

# DEMAND DESTRUCTION

## "CRUDE OIL"



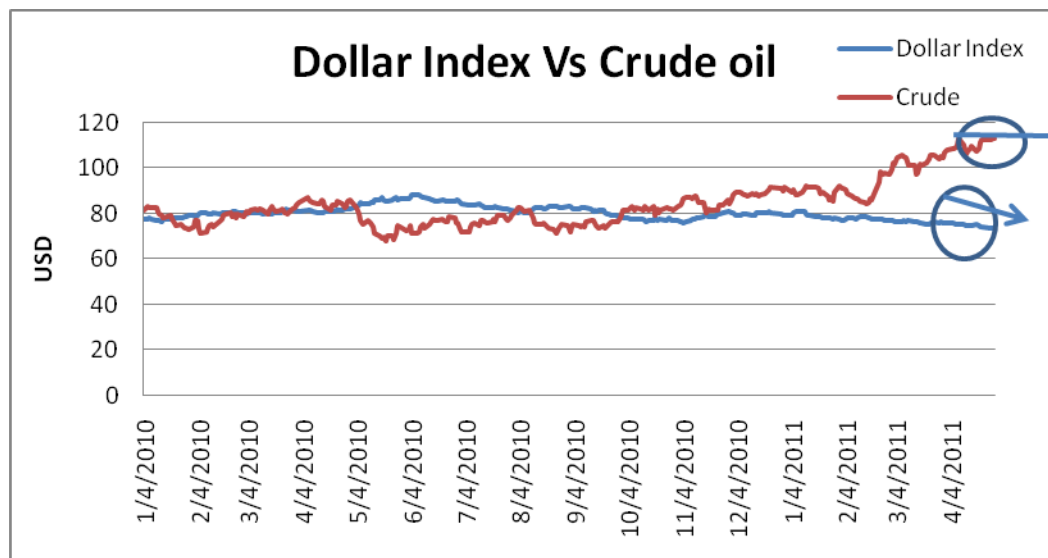
**NIRMAL BANG**  
a relationship beyond broking

Crude oil prices, after testing multi year low of \$35/barrel during the year 2009, have raced to \$115/barrel in the year 2011. A section of market participants is making noises of levels like \$130-150/barrel and some have even gone to the extent of predicting \$200/barrel.

The revolutions in North Africa have expanded from a tiny uprising in Tunisia, to a full blown Middle East revolt that has toppled governments and brought the west's biggest powers to war. With problems in Tunisia, Egypt and Libya at war, the question which comes up is who is next? Crude oil is trading with \$10-\$15/barrel premium, rightly termed as fear premium.

In 2008, massive speculation in crude oil was attributed to the spike of \$147/barrel and who would have imagined that prices are going to trade below \$35/barrel after it touched \$147/barrel. This is one the best examples of commodities cycle. One must not forget that commodities are cyclical in nature and with rapid rise in prices; demand destruction tends to take place. Commodities tend to outperform in an environment when real interest rates are negative (especially in the developed part of the world), governments are trying to stimulate the economy by giving packages and bond purchase programs which eventually results into higher liquidity. Higher oil prices may have disastrous impact on global economy which has just recovered from one of the worst crisis post great depression.

