

Goldman Sachs Exchanges

Why the ‘great de-stocking’ in oil and commodities could pave the way for future gains

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Recorded: May 24, 2023

Allison Nathan: Oil prices have underperformed this year as growth years continue to loom large, but are the lower prices here to stay? Or is the recent weakness overdone?

Jeff Currie: I think it's a lot of due to the macro environment that we're in that are creating these incentives to de-stock. I think the key message here is it cannot go on forever. Eventually, you have nothing left to de-stock.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.

To help shed light on what's going on in the oil and broader commodity markets, I'm sitting down with my colleague

Jeff Currie, global head of commodities research in Goldman Sachs Research. Jeff, welcome back to the program.

Jeff Currie: Great. Thanks for having me.

Allison Nathan: Jeff, when you last came on this podcast earlier this year, I hate to remind you that you were very bullish on commodities, and of course oil prices in particular have substantially underperformed this year. So my first question has to be to you have you ever been this wrong for this long?

Jeff Currie: The answer to that, I believe, is no. And Allison, you were on this team going back -- it's been over 20 years now -- for a decade and a half. Do you ever remember a time we were this wrong for this long without seeing some kind of information to change our view?

Allison Nathan: The only time that comes to my mind, Jeff, is heading into the financial crisis or a couple months there where we were still bullish and obviously ended up changing that forecast pretty quickly within a couple months. So, yeah, it's been a while. So what's going on?

And why are you sticking to your bullish views here?

Jeff Currie: Let's start with why we're not changing our forecast. When we look at the demand data, whether if it's oil, metals, any of the commodities with the exception of steel in China that is tied to the property sector, the rest of these commodities' demand is holding up. There is no sign of recession. In fact, oil demand just reached an all-time high back in this March, which is not indicative of a recessionary environment.

Even metals demand, despite the manufacturing weakness, is holding up. Turning to inventories, yes, they've been building in oil more recently, but they're still at very low levels on a historical basis relative to the 5-year average and particularly relative to demand levels. Similarly, we look at copper, aluminum, inventories have been outright exhausted and are near critical levels.

Allison Nathan: So if demand is holding up, why are oil prices dropping?

Jeff Currie: It's de-stocking. You know, it's a de-stocking that's being driven by higher interest rates, creating an

inability to hold physical oil in inventory or metal. And we look at it in the financial side because it's not only physical de-stocking but it's also financial de-stocking. So higher rates, fear of recession, and inflation fighting.

And you asked specifically on oil. Let's talk about the types of de-stocking we've seen physically and financially. And it's unprecedented. It's why we just put out a piece titled "The Great De-stocking" because we've never seen anything like this. So let's start with oil physical.

SPR, the Strategic Petroleum Reserves, since last March until now, they've discharged globally between France, US, and a little bit out of China 250 million barrels of strategic petroleum reserves. Let's look at sanctioned oil like Iranian oil. They've been sitting looking at oil, sitting on ships for nearly a decade that haven't been discharged. In this inflation fighting effort, governments are taking a more benign approach to sanctioned oil. It now has ways to get out, and you've drawn down nearly 80% of the Iranians' floating storage.

Russian floating storage is being discharged. So from a physical perspective, this is pretty significant. And then

when we think about what's going on on the financial side, there, just in the last 30 days, they've liquidated 250 million barrels of paper positions. Again, higher interest rates, making it difficult to hold the position plus higher volatility. And so I think it's a lot to do with the macro environment that we're in that are creating these incentives to de-stock.

I think the key message here is it cannot go on forever. Eventually, you have nothing left to de-stock. And in the metals, you are at that point where there is pretty much nothing left to de-stock. And the metals story is a little bit more straightforward type of de-stocking in the sense that in-use demand for manufactured goods is holding up much stronger than production. But you have many producers around the world very fearful of recession, higher funding costs, drawing down inventories of finished goods to be able to meet that higher in-use demand.

And again, this simply cannot go on forever. So we're getting to a point and it's been going on for nearly 12 months. We're getting to a point where the ability for the system to continue to de-stock is starting to be constrained.

Allison Nathan: But even if this has been primarily a de-stocking story, the economic data in China, which has been so important to the commodity demand story, does look like it's losing momentum. So are you concerned at all that, going forward, China weakness is going to derail the bullish story?

Jeff Currie: First, I want to talk about the consumer versus the producer in China because that dynamic has a lot to do with it. And then the other point is from a commodity perspective. The difference between the property market and green CapEx.

