ICBC Standard Bank

What’s in the price?

Cross-commodity investor positioning – 10th April, 2019

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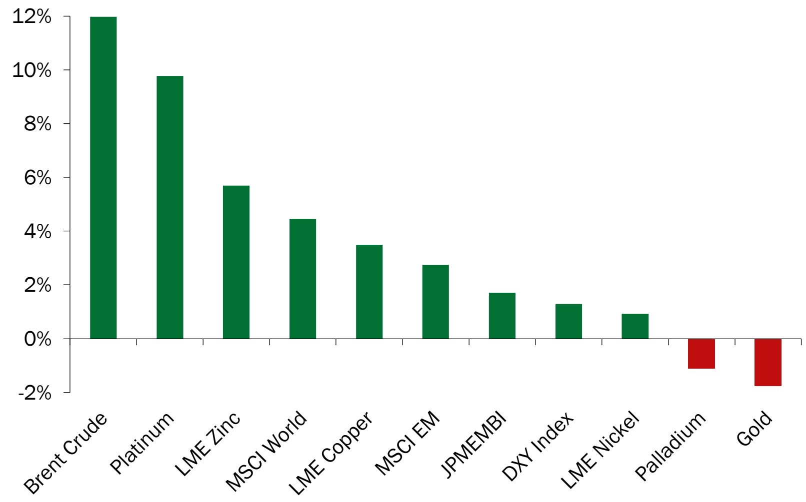
Summary Points

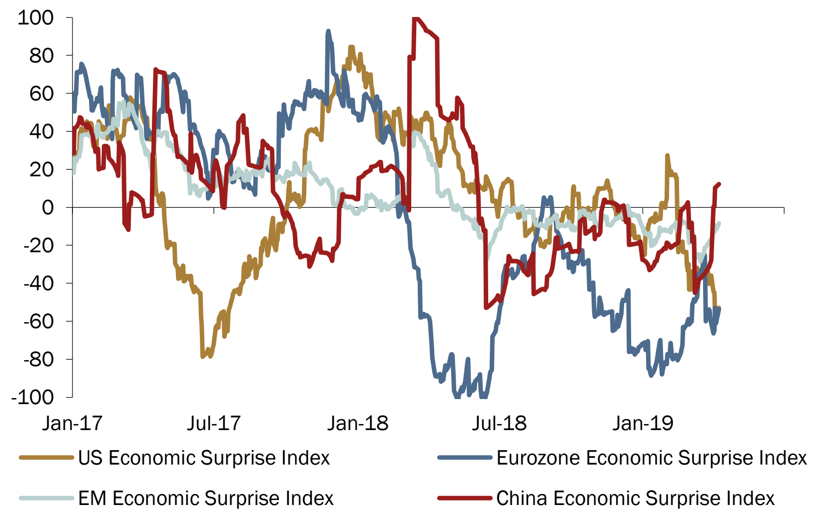
- In-line with other risk assets, commodities have broadly enjoyed a period of strong price performance since our last positioning update at the start of February[1].
- For industrial metals, which lack the supply narrative of crude oil, we continue to view this move as driven more by improving sentiment than tightening fundamental balances.
- That said, as detailed in our recent Base Metals Outlook[2], for many of the metals we do expect fundamentals to improve over the course of the year. Principally because of our relatively constructive outlook for Chinese demand.
- In which context, it is worth noting that the China macro surprise index – showing actual data vs. expectations – has broken back above zero in recent weeks.
- Looking at positioning, only zinc clearly exhibits material investor length, while the rest of the metals range from moderately long to moderately short. Even palladium's length is now greatly reduced after its recent price correction.
- If the much anticipated US-China trade deal is soon concluded and Chinese growth indicators continue to pick-up in-line with our expectations, an increasingly benign short-term macro backdrop should encourage the return of investor length to industrial metals and provide a tail-wind for higher prices.
- Naturally, this leads us to look for bullish opportunities across the complex but, given the still present tail-risks – such as a disorderly break-up of US-China trade negotiations, we think risk-reward is generally better found away from outright prices.
- Regarding gold, we remain short-term neutral, expecting it to continue trading within its recent range. In essence, this mirrors our relatively neutral US Dollar view. Nevertheless, with shorts building in silver, relative value opportunities may soon emerge.

Price performance since February 5th



Source: ICBC Standard, Bloomberg, CME, ICE, LME, LBMA, LPPM, DCE

China surprise index in positive territory but RoW still struggling



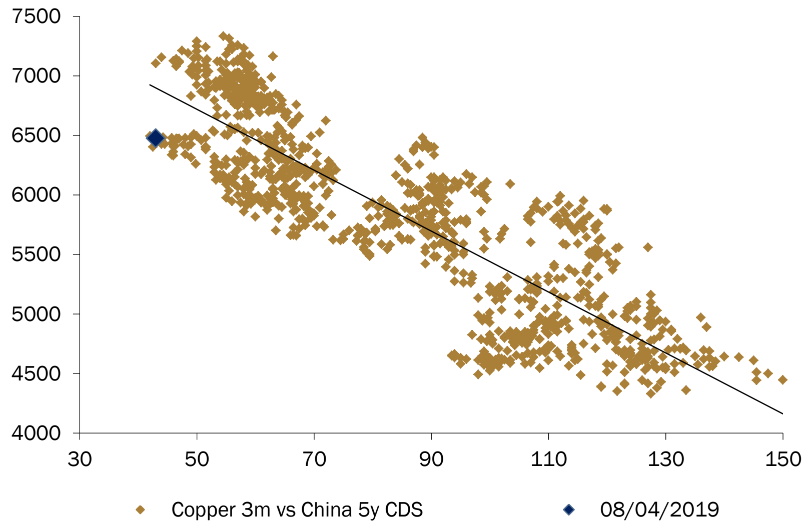
Source: ICBC Standard, Bloomberg, Citi

1 & 2: https://www.icbcstandardbank.com/CorporateSite/ResearchStrategy/Reports

Copper – Biding its time

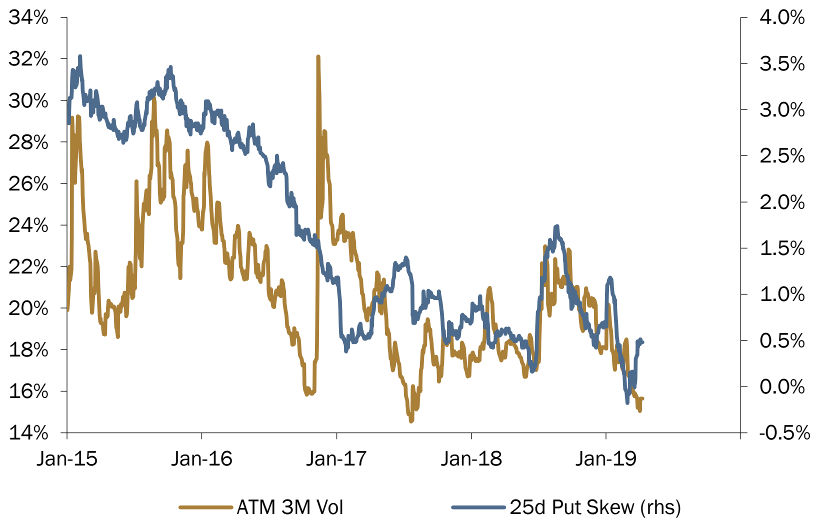
- Copper has been trapped in a relatively narrow $6,300 - $6,550 range over the past few weeks. As a result of its failure to break higher, it has lagged the rally in other China sensitive assets, while realised and implied volatility have also compressed.
- In part, attempts to break higher have been capped by recent LME inventory inflows, which have also resulted in a softening of the forward curve.
- If our view on China's demand is borne out, we expect onshore inventories to draw at least in-line with seasonal norms, the import arb to re-open and then ex-China inventories to move lower.
- This should lead to a re-tightening of spreads and higher outright prices. As a hedge to this view, we note that near-dated puts are currently cheap by historic standards.

Copper has lagged the recent rally in China sensitive assets



Source: ICBC Standard, Bloomberg, LME

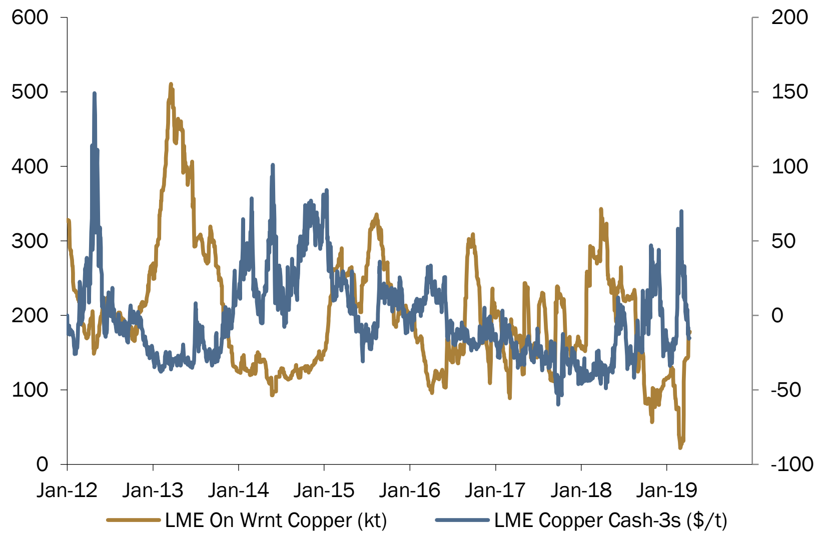
Volatility subdued and put skew* compressed



Source: ICBC Standard, Bloomberg, LME

*Skew: Referring here to the difference in implied volatility between an at-the-money option and a 25 delta put

