

Daily Themes

29 March 2010

Oil price to slide this Spring?

The current oil price of over \$80/bbl appears unsustainable. We hold a positive view of oil prices over the long term, but would prefer to open new positions at around \$70/bbl.

A decline in oversupply has helped oil prices achieve slight gains this year. Yet returns from oil have still outpaced the negligible earnings investors have received from cash. Trading opportunities emerged at the beginning of February, when the oil price fell back towards \$70/bbl. This followed disappointing US unemployment figures, which prompted a temporary loss of confidence in the sustainability of the economic recovery. However, prices subsequently rallied to over \$80/bbl.

Continued economic growth has triggered a revival in oil consumption this year. The recovery remains fragile in many developed countries, but stronger growth from emerging economies - the source of all the current growth in demand for oil - is supportive. Demand fell by a relatively modest 1.4% (estimated) in 2009, when the global economy shrank by 1.1%. The IEA (US-based International Energy Agency) expects consumption to rebound by 1.9% in 2010, and achieve a new high, as global growth reaches 3.1%. Significantly, energy efficiency is increasing around the world - oil demand fell further, and is forecast to grow at a slower pace, than overall global GDP. Indeed, the improvement in efficiency may be under-estimated. For example, demand grew by just over 1% in 2006-7, while the global economy expanded by an annual rate of over 5%. During that period, however, developed economies enjoyed stronger growth than is currently the case. In 2010, global growth will certainly be much more dependent on the contribution of emerging economies, which have a greater appetite for energy and other commodities than their advanced counterparts.

Supply issues will also come into play. An oil price of \$80/bbl will allow many 'unconventional' oil

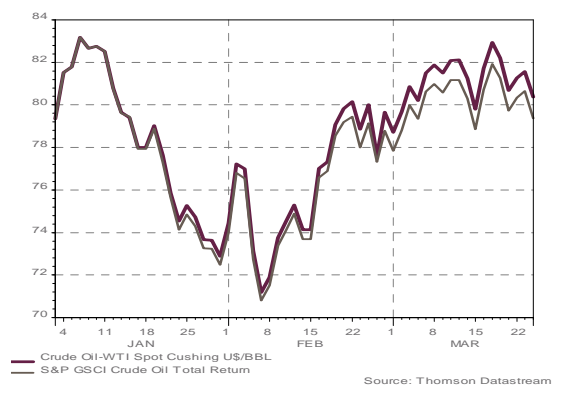
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projects, such as Canada's tar-sands, to generate attractive returns. The surprising strength of non-OPEC production, which has recovered to a new high, and is forecast to achieve additional modest gains this year, reflects this factor. Stocks have thus continued to build, although oversupply (in terms of days of demand) is less severe than during the depths of the recession in early 2009. This development has reduced some of the pressure on the futures market. The gap between the spot oil price and futures has narrowed. Thus, returns for investors are similar to the performance of the spot market, which is broadly flat this year.

Oil and oil futures indices have traded within a range in the first quarter of the year



After an exceptionally severe winter, the market is entering its traditional slack period, before demand accelerates during the summer 'driving season.' This development suggests that oil may trade down during the coming quarter to the bottom of the range seen in 2010, which includes a year-to-date low of \$71/bbl. Longer term, the outlook for the oil price remains positive, given the continuing economic recovery, which is being driven by industrialising economies and an emerging middle class that is rapidly acquiring automobiles.

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