PRICE MOVEMENTS
AND SHIFTING GLOBAL FLOWS

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The period from October 2015 to September 2016 featured solid economic growth and market uncertainties.

Our latest fiscal year was marked by significant price movements and quite a few surprises. China grew more strongly than most analysts had predicted; the Federal Reserve chose not to hike rates again after a single increase in December 2015; Britain voted to leave the EU; and oil supplies were resilient despite low prices, leading to an OPEC agreement to limit its production for the first time in eight years. In the markets we saw commodity prices as a whole fall to the lowest levels in 18 years[1], only for them to rebound by anywhere from 20-80 percent just a few months later. Of note is the fact that these moves were fairly steady in either direction, meaning that daily volatility remained subdued despite the large overall changes. In this changing price environment, demand held up better than most expected, particularly in the oil sector but also in copper and zinc, while coal was the surprise winner in terms of price growth this year. Global flows have shifted, with the US becoming a major exporter of crude oil, and China a world-scale exporter of finished products, on both the oil (diesel and gasoline) and metals (steel, aluminium) side. We have also seen emerging markets becoming major centres of demand growth.

What these shifts tell us is that markets continue to be resilient in changing circumstances, with both demand and supply adjusting to meet the realities of the moment, and despite uncertainties ahead, we expect to see the volume of commodities traded globally continuing to increase.

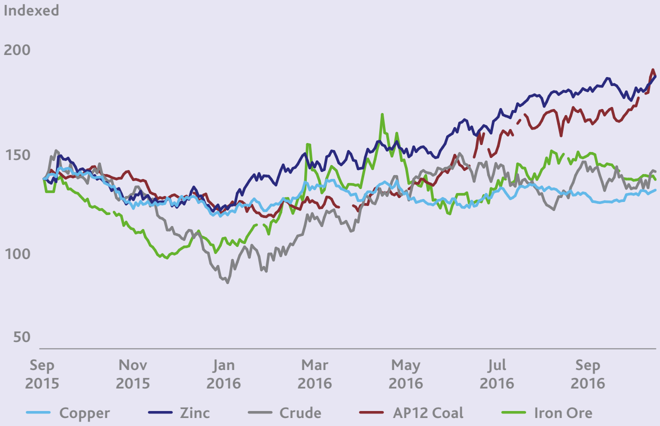
MACROECONOMIC ENVIRONMENT

Overall the global economy held up well this past year, recording relatively solid if unspectacular growth. As has tended to be the case recently, the US led the way, as the employment sector continued to show strong job gains, which fed through into rising incomes and ultimately consumption. The US consumer remains the ultimate driving force in the global economy, accounting for just under one out of every 10 dollars spent on the planet, and as such a healthy US consumption rate has continued to lift the global economy. Low interest rates have given the economy room to run, as seen in the growth in real estate, vehicle sales and fuel consumption, all important sectors for Trafigura and the commodity sector at large.

However, despite decent strength, the US economy has been unable to fully break out of its tepid recent range, with the result that the Federal Reserve has been faced with a clouded outlook as it decides the pathway of monetary policy. The weakness in headline GDP, which is likely to show full-year 2016 growth of below 2 percent, would suggest that the Federal Reserve should be seeking to keep rates low for quite some time. On the other hand, inflation is beginning to pick up, in line with the robust employment picture and rising oil prices. The Fed's dilemma between heading off inflation and allowing the economy to continue strengthening has been one of the dominant themes in the market over the last year. Although a hike in December 2016 seems likely, the path forward into 2017 looks increasingly unclear, potentially causing volatility ahead. The incoming US administration's plans on taxation and spending are also a major factor in creating uncertainty, as there is a lack of clarity on which of the initiatives proposed to date may in fact be feasible.

COMMODITIES INDEX

1 September 2015 – 27 October 2016



Source: Bloomberg Data, Trafigura Research.