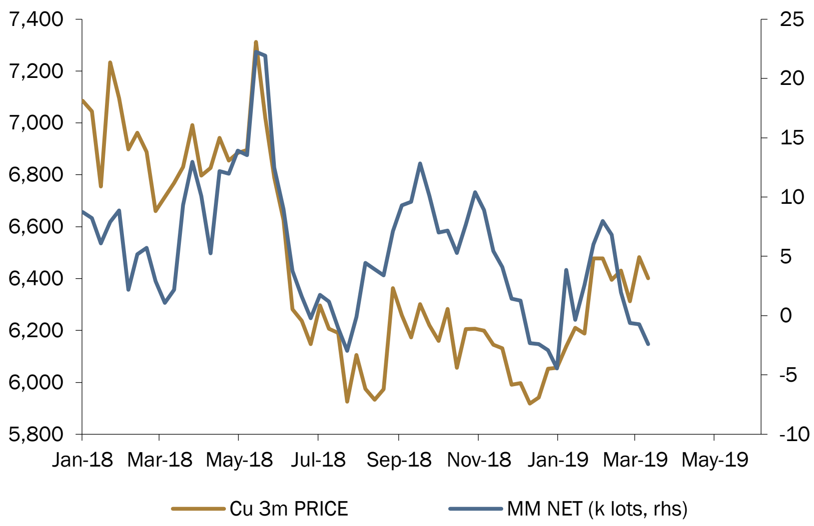
Spreads have eased in the wake of LME deliveries



Source: ICBC Standard, Bloomberg, LME

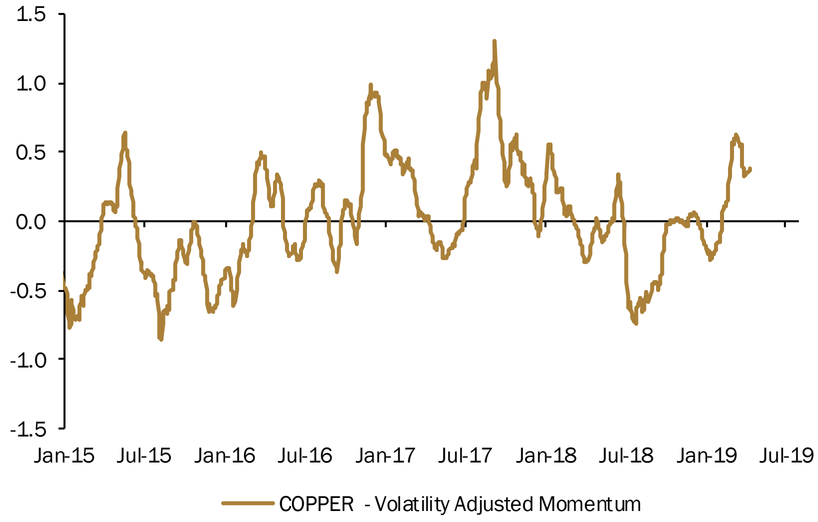
Copper

Overall investor positioning still muted



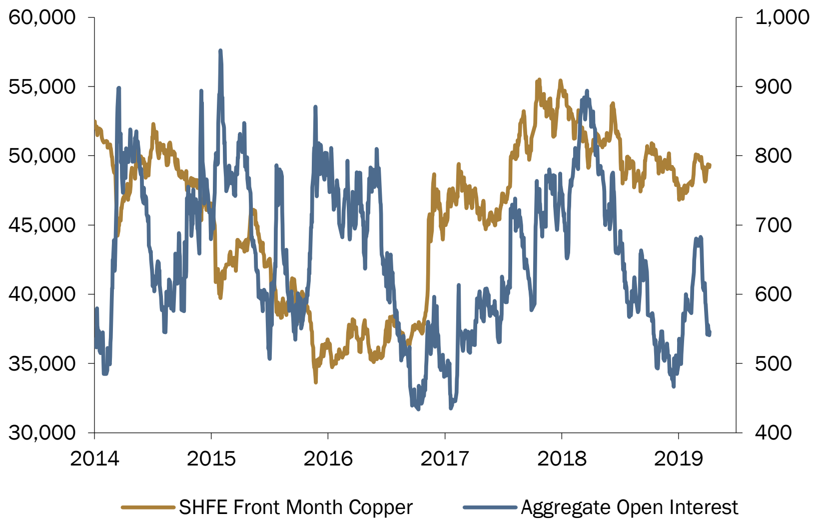
Source: ICBC Standard, Bloomberg, LME

With CTAs likely to have added but not yet become stretched



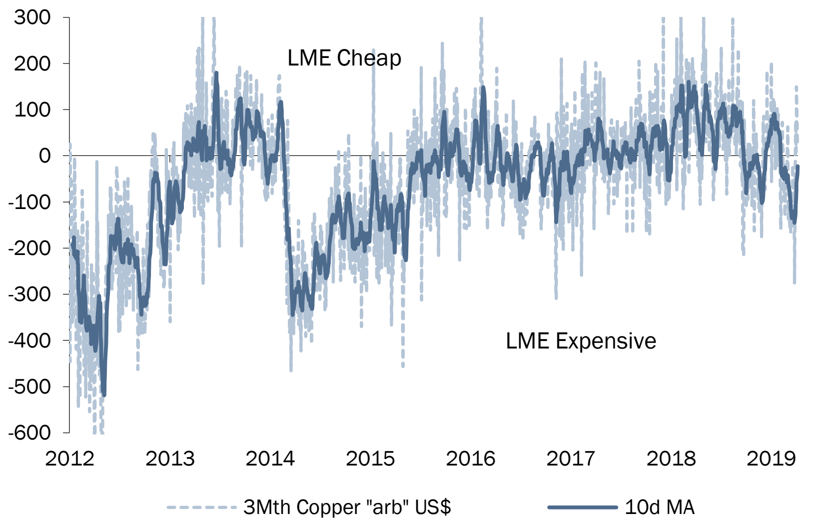
Source: ICBC Standard, Bloomberg, LME

SHFE positioning subdued



Source: ICBC Standard, Bloomberg, SHFE

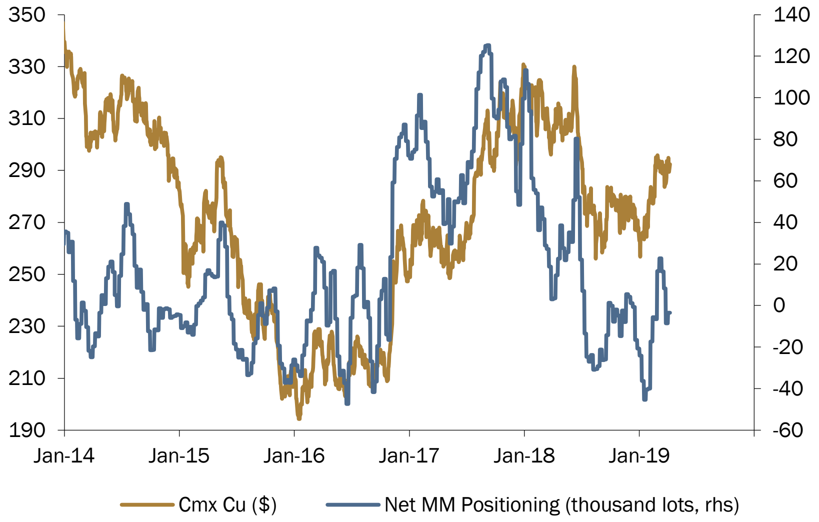
With the "arb" just re-opening as tax cuts are digested



