**From West to East**
*Weekly Investment View*
*22nd July, 2018*

# Supports, resistances may break; supply and demand stay

**Oil prices saw another day of sharp moves on the 16th of July, with the cost of a barrel of Brent crude dropping 4.6% to US$71.84. The move followed headlines suggesting Saudi Aramco was marketing excess production in Asia, as well as a statement by Secretary of the US Treasury, Steven Mnuchin, suggesting some countries may be given waivers to buy Iranian oil for a little longer.**

Oil prices have been erratic partly because there is a time mismatch between when Iranian oil is removed from the market in November and when other OPEC members start increasing production, which has started.

Market positioning in oil futures may also have played a part in the recent sharp moves. As of 10th July, there were 654,000 open speculative net –long oil contracts in the New York Mercantile Exchange, according to data from the Commodities and Futures Trading Commission. That is only 11% shy of the record long position seen in February. That number dropped to 631,294 as of 17th July, in a sign that speculators pared long bets, something that could have driven prices down.

Large speculative positions tend to cause sharp moves in prices as any news that does not conform with the general view prompts investors to suddenly shift their exposure. In fact, some traders use what they call 'crowded trades' as indications that markets could move in the opposite direction. Hence, as long as betting on higher oil prices is a popular trade, sharp moves downward can be expected on any news of additional supply. However, the driver for oil prices remains supply and demand — and the latter is still outpacing the former.

In the past five years global oil output increased on average by 1.5% while demand grew 2% per year, according to estimates by the US Department of Energy. Part of that is explained by lack of investment into new oil wells as oil prices dropped 75% to US$28/barrel between June 2014 and January 2016. Some of that is coming back online, as evidenced by the 1.5 million barrels of shale oil production the US added this year, bringing total crude output in the country to a record 11 million barrels a day as of 13th July.

However, US shale oil production faces logistic bottlenecks to reach international markets, making its export problematic for now. This phenomenon has been explicit in the discount of West Texas Intermediate crude to Brent. In fact, US oil imports have increased to more than 9 million barrels a day as of 13th July as refiners find it cheaper and easier to take foreign crude, while exports have dropped 51.3% since 22nd June. These factors may help explain why crude inventories in the US saw the biggest rise since April in the week ended 13th July, one of the headlines that prompted the rapid drop last Wednesday. Demand in the world's biggest consumer is not abating, though. As refiners stopped for maintenance, US gasoline inventories plunged by 3.2 million barrels in the week ended 13th July.

> ***"With production near maximum potential in the US and Saudi Arabia there is very little margin to deal with supply disruptions."***

**While oil still has bullish tailwinds, precious metals breached several technical levels on Wednesday.** That added fuel to a drop which sent platinum deeper into bear market territory.

The metal dropped 20.5% between the recent high of US$1,015.86 an ounce on 24th January to the 10-year low it recorded on 19th July. That may be largely due to platinum's high correlation to gold, which dropped below US$1,242/oz on Monday, a level where it had found support earlier this year, sending the commodity into a tailspin. Gold closed as low as US$1,222.97/oz before recovering 0.5% on Friday to US$1,229.53/oz. Silver breached US$15.6/oz, a level from which it had bounced every single time since April 2016, closing as low as US$15.3160 on Thursday before recovering to US$15.5141/oz on Friday.

In all three cases, these precious metals' price moves were much more driven by technical factors, such as key support levels being broken, and a rising dollar. These commodities, however, are also hostages to supply and demand dynamics. And to that extent, the potential directions their prices may take could diverge. In the case of gold, production still outstrips demand. As of the first quarter, demand from jewelers was dropping, though it was being compensated for by higher interest from central banks, particularly Russia which replaced much of its US Treasuries for bullion this year. Mine supply, meanwhile, increased 1.35% year-on-year in the first quarter.

Platinum is seeing a very different dynamic. The metal is used to make automotive catalytic converters, which reduce greenhouse emissions, and in oil refining processes, apart from its use in jewelery. In its industrial purposes, platinum can be replaced by palladium. However, palladium now trades US$66/oz above platinum, at US$894.77 last Friday. Two weeks earlier, that difference was more than US$130.

It takes no retooling of catalyst factories to switch from one metal to the other. Furthermore, starting last year, new automobiles in the US are required to follow more stringent emission standards, with much of the rest of the world expected to adopt similar standards by 2020. That means more complex and platinum-heavy catalysts. Finally, in January, 2020, ships will also be subject to emission standards.

