Economic Research

WEEKLY ANALYSIS

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Oil-price drop does not accurately reflect supply and demand

The 25% correction in crude oil prices in the last four months is exaggerated. The economic situation in Europe is not the decisive factor. Excessive pessimism will lead to a price rise.

Key Points:

- The oil-price drop was too rapidly blamed on the European sluggish economy
- Crude oil prices have fallen by almost -25% regardless of the production/consumption area
- The dip in crude oil should support growth
- The IEA estimates crude oil global demand at 92.4 mb/d in September, down 0.5%
- Global supply accounts for 93.8 mb/d, this is not surprising
- Europe accounts for only 15% of global demand
- In 2015 crude oil demand will reach 94.6 mb/d. Asia is to become the largest global consumer
- Speculative positions have been reduced by 50%
- An oil price increase at $100 is likely

Weak global demand is responsible for the acceleration in oil-price drop since September

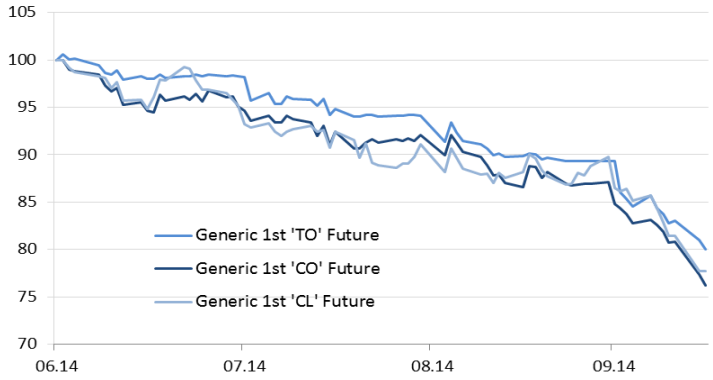
Since June's peak in oil prices, crude oil has steadily slipped and lost approximately -15% until September 2014, before increasing its correction phase in October and losing -10%.

The global -25% drop in oil prices in only four months has often been ascribed to a weak demand, specifically exacerbated by recent fears of a slowdown in the German economic activity.

The prices of classified crude oils which are used as a reference to estimate and fix prices of other crudes, also dropped, indistinctively.

The price of Brent Blend, from oil fields in the East Shetland Basin of the North Sea, West Texas Intermediate (WTI) in North America and Dubai-Oman light acting as benchmark for the Middle East and Asia all actually plunged.

Oil Price Europe (Brent)



Sources: Bloomberg, BBGI Group SA

Every single region in the world and every single oil field produce a different quality of oil. There are more factors which differ oil qualities such as sulphur, minerals, viscosity, than those which distinguish oil fields. Brent serves as a major benchmark price for purchases of oil worldwide, but it also depends on supply and demand and its use. For example, the fuel production for diesel engines requires an oil rich in molecules before refining, while lighter oil is used for gasoline blending.

Brent Crude is a sweet light crude oil which is extracted from the North Sea, and is named after the Brent oilfield was discovered in 1971, North of Scotland (Brent is the acronym of the formation layers that make up the field: Broom, Rannock, Etive, Ness and Tarbet). The price of light crude oils is generally higher compared to thicker and higher sulphuric ones, which are also harder to refine, more expensive and less efficient.

Even if Brent crude production is not very high, oil production from other regions tends to be priced relative to this oil and it is used to price two thirds of the world's internationally traded crude oil supplies. Brent is traded on the electronic Intercontinental Exchange (ICE) in London. In the United States, WTI crude is the reference (API gravity of 36.4), it is lighter compared to Brent (API gravity of 38) and with higher sulphide levels (0.48 against 0.40 for Brent). The Dubai crude is used as an oil marker because it is one of the rare crude oils sold in the Persian Gulf and available immediately, while other crudes are available through long-term contracts. If Brent and WTI crudes are considered as "light", Dubai crude is a « medium sour » crude oil, highly viscous and with about four times the molecular compositions of light crude and its API gravity (31) is 20% to 30% less.

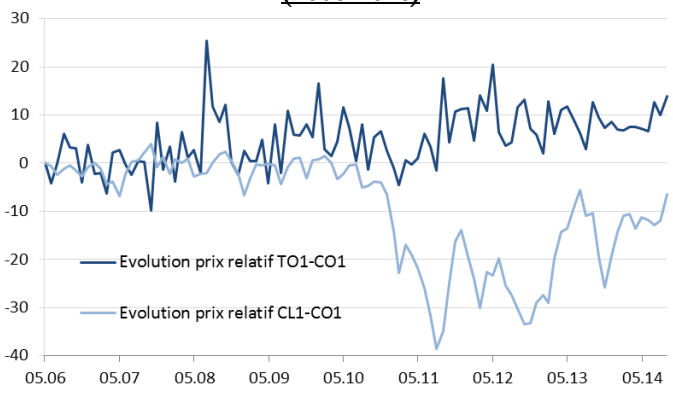
Theoretically, the price of oil in commercial contracts is set according to a formula containing one or more oil markers and a differential or adjustment factor. This factor varies depending on the source, quality, the possibility of refining and transportation costs related to the geographical location of the production area and the place of final consumption.