Source: ICBC Standard, Bloomberg, LME, SHFE

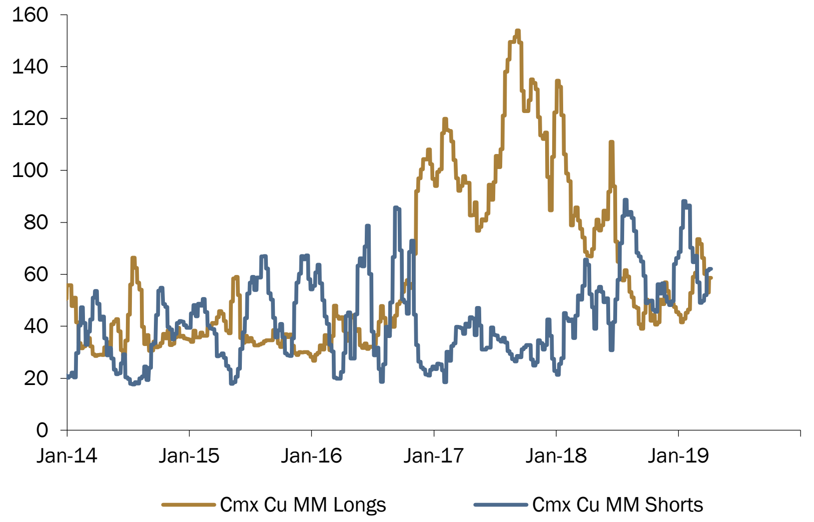
Copper

Comex net-investor positioning relatively muted



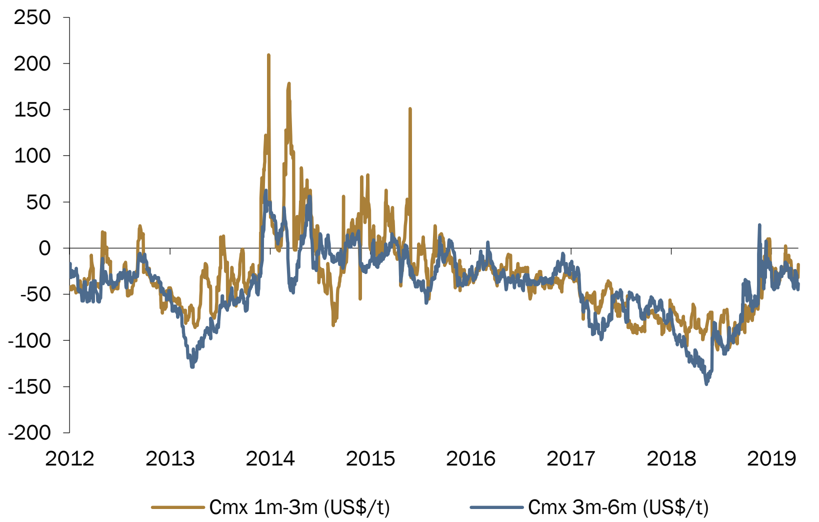
Source: ICBC Standard, Bloomberg, LME

With shorts having covered and length to build



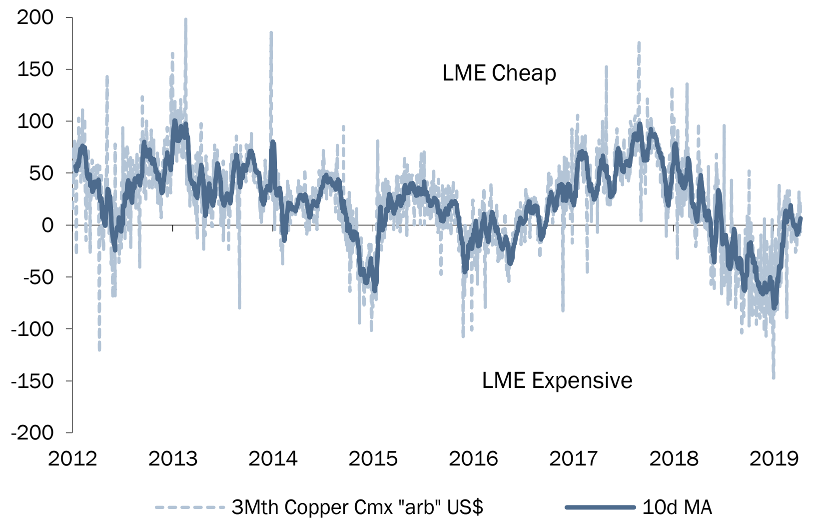
Source: ICBC Standard, Bloomberg, CME, CFTC

Comex spreads tightening on falling inventory but yet to flare out



Source: ICBC Standard, Bloomberg, CME

Systematic buying likely closing the Comex discount to LME

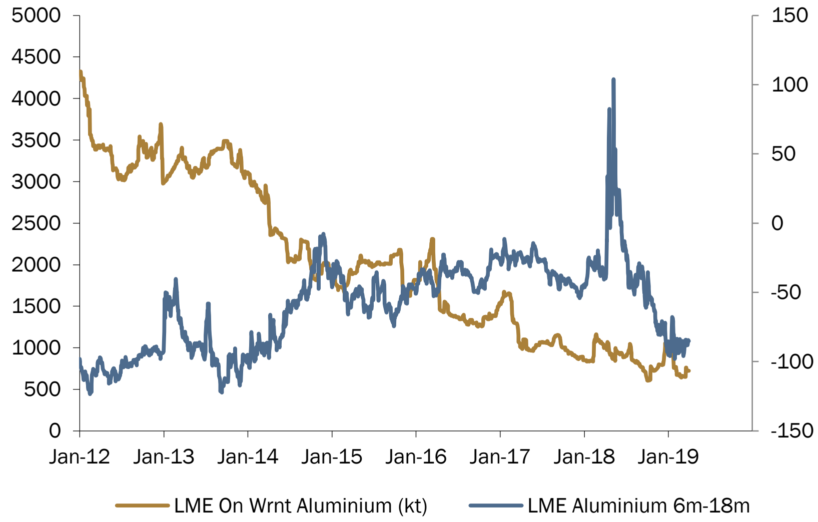


Source: ICBC Standard, Bloomberg, LME, CME

Aluminium – Between a rock and a hard place

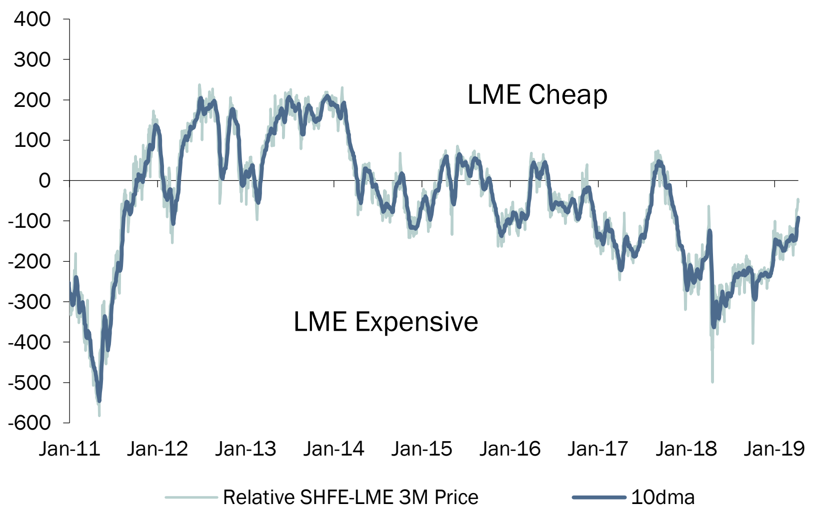
- Since the unwind of post-Rusal sanction tightness, the aluminium market has been stuck between an ex-China deficit and continued exports of Chinese semis.
- We do not see this situation changing in the immediate future and thus expect aluminium prices to continue their under-performance of risk assets, while volatility is also expected to remain subdued.
- That said, compared to prices, volatility and stocks, the forward curve now looks loose.
- As LME inventories continue to draw, we therefore view borrowing spreads – as an implicit option on periodic curve tightness – as better risk-reward than outright or options positions.

Spreads have retreated to pre-Rusal sanction levels



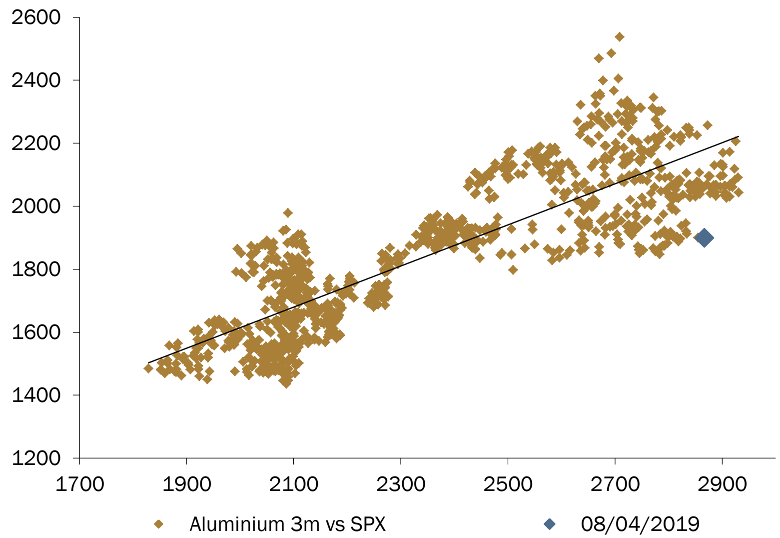
Source: ICBC Standard, Bloomberg, LME

China export "arb" narrowing but remains open



Source: ICBC Standard, Bloomberg, SHFE, LME

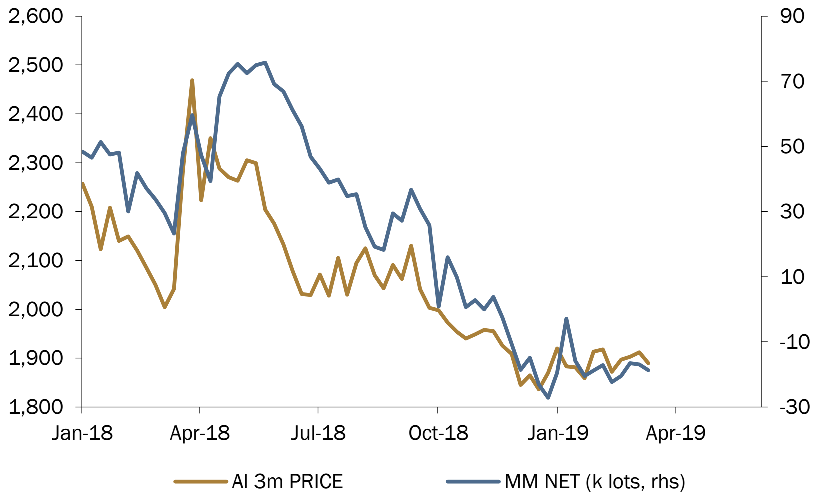
Aluminium has under-performed risk assets



