CIO | VIEW

CIO Commodity Commentary

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DWS

OUR MONTHLY ANALYSIS AND OUTLOOK ON COMMODITIES

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IN A NUTSHELL

- In the short-term, we expect demand concerns to continue to drive oil prices more than supply disruptions. Strategically, we believe prices should gradually reach our 12-month forecast of $60 per barrel for WTI.
- We believe gold prices will remain range bound, with risk sentiment and U.S. dollar movements driving fluctuations.
- Delayed planting has significantly impacted agricultural prices. It looks set to reduce crop supply both directly and indirectly due to reduced incentives from the recent U.S. disaster relief bill.

May's sell off in the commodity markets has been quite harsh, by any standards. Take oil, for example. Naturally, the slump in oil prices leaves some scope for recovery. And maybe pigs might fly. With many geopolitical risks still lurking around the corner that deteriorating supply might, of course, end up providing some support for oil prices. However, the reasons for recent price weakness have not gone away and even supply disruptions might not change that. Neither the ending of waivers on imports of Iranian oil, nor the United States' tightening of sanctions on Venezuelan oil did much to support oil prices. Recent weeks have been dominated by the U.S.-China trade war. As a result, many attacks on ships for example on two Saudi-Arabian oil tankers near the geopolitically important Strait of Hormuz almost fade from the spotlight. Likewise, markets took little reassurance from the shortfall in Russia's production below the levels voluntarily agreed between the Organization of Petroleum Exporting Countries (OPEC) and allied countries such as Russia (OPEC+). And this time around, the over-compliance to the OPEC+ agreement was actually far from voluntary. The Russian cutback was primarily driven by contaminated crude oil on the Druzhba pipeline – the world's longest oil pipeline carrying oil from Russia to Europe. And Russia was not the only contributor to the increased compliance with the OPEC+ agreement in May. Kazakhstan also produced less than expected, due to field works, while Saudi Arabia continued to stick to its commitment. We will closely watch the outcome of the next OPEC meeting on June 25 and 26 as it remains a major downside risk to oil prices. But just two weeks before the planned meeting members are juggling to find a new date as Russia is trying to push the meeting date. But rather than being an administrative issue it is representative of a deeper Iran-Saudi schism in light of attacks near the Strait of Hormuz.

More though than supply uncertainties, we believe demand concerns are tactically driving oil prices. First and foremost, the intensification of the trade war between the United States and China contributed to the sharp decline in front-end oil future prices. And consequently, an anticipated economic slowdown – as a result of the trade war – depressed oil prices. The outcome of the U.S.-China trade war is essentially a binary event "which is rapidly approaching the point at which both parties might not be able to find face-saving compromises any time soon," according to Johannes Müller, Head of Macro Research [Quarterly CIO View – Macro 6/7/19]. The provisional resolution between the United States and Mexico, however, was a little more predictable due to the high interdepend-

ency between both countries and the immediate devastating effects punitive U.S. tariffs on imports from Mexico would have had. The eventual outcome of the U.S.-China trade war looks a lot harder to predict. Weakness in oil-demand data is already materializing and can only be amplified by an adverse outcome of the trade war. Consequently, we expect high oil-price volatility in coming weeks, mainly driven by demand concerns. In addition, it is worth noting that the relationship between oil and the dollar has tended to be inverse over the past 15 years. Therefore, a stronger dollar might well hurt oil in the current risk-off environment.

Strategically, however, we believe that supply-side drivers will eventually reassert themselves. Whereas rising U.S. shale-oil-production growth and rising U.S. inventories are pointing to excess supply, geopolitical risks and OPEC+ supply cuts justify prices to gradually reach our 12-month forecast of $60 per barrel for West Texas Intermediate (WTI) [CIO View Quarterly – Forecast 6/3/19]. On the demand side, the same could contribute to lower albeit solid economic-growth forecasts.

The trade turmoil also runs like a common thread through the base-metals space. Prices for aluminum, copper and zinc have all been heading downward over the past 30 days. Of course, trade and geopolitical risks have also been good news for some – including shinier metals. Gold has set itself apart from the laggards. It breached the threshold of $1,300 per ounce as of 5/30/19. We expect, however, gold prices to remain range bound as movements look set to be dominated by risk sentiment and dollar movements. U.S. Federal Reserve (Fed) Chairman J. Powell stated lately that the Fed was "closely monitoring the implications of [trade-war] developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2% objective."[1] In light of the economic weakness, many market participants interpreted this as a dovish signal. Heightened rate-cut expectations fuelled by Powell's recent statement, however, might weaken the dollar further and support gold prices. A downside risk to our 12-month gold forecast of $1,315 per ounce is that the trade conflict weighs on the dollar. In our latest 12-month EUR/USD forecast, we have confirmed 1.15 as our strategic target. In the short-term, however, the uncertainty around the trade-war outcome might limit further dollar weakening. In turn, this should limit the upside potential of the gold price.

While base metals and oil stumbled during the past 30 days, agriculture outperformed the broader commodity market. In contrast to oil, it is not demand but supply shortfalls that dominated and a trend we expect to continue to dominate price movements within the agricultural space. Keep in mind that demand for basic agricultural goods and livestock tends to be relatively inelastic to price changes. So, what happened the past month and how might prices evolve? Prices in the past month were at various points strongly influenced by the trade war and flooding across the Plains and Midwest of the United States. The bad weather, in turn, contributed to deteriorating supply.

