Scotiabank's Commodity Price Index lost ground again in January, declining -5.1% m/m, pushed down by financial market volatility and heightened concern over the outlook for China and global growth. The All Items Index is now -26% below the April 2009 bottom during the last recession and is lower than a decade ago. A large part of the gain during the tremendous 2002-08 upswing — when considerable world economic momentum (especially in China & Southeast Asia) in an environment of limited supplies drove prices to record levels — has been erased.

Today’s battle for oil market share — not only between Saudi Arabia and the U.S. shale producers, but also between Saudi Arabia and Iran/Iraq — has prevented a rebalancing of excessive world supplies despite generally favourable demand prospects. The tentative agreement between Saudi Arabia & Russia (on the urging of Venezuela & Qatar) is a step in the right direction towards steadying world oil prices, though actual production cuts are probably needed. (Please see comments on page 3.)

The Oil & Gas Index once more led commodity prices lower in January (-15.9% m/m & -38.1% yr/yr). WTI oil prices — the bellwether for North America — fell from US$37.33 per barrel in December to US$31.78 in January and US$29.71 to date in February (touching a low of only US$26.05 in intra-day trading on February 11).

The decision of Saudi Arabia and its Gulf Co-Operation Council allies (the UAE and Kuwait) at the December 5 OPEC meeting not to set any OPEC quota — but instead to permit full-throttle OPEC output has pressured prices. Iran is now discounting its crude prices below Saudi levels in Asia and the Mediterranean to regain market share after sanctions were lifted on January 16.

Profitability has faded across the North American oil industry. Current WTI equivalent prices barely cover average cash costs in the Alberta oil sands (SAGD bitumen producers need prices in the high teens to US$25 to cover lifting, delivery & sustaining capital). Prices are also well below the average US$55 WTI breakeven price required to cover mid-cycle costs plus a 9% after-tax Internal Rate of Return, ranging from a low of only US$40 to a high of US$68 (Scotia Equity Research estimates based on 2015-16 capital costs & a US$0.71 Canadian dollar; US$50 is required for expansions of existing projects). Contrary to various reports, Alberta oil sands producers are unlikely to shut in output to any great extent if low oil prices persist (allowing a cooling off of the wells might ultimately hurt recovery). The US$85 breakeven required for standalone mining projects reported by the international media is not generally relevant, as these oil sands projects have not been...

The **Metal & Mineral Index** declined again in January (-2.1 % m/m, -22.2% yr/yr). The contract price for **Western Canada’s premium-grade hard coking coal bound for Japan & Asia** edged down from US$89 to US$81 per tonne (FOB Vancouver). **Potash prices** also eased to US$267.50 per tonne from US$277.50 for overseas sales from Vancouver. India (an important buyer for Canpotex) has just announced that it will suspend further potash imports over the balance of the fertilizer year (ending in March) due to drought, which has reduced fertilizer application. India will also delay negotiations for next year’s purchases until June.

**Base metal prices** were driven lower on negative sentiment over the outlook for China’s economy, a second correction in China’s equity markets and selling by Chinese hedge funds. However, in my view, a number of base metals were ‘over-sold’ in January, with actual supply & demand conditions better than feared. **LME zinc prices** fell as low as US$0.66 per pound — just above average world breakeven costs including depreciation — but have snapped back to a profitable US$0.75 on short covering.

**Refined zinc is actually in a ‘deficit’, with world consumption exceeding smelter production.** Global concentrate supplies are also in ‘deficit’, a fact which will become increasingly evident in 2016:H2, as concentrate supplies fall to minimum working levels, forcing smelter cuts in China. While global demand will increase by 3.5% in 2016, mine production will drop by 1% alongside Glencore cuts (500,000 tonnes), intended to shore up the market, and the impact of last year’s closure of Century in Australia and Lisheen in Ireland. **Zinc prices are likely to shoot up to US$1.25 by 2017.** The outlook for mine expansion and concentrate supplies from 2018-20 is quite limited, with recent prices not justifying development. Vedanta’s Gamsberg project in South Africa and the Selwyn project in Canada will be delayed; only MMG’s Dugald River is scheduled to come on stream in 2018.

**Gold has regained its lustre, climbing to a 12-month high of US$1,241 per ounce on February 11.** Equity market & currency turbulence have revived interest in gold as a ‘safe haven’. Negative interest rates — recently invoked by the ECB, the Bank of Japan and Sweden’s Riksbank — to bolster commercial bank lending in lacklustre economies have also buoyed gold. Financial market reaction to negative interest rates has been mixed, with some observers fearing that central bank power to support global growth may be fading.

While gold prices may be checked from time to time by renewed expectations for further Fed interest rate hikes (which may be limited in 2016), the medium-term outlook for gold is favourable. The **World Gold Council reports that global output dropped in 2015:Q4, with further declines expected in 2016-17.** Tightening ‘physical’ supplies will lift gold prices medium term to at least US$1,300. Gold is an important by-product credit for many poly-metallic mines.