1. Source: Bloomberg Commodity Index.

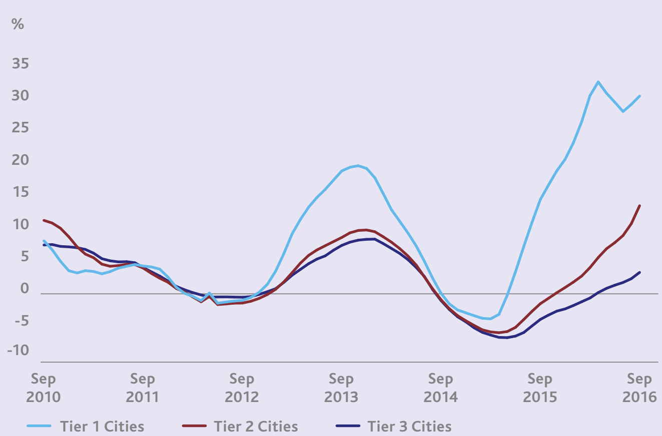
Regardless, the recent bias towards Fed tightening has combined with the likelihood of the Trump administration stoking inflation, together boosting the US dollar (USD) towards the end of the year. This has sent the Chinese RMB to a record low and weakened the British Pound (GBP) to levels not seen since the early 1980s (albeit the major part of this move was due to 'Brexit', the vote to leave the EU). The Euro has bounced around within a fairly narrow range, but has also come under pressure in recent months as policy has diverged between the US and EU, and also due to rising political risks including the upcoming elections in various EU member states. The stronger USD has in turn been a headwind for commodity prices, as production costs have fallen and consuming nations are finding it more expensive to import oil and metals.

Commodity markets are becoming used to the idea that Chinese growth is no longer the global force it once was, but the economy held up much better over the year than most projected. China's industrial slowdown did continue in the first part of the year, but saw a rebound starting in Q2 2016 due to government support. The Chinese authorities have supplied the economy with over USD2.1 trillion of additional liquidity, equivalent to the dollar value of the entire Indian economy. The infusion of funds boosted growth, particularly in the real estate sector, which saw a marked rebound across the board after suffering a severe contraction last year.

The strength in Chinese real estate and construction markets was the key story of the year in terms of metals demand. Housing prices started the move, rising first in the so-called Tier 1 cities (mainly coastal industrial hubs), but eventually seeing prices in Tier 2 and interior-located Tier 3 cities move back into positive territory as well. Rising prices led to a return of construction activity and land sales, creating a virtuous circle effect that boosted demand for copper, zinc and steel.

CHINESE NEW BUILD HOUSE PRICES

Change year-on-year



Source: China National Bureau of Statistics.

Elsewhere, Europe has not yet suffered any real impacts as a result of the UK voting to leave the EU. Indeed, the UK itself has so far defied most projections by continuing to grow at a steady pace, although inflation is starting to creep upwards due to the fall in the GBP. Germany has continued to power the rest of Europe, as manufacturing and exports have recovered, albeit at a relatively slow pace. The European Central Bank has maintained its accommodative policies, continuing to purchase large quantities of corporate and sovereign bonds, keeping interest rates at record lows.

However, the eventual withdrawal of Central Bank stimulus measures is likely to be a dominant headline over the next fiscal year, both in Europe and globally. While Central Bank rate hikes are likely to remain muted, bond markets are already reacting to the possibility of the liquidity tap being turned off and are pushing rates higher. At the same time inflation is starting to inch higher in most key regions, reversing the trend of recent years, supporting the increase in rates and in turn potentially tightening credit. How markets handle this new environment will help define the next trading year.

ENERGY MARKETS

In oil markets, a supportive macroeconomic environment has seen another year of solid demand growth, albeit a bit softer than 2015's 1.9 million barrel per day increment. However, even another year of demand growth has not been enough to address the issue of global oversupply, which continues to dominate the market. Throughout the year, the surplus has shifted between the crude side and refined products, meaning that from an overall hydrocarbons perspective, oversupply remained at record levels globally.

Despite the fall in US oil production at the beginning of the calendar year, overall supplies continued to build as various producers ramped-up production. Iran added approximately 700,000 barrels per day as it recovered from sanctions-enforced output curbs, while Saudi Arabia and Russia both hit record levels of production. These additional supplies more than offset disruptions in Nigeria and Canada, and ongoing declines in Venezuela and other Latin America producers. As a result, total hydrocarbon inventories rose to over 750 million barrels, over 500 million of which were in the OECD economies.

The issue of oversupply was not limited to crude however. Following last year's strong gasoline-led demand growth, refiners over-produced gasoline and other refined products, leading to significant stock builds in this area as well. As such, despite record levels of gasoline demand in the US this year, the market still saw gasoline inventories building at times when if the historical pattern had been followed, they should have been falling. The issue was not limited to gasoline, as distillate inventories also remained at very high levels throughout the year, although here the problem was weak demand more than oversupply. As a result of these elevated inventories, refining margins were not as strong as they were last year, but nonetheless were positive enough to incentivise refiners to maintain runs for the most part, adding to the global overhang.