So let's start with the consumer versus the producer in China. A very critical difference between China and the West is the West got the fiscal transfers. It got the checks that were sent to them during COVID. Chinese consumers did not get that. Their balance sheets, yes, some had substantial savings built up, but there wasn't the oomph that you could get from a Chinese consumer that you were able to get from a Western consumer. And they got to start working again, get a wage, rebuild that balance sheet, and begin to purchase.

In contrast, the producer, as soon as they got rid of the zero-COVID policy, the worker went back to the factory and the producer could produce immediately. And I think, if anything, we look at February, March, and early April, the data was surprising to the upside out of China. And that was being driven primarily from the producers' side because they could just turn the factories back on because people went back to work.

However, that consumer is more steady as she goes. And the bad data that you're referring to in April, margins were very weak. And as a result, the producers started to back off. When we look at retail sales, yeah, they missed but it's not catastrophic. The durable goods demand like property and things like that went down sequentially, but the services like restaurants and things like that went up. And it's just going to take time for that consumer to rebuild that balance sheet, and you're going to see a normalization in the producer side that will probably take place in May and June.

While it may not be the gangbusters that many thought that we saw the evidence of -- again, I want to emphasize,

March, this was looking gangbusters ahead of expectations, but it's because of that supply dynamic versus the consumer dynamic that is at play.

One last point here, bringing it to property versus the green CapEx. From our metals view, the green CapEx is far more important than Chinese property. And where you saw sequential decline in demand in China in April was in the property market. Why? Because people had pent up demand that was executing in late February and March after the Chinese New Year. And this created a surge in demand that you're now getting the give-back to.

And look at overall steel demand. And part of our super cycle story is the green CapEx story, whether it's the IRA in the US or the RePower EU in Europe and the green CapEx in China. That's the core of our super cycle story. It's not property development. So even if we do see a weaker property market in China, which is our expectation that it's structurally going to be weaker, it does not impact the demand for metal that we have forecasted. And that's the case we see born out that even copper demand and aluminum demand more recently has held up despite the weaker industrial production numbers that we've seen out

here.

But I think the main point to take away on China is the point that the producers came out of the gate really fast, created the surprise to the upside, but the demand didn't accelerate as quick because people need to get wages, rebuild their balance sheet. But eventually, as we look out in the second half of this year, we do think they're going to rebalance out and start to meet one another.

And one last point. When we look at the oil demand, yeah, it's come off somewhat, but it's still very close to the 16-million-barrels-per-day target, which is what ourselves and some of the other forecasters had expected for this time in 2023.

Allison Nathan: But even beyond China, there are a lot of questions being asked about the global manufacturing cycle at this point. We're seeing industrial production weakness out of Germany, for example. And there's just a lot of concern about recession risk and growth risk broadly. So how concerned are you about the demand picture from the goods and manufacturing side?

Jeff Currie: Well, let's first put it in context of the surge that occurred in COVID. Remember when I just made the point that Chinese consumers didn't get the fiscal transfers that the Western customers did? The Western consumers got those fiscal transfers, the checks in the mail, and as a result, because they couldn't buy it on services, bought it on goods. And you saw a huge surge in goods demand relative to trend. I recommend anybody look at that chart. It's mind boggling how big the surge was.

Now, what I find really impressive is we're trading sideways back to the trend line where it didn't collapse. So if anything, I'd argue that goods demand has held up much stronger than what you would have expected given that a surge that occurred in now 2020 and 2021. It's basically moving sideways back to the trend line.

But more importantly, it's again think about demand versus the production. The higher interest rates, recessionary fears. If you're a producer, if you want any inventory on site, the answer is no. You're going to de-stock. And so the production is far lower than the in-use demand because you continue to see this de-stocking.

Again, I think whether it's fears of a recession, higher interest rates, higher funding costs, they all create that desire and incentive to de-stock. That's why we've never seen de-stocking of this magnitude, and a lot of it's occurring in the manufacturing sector because that's where you have expensive stuff that would be sitting around in a warehouse or an inventory. And you don't want it, so take it down as low as you possibly can. And that's been driving the weaker metals demand from Western manufacturing more recently.

But again, it's something that just can't keep going on. Our economists view that we're getting close to the trough in this manufacturing. By the way, it's not a terrible trough in any shape or form. In Europe, yes, you have the problems with European gas there and the energy crisis that made it worse than the US and other places. But I think key message here, in-use demand looks better than the production. And it's trading or moving sideways back to a trend line after an enormous surge during COVID.

I'm not that worried about it, and here's the important point. Even though you just mentioned the concerns about what's going on in China, the demand for metal and other

goods in the manufacturing sector are offsetting any weakness that you're seeing in Europe or the US. And on a global basis, demand is still up.

