Weekly Market Summary

11th of Dec 2015

The Oil Rout Simply Can't Go On Forever !! A Good Time to Take a Contrarian VIew !? Fadi Nasser (SVP – Head of Treasury Sales)

The global economy is being hit by ``three big shocks'' -- a housing recession, a financial crisis and rising inflation -- making economic forecasting even more difficult than usual, according to economists at Lehman Brothers Holdings Inc. ``*The economic outlook at present appears to be unusually uncertain*,'' writes Paul Sheard, global chief economist at Lehman in New York, in a recent commentary.

The above is not fiction: The date is late June 2008 and global markets are in a semi-panic mode, watching US foreclosures spike, credit conditions markedly tighten and inflation expectations move sharply higher on soaring commodities. Specifically, oil prices have nearly doubled in the past year as investors seek refuge from a declining US dollar, while reports emerge that Israel recently held a rehearsal for a potential bombing attack on nuclear targets in Iran (the latter – OPEC's second biggest oil producer – asserting that it would respond to an Israeli attack with a "heavy blow"!). Crude oil for July delivery has just risen to a record US$ 139.89 on June 16th, and Saudi Arabia, the world's largest exporter of oil, is gathering producers, oil companies and consuming governments for an emergency meeting in Jeddah to discuss surging prices and possibly announce output increases of between 300,000 and 500,000 barrels a day, according to OPEC and media reports.

And to make things worst (or a tiny more surreal), Goldman Sachs group Inc. analysts - led by Arjun N. Murti - release a super-bullish report on May 5th 2008, stating that "*the possibility of US$150-US$200 per barrel seems increasingly likely over the next six to 24 months, though predicting the ultimate peak in oil prices as well as the remaining duration of the up-cycle remains a major uncertainty*,'' whilst Alexei Miller, the chief executive officer of OAO Gazprom – the world's biggest natural gas company – adds that this scenario may not be unimaginable and goes further in predicting (on June 10th) that crude prices would soon climb to US$ 250 a barrel. In turn, some investors bet on Miller's forecast with at least 3,000 options contracts purchased that give holders the right to buy oil at $250 a barrel in December. Those options close at 64 cents on June 13th.

The rest is history. On September 15th, 2008 Lehman Brothers – the fourth-largest U.S. investment bank at the time of its collapse with 25,000 employees worldwide - filed for bankruptcy! With $639 billion in assets and $619 billion in debt, Lehman's bankruptcy filing is the largest in history, as its assets far surpassed those of previous bankrupt giants such as WorldCom and Enron. That in turn was followed by what is now perceived to have been the worst financial crisis since the Great Depression of 1929-1930! During the following weeks, the remaining investment banks on Wall Street , the biggest insurance company (AIG), as well as mortgage lenders chartered by the US government to facilitate mortgage lending (Fannie Mea & Freddie Mac) went under in one way or another. To stop further collapse and to ward off total economic catastrophe, the US government made its most dramatic interventions in financial markets since the 1930s, adding hundreds of billions of dollars into the US banking system (coinciding with equally colossal interventions in Europe).

Oil had earlier peaked at US$ 147.30 (July 11th, 2008). Yet by late December, prices had collapsed some 70% and were hovering around US$ 40. Clearly, demand for the black gold had not fallen that much, but did anyone ever thought that prices of oil are solely set by the supply/demand curves ?! They are the product of an extremely volatile mixture of speculation, oil production, weather, government policies, health of the global economy, geopolitical uncertainties, strength/weakness of the US dollar, investors' herd mentality, etc… After all, oil is so much more than a fuel. It is a force even bigger than its $3.4 trillion market. It is a weapon, a strategic asset, a curse. It is a maker and spoiler of fortunes, a leading indicator and an echo chamber!!

Fast forward to the 2010-2014 period: An improvement in global growth prospects and trillions of new money added to the financial system by central bankers (various Quantitative Easing programs) led to a sustained jump in oil prices above the US$100 mark, even as China was starting to show tentative signs of an upcoming slowdown and as Americans and Europeans drove fewer miles in more efficient cars that curb consumption of gasoline, the biggest source of oil demand. Meanwhile, oil supplies continued expanding as the higher prices made techniques such as deep water drilling and fracking pay off (the flourishing US Shale industry).

However market fundamentals rapidly worsened in the summer of 2014, with Chinese imports sagging and European growth stalling, whilst a stronger U.S. economy made barrels priced in dollars relatively more expensive and resulted in a general drop in commodity prices. Instead of reducing the supply glut by pumping less oil, Middle Eastern exporters engaged in a price war to defend their market share. At its crucial November 27th 2014 meeting, the 12-nation Organization of Petroleum Exporting Countries ("OPEC") kept its output target unchanged even as oil was witnessing its steepest slump since the global recession, prompting speculation it had abandoned its role as a swing producer. "*We will produce 30 million barrels a day for the next 6 months, and we will watch to see how the market behaves,*" OPEC Secretary-General Abdalla El-Badri told reporters in Vienna after the meeting. "*We are not sending any signals to anybody, we just try to have a fair price.*" Such comments prompted us to highlight - in our economic piece entitled "Oil Prices Crash: The Start of a New Era??" dated 28th Nov. 2014 - that the world was now entering a new era for oil prices, where the market itself would manage supply, and no longer Saudi Arabia and OPEC. "*Conventional oil producers in OPEC can no longer dictate prices*", United Arab Emirates Energy Minister Suhail Al-Mazrouei had previously stated in an interview in Vienna on November 26th. Newcomers to the market who have the highest costs and created the glut should be the ones to determine the price, he added.

At last week's OPEC meeting, members kept the pressure on by announcing they would maintain current production levels, estimated at 31.5 million barrels a day. Yet with several members eager to increase their own production and Iran poised to ramp up exports after reaching a nuclear agreement with six world powers, OPEC remains torn over a long-term strategy. Elsewhere, U.S. shale output has proved resilient as drillers cut costs and focus on the best terrain, though their limits are starting to show. The price collapse has forced high-cost drillers in North Dakota and Texas to idle rigs at a fast pace, while international oil giants like Chevron, Shell and Halliburton – not to mention similar large regional names – cut thousands of workers and tens of billions of dollars in capex spending.

Oil is trading this morning at the lowest level seen during the 2008-2009 global financial crisis (with Brent prices closing yesterday below the psychologically important $40 a barrel and last dealing at US$ 39.20) and this latest price slide surely shows no sign of abating! However, with oil commentators relentlessly pointing to the high level of US crude inventories (more than 120 million barrels above the 5-year average) & upcoming increased supplies to markets, and the Commodities Research team at Goldman Sachs recently releasing a bearish note (The New Oil Order – Low Prices, not OPEC - will rebalance the market) which does not exclude a move down in oil prices - to near US$ 20/bbl – over the coming months, I personally feel a strong sense of déjà vu where extreme market bearishness and risk/reward analysis would soon lead to a market shift towards higher oil prices (Only time will tell !)

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