# PRONOUNCED VOLATILITY AND ECONOMIC SLOWDOWN

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Markets are constantly in motion, but by almost any standard the period from October 2014 to September 2015 was a year of pronounced volatility and movement.

Across our fiscal year, the economic narrative switched from a rapidly increasing commodity appetite from China, to a slowdown across emerging markets. This movement was reflected across asset classes and geographies, and across companies and countries large and small.

For a decade now, commodity markets have felt the inexorable upward pull of two factors: surging Chinese growth and accommodative monetary policy by global Central Banks. The sustainability of these two factors was called into question over the year, leading to a weaker price environment for commodities. However, the fiscal year ended with interest rates broadly in the same place they have been for over seven years, with the US Federal Reserve looking set to continue to keep rates low for some time yet. While Chinese growth looked weaker in 2015 than it has at any time since 2008, structural economic forces should continue to drive commodity demand growth over the long term.

### ECONOMIC SLOWDOWN IN CHINA

China's slowdown had to some extent been expected as the economy matured, but the timing and the speed with which it would unfold were unknowns. While the government remains committed to a growth target somewhere between 6 and 7 percent per year, it became clear towards Q4 2014 that growth was in fact running below those levels. Although the headline GDP numbers were in line with the government's objectives, other indicators such as freight traffic, electricity consumption and physical demand for key commodities were all weakening. Some of this is a natural result of the economy moving from an investment- and export-intensive growth model to a more consumption-led one. Investment in infrastructure in particular has been a material driver of China's commodity demand growth, but as the country has entered the middle stages of development, the need for exponential expansion has slowed.

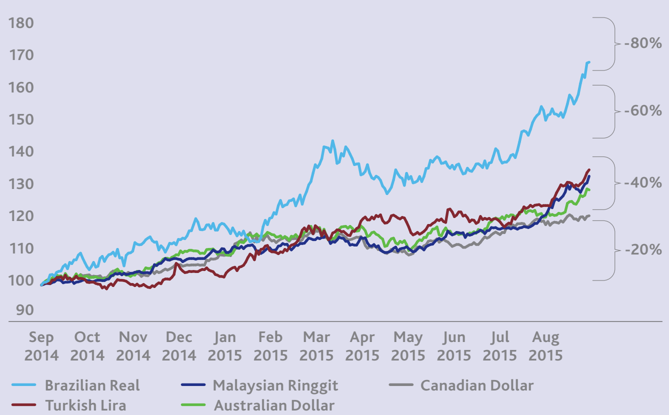
Slowing growth in China has affected commodity producers and prices around the globe, from iron ore producers in Brazil to oil exporters in the Middle East to coal companies in Australia. Exporters of manufactured goods have also been impacted, with Japan, Korea and Germany all seeing trade volumes suffer.

### PRESSURE ON EXPORTER CURRENCIES

The weakness in global trade has put pressure on the currencies of major exporters over the past year, which in turn has led to lower production costs in many key producers. In particular, Russia and Brazil, two major partners for Trafigura, have seen their currencies depreciate significantly, impacting costs in a positive manner and growth in a negative one. In addition to the commodity-price-led currency moves, the last fiscal year also saw a reversal of one of the defining trends of the last decade: USD weakness. From 2001 to the end of 2007, the USD depreciated by more than 35 percent, both a symptom of, and a contributor to, rising commodity prices. Funds moved out of the falling currency and into rising commodities. However, driven by expectations that the Federal Reserve would start raising rates sooner rather than later, starting in late summer last year the USD reversed direction and has since climbed 25 percent, contributing to the fall in commodity prices.

### EXPORTER CURRENCIES VS. USD INDEX

The renewed strength of the USD in 2014 combined with commodity price weakness to pressure the currencies of major commodity producers.



