COMMODITIES: INFLATION IN FOCUS AS GOLD BULLS GATHER STRENGTH

BY OLE HANSEN

Gold has the potential for real long-term strength on the back of geopolitical uncertainty and an elevated risk of correction in risky assets.

Commodities in general are benefiting from an increased focus on inflation as the current expansion cycle moves toward its late stage, where price pressures tend to build. Commodity index investors have pushed the Bloomberg Commodity index to an 18-month high, while the energy-heavier S&P GSCI has reached a 27-month high.

With crude oil representing 39% of the exposure in the S&P GSCI and 15% in the BCOM, any demand from index investors has been benefitting crude more than most other commodities.

The global oil market is currently moving towards a healthier balance between supply and demand. This was especially helped by the December 2016 decision by Opec and Russia to curb production in order to clear the glut that had developed following rapid non-Opec production growth between 2011 and 2014. Strong demand driven by the current synchronised global growth and several supply disruptions during the final quarter helped lift the price well above levels previously seen as possible during this phase of the recovery.

In our view, however, the job is not yet done and the November's decision to extend the original output cut agreement to the end of 2018 with a review in June was the clearest sign of the challenge that still lies ahead.

With Opec and Russia having promised to keep production capped, the three key questions that are likely to determine the price of oil in 2018 are the production response to higher prices (not least from US shale oil producers), the potential from new supply disruptions, and the continued strength of the global economy.

Another year of robust global demand growth in the region of 1.5 million barrels/day (the December average of estimates from Opec, the International Energy Agency, and the Energy Information Administration) is expected to be met with a rise in non-Opec supply of 1.4 million b/d.

The shortfall of just 0.1 million b/d, if realised, risks slowing or even reversing the rebalancing process.

BARRING ANY GEOPOLITICAL UPSETS, THE RECORD OIL LONG HELD BY FUNDS AT THE BEGINNING OF 2018 COULD POSE A POTENTIAL CHALLENGE TO THE CURRENT BULLISH MOMENTUM

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What can go wrong? Barring any geopolitical upsets, the record 1 billion barrel oil long held by funds at the beginning of 2018 could pose a potential challenge to the current bullish momentum. A seasonal slowdown in demand from motorists and refineries should see storage levels rise during the first quarter. We also have some concerns about the Chinese economy in 2018 that ultimately could lead to lower-than-expected demand growth.

Given the impact on the price of oil of a few hundred thousand barrels per day in changed supply or demand, we see the risk – especially during the coming months – skewed to lower prices, with Brent crude oil at risk of returning to $60/b.

By year-end we see Brent crude at $60/b with WTI three dollars lower at $57/b.

Renewed geopolitical risks (of which we have had plenty during the second half of 2017) are likely to be the key source of support and one which could upset our call for lower prices during the first quarter of 2018 – particularly President Trump's demand that the Iran nuclear deal shall be rewritten within six months with extra demands added.

After almost hitting our year-end target of $1,325/oz last year we maintain a bullish outlook for gold into these early stages of 2018. The dovish December 13 Federal Open Market Committee rate hike and the US tax reform agreement both helped signal another low point for gold with inflation once again emerging as a key driver for gold support.

BY YEAR-END WE SEE BRENT CRUDE AT $60/ BARREL.

Following the strong rally, a correction and subsequent rejection to the downside is probably what the market now needs to create the foundation required to push the price higher to and potentially beyond key resistance at $1,375/oz.

Our bullish sentiment derives from the belief that inflation will receive increased attention as it moves higher, while geopolitical risks remain elevated with the market disliking the uncertainty created by the unpredictability of the US president. Investors are likely to continue to seek tail-end protection against the increased risk of a correction in other asset classes, particularly stocks and bonds but potentially also cryptocurrencies.

Our trade idea for Q1 is to be long gold against WTI crude oil. Gold's recent underperformance relative to oil has seen the ratio slump to 20.7, a 30-month low. We favour using WTI over Brent given the lower cost (backwardation) of holding a short position in WTI.

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Ole Hansen joined Saxo Bank in 2008 and has been Head of Commodity Strategy since 2010. He focuses on delivering strategies and analyses of the global commodity markets defined by fundamentals, market sentiment and technical developments.