

Oil Market Monthly – 7 December 2009

Minerals & Energy: Ben Westmore

Key Points

- Oil prices have tracked in a narrow range between US\$75-\$80 since mid October.
- The past few months in the oil market have been characterised by a substantial decline in price volatility.
- Both OPEC and non-OPEC countries increased supply in October, consistent with a gradual rise in global oil demand.
- The oil price futures curve continues to reflect concerns that a swift pick-up in the pace of the global recovery may lead to future supply constraints.
- In the US, tepid demand for oil products continues to hang over the market, with distillate stocks remaining around their highest level since the beginning of records in the early 1980's.
- A sustained upward trend in oil prices is unlikely until a series of draw-downs in OECD stocks of oil product is observed and markets are more confident that the global demand recovery is on firm footing.

Oil prices track sideways over November

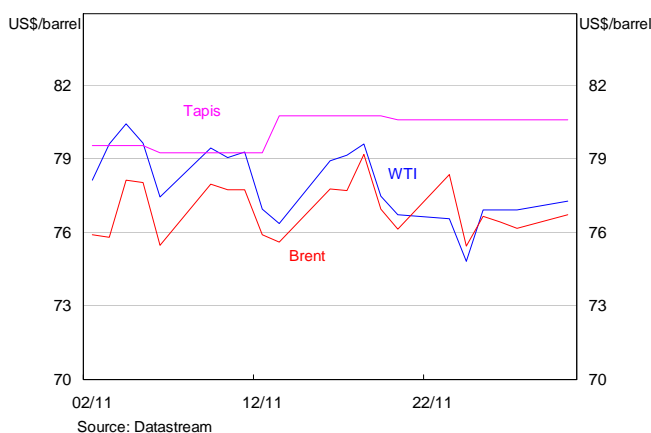
Oil prices were broadly flat over November after gradually rising through the middle part of October. The price of West Texas Intermediate (WTI) has traded within a narrow range of US\$75-\$80 since mid October, reflecting mixed macroeconomic data releases and relatively little change in fundamental conditions in the market. In particular, hopes of a V-shaped recovery in oil demand were tempered by US industrial production and retail sales (exc. autos) data for October, which printed below market expectations. Nevertheless, there are increasing signs that some of those economies most affected by the financial crisis are on the improve: September quarter GDP data for the Eurozone and Japan were stronger than expected, with government stimulus measures continuing to support expansion. As we have noted since early this year, the global economic recovery is likely to be a gradual process and, in trend terms, oil price movements have come to reflect this view. Indeed, substantial headwinds to growth are expected to linger for some time, in the form of weak labour markets, more restrictive future government policy and further financial deleveraging by households and businesses.

Oil price volatility greatly reduced from earlier this year

The past few months in the oil market have been characterised by a substantial decline in price volatility (see Graph 2). This follows the plunge in the oil price from its record high in mid-2008 at the onset of the financial crisis. Similar to the oil price shocks in 1986 and 1990, the recent spike in price volatility has been followed by some residual instability as investors remain uncertain about prospects for the market and sentiment is fragile. What these previous episodes also show, however, is that once price volatility dampens, it does so for a number of months. This is in line with our central forecast for a modest rise in the oil price over the medium term as fundamental conditions steadily improve.

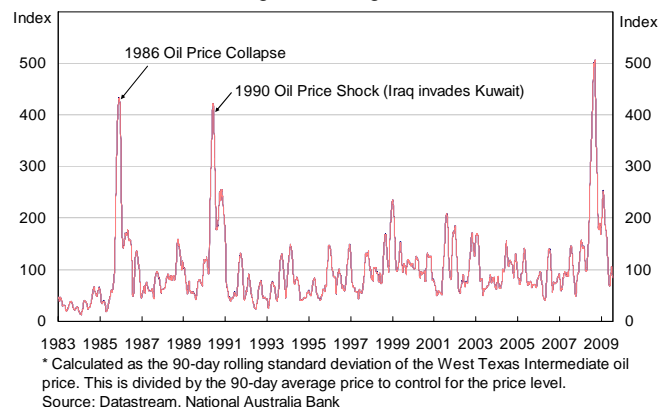
Graph 1

Nominal Oil Prices - November 2009



Graph 2

WTI Price Volatility Index*
Long-run average = 100



IEA further upwardly revise their 2009 and 2010 oil demand forecast

In their October *Oil Market Report*, the International Energy Agency (IEA) slightly revised their forecast for 2009 and 2010 global oil demand upward, citing stronger than expected preliminary demand data for China and Saudi Arabia. The estimates were raised by 210 kb/d and 140 kb/d, to take the demand forecast to 84.8 mb/d and 86.2 mb/d in 2009 and 2010 respectively. Nevertheless, the IEA are quick to emphasise that the demand outlook remains uncertain, especially in the US where diesel demand – which is highly correlated with economic activity – continues to languish. This is consistent with indicators suggesting that in the first half of the year firms serviced the pick-up in US consumption by running down inventories, causing relatively weak domestic production growth.