The other side of the equation, supply, is hardly supportive of platinum prices remaining this low. South Africa produces almost 70% of the world's platinum. Listed miners in the country reported flat-to-negative growth in platinum output in the first half as they closed unprofitable mines and tried to offset that loss by increasing production in more efficient ones. Platinum group metals, by the way, are particularly difficult to extract and when a mine is closed it is very expensive and difficult to bring it back online. Much of the lost supply has been replaced by more efficient recycling. However, there is a limit to that, too.

***"Dwindling mining and increased demand may skew the balance for platinum in the next two years."***

**Also keeping the lid on commodity prices, however, has been the strong US dollar.** The dollar index tested 95.3 last Wednesday, a resistance level that, if breached, could presage another round of appreciation for the currency. The index, however, retreated to 94.476 on Friday. The snap rally had been fueled by Fed Chairman Jerome Powell's comments in Congress, where he reiterated the intent to continue to increase interest rates at the current pace. The reversal came courtesy of President Donald Trump's comments that he was not happy with rising interest rates and the resulting strong dollar and also that he was prepared to step up the trade war, which, in his own words, has become a currency war, with China.
While President Trump's comments are consistent with his pre-election rhetoric, Mr. Powell has reason to stay on the rate hike path – "for now", as he put it. US headline inflation accelerated in June to 2.9%, the highest monthly print in six years, while unemployment is at the lowest in more than 30 years. Then, on Thursday, the US recorded the lowest jobless claims figure since 1969.

***"A stronger dollar may slow the US economy and its inflation, which ultimately may slow Fed rate hikes."***

But until the stronger dollar filters into the economy, Mr. Powell seems unwilling to change his stance. His position, in fact, is starkly in contrast to that of Janet Yellen, Ben Bernanke and even Alan Greenspan. The past three Fed Chairs often sought confirmation that better data was consistent before becoming hawkish. Mr. Powell wants comfort that things have gotten worse before he shifts tack.
As long as the Fed continues to indicate it will raise interest rates five more times before it stops – as the current median forecast of the FOMC voting members suggests – the dollar is likely to continue to rise. That trend has wreaked havoc among emerging market currencies.
**The Indian rupee, for instance, closed at its lowest in history, at R$69.0525, on Thursday as political uncertainty was added to the weight of higher oil prices – which affects both the country's imports and current account.** On Friday, Prime-Minister Narendra Modi faced the first no-confidence vote in the Indian Parliament in 15 years as the Congress Party tested the strength of the Bharatiya Janata Party-led government. The Prime Minister easily won the vote, but the motion worried investors.
The move by the Congress Party was the initial salvo in the electoral season. And while the fact that Modi got more votes than he commands in Parliament to win, it also signals an opposition more willing to use every opportunity to undermine the government. The moves come as almost half of the respondents in a May poll by CSDS-Lokniti said they did not want the incumbent party to return to power. The victory in Parliament as well as the drop in the US dollar index still helped buoy the rupee to 68.8488 on Friday.

***"The no-confidence vote gave investors a taste of rising political noise ahead of Indian elections, and how that could impact the currency."***

In the run-up to the election, the BJP is already leveraging its use of social media, however, having even drawn Facebook Inc. into the fray. After reports that lynch-mobs have formed as a result of private message forwarding, Facebook's chat application WhatsApp has limited the number of times someone can forward a message. The move may also help the Indian government keep a lid on fake news that could be used in elections. Other governments will also rejoice.
The US technology company is increasingly finding itself at the center of political attacks and attempts at controlling its powerful social media platforms. It is no wonder that Facebook set a record for the amount spent by a US company in lobbying in the second quarter. Similarly, The European Union slapped Alphabet Inc.'s Google with a €4.3 billion fine last week for bundling its applications.
While the reasons are different, the underlying thread is similar. Social media and search providers have become powerful opinion influencers, similar to TV broadcasters in the 1970s. Commanding some control over these giants could mean losing or winning an election, so they will be increasingly targeted by governments and will have to spend more to appease politicians. The trouble is that, unlike TV channels 40 years ago, these internet giants are global — what appeases politicians in one country may anger those in others.

***"Expect political attacks against US internet giants to increase as they become ever more important."***

**Investment Summary:** US stocks ended the week flat after dropping on Friday on the back of President Trump's comments. Tech stocks were lower after Netflix reported weaker than expected growth, though Microsoft offset the impact, beating expectations. Most of the key companies in the sector report earnings in the next two weeks. The yield on the 10-year US Treasury jumped 5.5 basis points last Friday to 2.89%, just as the dollar dropped, also in reaction to President Trump's remarks. Nearer to home, the Dubai Financial General Market Index logged its third consecutive week of gains.

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