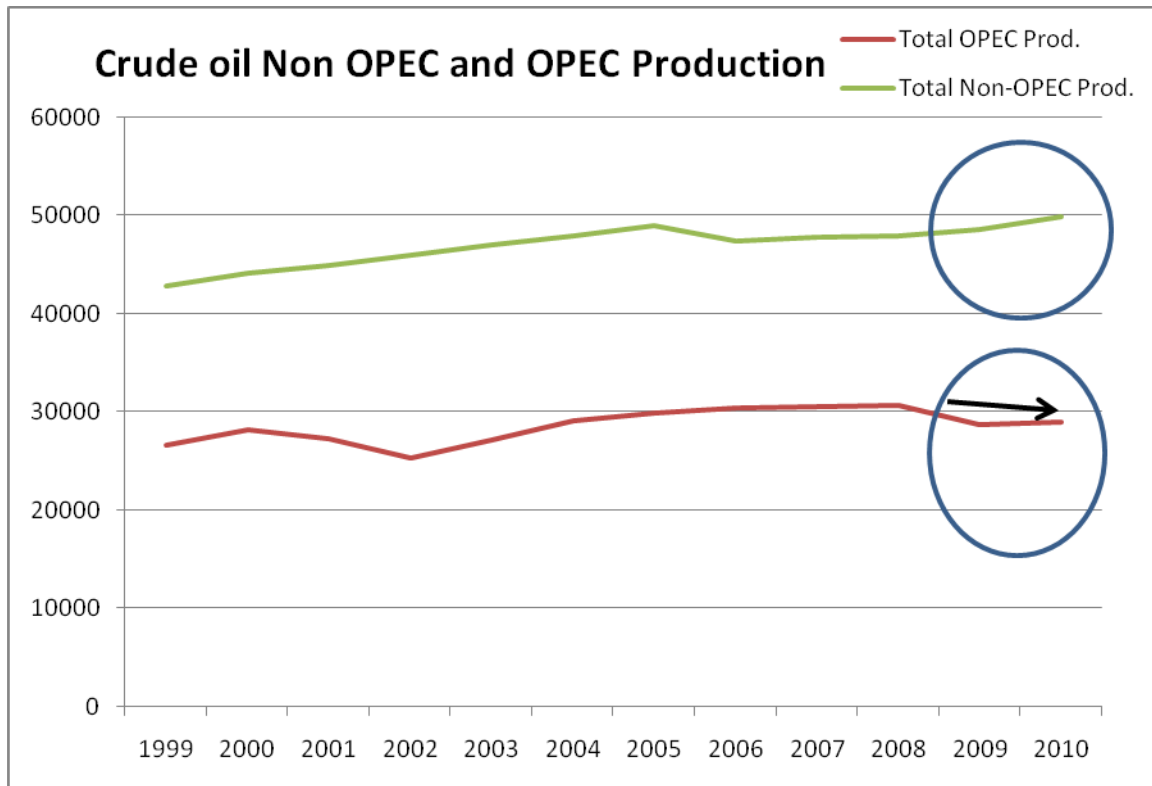
### Dollar Index and crude oil:



Source: Reuters, NBSPL

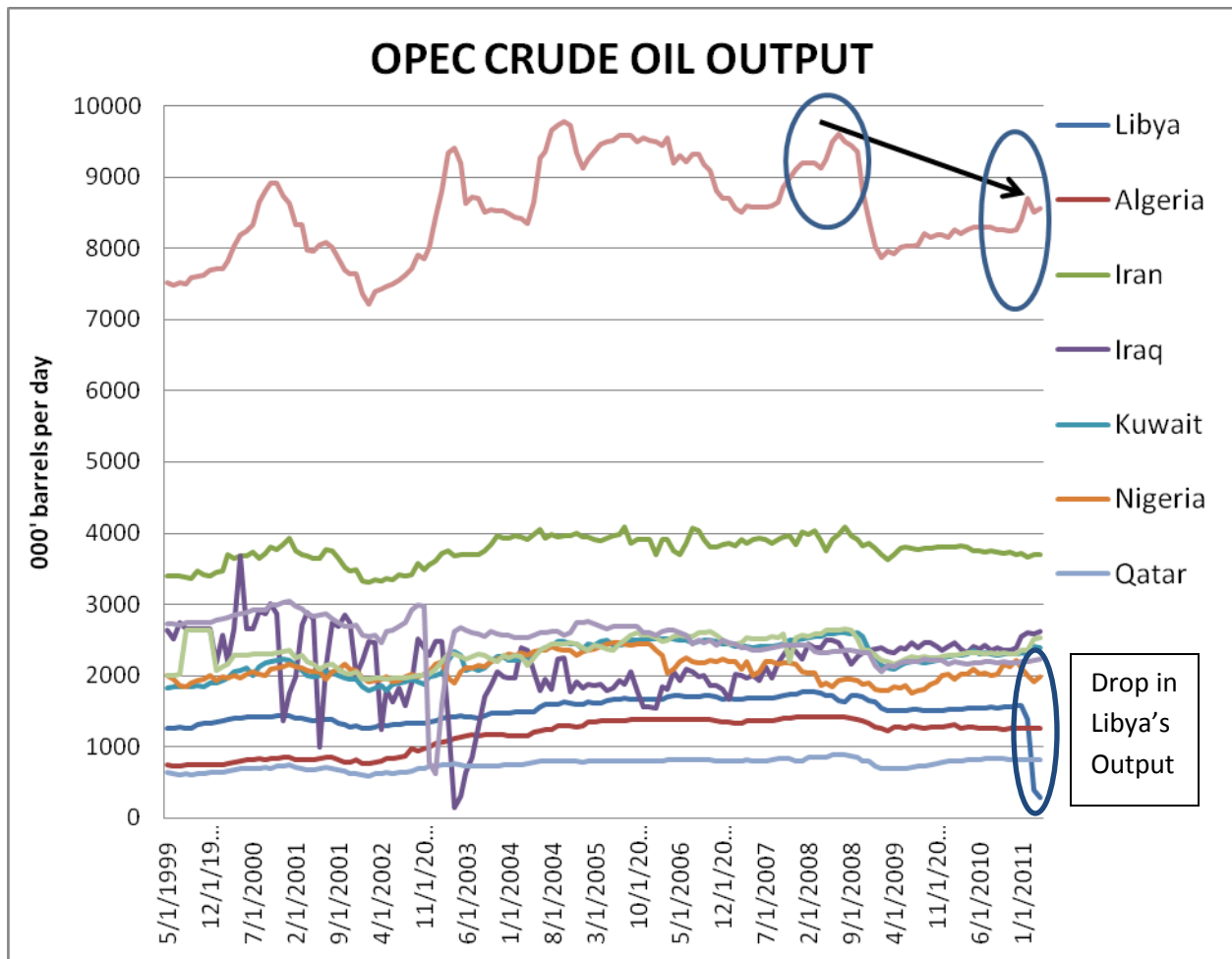
Crude oil prices tend to move up when dollar index tends to drift lower. Since the last fortnight, we have seen a crack in dollar index and it is trading at 3 years low. Despite this development, prices of crude oil which in normal scenario should have edged up have remained flat. Meanwhile, the dollar index has dropped by almost 4%.