Source: ICBC Standard, Bloomberg, CME

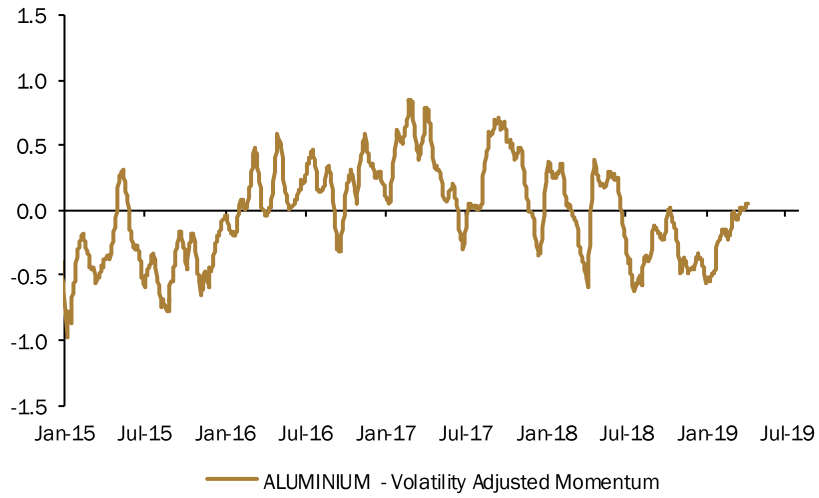
Aluminium

Investor positioning still net short



Source: ICBC Standard, Bloomberg, LME

But momentum funds have likely covered back to flat

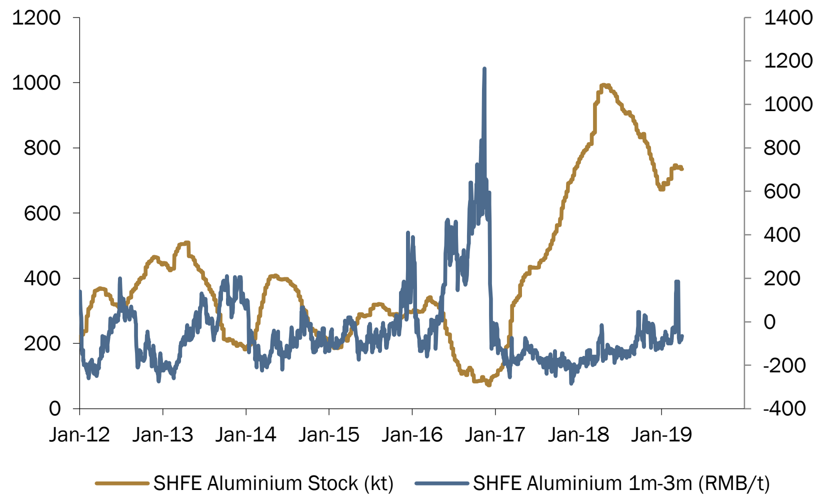


Source: ICBC Standard, Bloomberg, LME

SHFE exposure lacking clear direction

Source: ICBC Standard, Bloomberg, SHFE

And spreads suppressed by elevated stock levels

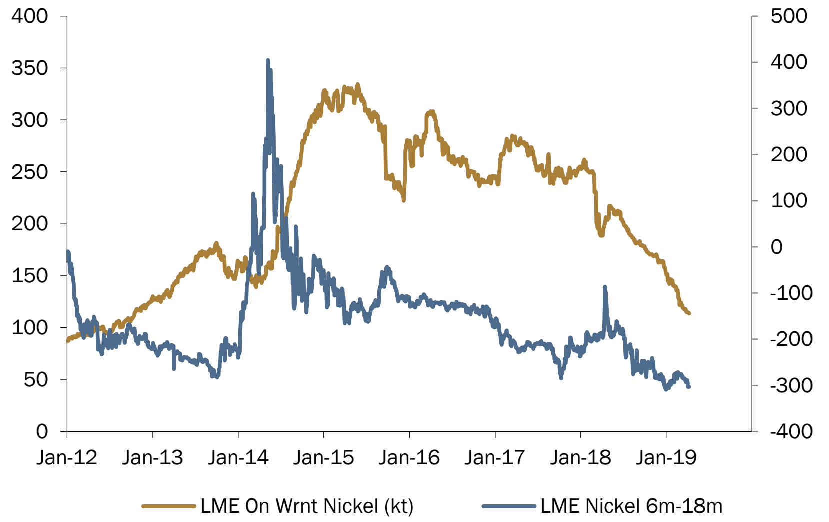


Source: ICBC Standard, Bloomberg, LME, SHFE

Nickel – Wide contango despite continued erosion of LME stock

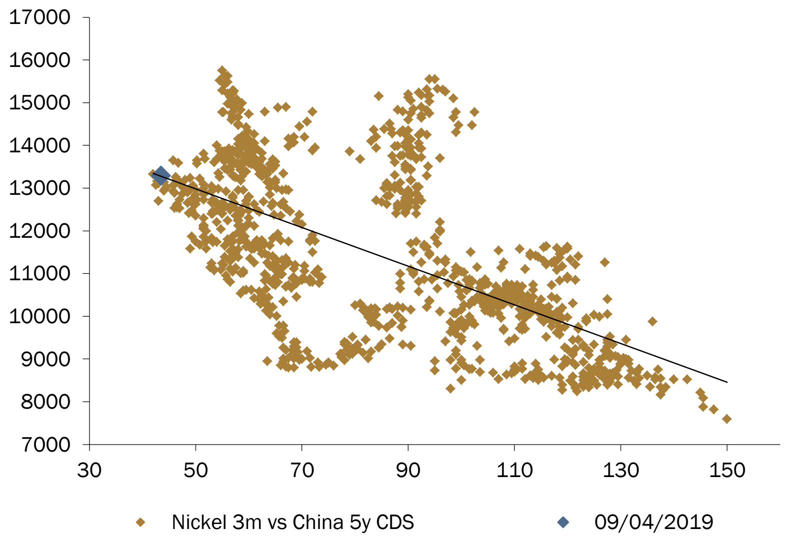
- Benefitting from the gradual addition of LME length and SHFE short covering, Nickel's rally has kept pace with the move in wider risk assets.
- Spreads, however, have remained subdued. In our view, this is a result of forward buying related to battery manufacturing.
- At the same time, LME stocks have continued to draw at a steady pace. If this persists, it creates the potential for a significant shift in the shape of the forward curve.
- Indeed, historically, the curve has swung from contango into dramatic backwardation when stocks have moved below 50kt.
- Although outright prices were significantly higher when this last occurred before the financial crisis, the market was also c.45% smaller, so equivalent stocks/use levels will be reached at higher absolute inventory levels.

LME inventory continuing to draw



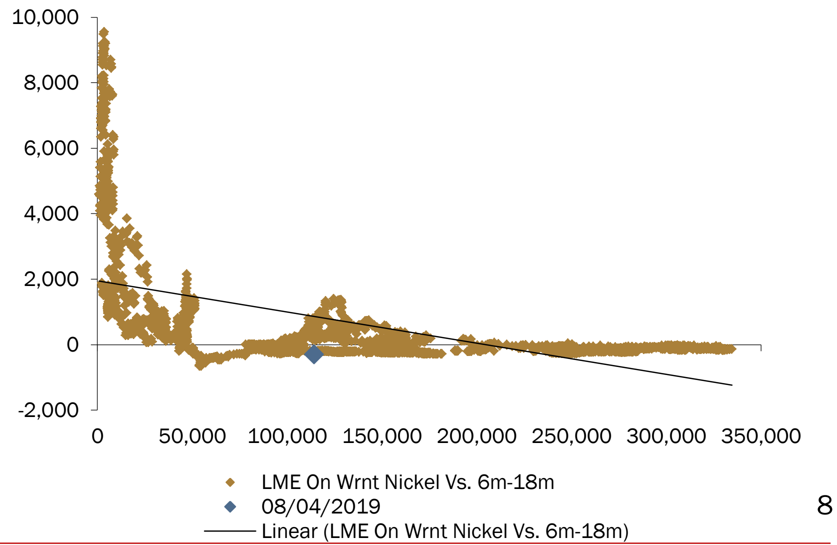
Source: ICBC Standard, Bloomberg, LME

Outright performance in-line with China sensitive assets



Source: ICBC Standard, Bloomberg, LME

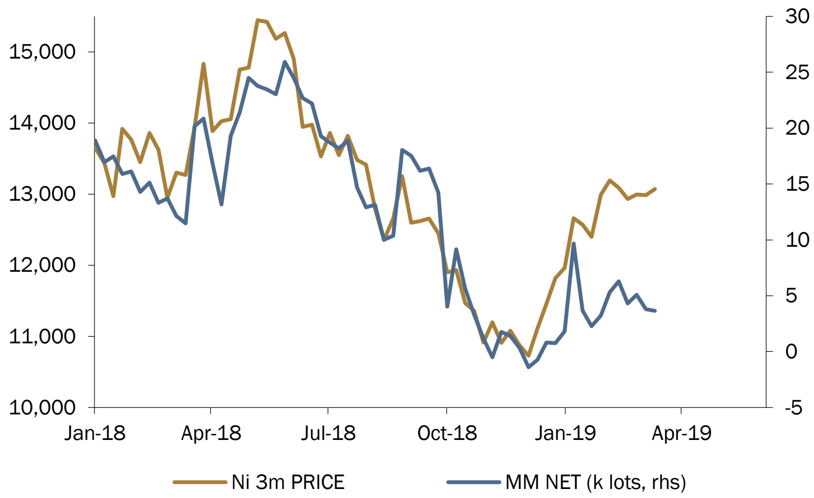
Historically, backwardations have flared out as stocks dwindle