As evidenced by refining margins holding up, demand overall continued to be healthy, with strong growth in particular in the US, China, India and Mexico. The composition of that demand has been led by gasoline, as diesel demand has remained soft. The divergence in the fortunes of the fuels has resulted from the relative strengthening of consumers globally, boosting gasoline, while industrial activity has stagnated, weakening diesel demand.

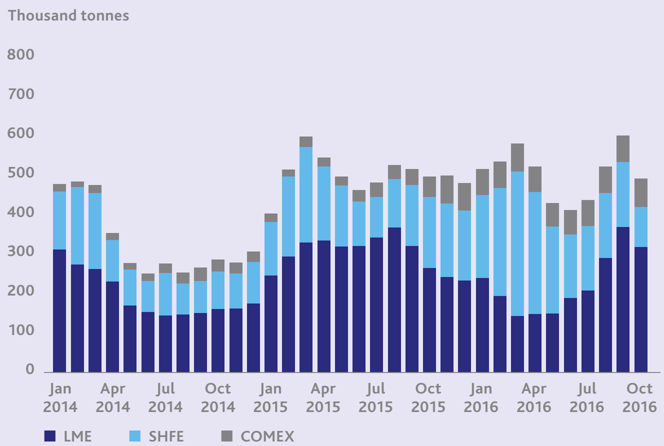
Towards the close of the year, OPEC member nations reached an agreement to limit their production, potentially lowering total volumes by 1.2 million barrels per day, in addition to up to 600,000 barrels per day from Non-OPEC members. If the organisation's members adhere to their agreed limits, we will start to see a tightening market next year. Yet compliance traditionally has been a major issue in this type of deal, and a higher price could lead to significant additional volumes being produced in the US, China, Latin America and elsewhere. It remains to be seen what the ultimate impact will be.

NON-FERROUS MARKETS

Metals markets this fiscal year were much more differentiated in their movements than they were in 2014-15. Divergent market fundamentals pushed zinc and nickel prices significantly higher and aluminium moderately higher, while copper, normally seen as the key bellwether of the global economy, remained essentially flat over the course of the year.

Copper began drifting lower in late 2015 along with the rest of the commodity complex, reaching a low of USD4,330 per tonne in January. Despite some increased mine outages towards the end of the year, mine supply generally was much less of an issue this year than in years past. Outages in Chile were balanced by a ramp-up in Peruvian output. Prices did not fall enough to force major mine closures, as many analysts had projected given the slide towards the low-USD4,000s. However, while outages per se were down, the issue of ore grade deterioration has led to the overall level of concentrate availability being impacted. This will be an area to watch in coming years as well.

EXCHANGE INVENTORY OF REFINED COPPER



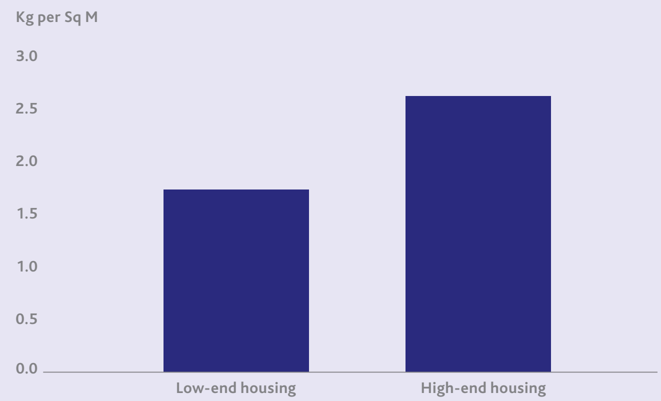
Source: IAI, Trafigura Research, November 2016.

While copper concentrates availability remained robust, challenges emerged on the refined metal side. Overall, the balance did end up looking better than projected at the beginning of the year, as a rebound in China's real estate and vehicle sectors, combined with increased build-out of the national electricity grid, meant that demand growth stayed above 3 percent year-on-year. Other regions also contributed to demand growth as well, with India and other Asian economies (ex-Japan) performing better than in recent years, and Europe growing materially for the first time in five years. However, stronger than expected demand was still not enough to clean up the market, leaving a significant surplus of refined metal for the year, which weighed on prices. As a result, copper ended the fiscal year almost exactly where it began, around USD4,800 per tonne.

As was widely anticipated, supply dynamics in the zinc market drove prices significantly higher, reaching five-year highs. The closure of the Century Mine in Australia and Lisheen Mine in Ireland had been built into projections for some time, but the voluntary closure of two key mines by a major mining concern brought the deficit into even sharper relief. As the year progressed, the concentrates deficit made itself felt, resulting in a major price move higher. Demand also held up well, driven by galvanized steel, in turn a beneficiary of stronger infrastructure and real estate demand in China. Although prices hit a low of just under USD1,500 per tonne in January, they then marched steadily upwards to just shy of USD2,500 per tonne by the end of the financial year. Although the supply picture is expected to improve somewhat over the coming year, it is likely not enough to rebalance the market, particularly if demand continues to remain strong.