The recent United-States-Department-of-Agriculture (USDA) report showed severely delayed planting. This was especially true of corn and soybeans and has continued to aggravate concerns regarding a potential shortfall of expected crop yield (i.e. lower production per acre, even where and when planting these crops takes place). Persistent rain has severely limited U.S. farmer's ability to plant with current corn planting progress at 58%, about six standard deviations below the 5-year average of 90%. Similarly, soybean planting is behind at 29% vs. the 5-year average of 66%, which is about 2.9 standard deviations below. And while China announced to delay purchasing U.S. soybeans and soybean demand generally has been lower due to the spread of the African Swine Fever (ASF)[2], planting delays continue to outweigh demand concerns.

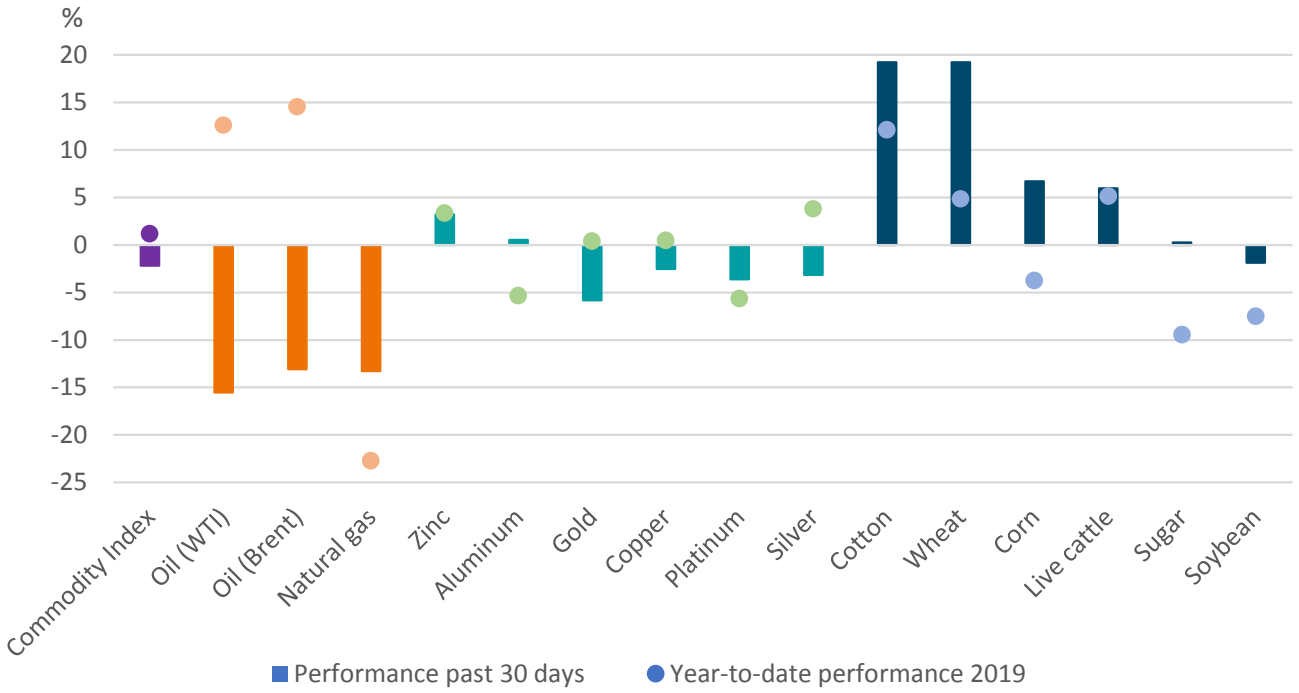
The delayed planting is significant for two reasons. First, the later grains are planted the greater the impact of subsequent adverse weather conditions on crop yield. Second, while the disaster-relief bill with $4.5 billion for the USDA is intended to support farmers, it may also take away the incentives for some farmers to plant at all. The bill explicitly states that "crops prevented from planting in 2019"[3] shall be covered under given conditions up to a certain percentage. Some farmers might use the bad weather as an excuse not to plant, abiding by the mantra: "A bird in the hand is worth two in the bush." Consequently, low

[1] Source:https://www.nytimes.com/reuters/2019/06/04/business/04reuters-usa-fed-powell.html as of 6/4/19
[2] African Swine Fever is a highly contagious viral disease of wild and domestic pigs.
[3] Source: https://www.congress.gov/bill/116th-congress/house-bill/2157/text?q=%7B%22search%22%3A%5B%22HR+2157%22%5D%7D&r=1&s=7 as of 6/12/19

planting coupled with low inventory looks set to amplify the upside potential for grain prices.

Likewise, supply shortages have been pushing up pork prices. These higher prices have been caused by among others, the ASF. And as the total demand typically is less sensitive to gross-domestic-product (GDP) growth, China – the largest pork consumer – will be forced to tap international markets. Therefore, we believe that there is upside potential for the pork price.

PAST 30-DAY AND YEAR-TO-DATE PERFORMANCE OF MAJOR COMMODITY CLASSES



Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 6/13/19

GLOSSARY

Dove
Doves are in favor of an expansive monetary policy.

Gross domestic product (GDP)
The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Organization of the Petroleum Exporting Countries (OPEC)
The **Organization of the Petroleum Exporting Countries (OPEC)** is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

U.S. dollar (USD)
The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

Volatility
Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

West Texas Intermediate (WTI)
West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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