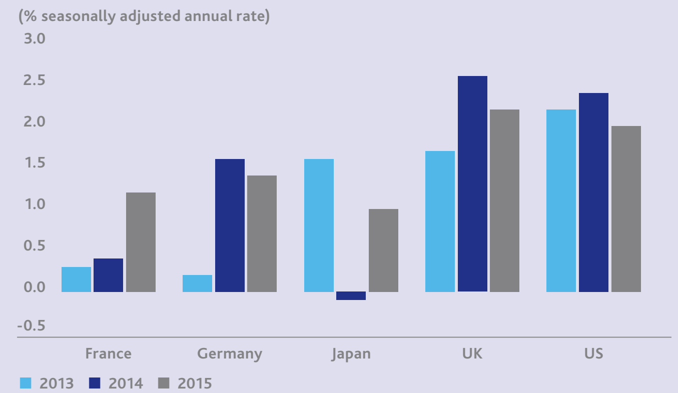

*Source: Bloomberg, Trafigura Research.*

### GROWTH IN THE US RELATIVE TO OTHER MARKETS

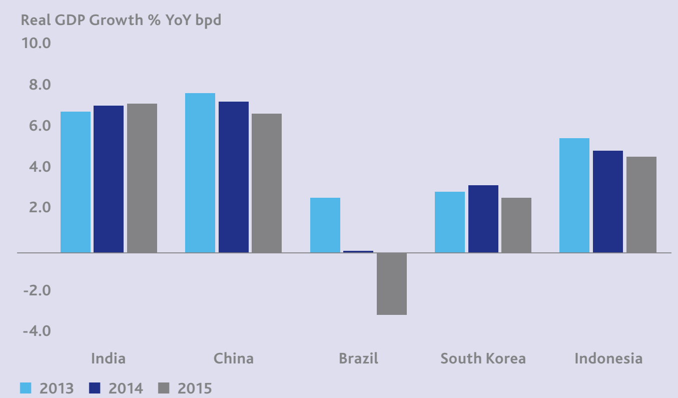
The strength in the USD was also driven by relatively stronger growth in the US. As China and emerging markets slowed, the US and Europe served as engines of growth, with consumers spending at levels not seen on a sustained basis since the global financial crisis. Although business investment remained lacklustre compared to what would be normally expected at this stage in a recovery, real estate investment, rising employment and export gains engendered a more positive economic landscape.

### REAL GDP GROWTH

With few exceptions, the most recent GDP figures show weaker growth in 2015 versus 2014.




*Source: IMF, Trafigura Research.*




*Source: IMF, Trafigura Research.*

As a result of slow Chinese growth, global demand in key commodities was weaker than expected. Energy demand was notably weak in 2014, while the weakness spread to non-ferrous metals and bulk minerals (iron ore and coal) in 2015. Across most commodities, rising supplies met weaker than expected demand, creating an oversupply glut that in most cases has not yet begun to unwind.

### THE OIL MARKET

Oil was the first to show signs of an unbalanced market, with prices beginning to deteriorate in late summer of 2014. Prices had been fairly stable above USD100 per barrel (Brent, nominal USD) since 2011, occasionally spiking above USD120 per barrel but generally staying close to the USD100 mark. In the view of many industry participants, this was driven by higher costs, particularly of steel but also of the types of resources that were now available to the industry. The marginal barrel was thought to come either from the oil sands in Canada, or from the ultra-deepwater developments coming on stream in West Africa and Latin America – expensive developments in the USD90+ per barrel break-even range. That higher cost was thought to set a floor under prices.

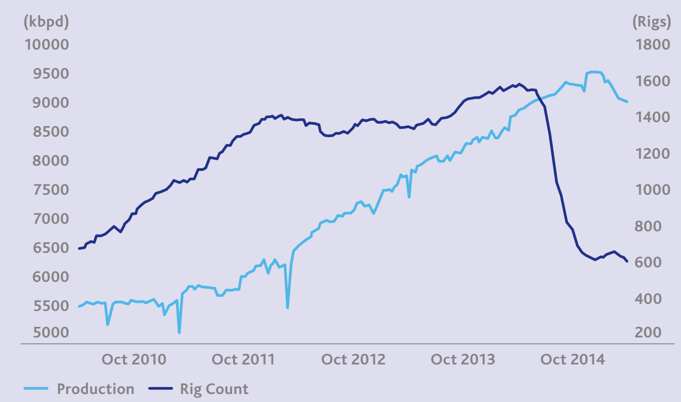
However, as they tend to do, higher prices drove economic and technical innovation, in this case creating, in a remarkably short space of time, the US shale industry. Horizontal drilling and hydraulic fracturing, techniques which had been around for decades, were now combined, unlocking a whole new resource base in the US.

Supplies from Libya, which had been offline since the Arab Spring began in 2011, came back into the market at the same time that US shale production was growing sharply. In fact, according to the US Department of Energy, US production has grown by an average of 1.1 million barrels per day (bpd) each year since 2012, the most rapid and sustained increase in volumes since Saudi Arabia's take-off in the early 1970s, when it added over 1 million bpd of production capacity a year.