Source: ICBC Standard, Bloomberg, LME

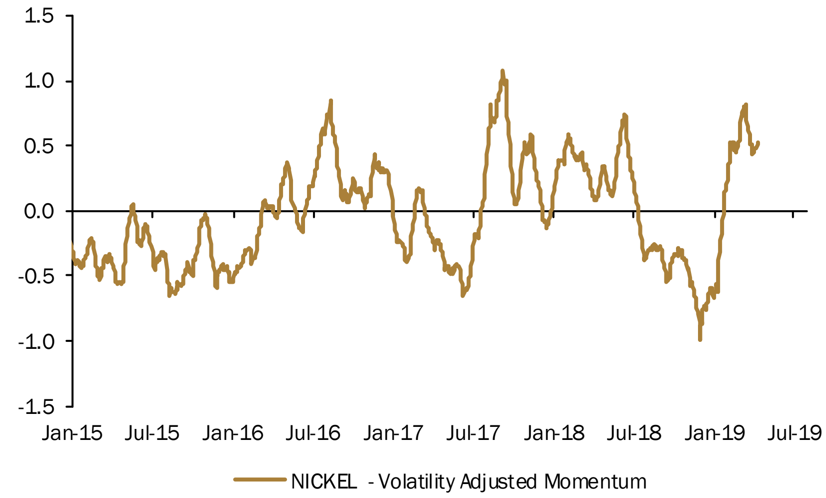
Nickel

Investor positions have picked up but not surged



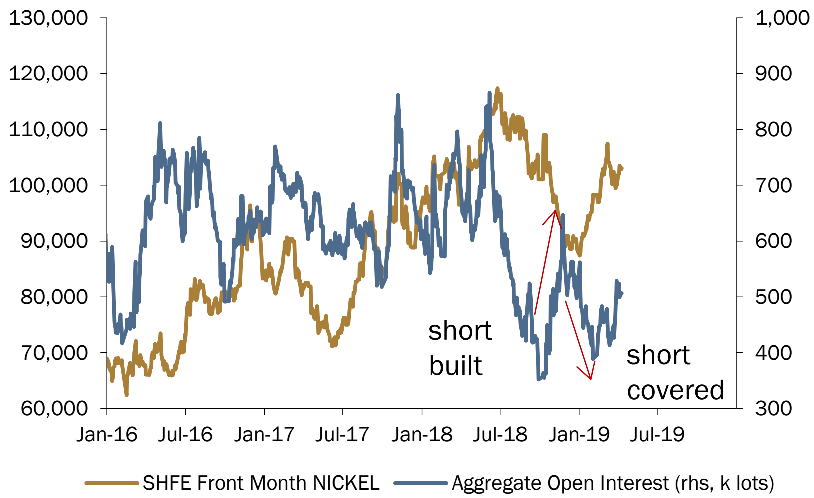
Source: ICBC Standard, Bloomberg, LME

With much of the buying likely systematic in nature



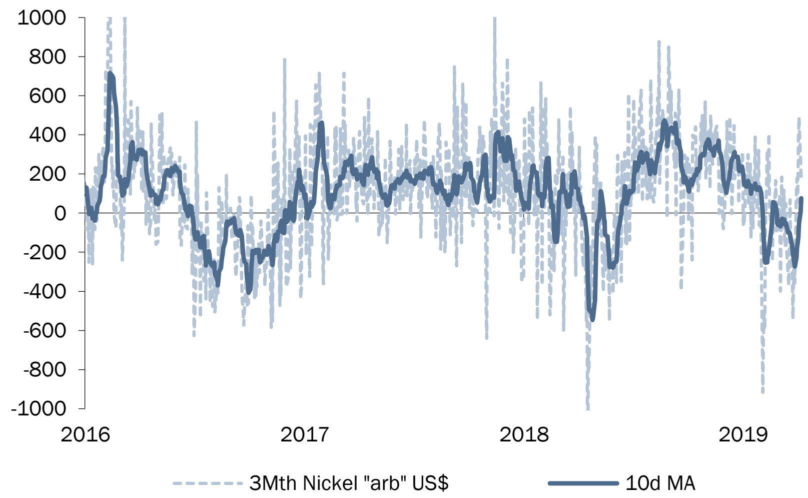
Source: ICBC Standard, Bloomberg, LME

SHFE position yet to rebuild



Source: ICBC Standard, Bloomberg, SHFE

"Arb" re-opening post VAT cut enactment

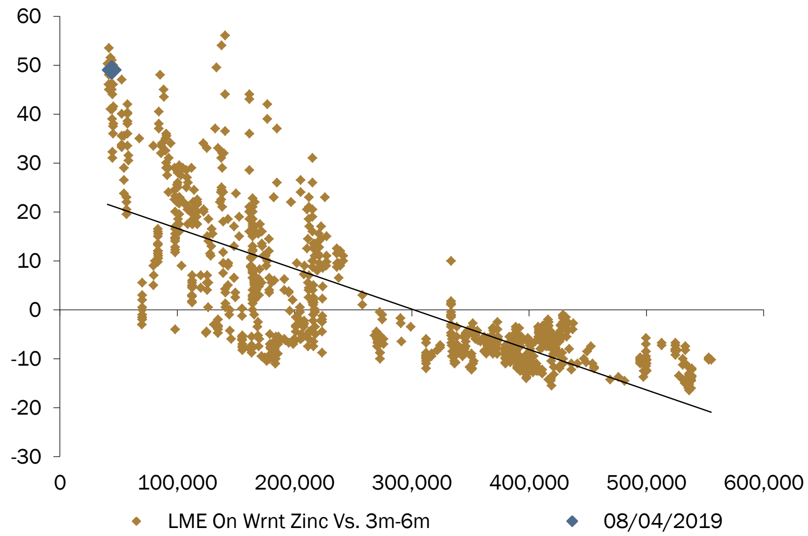


Source: ICBC Standard, Bloomberg, LME

Zinc – Spreads have moved but volatility has not

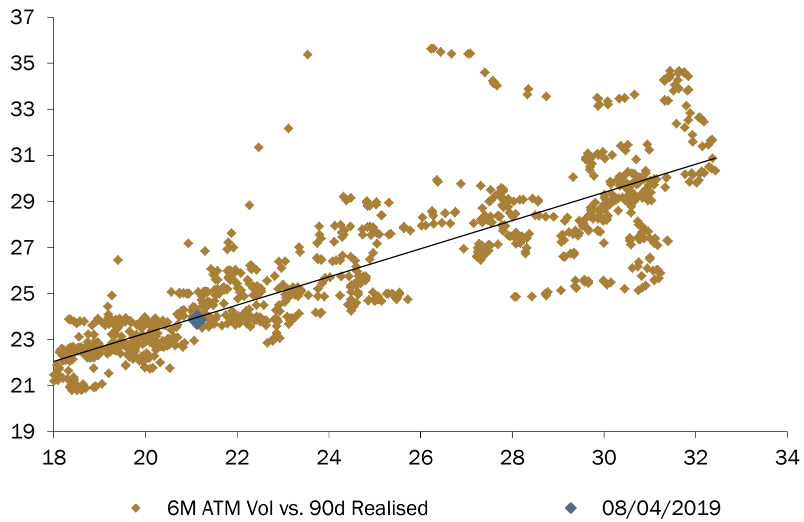
- In stark contrast to Nickel, dwindling Zinc stocks have resulted in a significant tightening of the forward curve.
- On an outright basis, zinc also has outperformed the complex in recent weeks and is the only base metal which appears to contain significant investor length.
- To date, this move has been relatively orderly, with realised volatility holding in the mid-20s and implied volatility following suit. The skew around this is generally to the downside, with increased put skew in longer-tenors. From a flow and fundamental perspective this is understandable, with the refined market likely to loosen into 2020.
- In the near-term, however, we think both implied volatility and call skew under-price the potential for a sharp move higher if exchange stocks approach zero and backwardations temporarily become extreme.