### Crude oil Supply Scenario



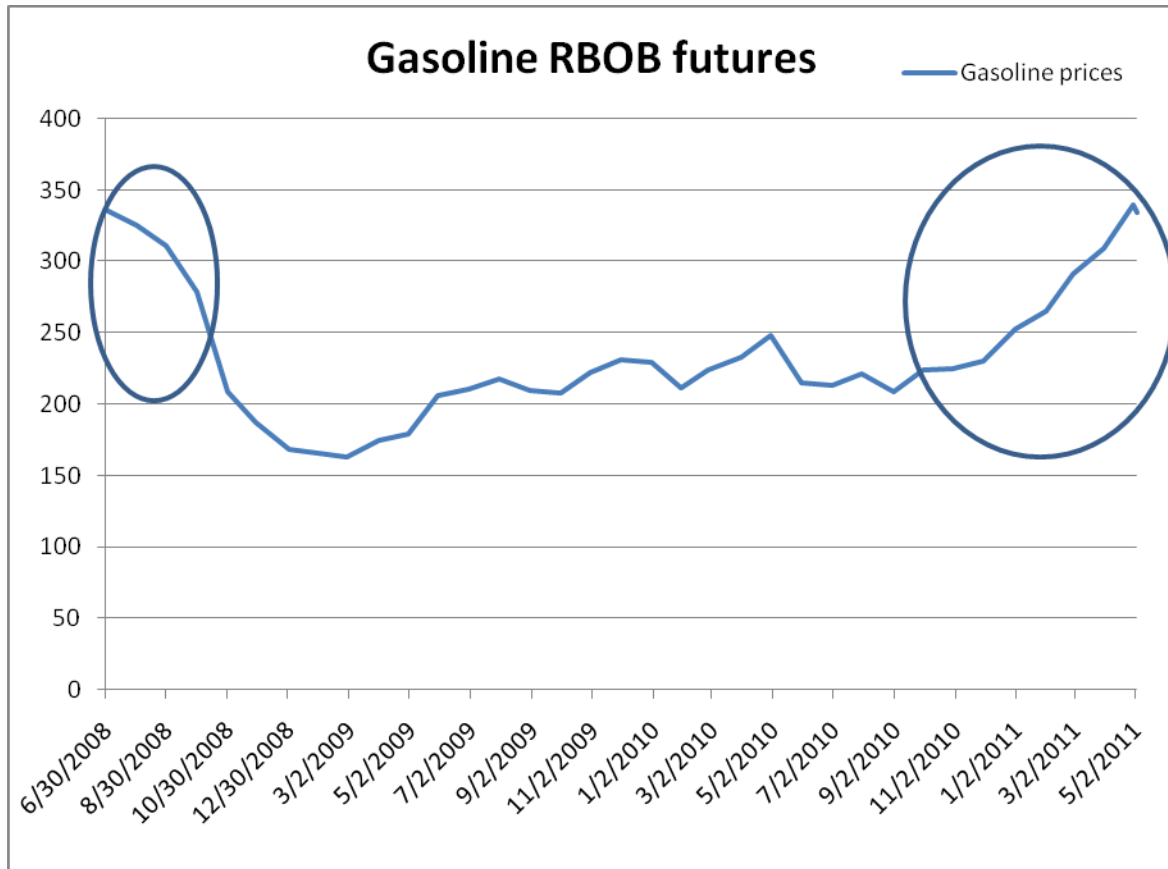
Source: Bloomberg, NBSPL

Interestingly post crisis in Middle East countries, overall output from OPEC especially from Libya has dropped dramatically. Saudi Arabia is still not pumping more crude oil into the market by stating that markets are over supplied. On the other hand, Non OPEC output continued to move up especially due to rapid rise in production by Russia. Non OPEC production in last one and half years has moved by more than 1.8 million barrels per day and OPEC production has dropped by 1.6 million barrels per day. So as of now we don't have huge deficit in oil market for it to shoot up to \$120-\$125/barrel. It's the fear premium, that if protests begin in Saudi Arabia then what would happen to crude oil prices.