Thus, Brent represents the European market, while WTI is used as benchmark in the United States.

Substitutability relationship is sometimes deficient as suggested by the historical price gaps

Prices and the chances of substitution of produced and traded petroleum products depends on a variety of factors, thus, in some cases the oil prices and exchange market prices may vary significantly, both in the short and medium-term.

WTI and Dubai Crude Price Evolution vs. Brent (2006-2014)



Sources: Bloomberg, BBGI Group SA

Concerning the 2006-2014 period, we can observe that the price of Dubai crude oil posted the strongest growth (+50.3%), consequent to a greater demand compared to Brent (+30.6%) and WTI (+26.8%).

A short-term analysis of valuation gaps indicated that volatility of 0 to $20 per barrel in favour of Dubai crude compared to Brent. Moreover, Dubai crude is almost systematically traded with an average $10-15 premium during the period.

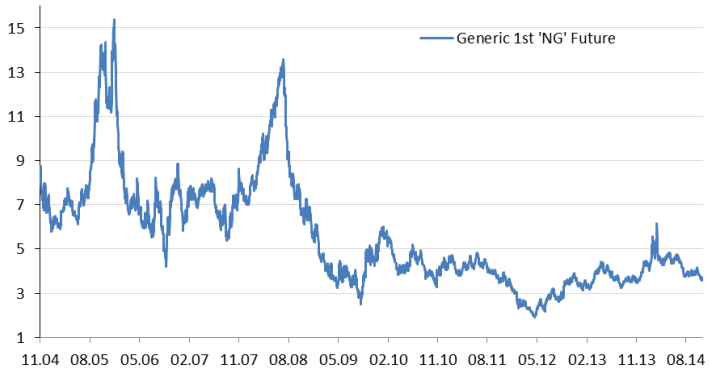
The WTI has a totally different scenario which was particularly marked between 2011 and 2012. WTI prices have been systematically traded below those of Brent crude. The Brent/WTI oil price spread was of nearly 30% before being overturned in these last two years.

Economic growth rates do not justify the situation and hide more complex realities

Between 2011 and 2012, the expected economic growth differentials between Europe and the United States were more inclined towards the latter. In this case, the WTI crude price should have theoretically benefited from the improving economic activity and, consequently, displayed a superior rise in price per barrel, either greater or similar to that of Brent and Dubai crude.

The expansion of shale oil and gas liquids in the United States has altered and substituted the perspective concerning WTI, European and Middle Eastern oils during this period. Falling gas prices below the $4 level have unilaterally pushed WTI prices downwards.

Natural Gas Price (USA)



Sources: Bloomberg, BBGI Group SA

Today, U.S. economy shows great signs of vigorous economic activity, as also indicated by the released +3.5% GDP growth figures for the third quarter. In Europe, statistics are definitively more pessimistic. The fall in German exports and industrial production, have revived fears of a weaker demand of oil products in Europe.

At present the real issue is to actually assess the consequences of medium-term developments of the main economic areas on global oil demand.

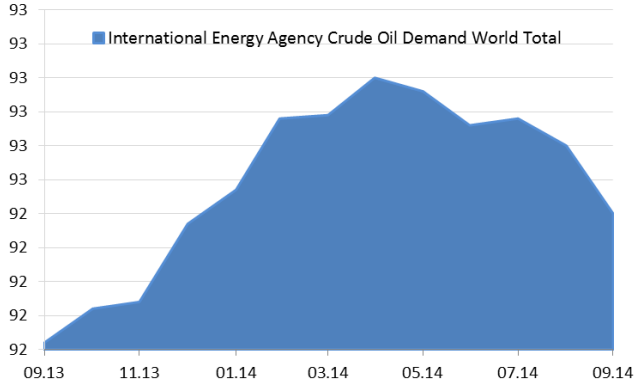
Markets seem to be currently convinced that the European economic slowdown and the downward revision of growth by the IMF will be sufficient to bring down global demand. This could also cause an imbalance which could drastically and without any distinction push crude oil prices down, no matter the geographical production/consumption area.

But what is the real situation in terms of global oil demand?

The market shows no clear imbalanced between supply and demand

The forecasts for global oil demand according to the International Energy Agency (IEA) were revised by 0.2 mb/d since September's Report to 92.4 mb/d (million barrels per day) for 2014. The chart below shows the global oil demand trend over the past twelve months.

Global Oil Demand according to the IEA



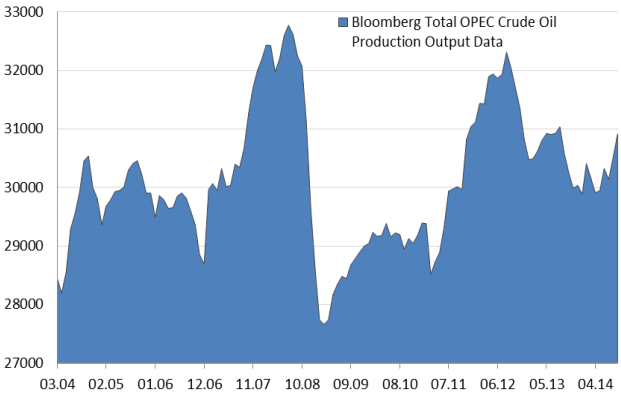
Sources: Bloomberg, BBGI Group SA

If we actually observe a decline in global demand, it appears very limited, since the estimated decline between April 92.8 mb/d maximum level and the consumption level in August, of approximately 92.4 mb/d represents only 0.4 mb/d, in other words barely 0.5% of daily consumption.