Sharp backwardation, with exchange inventory on its lows



Source: ICBC Standard, Bloomberg, LME

Implied and realised volatility still in-line



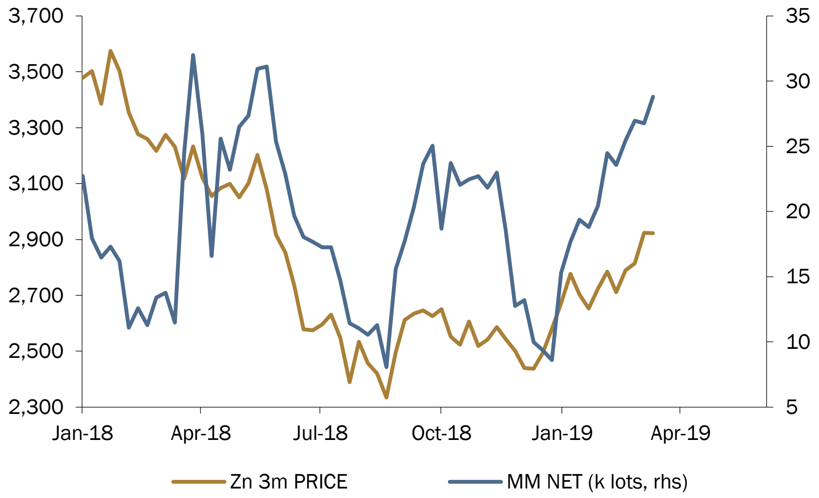
Source: ICBC Standard, Bloomberg, LME

In absolute terms, volatility remains subdued

Source: ICBC Standard, Bloomberg, LME

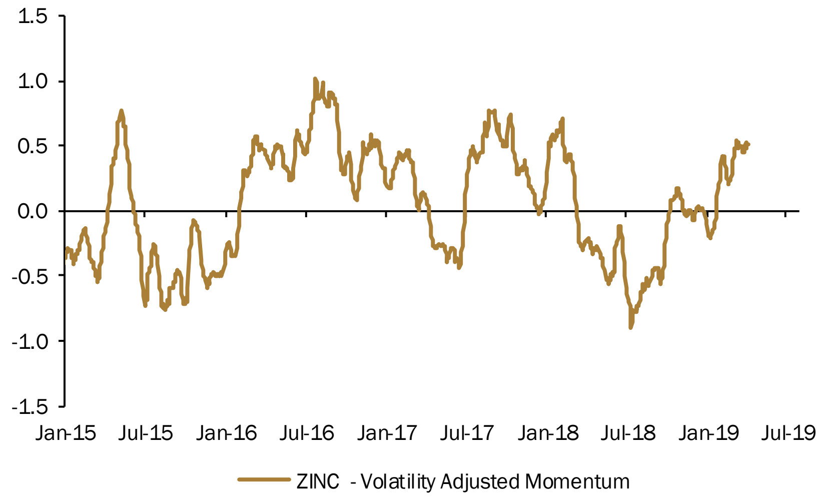
Zinc

Investor length picking up materially



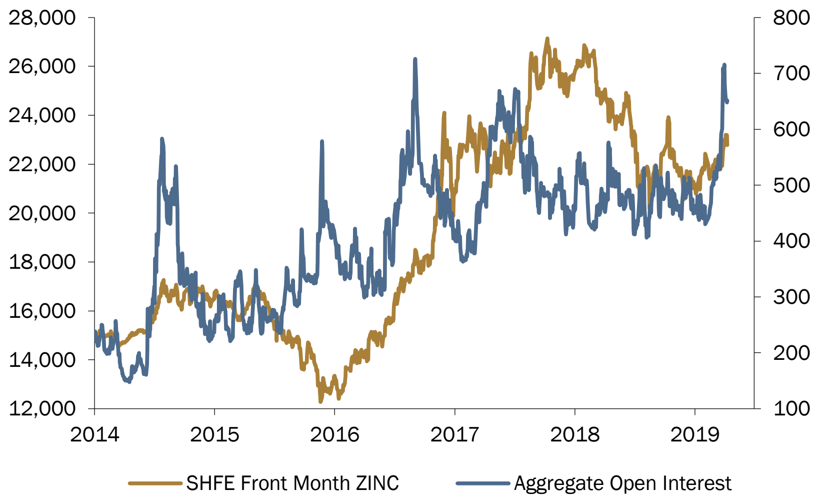
Source: ICBC Standard, Bloomberg, LME

With CTAs likely building length



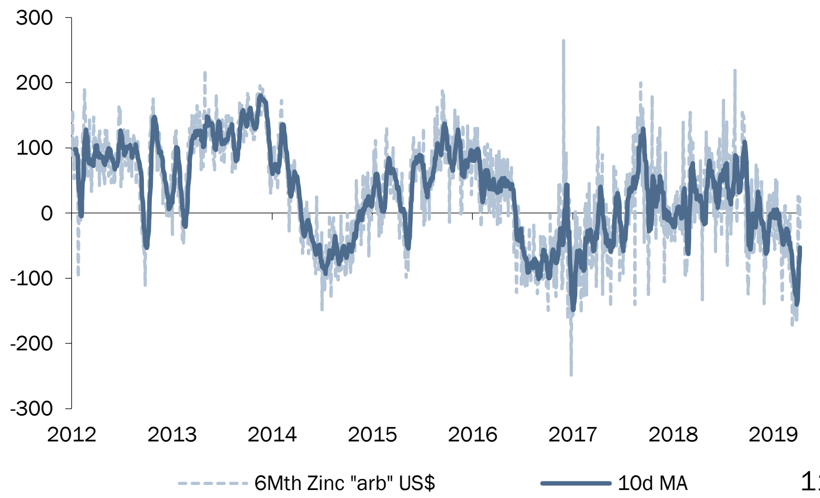
Source: ICBC Standard, Bloomberg, LME

Large SHFE positions but without clear direction



Source: ICBC Standard, Bloomberg, SHFE

LME has run ahead of SHFE but VAT cut bringing them into line

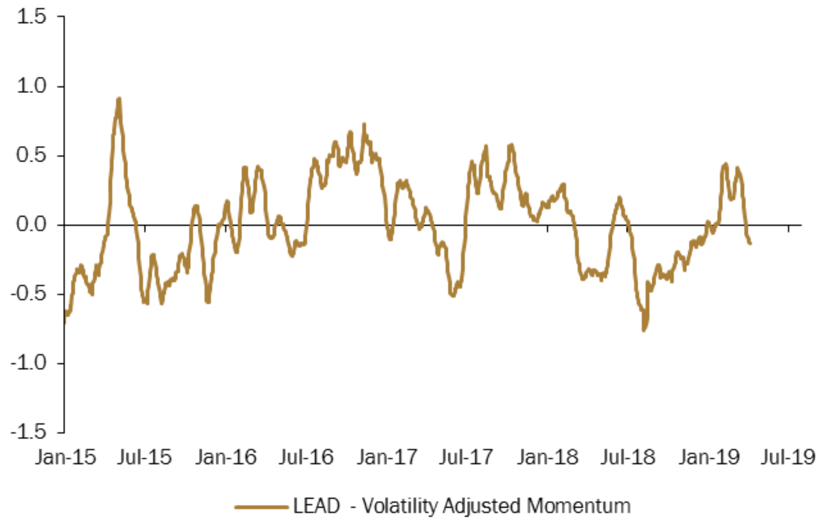


Source: ICBC Standard, Bloomberg, LME, SHFE

Lead – Short positioning could present contrarian opportunity

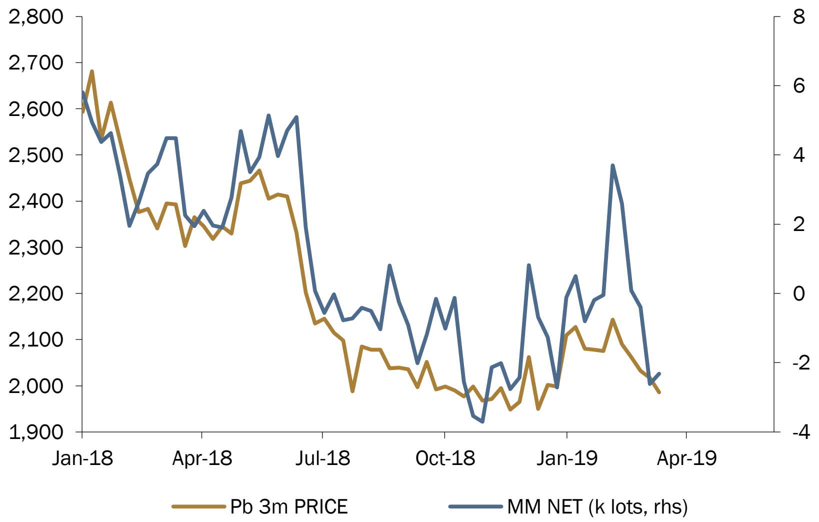
- Fundamentally, the lead market is struggling for a narrative, with a balanced supply-demand outlook driven by limited growth on either side of the equation.
- From a positioning perspective, however, it is the only LME market where we believe material shorts have been placed and momentum indicators suggest that systematic selling is likely to persist.
- This should push the China import "arb" open and see metal begin to move onshore.
- If short positioning were to become stretched, this would create a contrarian opportunity to position for a short-covering rally.

Momentum breakdown likely leading to CTA selling



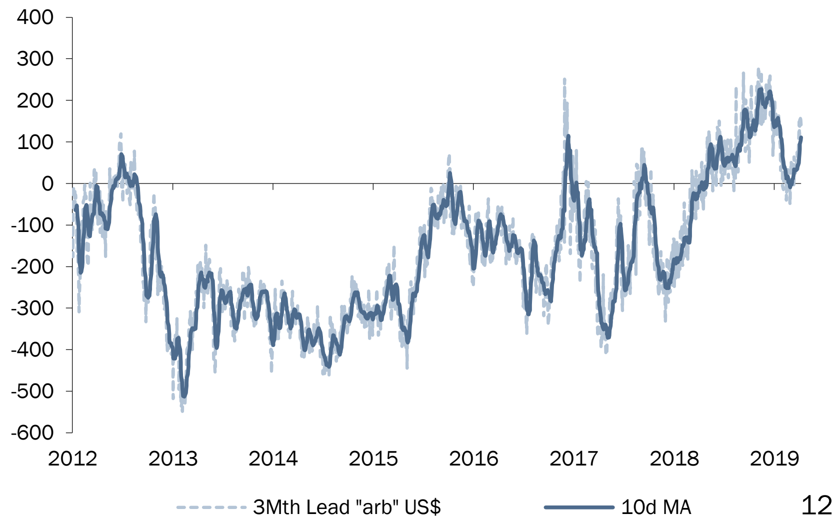
Source: ICBC Standard, Bloomberg, LME

With overall investor positioning now net short



Source: ICBC Standard, Bloomberg, LME

But "arb" re-opening, creating potential for China to pull metal

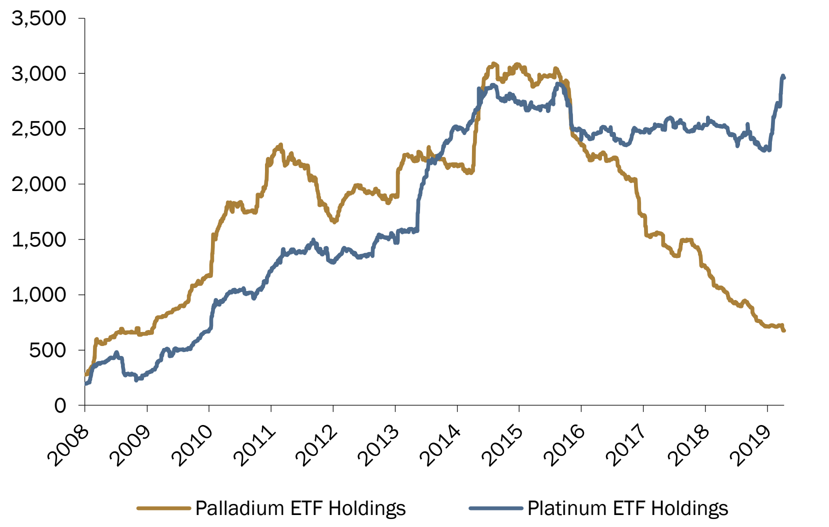


Source: ICBC Standard, Bloomberg, LME, SHFE

PGMs – The end of the trend or a bump in the road?