Allison Nathan: Even if demand is still up, let's talk about the supply side a little bit more. You've said repeatedly that demand is exceeding supply, but there are a lot of concerns about supply growth as well. We've seen more ample Russian production on the energy side than I think we had broadly expected. Compliance with the recent OPEC cuts is being questioned. So how have supplies really evolved? And can you really expect supplies to be more of a support than a drag on the overall landscape going forward?

Jeff Currie: This is part of that de-stocking point we were making before. It is that the Russian production, whether if it was pumped out of the ground, put on ships that was sanctioned, this stuff is being discharged. That's part of this de-stocking process we're talking about. Iranian floating barrels that have been sanctioned sitting on ships for a decade are de-stocking.

So like Iran surprised by 250,000 barrels per day to the

upside, produced more and de-stocked the inventory that was sitting there because, at this point, there's now an entire insurance system and everything that allows that sanctioned oil to be distributed back onto the market. Russia, a similar dynamic we're seeing there.

Now, the question that you brought up is really OPEC and the question about the recent cuts. Because if you say OPEC-plus, that includes Russia, who, as you just pointed out, has been a serious cheat more recently in terms of its promised 500,000-barrel-per-day cut.

When we look at the most high frequency data in Russia, it suggests that they have implemented the cut for May. I would tend to think that they're going to do it. Why? Because OPEC can't sit around and let Russia cheat on them over and over. And let me remind all the listeners, Saudi Arabia was the one who really put the nail in the coffin on the oil Soviet Union. So the Putin administration has to remember that, and the last thing they want right now is a price war similar to what they had in '86 with the Saudis or what they saw in March of 2020 with the Saudis. So I think that will create some discipline because they wouldn't survive it.

Turning to OPEC, as you pointed out, in April there was a surge in the export. But again, the more recent data suggests that they are complying. The one thing about this current OPEC and its leadership is that they've been incredibly compliant. We've never seen compliance this high, and I think it goes to a broader point here. It's because of the lack of investment in non-OPEC production and particularly non-OPEC ex-US, core OPEC is the only game in town. And by the way, even against Russia now because of the lack of investment and the ability to bring in technology or capital, core OPEC is the only game in town. And that includes US shale that's not growing at the same rate that it was due to capital availability, restrictions around capacity to produce, geological issues.

So OPEC, and particularly Saudi Arabia and UAE, are the only ones out there with spare production capacity and are investing in future production capacity, which leaves them with incredible market power that they can exercise. And they did so back in October. Let me remind our listeners that never in the history of OPEC have we ever seen a move like last October, where they preemptively cut production before a demand event. Historically, they're always late to

the game.

You brought up '08. They didn't cut until deep into that recession. It was, like, November of '08 that they finally cut because, if they try to preempt it, they would lose market share. It's a really different environment that we're dealing with in OPEC today versus even five years ago.

Allison Nathan: So what are you expecting from the June 4th OPEC-plus meeting?

Jeff Currie: Our base case is a rollover. What do I mean by a rollover is just maintaining the existing cuts that have been announced in place. However, given the recent rhetoric out of OPEC around the short sellers -- because, remember I just wasn't de-stocking -- we now have a market in gas, oil, and things like that that are outright short. We think it discounts oil \$10 to \$15 a barrel.

And when we think about OPEC and the resent points yesterday is they were like, "Watch out the short sellers." We would say they would rollover. They don't know the effect of the April cuts. It takes 60 days, bare minimum. And I think it would be premature, but some of our

competitors are forecasting additional cuts come this June, given that those recent announcements coming out of the organization. However, our base case is let's take a wait-and-see approach, particularly given the fact that consensus view, including ours, everybody sees June as being big deficit months. And we saw some of the evidence of it in the weekly stats more recently that this market does shift during the summer months and start to be shifted into a deficit. And maybe additional cuts wouldn't be needed. We'll see. But not everybody agrees with us with the rollover view.

Allison Nathan: So meanwhile, European natural gas prices have fallen to the lowest level since the start of the energy crisis, so what's driving that? And does that mean that the European energy crisis is over?

Jeff Currie: Well, they're down to 29 euros. That's 10% of the peak last summer. There were over 300 euros a megawatt hour last summer. They're trading at 29 today, so that's a substantial decline.

By the way, to put it in perspective, that's still near \$10 in BTU versus the US at, what, 250 right now? So it's still a

historically high price. What's driven it? One was a warm winter, obviously. But it was the high prices also saw consumers make very large conservation efforts. They were consuming at a given heating degree day during this winter 18% less gas. That's huge.

