems to focus on the stability of the rig count rather than on the strong US supply figures for the time being. As such, current prices are subject to a downside risk in our view. **We thus expect oil prices to remain well-supported by fundamentals, albeit at lower levels (Brent at USD 64/bbl).** The US benchmark (WTI) should continue to trade at a discount compared to its European counterpart as moving oil from Cushing to the Gulf Coast has become more expensive on growing transportation constraints. Yet some new infrastructure projects should be completed soon, leading to a slightly tighter spread in the coming months.

Structurally, we think that US shale producers act as an anchor for oil prices at around USD 55/bbl in the long-term, warranting the backwardation of the curves. **This means that spot price returns might become limited. Investors wishing to maintain their long position over time should, however, enjoy a positive carry in 2018.**

Copper: Supply to be the main driver amid some China-fueled volatility.
Target 12M: USD 7500 /mt (vs spot USD 7085/mt)

Base metals shined in H2 2017, outperforming global equities and bringing copper and aluminium prices to levels not seen since the 2014 commodity sell-off. **As we believe that global economic growth is likely to remain strong in 2018, we expect base metals to continue to ride the cycle and perform well this year.** Since the start of the year, markets have been consolidating, giving way to idiosyncratic, metal-by-metal specific stories. Chinese economic activity, regulation and supply dynamics should move back to the fore.

[1] Bottom-up estimates for marginal costs point to a USD 52-59/bbl range, depending of the company and the wells location

In China, as policymakers shift focus to financial stability, some slowdown in the pace of economic growth is to be expected. Indeed, monetary conditions are becoming gradually tighter as exhibited in recent credit data. Given the dominance of Chinese demand in the metals space, it is difficult to avoid the issue.
The aggressive targeting of financial excesses has dampened domestic activity recently, **but robust foreign demand, along with surprisingly resilient infrastructure and housing construction, has lead us to believe there is enough momentum in the economy to sustain low 6% growth in the next few quarters**.

Looking forward, **we see limited downside risk to our baseline scenario as any material deceleration in headline growth to the 5% range would trigger a significant policy response**.

All in all, with the headline figure near to its recent peak, **we will keep a close eye on future PMI releases given the sensitivity of investors' positioning to this data** (chart VI). Short term, this newsflow could trigger some volatility episodes in the base metals complex. We would, however, see these as transitory and a tactical opportunity, given the dynamism of ex-China economic activity and our supply outlook.

On the supply side, China is also a key player for most base metals such that short-term physical balances are being affected by Chinese regulation (state-mandated factory closures and policies to protect the environment during the winter season). Inventories are already down from recent highs (Chart VII). **Medium term, supply might face physical constraints in some segments. Years of low investment in the non-ferrous metal sector are likely to translate into a market deficit and, in turn, price acceleration, especially in long-cycle commodities such as copper** (Chart VIII). Compared to history, the duration of disinvestment has been particularly long this time, leading to high levels of caution on the part of companies' management, despite current prices exceeding median cash costs.

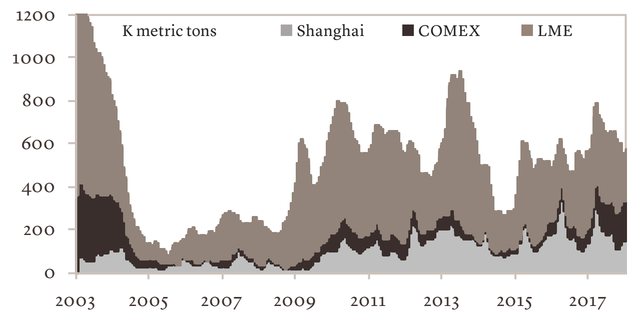
In our baseline scenario, global trade should remain supportive, while the USD will stay under pressure, suggesting another two-digit performance for copper in 2018. Against this backdrop, we revise our target up, expecting copper prices to be at USD 7500/mt by end 2018.

Gold: Weaker US dollar is supportive, but real rates to remain an anchor.
Target 12M: USD 1300/ounce (vs spot USD 1345/ounce)

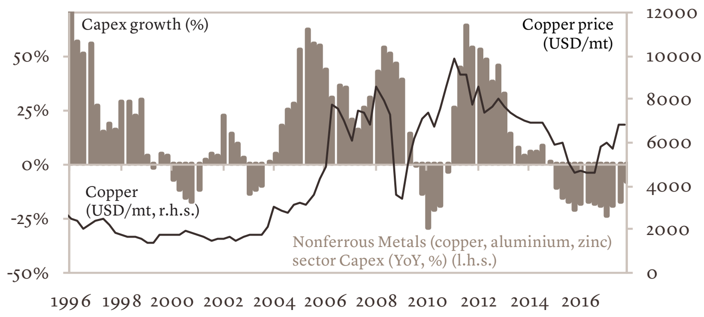
Gold is experiencing a strong rally, posting more than 10% gains since July last year. Initially triggered by receding geopolitical concerns, the upward trend has been reinforced more recently by the USD weakness across the board. Strikingly, this impressive move took place at a time when the US bond market was experiencing a sharp sell-off, pushing real rates up by 15 basis points.