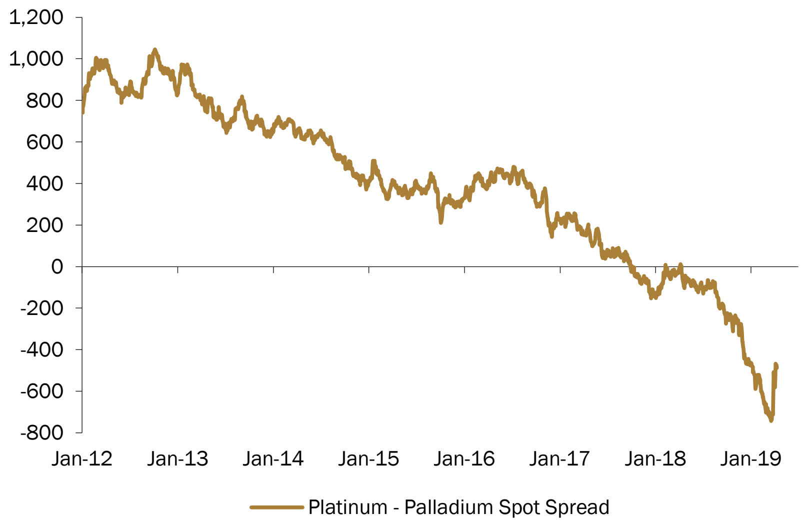
- Palladium's outperformance of platinum has witnessed a dramatic reversal since Anglo American CEO Mark Cutifani commented that palladium prices were a bubble.[1]
- In terms of positioning, investors have made substantial additions to Platinum ETFs and covered shorts in the futures market. By contrast, palladium ETF holdings have continued to drift lower – providing an important source of marginal physical supply – and futures length has been cut, with momentum investors likely have significantly reduced their positions.
- Despite this, little has changed fundamentally and we continue to view substitution in catalytic converters as an incremental multi-year process rather than something which will occur either immediately or in wholesale fashion.
- Once palladium futures exhibit a material short position, as they did in summer 2018, it should present an opportunity.

Pt ETF holdings surge, while Pd liquidations continue



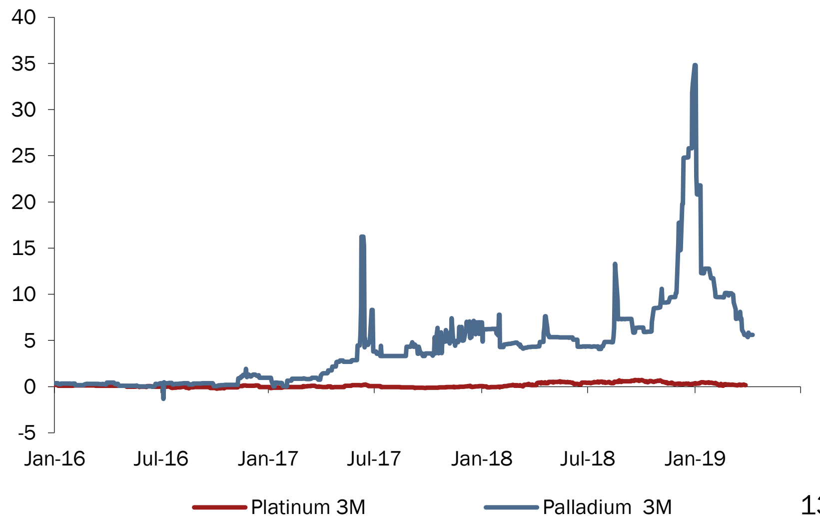
Source: ICBC Standard, Bloomberg

A sharp snap-back in the Pt/Pd ratio but is a turning point?



Source: ICBC Standard, Bloomberg, SHFE

Indicative three-month PGM lease rates – Pd still tight

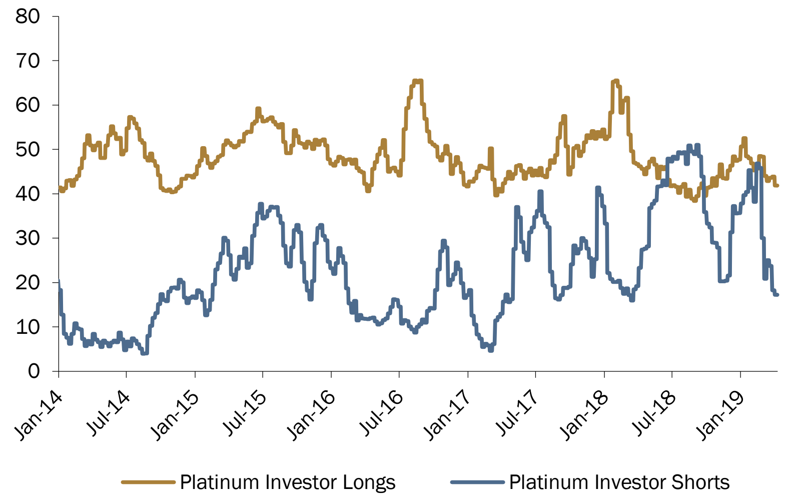


Source: ICBC Standard, Bloomberg, LPPM

1: https://www.ft.com/content/b638b628-5074-11e9-b401-8d9ef1626294

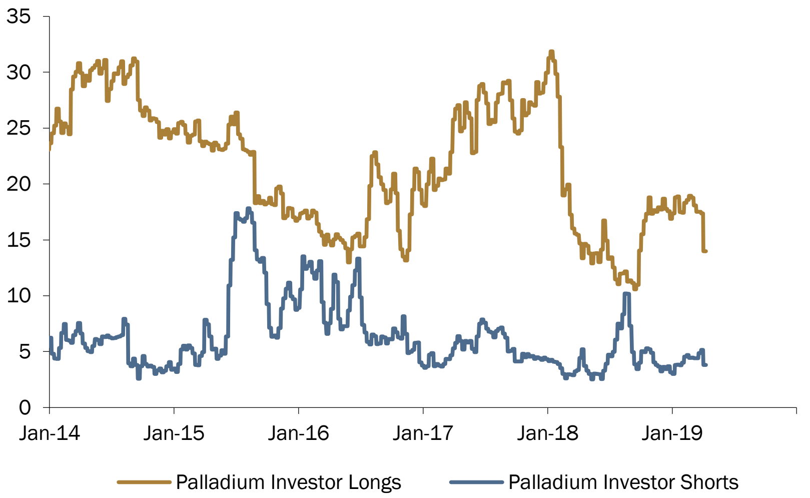
PGMs

Significant investor short-covering in Platinum



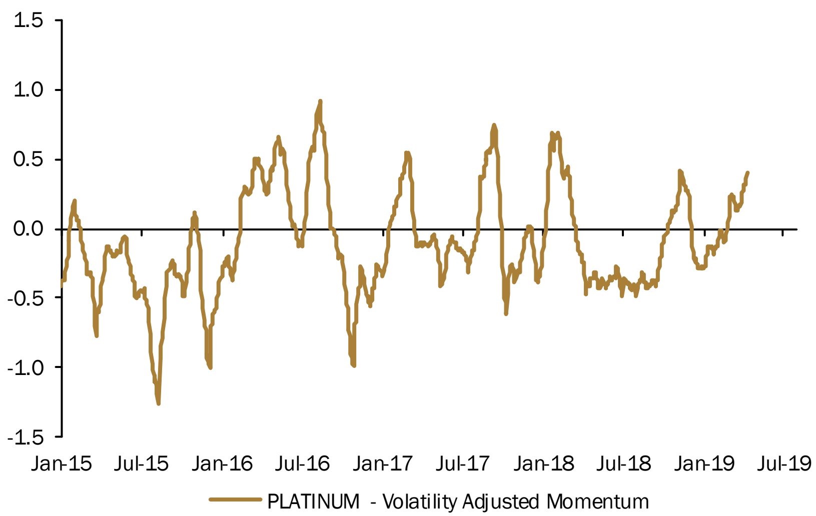
Source: ICBC Standard, Bloomberg, CME, CFTC

Compared to length liquidation in Palladium



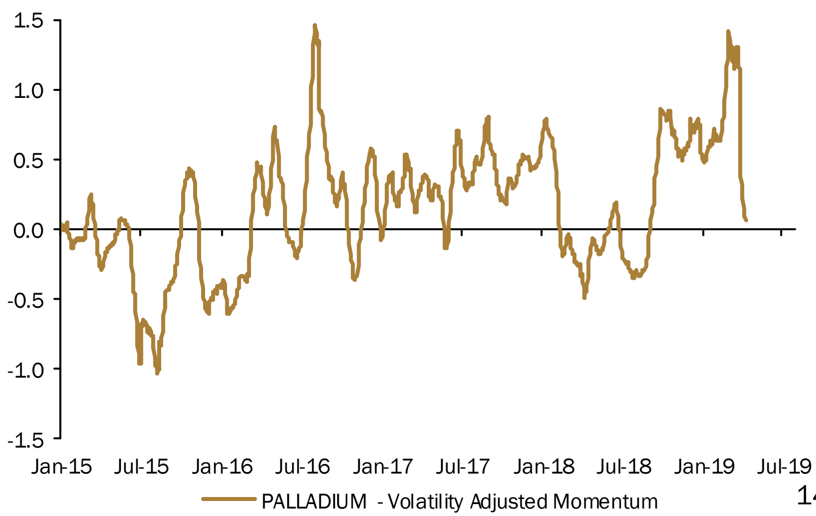
Source: ICBC Standard, Bloomberg, CME, CFTC

CTAs beginning to build length in Platinum



Source: ICBC Standard, Bloomberg, CME

Compared to a rapid exit from Palladium



Source: ICBC Standard, Bloomberg, CME

Gold & Silver – Some defensive assets more equal than others

- Gold prices have been stuck between a dovish FOMC and relatively firm risk asset performance. Indeed, its short-term relationship with real US yields has broken down, with FX, equity and bond markets pulling gold in different directions.