Here in my office in London, the temperatures of the office were quite cold. Substantially lower than what they would have been a year ago. But by the time you got to March and we were down to 40 euros of megawatt hour, the lights were coming on and the heat was coming on. And you look at the conservation efforts more recently, they're not at the same degree that they were five or six months ago. So that's point number one.

Point number two, industrial demand is very weak. Some of that was lost permanently. Things like fertilizers that were moved to places like the US. So looking at it at a global perspective, it's not nearly as bad as what you see here in Europe on a local perspective. But the other point, too, is many of these sectors and the ones that you're seeing de-stocking -- aluminum, smelting, and things like that -- do everything you possibly can to reduce your cost basis by not operating today and de-stock anything.

So again, this idea of the great de-stocking is very much alive and kicking and very apparent here in Europe, particularly in energy-intensive manufacturing sectors. And then the third factor that got us down to the lower levels is the Chinese. They quit importing LNG in the second half of last year. Everybody goes, “Oh, Europe survived this.” One of the key reasons why Europe survived this is the world's largest commodity consumer, the world's largest oil importer, and the second largest economy of the world was shut down. They weren't taking the LNG, and Europe was able to take it.

We think these prices are not reflective of what the forward is going to look like. We see prices moving back into that 70 euros a megawatt hour range this summer and back to 95 next winter. Why? Because China is going to be back in the market for gas, and we're seeing evidence of that occurring.

The industrial demand weakness driven by de-stocking cannot continue to go on unless we have a substantial recession. And then the consumer conservation efforts won't hear at 29 euros a megawatt hour. The answer to

your question, “Is the energy crisis behind us in Europe? Is it over with?” the answer is absolutely not. We got back to 95 euros a megawatt hour and that's indicative of a significantly short market.

Allison Nathan: So you're bullish on European natural gas. You are broadly bullish on oil and other commodities. Give us a little bit more detail. Where could oil prices go to by the end of the year? And where do you have most conviction in the upside across the commodities complex?

Jeff Currie: Our target on oil is to finish this year at \$97 a barrel. At 75, that's a long ways away right now. But I think a key point is this summer we expect the market to transition into a significant deficit. Let me say the recent data suggests we're already making that transition into deficit markets.

And as the inventories begin to draw and if you don't get a recession, then you reverse all those short positions. The upside here I think is substantial. In fact, here's a way to quantify it. The market is as short today as it was during COVID when prices went negative. Do any of the listeners on this podcast think that the fundamentals are as bad

today as they were in April of 2020? Absolutely not. Yet the market is pricing as if that were the case.

And if you do not get the evidence that you have that huge recessionary driven surplus, the shorts get out of the market. In a deficit environment, the market pops significantly, shifts the technicals, you move back to trend market. And not only we take unwind all the shorts, then you have the length come back into the market in a more normal fashion. That alone will swing the market, let alone looking at what the fundamental picture does.

So that's why, if I were OPEC, I'd be a little cautious about doing another cut here. Just give it time. Have some patience here because I think the upside going into the summer months is substantial. And we see it moving back over \$100 a barrel in April of next year. So you really have a different fundamental picture in the second half of this year.

Now, the question of what's our favorite commodity here? You know, I always love copper. It's running on fumes right now. There's crumbs. There's not much copper left in any of the storage facilities. The question is, can you get

investors wanting to come back to that market? Because unlike oil, at least you can point to A) there was some fundamental weakness; inventory is built because of the warm weather. Copper you couldn't. Yeah, there were some concerns about China, but the market is outright short many of these commodities.

But I think the way to describe it is, from the very long term, we think the upside on copper is the most. Now, I'd like to point out copper is the new oil. It's the strategically most important commodity to energy and decarbonization. So we're going to need it. We do not have the supply. There's nothing in inventory right now. And green CapEx, not China properties, is behind that story.

So we see the fundamentals tightening. The question is, will you see someone go back and start buying these markets? I think once of them begins to trend and go to the upside, the rest of them will follow suit. Usually copper moves first before oil. That's why we'll be watching both of them this summer, but both of them are facing really tight fundamentals environment that's likely to get tighter as we go into the second of this year.

But if you absolutely have to ask me to choose between the two, I'm going to take oil over copper.

Allison Nathan: So is the recession that investors are fearing the biggest risk? Or what other risks are you focused on relative to your views?

