

The Global Outlook for Crude Oil



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Strong crude oil prices are largely discounted by the market, and geopolitical and monetary factors suggest that prices could climb higher. However, a closer examination of the fundamentals offers evidence to the contrary. Despite political tension in the Middle East and monetary policies such as quantitative easing, signs point to an increased risk of falling prices, argues Bloomberg Industries senior analyst Christian O'Neil.

Market Expectations

"The market to some extent has gotten very comfortable with an environment of crude oil price—or, in another sense, very complacent," says O'Neil. Institutional investors on both the buy side and sell side have a positive bias toward crude oil, particularly versus natural gas.

Looking at the average analyst ratings on oil-leveraged exploration and production companies and natural gas E&Ps, it's clear that historically they move in tandem (see Figure 1). There can be periods of divergence, given the individual fundamentals, but the current gap between the two is the widest it has been in more than ten years.

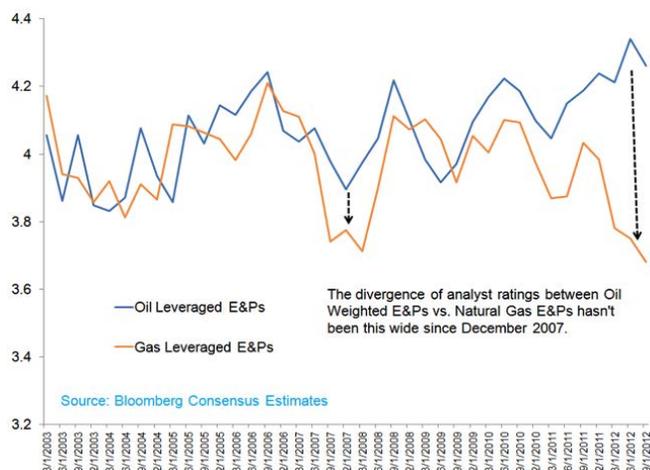
While the stock market has enjoyed a steady recovery since March 2009, the overall E&P sector has outperformed it over the past three years. When the sector is broken down further, focusing on companies that are more leveraged to crude oil production, the outperformance is even stronger. "Institutional investors, recognizing tight crude oil fundamentals relative to supply and demand, have been betting on that," explains O'Neil.

The price of Brent crude oil is highly correlated to its underlying equities. When there is a spike in oil prices, there is a corresponding peak in the price for oil-leveraged E&Ps. The peak in oil prices is usually followed by a sharp correction, which is also reflected in the E&P stocks.

When Brent crude prices rose to a high of \$146 per barrel in 2008, the price of oil-leveraged E&Ps also peaked. But while crude oil prices recaptured 90 percent of their peak price in April 2011 and March 2012, the stocks actually reached higher levels than where they were trading in 2008. The price of Brent crude has not been able to surpass its 2008 high.

"Energy is what we call a beta sector relative to the overall market," says O'Neil. "During 9 of the last 11 quarters, energy has outperformed the market when it's been up and underperformed the market on the way down." That has made the space attractive to growth and momentum investors. However, those investors will not continue to invest in the space if they do not believe that crude oil prices are going to reach the next level.

Figure 1
Oil vs. Natural Gas Leveraged E&Ps—Consensus Recommendations



“You could see things unfold quickly in terms of what happens to the crude oil prices and the underlying equities,” O’Neil says.

Demand Factors

Oil demand is largely a function of GDP growth. China, the U.S. and Europe, which account for approximately 55 percent of global GDP, are the source of about half of the world’s oil demand.

The argument has been made that global demand will increase over the coming decade as developing countries such as China see their thirst for oil grow. But the U.S. and Europe, which collectively make up about 37 percent of the crude oil market, can affect the demand side of the equation with just modest changes in negative demand. Incremental demand for crude oil in Europe has been negative for several years, and the U.S. has been going negative as well. Yet oil demand forecasts are calling for nearly trend-line demand growth in 2013 (see Figure 2).

“There’s a disconnect you’re seeing within the market, where incremental demand is close to trend line demand growth over the past ten years, but the GDP forecasts are actually below trend,” notes O’Neil. “We think the risks are rising for crude oil demand numbers to come down.”