Chinese apparent oil demand has been strong so far this year, growing by 15.1 per cent over the year to September. Even so, examining the composition of demand suggests this may be significantly related to the focus of government stimulus spending. One example is the pick up in gasoline demand that has coincided with the Chinese government's reduction in a sales tax on small motor vehicles. Since the beginning of the year, the overall stock of vehicles in China has risen by one-fifth.

Oil supply rising in both OPEC and non-OPEC countries

The IEA estimate global oil supply to have risen by 635 kb/d to 85.6 mb/d in October. Production by Organisation of Petroleum Exporting Countries (OPEC) rose during the month, further reducing the group's compliance with target levels to 61 per cent in October, down from 64 per cent one month earlier. Likewise, non-OPEC countries increased supply in the month as seasonal maintenance in the North Sea ended and there was minimal hurricane activity in the US Gulf of Mexico.

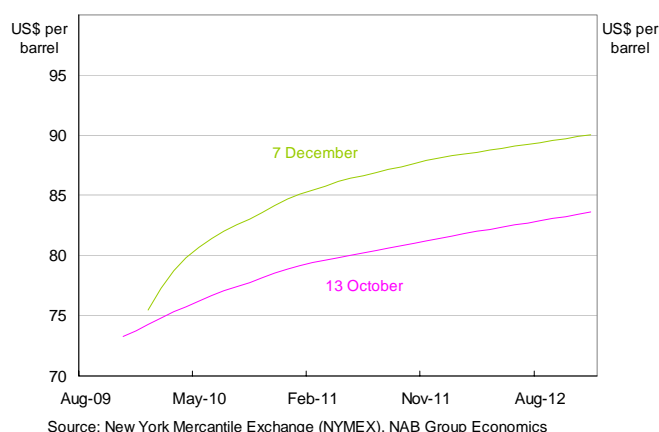
Concerns mount over possible supply constraints

The oil price futures curve remains in steep contango, shifting upwards over the past six weeks with the increase in the spot price over the second half of October (see Graph 3). The forward structure of the curve has steepened, consistent with a pick-up in Cushing crude oil stocks over November. The back-end of the curve continues to reflect concerns over the possibility that a swift pick-up in the pace of the global recovery may lead to future supply constraints. Specifically, concerns relate to a lack of exploration and development, delays in oil projects and geopolitical events in Iran. Tackling each of these separately:

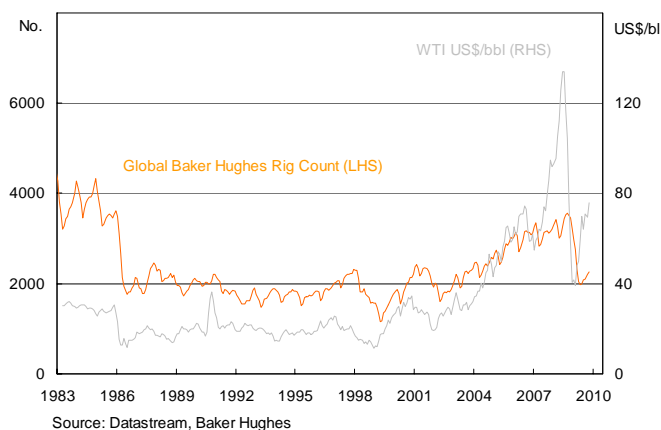
- The steep decline in the oil price from September 2008 to April 2009 was accompanied by a fall in oil exploration and development. Since October 2008, the Baker Hughes Global Rig Count has shown the number of oil rigs mostly retracing the steady rise from 2000 (see Graph 4).
- In the United Arab Emirates, the finishing date for developments to the Bap and Huwaila oil fields, forecast to add capacity of 390,000 barrels per day, have been set back. While, in Iran, progress on the long awaited expansion of the Azadegan field remains very slow.
- Following the insistence by the US government that Iran send 75 per cent of its low enriched uranium to Russia and France for processing, President Mahmoud Ahmadinejad has indicated a strong desire for Iran to process the uranium domestically. Although the US and their allies are yet to respond, the possibility of trade sanctions on Iran continue to be factored into oil prices.

One factor supportive of future oil supply is the investment activity of China over recent years. China continue to develop strong relationships with numerous resource-rich African countries, notably Angola and the Democratic Republic of Congo, often undertaking substantial infrastructure projects in return for some access to their resource base.

