Commodities' stellar performance this year has been persistent, raising questions about how long it can last. In many ways, the year has been a return to normal, with commodities providing a strong portfolio diversifier for investors as the asset class moved away from its once tight negative correlation to the US dollar.

But as in equities, there have been individual commodities that have seen underlying values rise significantly, (precious metals, the Platinum Group Metals (PGM)) while others have seen values plummet (especially base commodities and some grains).

1Q outperformance was concentrated in two subclasses: grains and energy, the former responding to shortages resulting from earlier year’s drought and heat, the latter responding to shortages triggered by cold weather in North America and geopolitical events. But in 2Q, there was role reversal, as good weather and a long sowing season rapidly changed fortunes for the grains.

Going forward, positive momentum should continue across the commodity complex in 2H. Citi is strongly bullish on the PGM group as the metals complex should by year-end ride the growth wave triggered by recent stimuli offered in China. They are also positive on both platinum and palladium, but particularly the latter. And within the base metal space, Citi analysts prefer copper and nickel and negative iron ore driven by Asia-specific supply and demand factors.

1H 2014 Cumulative Commodity Investment by Sector

Source: Bloomberg, Citi Research (through early July 2014).
Energy

Global oil markets are caught between bearish fundamentals and bullish geopolitics. There are bearish risks from Libya and potentially Iran, but with Iraq on edge and Russia/Ukraine still simmering, oil prices are expected to find support. Meanwhile, emerging market demand is not the performer it once was, though US demand looks a little brighter, and growing refinery capacity pressures product margins. WTI and North American crude markets can perform in summer 2014, but become sloppy into year-end, as production growth and pipeline connectivity increasingly reach the Gulf Coast, but crude exports can also expand significantly.

Several key factors are driving US Henry Hub prices: (1) Prices have fallen on milder weather and a return of robust production; (2) 2015 supply assumptions, which some believe could be very strong, also set price direction, as stronger supply reduces the gas storage requirements for both 2015 and 2016. Globally, history is being repeated. High European gas inventories as a result of a mild winter continue to affect the market similar to what took place in 2012 in North America. A strong price rebound in Europe is not expected yet. The excess LNG available has also contributed to lower JKM (Japan-Korea Marker) prices.

Bulk commodities

Iron ore – Iron ore prices should remain range-bound between $90 and $110 during H2 due to a pause in expansion of iron ore export capacity, declining Chinese iron ore production, and improving Chinese steel demand. Citi analysts believe that prices could then fall again in 2015 as supply increases both in Brazil and Australia.

Thermal coal – The thermal coal market is expected to remain under pressure in July and August, but prices should receive a boost starting in September from Indian demand and improving Chinese industrial activity, then endure another difficult year in 2015. Citi’s average price forecast for 2014 stands at $76/t.

Coking Coal – Prices have fallen dramatically on the back of strong supply growth and weak demand. Indeed, Australian supply continued to grow, up an estimated 7.5% YoY in the first half. However, Citi analysts believe that the catalyst for a rebound in prices could come from the demand side. Chinese steel production is improving in response to improved mill margins and should remain supported by fiscal stimulus and monetary easing. Citi has reduced their average price forecast for 2014 to $120/t.
Precious and Platinum Group Metals

**Gold** – We expect emerging inflation concerns driven by the extended low interest rate environment to counter the seemingly easing Geopolitical issues, particularly with regard to Ukraine, with gold prices projected to remain range bound. Essentially, we **see a stabilization in gold prices through this year in a $1,290/oz. -$1,350/oz. range**, with stronger physical market activity from retail investors, ETF flows and Central Banks essentially limiting any potential downside moves.

**Silver** – Silver prices have been the underperformer of the precious metals space in 2014. Going forward, we believe that the combination of mine supply growth and sluggish fabrication demand may continue to hamper silver’s relative price performance to gold, with **modest downside moves from current levels of $21/oz**.

**Platinum Group Metals (PGMs)** – Fundamentals for both platinum and palladium remain largely positive. However, Citi analysts continue to favour palladium for its significantly more positive auto demand outlook, strong physical investor uptake, and limited supply growth potential.

Chinese jewellery demand already appears to have been impacted by higher platinum prices judging by platinum imports. In contrast, reported Palladium imports, which have limited price sensitive jewellery demand exposure, have risen by 22%, driven principally by strong auto demand.

Finally, despite the South African strikes ending, we see little prospect of downward prices corrections for either of the PGMs. **As such, we have further upgraded our palladium price outlook for the remainder of 2014, expecting prices to average $900/oz. in the 4th quarter. The average price forecasts for Platinum in 2014 remain unchanged at $1,475/oz.**

**Base Metals - Nickel likely to be outperformer**

**Copper** – Recent China macro economic data, plus expected Q3 Grid related China demand gains point to continued support for copper prices through H2 2014. Indeed, returning investor appetite and improving market fundamentals should keep prices within the current $6,900/t - $7,200/t range through 2H.

**Nickel** – Nickel has been the outperformer ever since the start of the Indonesian ore export ban. At the same time, with nickel demand also expected to grow by 5.7% this year, Citi analysts **see prices averaging $18,550/t in 2014**.

**Zinc** – Continued sluggish growth in galvanised steel sheet production in China and subdued Chinese construction do not support a bullish demand picture despite clear signs of improvements in both US and Europe. The current zinc rally looks unsustainable in the short term, and Citi analysts expect prices to average $2,100/MT through Q3.

**Aluminium** – Continued over-production expected to limit potential upside for aluminium prices, with uncertainty over future warehousing reforms also an inhibiting factor. Citi analysts now see little prospect of prices now sustaining upside moves outside a $1,850-$1,950/t price range in H2.
Agriculture

Adverse weather conditions in Latin America and California, geopolitical heat in the Black Sea region, low calf/cattle inventories and robust US export boosted agriculture prices across the board through April of this year and against the fundamental backdrop for many crops considering the strong 2013 Northern Hemisphere harvest.

But early 1H’14 price strength ended June with a whimper for many staple crops except for cocoa, coffee and sugar where Citi Research maintains a bullish-to-neutral stance. Prices began easing in May for benchmark cereals and row crop/grain prices seem poised for another 10% correction if US and Northern Hemisphere weather remains favourable while El Nino risk can support soft commodity prospects.

**Cocoa** – Prices could stay elevated and strong into 2015; rally expected in 3Q’14 as market prone to ongoing albeit modest seasonal deficits. Citi analysts expect **prices to persist north of $3,000/MT**.

**Coffee** – Prices may remain near historically high levels as the deficit likely carries over into 2015/16, although better 2Q weather in LatAm has eased some crop stress in Brazil as LatAm exports have surged to records.

**Cotton** – Prices are likely to stay in the low 70s/high60s range especially as fabric demand has been turning structurally towards synthetics in recent years as Chinese demand falls.

**Corn** – Extremely bearish new-crop environment where Citi analysts have been forecasting average **prices to post below USd380/bu in 4Q’14**.

**Wheat** – **Prices could level to USd500-550/bu** amid surplus row crops that should keep dragging wheat prices downwards and increase substitution effects.

**Commodity Market Sector Performance**

Source: Bloomberg, Citi Research (through early July 2014).
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