GDP forecasts aside, demographic trends in the U.S. also point to decreasing demand. From a person’s peak driving period—their mid-30s to mid-50s—until retirement age, the average number of miles driven annually falls off nearly 50 percent. By the end of this decade, the U.S. will lose 3.8 million people from the group of most active drivers as the population ages. The U.S. used to routinely grow its incremental oil demand by 200,000 to 500,000 barrels per day, but over the next couple of years changing demographics alone could lead to flat or declining demand in the U.S. market.

Price also has an effect. Going back to the mid-1980s, anytime that gasoline prices have increased by 15 percent or more and the absolute price of gasoline in real terms rose above \$3.00 per gallon, it has led to flat or declining demand growth. Higher crude oil prices have an effect on the consumers’ psychological mentality and their driving habits.

While U.S. demand was affected by the Great Recession, European demand had already been decelerating. Demand destruction of another 200,000 to 300,000 barrels per day out of Europe is likely, according to O’Neil. When that is added to the 200,000 to 300,000 barrels of demand being lost per day in the U.S., it could offset China’s incremental demand of 600,000 barrels per day and make it easier for the market to bring on supply to meet that demand.

Supply Factors

Another argument for higher crude oil prices is the inability of the market to grow supply in a significant way. During

Figure 2
Incremental Crude Oil Demand and GDP Growth

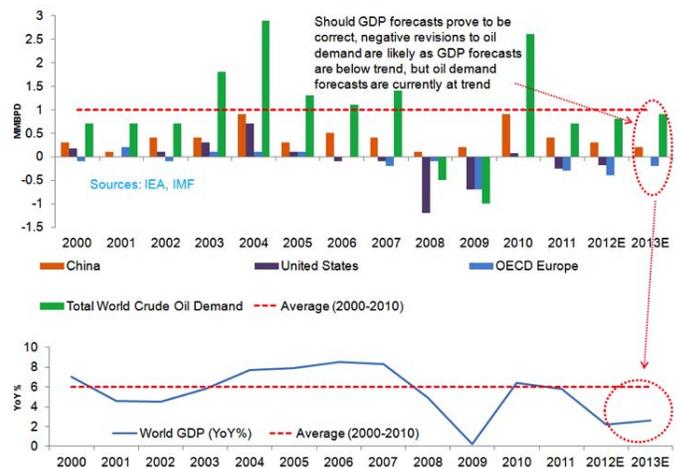
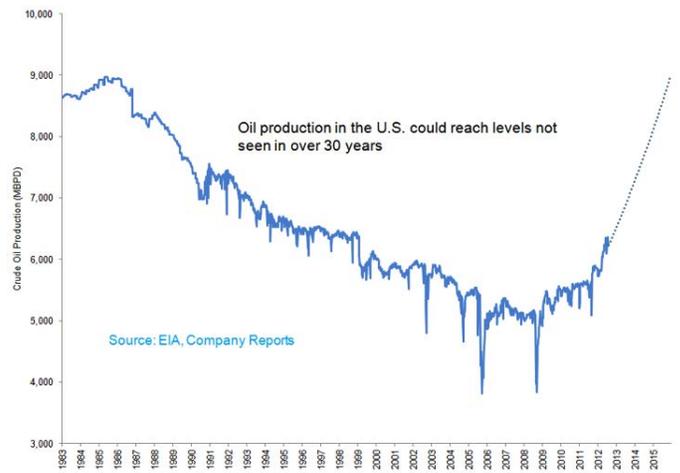


Figure 3
U.S. Crude Oil Production



the crude oil spike in 2008, neither OPEC or non-OPEC producers provided a sizable supply response. However, the advent of horizontal drilling in the U.S. and fracking could change that. “What’s really going to surprise the market on the supply side, is how quickly U.S. crude oil supply is going to grow and grow meaningfully,” says O’Neil.