Graph 3
Crude Oil Price Futures*



Graph 4
Crude Oil Supply Response

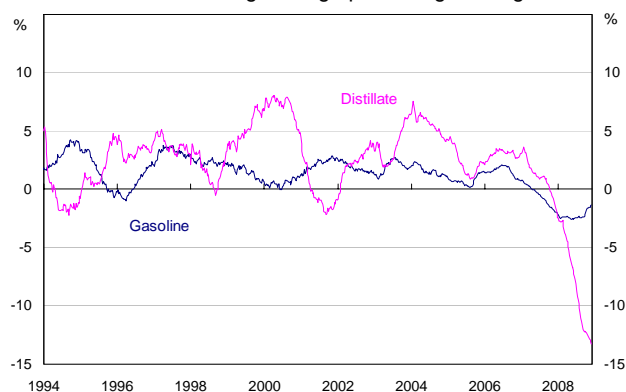


Miserable distillate demand continues to weigh on the oil market

Data from the US Energy Information Administration (EIA) continue to show very weak demand conditions in the US oil market. While crude oil inventories have been drawn down (albeit from very high levels) over the second half of 2009, refinery operation as a proportion of capacity has remained surprisingly low. Tepid demand for oil products continues to hang over the market, with distillate stocks (diesel, heating and fuel oil) remaining around the highest level since the beginning of EIA records in the early 1980's. This accords with the collapse in distillate demand over the past year, as transport and production activity in the US were heavily hit (see Graph 5). Although some of the supply overhang for distillates is likely to be worked off with the onset of the US winter, the recovery in production growth remains integral to restoring the market balance. The US ISM manufacturing PMI, a reasonable leading indicator of production, has depicted moderate expansion in the sector since the middle of this year. This portends a pick-up in distillate demand, albeit at a modest pace.

Graph 5

US Apparent Oil Product Demand
12 month rolling average percentage change



Source: US Energy Information Administration, NAB Group Economics

Oil prices unlikely to trend higher without an improvement in market fundamentals

Looking forward, oil markets are likely to continue taking guidance from macroeconomic indicators. NAB Economics expect an expansion in the world economy in Q4 2009 before global growth picks up throughout 2010. Nevertheless, our view remains that the recovery will be more gradual than in most previous episodes and that there is the potential for a near-term patch of weaker growth as the effects of government stimulus measures wane.

In the short-term, oil prices are likely to remain range-bound. With a reasonably upbeat demand outlook already priced into oil markets, weak fundamental conditions in the form of abundant global oil supplies are the factor weighing on the oil price. Indeed, a sustained upward trend in oil prices is unlikely until a series of draw-downs in OECD oil product stocks is observed and markets are more confident that the global demand recovery is on firm footing.

Further into the forecast period, OPEC have expressed their desire to maintain an oil price that is consistent with production from relatively high cost reserves. Even so, substantial OPEC spare capacity implies that the rise in prices is likely to unfold gradually.

In late 2009 and early 2010 Australian petrol prices are forecast to remain steady as the rise in Tapis prices is offset by the Australian dollar strengthening against the US dollar.

Quarterly price profile

Oil Price Forecasts - Quarterly Average Terms

	Q3 09	Forecasts						
		Q4 09f	Q1 10f	Q2 10f	Q3 10f	Q4 10f	Q1 11f	Q2 11f
Brent US\$/bbl	68	74	73	75	77	79	81	83
WTI US\$/bbl	68	77	79	80	82	84	86	88
Tapis US\$/bbl	72	78	83	85	87	89	91	93
Petrol Ac/L (a)	124	120	119	118	118	120	121	123

Source: Datastream, NAB Group Economics

Group Economics – Some Useful Contacts by Specialisation

Alan Oster Alan.Oster@nab.com.au	Group Chief Economist Economic, Financial & Business Conditions	(03) 8634 2927
John Sharma John.Sharma@nab.com.au	Economist (Australia) Economic & Financial Conditions	(03) 8634 4514
Ben Westmore Benjamin.Z.Westmore@nab.com.au	Economist (Australia & Commodities) Economic & Financial Conditions	(03) 8634 8602
Michael Lee Michael.S.Lee@nab.com.au	Senior Economist Modelling and Econometric Support	(03) 8634 8562
Dean Pearson Dean.Pearson@nab.com.au	Head of Industry Analysis Industry Conditions	(03) 8634 2331
Frank Drum Frank.H.Drum@nab.com.au	Economist Agribusiness Commodities and Industry Analysis	(03) 8634 2041
Gerard Burg Gerard.Burg@nab.com.au	Economist Industry Analysis	(03) 8634 2788
Brien McDonald Brien.McDonald@nab.com.au	Economist Industry Analysis & Risk Metrics	(03) 8634 3837
Daniel Farley Daniel.M.Farley@nab.com.au	Economist Property Market Analysis	(03) 8634 2168
Tom Taylor Tom.Taylor@nab.com.au	Head of International Economic & Financial Conditions	(03) 8634 1883
Robert De lure Robert.De.lure@nab.com.au	Economist Country Risk & Asian Economies	(03) 8634 4611
Mark Rodrigues Mark.E.Rodrigues@nab.com.au	Economist (International) Economic & Financial Conditions	(03) 8634 1823
John O'Connor John.F.O'Connor@nab.com.au	Economist (International) Economic & Financial Conditions	(03) 8634 8076

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