- Accordingly, shorts have been covered but only tentative length added. Momentum driven positioning is also likely to be around neutral.

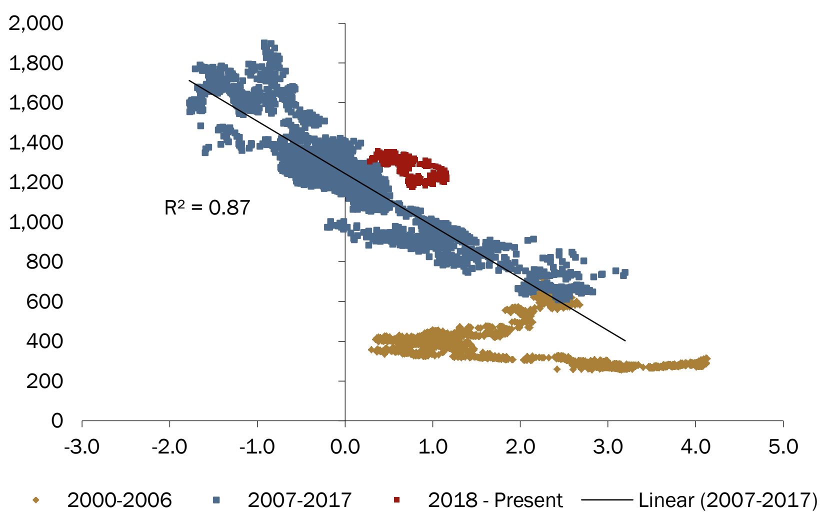
- By contrast, silver's lacklustre performance is again seeing shorts added, with momentum funds also likely to have turned sellers.

- In the short-term, we see few fundamental reasons why this cannot continue but, with the gold / silver ratio around historic wides, there could be a contrarian opportunity if silver positioning becomes stretched.

Gold/Silver ratio trading to decade wides

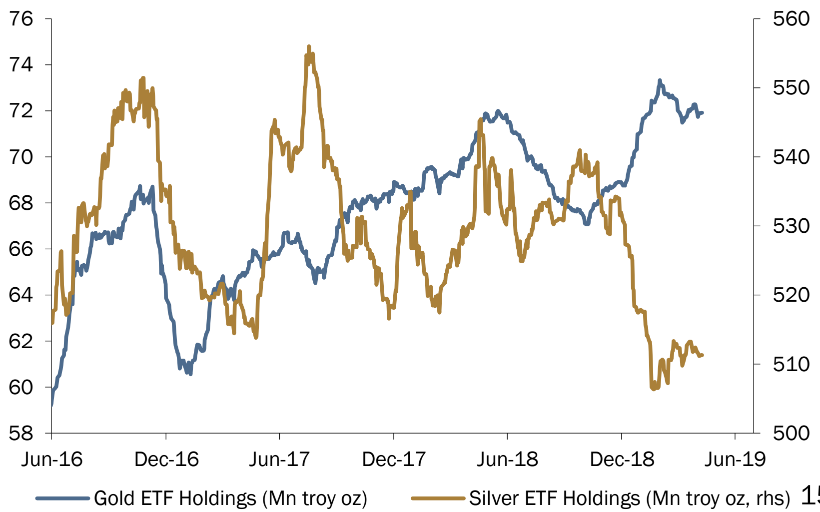
Source: ICBC Standard, Bloomberg, CME

US 5yr Tips (% yield) vs. Spot Gold (US$/oz)



Source: ICBC Standard, Bloomberg, CME

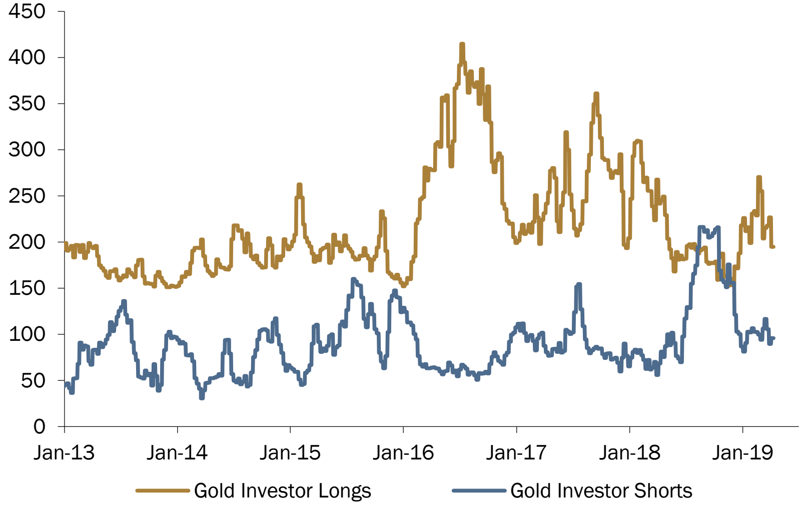
Steady Gold ETF positioning after Silver cut around turn of year



Source: ICBC Standard, Bloomberg

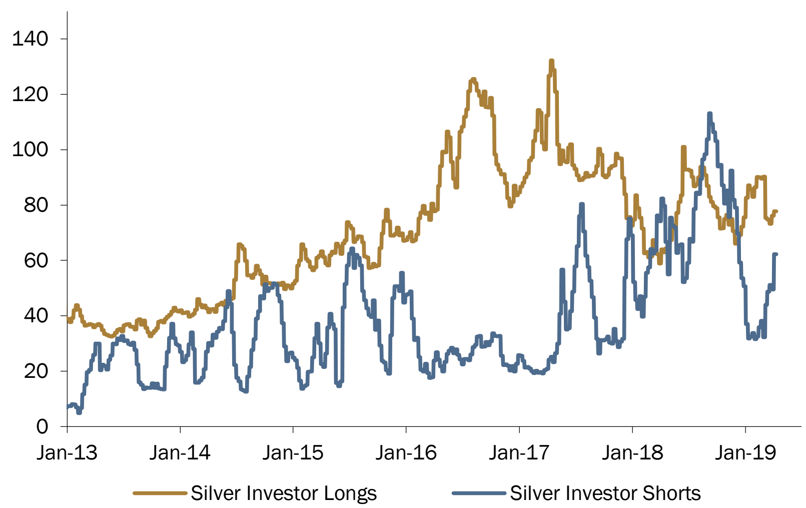
Gold & Silver

Neutral investor positioning in gold



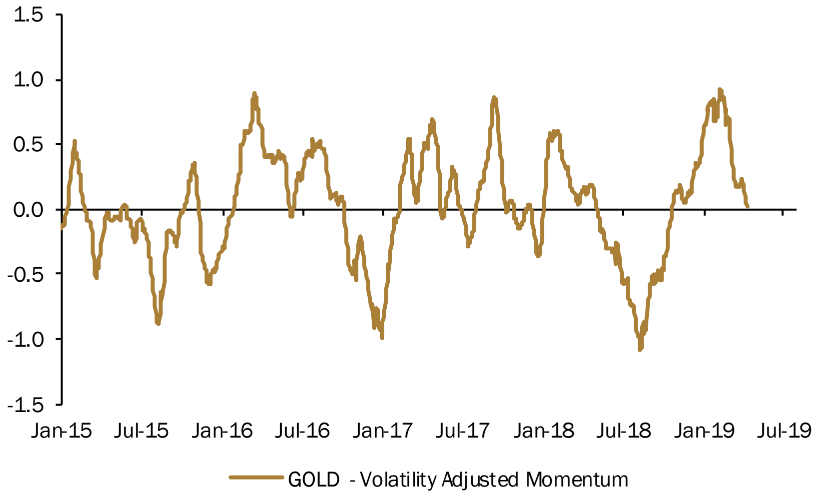
Source: ICBC Standard, Bloomberg, CME, CFTC

Shorts rebuilt in silver



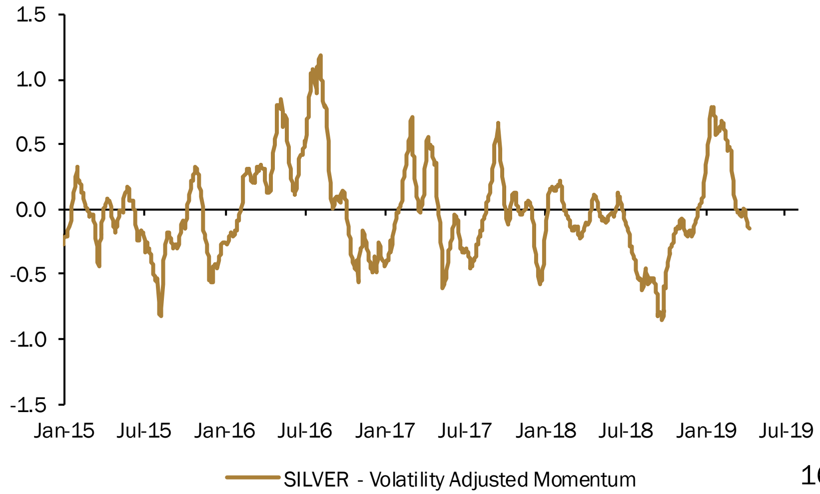
Source: ICBC Standard, Bloomberg, CME, CFTC

CTAs likely to have liquidated gold length



Source: ICBC Standard, Bloomberg

And now running short silver



Source: ICBC Standard, Bloomberg, CME

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