This tide of supply was met by some of the weakest global demand in over 20 years. Demand grew by just 0.85 million bpd[1], meaning growth was less than 1 percent for the first time since 1993 outside of a major financial crisis or US recession. The resulting oversupply would normally have led to an OPEC production cut that would have balanced the market and stabilised prices, but in the face of sustained US shale supplies, the Group decided to fight for market share and maintain production at record levels. The result was a drop in prices of over 50 percent to the mid USD40s, a range not seen on a sustained basis since the early 2000s.

### US OIL PRODUCTION AND RIG COUNT

Despite the sharp fall in US rig count, production continued to hold at elevated levels, thanks to cost cuts and efficiency gains.



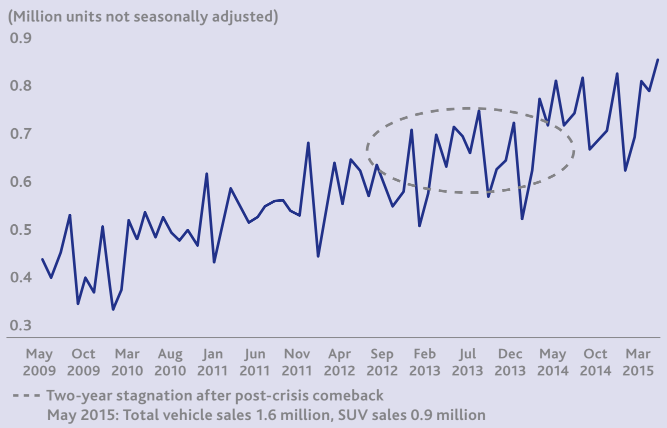

*Source: US Department of Energy, Baker Hughes, Bloomberg, Trafigura Research.*

1. BP Statistical Review of World Energy, 2015 edition.

However, the drop in oil prices proved a boon to consumers, who began to increase demand as prices fell. Vehicle sales, particularly of light trucks and SUVs, rebounded strongly in the US, the world's largest vehicle market. Similar increases were seen in Europe and China, helping support product margins well into the middle of 2015. As a result, prices then moved back upward in Q2 2015, retracing almost 50 percent of their fall and hovering above USD60 per barrel. However, this resulted in significant forward hedging by producers, who had been able to bring their costs down such that they were profitable at those levels. Unlike the 2008 price collapse, costs during this price correction have not been 'sticky'. In 2008, oilfield service providers viewed the fall in prices as due to weakness in financial markets, not in the fundamentals of supply and demand. This time around, however, the weakness emanated directly from the oil market itself, and as such, costs had to fall in order to compensate. Producer hedging meant that production that was previously at threat of being turned off was able to keep going, adding supplies to the market.

### LIGHT TRUCK SALES IN THE US

After a two-year period of stagnation following the financial crisis, the fall in oil prices helped light truck/SUV sales accelerate sharply.




*Source: Bloomberg, Wards, Trafigura Research.*

As long as consumer demand was increasing rapidly, and margins were strong, the excess supply could be absorbed. But the rate of supply increase meant that even relatively strong product demand in early 2015 could not absorb all the barrels, and surplus inventories began to build in both crude and products. This in turn led to prices falling heading into the summer months, which normally are a seasonally strong demand period.

This dynamic of price increases bringing back US volumes could persist for some time, as shale production can generally be brought on or off much more rapidly than traditional production. In addition, volumes from Iran, Iraq, Brazil, Canada and other areas are expected to come into the market in the coming year, adding to the supply situation. Balanced against this, the global economy should continue to see robust demand growth again in 2016, helping to redress some of the current imbalances.

### THE METALS MARKET

Metals have generally been slower than oil to react to weakness in China, the world's largest commodity market, but from early 2015, prices moved downward quite substantially. As with oil, capacity has been ramping-up in recent years in the expectation of strong demand from China, only for that capacity to come on just as demand slowed.

Copper, often seen as a barometer for the health of the global economy, moved from about USD7,000 per tonne in September last year to trading just under USD5,000 per tonne at the close of our fiscal year in September. The structural changes China is undergoing as it moves from an investment-led model to a more consumer-based economy have seen copper demand stagnate in the world's biggest consumer of the metal. Electricity grid build-out in particular has been slower to materialise this year than expected, due in no small part to an ongoing corruption crackdown that appears to have stymied decision making. Furthermore, as the pace of China's urbanisation slows from breakneck to merely rapid, real estate activity has slowed as well, leading to less demand for copper in housing. Over the medium term, the excess housing inventory in China should be absorbed, as workers continue to move from the countryside into cities. As inventories drop, construction activity should begin to pick up.