The U.S. oil rig count is up almost 20 percent from the beginning of 2012, and U.S. crude oil production, which bottomed out in 2009 after peaking in the 1980s, has begun to increase. With the advent of horizontal drilling, companies will continue to find new oil producing zones. But just the prospective acreage in the Bakken, Permian basin, Eagle Ford and a couple of smaller oil producing areas, U.S. production could grow between 3 million and 4 million barrels over the next three years (see Figure 3).

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— Christian O’Neil, Bloomberg Industries

Anecdotally, the North Dakota Oil and Gas Commission recently announced that North Dakota oil production has reached 710,000 barrels per day. At the beginning of 2007, that number stood at about 10,000 barrels. To put that in perspective, Qatar produces about 750,000 to 770,000 barrels per day.

In terms of inventory, dividing the U.S. inventories by estimated demand results in about 54 days of supply. Even ignoring the incremental source of production, the U.S. is well supplied.

Geopolitical and Monetary Factors

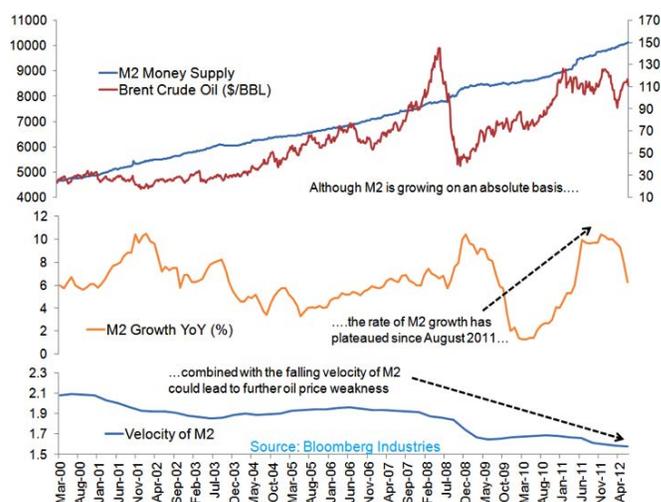
Two of the biggest reasons cited for higher crude oil prices are monetary policy and geopolitical concerns.

About 16 million barrels per day are shipped through the Strait of Hormuz. If tensions in the Middle East were to escalate, and Iran successfully closed the Strait of Hormuz, the estimated spare capacity in the market—between 3 million and 6 million barrels—would not be sufficient. Crude oil prices likely would soar well beyond the levels seen during the peak of 2008, which is clearly a risk that needs to be taken into account.

As to monetary policy, historically there has been no correlation between changes in the U.S. dollar and crude oil prices—until the past decade, when that correlation began to strengthen. As the U.S. government prints more money and devalues the dollar, it puts upward pressure on commodity prices. People use gold and crude oil as a method to protect themselves against devaluation of the currency.

The absolute money supply has been growing along with the Brent crude oil price, but it is actually decelerating within the market (see Figure 4). “While we’ve seen each piece of quantitative easing push hard assets like crude oil

Figure 4
M2 Money Supply vs. Brent Crude Oil



higher,” says O’Neil, “each level of quantitative easing is getting smaller. And the effect in terms of money supply, is actually getting smaller.”

The velocity of money is decelerating as well. While dollars are being created as the Federal Reserve prints more money, those dollars aren’t moving through the economy. “The argument for inflation, which would argue for higher commodity prices—that scenario is not playing itself out,” adds O’Neil.

There is also the risk that the dollar will have strength relative to some of the other currencies. A stronger dollar could surprise the market and put downward pressure on crude oil prices.

Conclusion

Each peak in crude oil prices is resulting in smaller corresponding peaks in the underlying equities. “We’re seeing lower highs and lower lows,” says O’Neil. And equity investors appear to be starting to question the sustainability of higher crude oil prices. Declining demand from the U.S. and Europe, combined with surprising gains in U.S. production, may indeed apply downward pressure on those prices.

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111 Town Square Place, Suite 1215 • Jersey City, New Jersey 07310, U.S.A. • + 1 201.719.7210

2nd Floor • Bengal Wing • 9A Devonshire Square • London, EC2M 4YN, U.K. • + 44 (0) 20 7397 9630

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