Jeff Currie: Obviously, a recession could be -- and even if you did get a recession, a lot of it's priced in. And even OPEC has responded by cutting it. Put it this way. We have a 1.5 million barrel per day deficit in the second half of this year. To even get a balanced market, that means demand would have to contract by 1.5 million barrels per day. Consensus has a 2 million barrel per day deficit with these cuts. Or the IEA does. That means that you're talking about an absolutely massive recession that would need to occur to justify all of that short selling, which is why I would say, even a modest slowdown, which typically a rate-induced recession is not a massive contraction like '08, which was a credit imbalance that created a big contraction.

You know, it's rare that even oil demand would stop that much during an interest rate induced recession. Which

our economists and so far the evidence point is they put it at a 35% probability while the market has it at 55. So I agree with you that's a big risk, but is it going to be the one that creates the pullback? I still think, in the back of my head, the one that concerns me is another viral outbreak, a pandemic, or something like that that really shuts down activity in oil and commodity demands being a risk.

But you are absolutely spot on. Demand side is where the risk. It's not supplies. Supply just doesn't come out of the woodwork. By the way, it did with the Iranian barrels. We didn't expect the governments to turn a blind eye to the Iranian barrels as well, but they did. So I want to be cautious there. There was stuff that came out of the woodwork this more recent period. But, yeah, usually it has to come from demand.

Allison Nathan: Let's turn to gold, which has been a beneficiary of these recession fears. You've seen gold substantially outperforming in the recent period, along with other safe haven assets. So is that sustainable? What's your view on gold? And how does positioning look relative to that asset at this point?

Jeff Currie: Yeah, gold has kept its value up. It's outperforming the rest of the commodity complex, but let's just put it in perspective. We crossed \$2,000 an ounce back in July of 2020, nearly three years ago. It's the same level. It's been trading sideways for three years.

The fundamental backdrop on gold is just downright impressively bullish. Central banks in the emerging markets, last year, we were at 1,200 tons of gold. We haven't seen this type of gold buying by central banks since the Breton Woods era, going back into, like, 1960s. The physical demand is there.

The problem is you don't have the investor demand, and the Chinese demand has been a little bit weaker. And I think that the key, if you really wanted to go above 2,100, you have to take a view that very few investors are willing to take. It's that the Fed cannot manage this inflation situation. But you don't see the 5.5 core does not turn into a 2% number over the course of that time period because right now, you look at the way gold is trading in a lot of the defense assets that you referred to, they're trading in line with break evens. And the breakeven inflation gives the benefit of the doubt to the Fed that they will manage this

thing and they will get the inflation back.

So if you're taking a view of gold busting above 2,100, which our forecast is 2,050. We're in the high 1900s. So we'll see a little bit more upside here, but it's not nearly as what you would get if investors throw in the towel of where breakevens are today and reassess them at higher levels. That's where you would actually see the real upside above 2,100.

Allison Nathan: So just to conclude, what are the commodity markets telling us broadly about the economy and its outlook ahead?

Jeff Currie: The world's falling apart in terms of take it where oil prices are today. They're pricing at 2% contraction in global demand. That's huge. Whether it's copper, oil, the rest of them.

Here's the thing that I find peculiar is the rate markets and commodity markets have priced in these recession fears, but the equity markets haven't. It's almost like they're passing Go, collect the \$200, and go straight to the good things of a recession, which is lower interest rates and

lower commodity prices and have priced in higher equity valuations.

What is that telling you? Commodities are the best hedge in case the recession does not occur and interest rates end up being much higher, commodity prices much higher. The equity markets will likely struggle under that environment. But, yeah, so far, the commodity markets have borne the brunt of these recessionary fears, creating a record amount of selling that we witnessed over the last month.

Allison Nathan: But given that we don't expect a recession, essentially you're saying the signal the commodity markets are giving is wrong.

Jeff Currie: Yep.

Allison Nathan: And therefore, position for upside and also great hedge for risky assets in case those recession risks do become realized.

Jeff Currie: Yeah. Absolutely. Again, the evidence doesn't support the recession. People are trying to price in

the expectations of a recession in this markets without any evidence today that that's actually occurring. You know old game of rock, paper, scissor? Paper beats rock because the paper covers the rock. This time around, we think rock is going to beat paper. Meaning, the fundamentals don't support the recession, and those paper shorts are likely going to be taken out.

I can point out rock is far more resilient than paper in the long run. So while paper may beat rock in Rochambeau today, I would take the fundamentals in the rock over the paper as we look out into the end of 2023.

Allison Nathan: Jeff, thanks so much for joining us. Always a fascinating conversation.

Jeff Currie: Great. Thanks for having me.

Allison Nathan: And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called The Markets. Each week, in just 10 minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead.

June 16th is the last day The Markets will be on our Exchanges feed, so make sure to search for “The Markets” and follow its new feed wherever you get your podcasts.

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