There is much to think through if we consider the supposed causal link between the evolution of demand (-0.5%) and crude oil prices (-25%). The explanation for recent volatility in crude oil prices may come from other factors within the same equation.

Has global oil supply actually recently increased and finally caused the recent drop in crude oil price? Global supply rose by almost 910,000 b/d in September to 93.8 mb/d, on higher OPEC and non-OPEC output. In terms of OPEC, production appears to have increased by 900,000 b/d between June and September, back to the August 2013 levels. OPEC's oil supply increased by 2% (from 30.3 mb/d in June to 30.97 mb/d in September) due to higher Iraqi and Iranian flows.

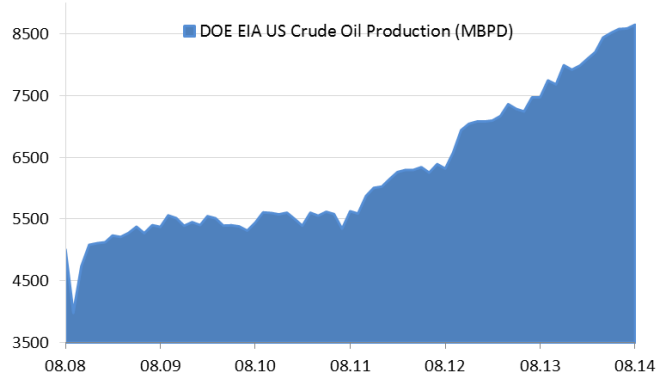
Total OPEC Crude Oil Production



Sources: Bloomberg, BBGI Group SA

In the United States, crude oil production since the beginning of the year was up from 7.9 mb/d to 8.6 mb/d as indicated by the US Energy Information Administration (EIA). Crude oil production in the United States has more than doubled since the 2008 shock.

Crude Oil Production according to the U.S. EIA



Sources: Bloomberg, BBGI Group SA

Crude oil production seems to be on the rise, the same seems to be for the IEA forecasts which expect demand to reach 94.6 mb/d in the 4th quarter 2015. Thus, consumption will exceed current production levels.

In 2014, the U.S. will continue to be the world's largest oil consumer (30.4 mb/d), backed by Asia (30.1 mb/d) and Europe (14.1 mb/d) which will only account for 15% of global oil demand.

In 2015, the situation might reverse as Asia might impose itself as the world's largest oil consumer as demand is picking up in the region (from 30.6 mb/d to 31.1 mb/d).

The oil-price drop is not sustainable and is about to bottom

Among OPEC countries, crude prices ensure a balanced budget, ranging from $80 (Kuwait) to $120 for Saudi Arabia. Obviously, it is not the OPEC's interest to let crude oil prices slip, but the oversupply of previous years, when prices were much higher, could motivate the Gulf Cooperation Council (GCC) countries and Saudi Arabia to halt a unilateral cut in production at the next OPEC meeting on November 27. Saudi Arabia usually is more responsive when crude prices fall. It is certainly willing to use pricing as a lever to preserve its market share, the kingdom made a move to show that it would cope with falling prices for several quarters while adding pressure on other energy producers.

In the United States the fall in gas and conventional oil prices is not helping gas and shale oil producers either. Thus, a sustained drop in energy prices would also push U.S. producers to reduce production levels.

Falling oil prices have placed further strain on countries such as Iran, Venezuela and Russia.

Seasonal refinery maintenance should be completed before the end of the year, and as a result demand for crude should increase. But in the United States, the difficulty of exporting surplus production of oil or gas, could contribute to lower prices.

The net-long positions in oil futures declined from 459,000 contracts in June to 267,000 end of October according to data from the Commodity Futures Trading Commission (CFTC). Speculative positions for January accounted for approximately 350,000 contracts. So we can see that in October, there was a very sharp decline in non-commercial speculative positions, justifying a clear trend reversal that accompanied the fall in prices. We must go back to March 2011 to find a similar level of net non-commercial positions according to the CFTC.

We must add that natural gas prices rebounded by almost +25% in the United States, after their October-low ($3.54). This increase could be the sign of an impending resumption of WTI and Dubai light oil prices. Given the growth and demand differentials, Brent crude should stay behind. The price gap between WTI ($81) and Brent ($77) should further shrink and possibly hit higher levels, as was the case until 2011.

Conclusion

Despite the European growth slowdown, crude oil demand will remain high and almost unchanged in 2014 before picking up in 2015.

The fall in oil prices is exaggerated and does not accurately reflect the market situation.

The current level is a positive factor for global consumption and growth.

Crude prices also benefit from a seasonal effect and should soon rebound to $100.

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