The **Forest Products** Index also inched lower in January (-0.4% m/m, -9.7% yr/yr). Slightly lower **Western Spruce-Pine-Fir 2x4 lumber prices** at US$262 per mbm and a US$20 drop in **Supercalendered A paper prices** (for magazines, catalogues & direct mail) to US$745 per short ton just offset a US$20 gain in newsprint prices to US$525 per tonne in the Eastern United States. The newsprint increase is the first since
October 2010, when prices climbed to US$640, and will likely be followed by a second hike of US$15 in February-March. High mill operating rates across North America (94% in 2015:Q4), a slight gain in U.S. newsprint consumption in late 2015 — despite the negative impact of electronic media — and expectations for further U.S. mill closures in mid-2016 are supporting the gain. Northern bleached softwood kraft pulp prices were unchanged at US$940 per tonne in the U.S. market in January/February.

The Agricultural Index also lost ground in January (-1.1% m/m, -10.4% y/y). Grain & oilseed prices were broadly lower and hogs fell, more than countering stronger cattle prices. On a more positive note, Canadian export volumes of the major grains & oilseeds plus peas and lentils should easily top 40 million tonnes in the 2015-16 crop year — setting a new record. A competitive Canadian currency (particularly vis-à-vis the U.S. dollar), the high quality of Canadian milling & durum wheat and this winter’s smoothly functioning rail system have allowed exports to increase to 18.89 million tonnes to date (2.7% above last year’s record).

Saudi Arabia & Russia Agree To Output Freeze To Shore Up Oil Prices

A tentative output freeze at January 2016 levels — agreed by Saudi Arabia and Russia at the February 16th meeting in Doha, Qatar, contingent upon participation by other OPEC and non-OPEC producers — would go some way towards bringing supply back in line with demand by late 2016. However, given the intention of Iran to lift its oil exports back to pre-2012 levels, actual production cuts by OPEC and Russia are probably needed — even if world demand advances at a healthy 1.8% clip in 2016 and U.S. oil production is cut modestly. Supply & demand conditions may not fully rebalance until 2017. Oil markets were initially unimpressed by the news, though WTI rallied slightly to US$30.66 on February 17.

A look at supply & demand developments in 2015 gives some idea of the pre-conditions for a lasting rebound in oil prices. Global supply exceeded demand by roughly 2 mb/d in 2015 (as measured by OPEC production over & above the ‘call’ for OPEC crude). This occurred despite solid growth in world consumption of at least 1.7% in 2015 — up 1.6 mb/d — (El Niño weather and slow global growth apparently pared consumption in the fourth quarter). However, OPEC massively increased its oil production, while non-OPEC players, such as Russia (+150,000 b/d), managed to edge output higher or proved remarkably resilient to low oil prices (e.g. the U.S. shales). Mexico was one of the only countries showing lower oil output last year.

A look at production developments since the November 27, 2014 OPEC meeting — at which the Saudis first revealed their intention to defend ‘market share’ — is revealing. Notably,

1) Rather than cutting output to shore up international prices, OPEC actually increased production by an enormous 2.63 mb/d — led by Saudi Arabia (+580,000 b/d) and Iraq (a huge and quite unexpected +970,000 b/d). Production gains by other OPEC countries have been modest, with actual declines in Libya, Nigeria, Algeria, Venezuela and Ecuador. Rather than a broad-based production cut by OPEC countries, what is needed is a big output cut specifically by Saudi Arabia and Iraq. News that Iraq is willing to freeze its own output — albeit at record January 2016 levels — is one of the truly positive outcomes of the recent agreement.

2) Saudi Arabia has been successful in blunting U.S. shale production, though overall U.S. output has only edged down by 376,000 b/d from the April 2015 peak through November. The EIA assumes that U.S. oil production will drop to an average of 8.7 mb/d in 2016 — 700,000 b/d lower than the 9.4 mb/d of 2015 — helpful in addressing over-supply. However,
given a 50% advance in U.S. drilling productivity, superior engineering skills and a desire by producers to maintain output, this production forecast seems on the low side. It appears that only the withdrawal of capital from the industry will significantly cut output. It was the rapid expansion of U.S. shale production from 2012-14 which ultimately destabilized world oil markets in the Fall of 2014.

3) Iran’s oil production was 2.99 mb/d in January 2016, little changed from 2.76 mb/d in November 2014. Iran exported 2.5 mb/d prior to 2012, when an EU ban and other sanctions curtailed volumes to 1.1 mb/d; Tehran hopes to lift exports by 1 mb/d over the next 12 months, though its actual capability is open to question. While the Saudis will likely offer a ‘special deal’ to Iran in the aftermath of sanctions, any restraint would be helpful in restoring oil market balance.

Finally, the broad-based strength of the U.S. dollar (+22% since July 2014) has been an important factor deflating commodity prices — including oil — since July 2014. Relief from this strength — perhaps triggered by a delay in further Fed funds rate hikes this year — would help to lift oil prices.

Though the pact between Saudi Arabia and Russia to freeze output is only a step in the right direction, we are encouraged by the change in mood within OPEC towards addressing the over-supply issue. It may lessen intense price discounting. Nevertheless, major oil companies are preparing to live with oil prices no higher than US$60 over the balance of the decade.

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2. Index deflated by U.S. Producer Price Index for Intermediate Goods.
   – Shaded areas represent U.S. recession periods.