We have long supported the view that gold prices should remain in a range, dictated by relatively low and stable US real rates (Chart IX). This outlook on rates is structural, influenced mainly by potential growth being below that of past decades (due to negative demographics and weak productivity). On a shorter-time horizon, we expect the US Federal Reserve (Fed) to pursue its monetary policy tightening – another factor that should prevent a surge

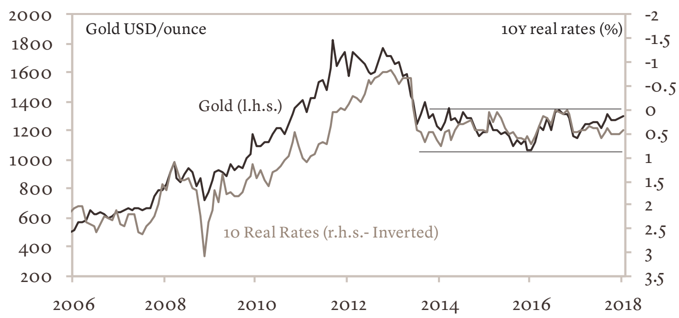
VII. Inventories on copper are trending lower



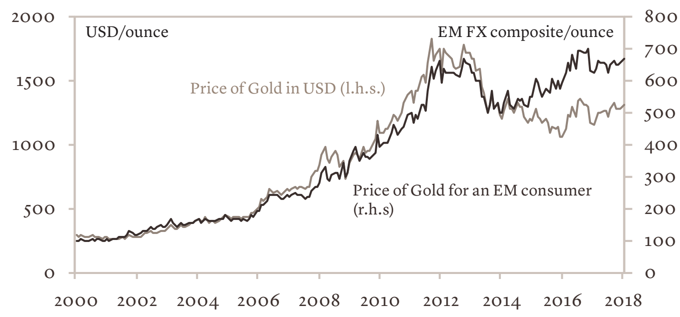
VIII. Under-investment over the past few years calls for higher prices



IX. Gold in the upper end of our range despite rising real rates



X. EM consumers benefit from weaker US dollar



Sources: DataStream, Lombard Odier calculations
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in gold prices, especially if the long-awaited bottoming out of inflation and wage growth data leads to further repricing of Fed action.

Interestingly, real rates, which had been the main driver over the past 18 months, are now less correlated with gold than the US dollar. A weakening USD environment, particularly against emerging markets currencies, is likely to fuel additional demand for gold (chart X). The latest datapoints confirm this: after several years in negative territory, jewellery consumption is accelerating in Brazil, China, Russia and Taiwan, certainly helped by a domestic and global cyclical pick-up.

Cross-asset relationships show that current levels of US real rates and USD suggest that gold might be slightly overvalued – or seems to price in some geopolitical risk. **We keep our neutral positioning unchanged, while raising our target to USD 1300/ounce to take into account the effect of a weaker US dollar going forward and, in turn, potential strengthening of emerging markets demand. Yet, in the absence of systemic risk (likely to further fuel financial demand), the medium-term anchor to real rates limits the upside**.

Sophie Chardon, Cross-Asset Strategist

Investment implications

On top of the fundamental analysis developed above, investment flows certainly offered strong support to the broad-based rally experienced in December and early January. Indeed, the rise in intra-commodities correlation suggests that allocation flows were at play, seemingly driven by inflation fears. After years of gloom, market sentiment seems to have changed for the better.

As such, we think it is worth maintaining an exposure to the asset class – despite expected returns having been reduced by the impressive price action witnessed last quarter. **With more risk on the upside** (given rising inflation or geopolitical risk) **than on the downside, the asset class looks interesting. Yet, for those who do not already have an exposure, stretched speculative positioning calls for caution in the short term as better entry points might arise over the course of the year**.

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

AMSTERDAM
Lombard Odier (Europe) S.A. · Netherlands Branch[2]
Herengracht 466 · 1017 CA Amsterdam · Nederland
amsterdam@lombardodier.com
Credit institution supervised in the Netherlands by De Nederlandsche Bank (DNB) and Autoriteit Financiële Markten (AFM).

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

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Suite 921 Europort · P.O. Box 407 · Gibraltar
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luxembourg@lombardodier.com

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Lombard Odier (Europe) S.A. · Sucursal en España[2]
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Lombard Odier (Europe) S.A. · Succursale in Italia[2]
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Bank Lombard Odier & Co Ltd · Representative Office Moscow
82 Sadovnicheskaya Street · 115 035 Moscow · Russian Federation · moscow@lombardodier.com
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PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France.
RCS PARIS B 803 905 157 · paris@lombardodier.com
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Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
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Lombard Odier (Hong Kong) Limited
Museum Tower, 7th floor · 4 Berkowitz Street · Tel Aviv 6423806 · Israel · telaviv@lombardodier.com
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MONTREAL
Lombard Odier & Cie (Canada), Limited Partnership
1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7
montreal@lombardodier.com
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NASSAU
Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
nassau@lombardodier.com
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Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá ·
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Lombard Odier (Singapore) Ltd.
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Lombard Odier Trust (Japan) Limited
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