Aluminium prices moved in a much narrower band than zinc, albeit still moving materially, falling to under USD1,450 in late 2015 before rebounding to nearly USD1,700. Prices remained range-bound despite strong demand growth, due to the significant capacity China has invested in over the last decade. Better integration of smelting capacity across the value chain, particularly with captive power generation, and falling energy costs have led to a lower and flatter cost curve, with Chinese companies now in a much more competitive position than previously. However, that shift did not prevent some reduction in capacity in 2016 when prices dipped to low levels. As a result of the capacity curtailments, the market has seen sharp declines in onshore aluminium stocks, potentially pointing to a move higher if demand continues to perform as it has done in recent years.

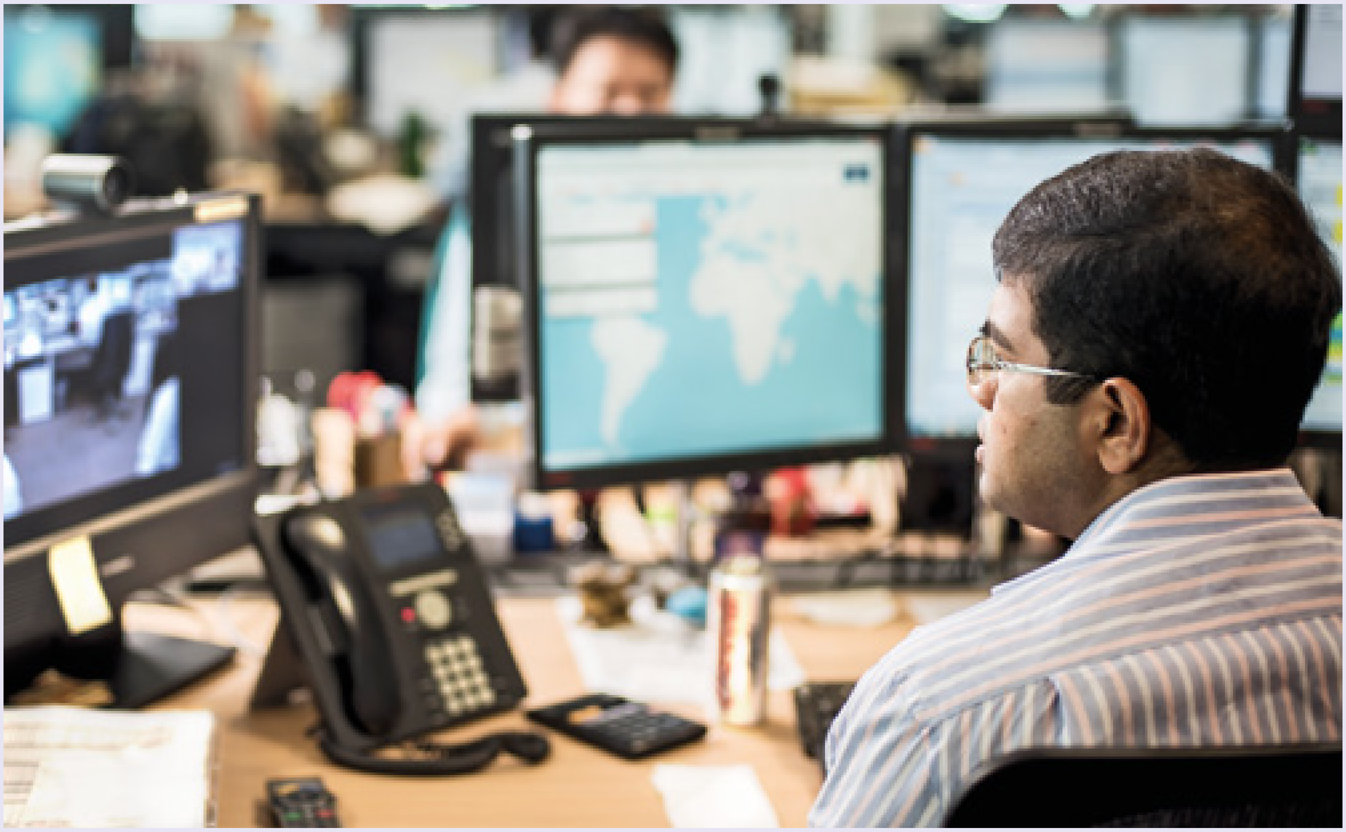
CHINA ALUMINIUM CONSUMPTION IN CONSTRUCTION



Source: Wood Mackenzie.