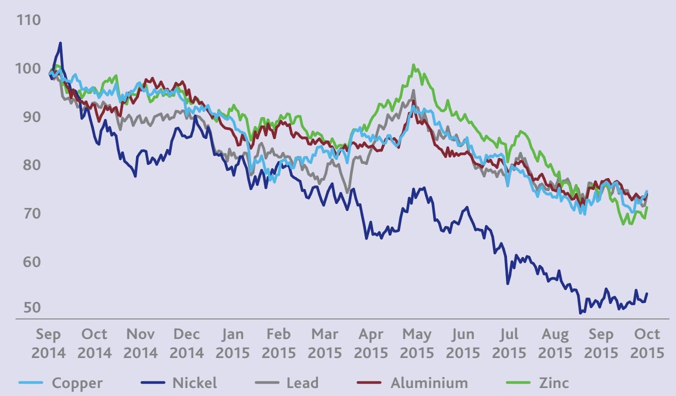
Most other industrial metals fell by a similar percentage to the copper market. New uses for aluminium, including in transportation and in high-voltage electricity grids, have meant that demand both inside and outside of China has been rising steadily, outperforming growth of the other base metals. Stronger vehicle sales in the US and Europe in particular have contributed to this rising demand as companies such as Ford move their most popular models to aluminium-based designs. China, however, has moved from being the world's largest importer to being a growing exporter, as low-cost capacity built during the boom years continues to come online and add to global supplies, reversing the dynamic of the last decade to some extent. The shift has left the market as a whole in surplus, which combined with significantly lower energy prices, has brought prices down to the lowest levels since the global financial crisis.

Nickel was hit hardest among the non-ferrous metals group over the past year. Nickel inventories rose substantially this year on the back of weak demand, substantial destocking of stainless steel and less supply disruption than had been anticipated due to the ban on ore exports from Indonesia, leading to a price correction of closer to 50 percent. The zinc market was expected to see deficits this year due to the closure of some significant mines; however, similar to the other metals markets, weak demand has meant that the overall balance was close to flat, weighing on prices.

Unlike in the oil market, metals producers have already reacted to the lower price environment by announcing supply cuts in key metals. This has helped keep a floor under prices, but it is unclear whether the announced cuts will be enough to halt the slide entirely. As with oil, demand growth will have to do its part to help rebalance the market.

### METALS PRICES (INDEXED TO 1 SEPTEMBER 2014)

Although not as dramatic a fall as we have seen in oil over the past year, metals prices have declined relatively sharply as well, reflecting slowing demand out of China.




*Source: London Metals Exchange, Bloomberg, Trafigura Research.*

### BULK COMMODITIES

For the bulk commodities, where 40-50 percent of costs were energy-related at the peak, the collapse in oil prices has led to a dramatic decline in prices, with iron ore prices currently 70 percent below where they were at the start of 2014. Not all of the price weakness can be attributed to reduced costs, however – with global steel production set to contract in 2015, for only the second time since 1998, demand for iron ore and metallurgical coal has struggled. On the surface, seaborne iron ore supply has seen almost no growth this year although this masks a battle for market share between Australian and Brazilian suppliers that increased exports by 50 million tonnes this year, and a long tail of smaller producers that have been displaced. This highlights the high level of efficiency in the iron ore market: despite negative demand growth, the iron ore market will not register a surplus this year, unlike most of the base metals.

Similar to iron ore, the coal market has suffered from weak demand this year. Shifts in the structure of China's economy meant that power consumption growth has declined sharply as heavy industry slows. The seaborne coal market has felt additional pressure as China has implemented policies aimed at reducing imports, while investment in new forms of power production and distribution are reducing generating capacity in the provinces that have traditionally been the market for imported volumes. The future of seaborne coal demand now lies outside of China. India has committed to a significant increase in coal-fired generation capacity between now and 2020, as has South Korea.

What has become clear over the last fiscal year is that the world can no longer count on seemingly limitless Chinese demand growth, and as such, a material portion of the commodity production projects that had been initiated in a higher price environment will need to be rationalised in order to rebalance the market in line with this new reality. In particular, projects that are higher cost or that were only possible by taking on significant leverage will have to be re-evaluated in light of the recent price environment.

### LOOKING AHEAD

Looking ahead, after a period of supply rationalisation and potentially weaker emerging market growth, structural changes in the world economy will mean that demand for commodities will continue to look positive. Although China may no longer be the primary driver of commodity demand, new areas of growth are likely to emerge, whether in India, Southeast Asia or Africa. Increasing numbers of people will move into cities in search of better economic prospects, and rising incomes will drive demand for everything from vehicles to appliances, and from infrastructure to housing, all of which will rely on the trade of energy, metals and minerals.