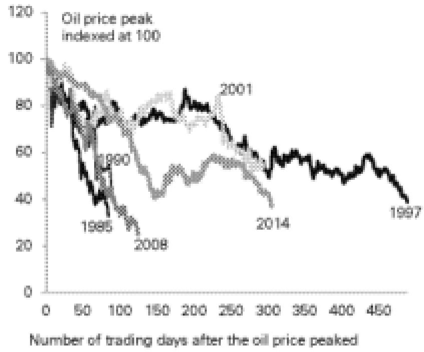
Commodities: Supply adjustment is well underway for oil, not so for the metals

- By next year, we expect that OPEC will have engineered one of the sharpest historical declines in US production. A modelled contraction of at least 650 kb/d would be comparable with the 600 kb/d fall in 1989 which occurred in the context of an extended supply slowdown beginning after prices fell in 1986.
- Our modelling indicates that while the first half of next year will remain oversupplied and risks remain to the downside during this period, the steady contraction of US supply along with trend rates of demand growth will lead to a more normalised market balance in 2017.
- We believe that the current recovery period in oil prices will be one of the slowest and most extended on record, owing partly to further growth in OPEC supply to 2017 when modelled OPEC production of 32.4 mmb/d matches our calculated call on OPEC (i.e., the volume required from OPEC to balance demand).
- Oil at a Brent price of USD45/bbl is below the 2016 national budget breakeven level for all of the ten countries assessed by our EMEA macro team, and also below the breakevens for fourteen countries assessed by the IMF apart from Turkmenistan (with a breakeven of USD42.7/bbl).
- However, budget breakevens may continue to fall as a result of coping strategies in the form of spending cuts and currency devaluation while government bond issuance and asset sales help to fund deficits, thus making another year of low prices survivable.
- We maintain our bearish outlook for gold. We believe the first step in US policy normalisation will now more likely than not take place this month. Moreover, further tightening in 2016 is long overdue and a full pricing-in of this risk has yet to unfold. Additionally, further 6% strength in the trade-weighted US dollar confirms the downside scenario for gold.
- For industrial metals, the barriers to exit in many markets are high. These barriers range from the need to cover high fixed cost bases, take-or-pay supply contracts; pressure and incentives from governments to maintain employment and balance current accounts to a struggle for survival.
- The metals industry still has to adjust to structurally lower Chinese demand while long gestation projects continue to add tonnes to the market. While we see supply cuts gathering momentum in 2016, we only expect price stabilisation in 2017 when the markets start to look more balanced.

Figure 1: Oil price slumps compared



Source: Bloomberg Finance LP, Deutsche Bank Research

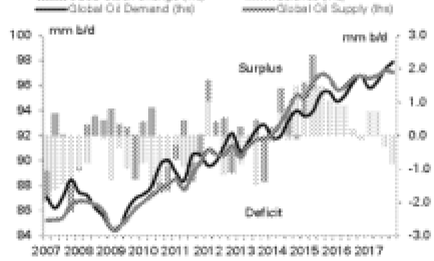
Oil fundamentals have bottomed; have prices?

Our view is that market balances have seen their weakest period and that a slow and steady process of US supply curtailment is well underway. We have already seen a 440 kb/d decline in the US since July, although this was preceded and overshadowed by an OPEC increase of 1,400 kb/d between November 2014 and June 2015.

Gradual improvement towards a more balanced market in 2017 is likely even with the onset of incremental Iranian exports next year. Further declines in the US will offset the Iranian ramp-up, while underlying demand growth of 1.2 mmb/d will take up the slack of excess Saudi and Iraqi volumes.

Even if it is true that balances have seen the worst, market balances should remain weak for virtually the entire next year. Surpluses are most evident in the first half with an excess of +830 kb/d. Inventories will likely build once again over this period while we model the second half surplus at +177 kb/d.

Figure 2: Global crude oil balances normalise in 2017E



Sources: IEA, Deutsche Bank Research