The global demand picture for aluminium is being driven by rising intensity of use. As Chinese consumers have moved up the income chain and into higher-end housing, their consumption of aluminium used in construction has gone up by approximately 60 percent. Rising substitution in vehicles, with aluminium being increasingly favoured due to its weight-to-strength ratio, has seen aluminium consumption per vehicle sold in North America rise sharply from 100kg/vehicle in 2010 to 150kg/vehicle in 2015. This is expected to rise further in coming years, nearly doubling to 2030.

Nickel prices continued to slide coming into the start of our fiscal year, reaching a low of USD7,600 per tonne in February, but then remaining range-bound between USD8,200 – USD9,000 for most of the year. That changed in summer, when a new government in the Philippines instituted a stringent environmental audit, leading to mine closures and a significant impact on supply availability. Stocks of nickel ore are hovering at the lowest levels in four years, keeping prices above USD10,000 per tonne today. However, the market is adapting, with Indonesian suppliers starting to produce nickel pig iron, replacing some of the units lost after raw ore exports were banned at the start of 2014. Despite this offset, demand for stainless steel, which relies on nickel as an input, continues to rise on the back of the Chinese liquidity push, and therefore the market is likely to remain in deficit for some time to come.

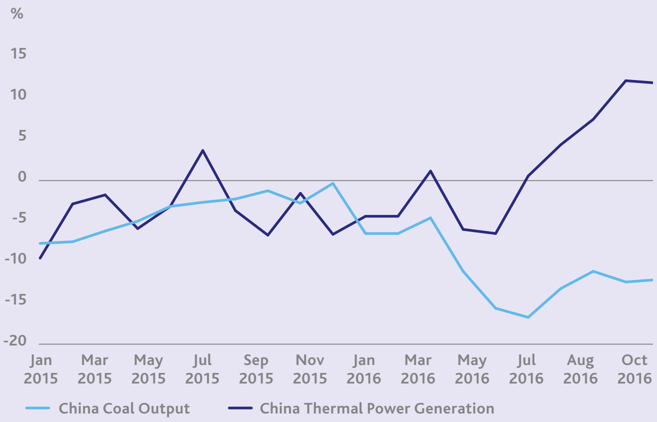


Staff at Trafigura's Singapore office.

BULK MARKET

Coal was the big winner this year, essentially doubling from USD36.50/mt in February to over USD70/mt by year-end, the steepest rise on record. This was due primarily to government-enforced curtailments of mine production in China, as the country looked to reduce over capacity in loss-making sectors of the economy. The government has targeted closure of 500 million tonnes of production capacity in the next three to five years, and also sought to cut back available capacity by reducing the number of operating days from 300 to 276 days a year.

CHINA COAL OUTPUT AND THERMAL POWER GENERATION, YEAR-ON-YEAR GROWTH



In the meantime, Chinese demand continued to march upwards, driven by economic activity, itself a result of the increased liquidity put into the economy earlier this year. Power generation grew by over four percent year-on-year, as industrial activity rebounded on the back of bank lending and overall demand growth. Rising Henry Hub prices and relatively stable LNG prices have also allowed coal prices to remain at elevated levels.

Iron ore benefited from rising steel demand, which in turn was driven by the liquidity push from the Chinese government, as well as strong growth globally in terms of vehicle sales and real estate. The run-up in coking coal prices towards the end of our fiscal year seems to have pushed iron ore prices higher as well, but it is unclear how long this effect might last. Unlike other markets such as zinc or crude, supply cutbacks by smaller producers were offset by significant increases from bigger players, as well as the start-up of large scale projects in Australia and Brazil. As with most of the other commodities, policy decisions in China are likely to play a major part in determining the forward path for iron ore.

LOOKING AHEAD

Commodity markets are driven by a complex interplay of physical fundamentals, macroeconomic drivers, geopolitics and policy events, and as such remain ever-changing. The conventional wisdom at the start of our fiscal year was that markets would continue to slide indefinitely as China continued a sharp slowdown and overall supplies failed to adjust. Instead, we have seen better demand growth, driven by a robust global consumer class, and supplies impacted by producer cuts and policy initiatives. Overall, markets feel more balanced than they have over the last few years, and while significant question marks remain around Central Bank behaviour and government policies, a stronger global consumer should help propel markets forward.