**OPEC Crude oil production**

Source: Bloomberg, NBSPL

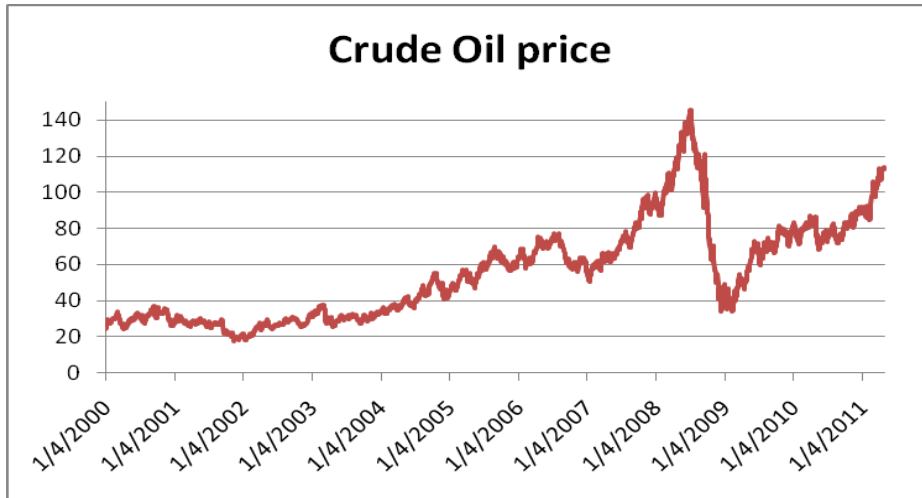
We have seen post crisis in Libya oil output has fallen from 1.58 million barrels to just 3,00,000 barrels which has resulted in this massive spike in crude oil futures. As shown in the graph, Saudi Arabia which had cut its production by more than 3 million barrel per day post recession in order to support the depressed prices, even after the recovery in global economy, they have still not raised their production to pre recession levels. In fact in the month of March, 2011, their production declined by 8,00,000 barrels per day and officials were seen quoted that because of oversupply in the market, the production has dropped. Saudi Arabia, the largest crude oil producer not pumping more oil despite turbulent Middle East scenario is clearly indicating that if more oil pumped into the market may result into glut. As far as supply constraints are concerned, Saudi Arabia can pump more than 3 million barrels of oil if required. So we feel more than supply concerns, demand destruction will be in focus due to rising cost of capital and rising inflation.

**U.S. Gasoline Price a big concern?**

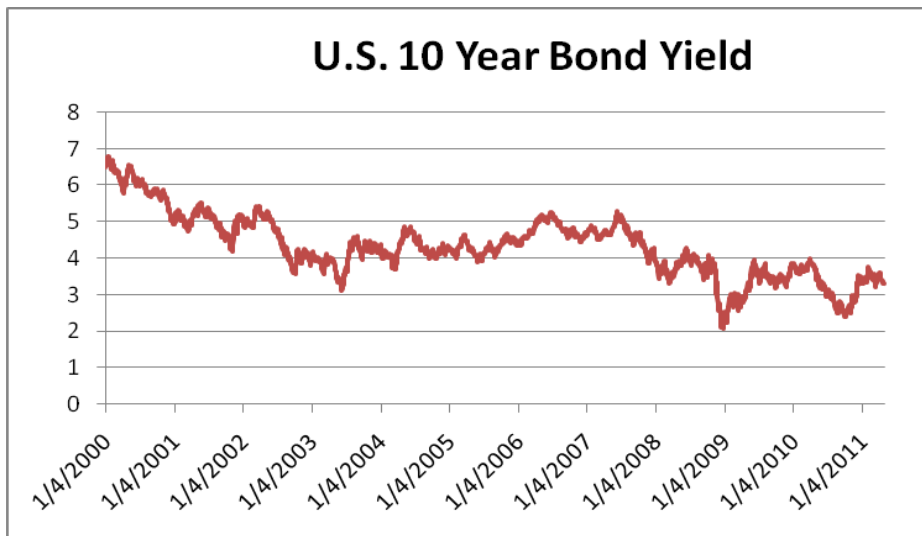
Source: Bloomberg, NBSPL

U.S. demand for gasoline continued to decline across the nation, according to a Spending Pulse report by MasterCard Advisors LLC, a division of MasterCard Inc. Weekly gasoline demand averaged 9.188 million barrels a day for the week ended April 1, down 1.2% from the prior week. Meanwhile, retail gasoline prices are 28.9% higher than they were a year ago at \$3.61 a gallon. Prices have surged ahead of the key summer driving season, when gasoline consumption peaks in the U.S., and further gains could be very negative from the demand point of view. However, demand is under pressure as prices march toward record levels, Gasoline prices are at the highest level since October 2008, which is not good for U.S. also as it is just recovering from the recession, higher fuel prices is threat to U.S. recovery.

### Crude oil and U.S. 10 Year Bond Yield

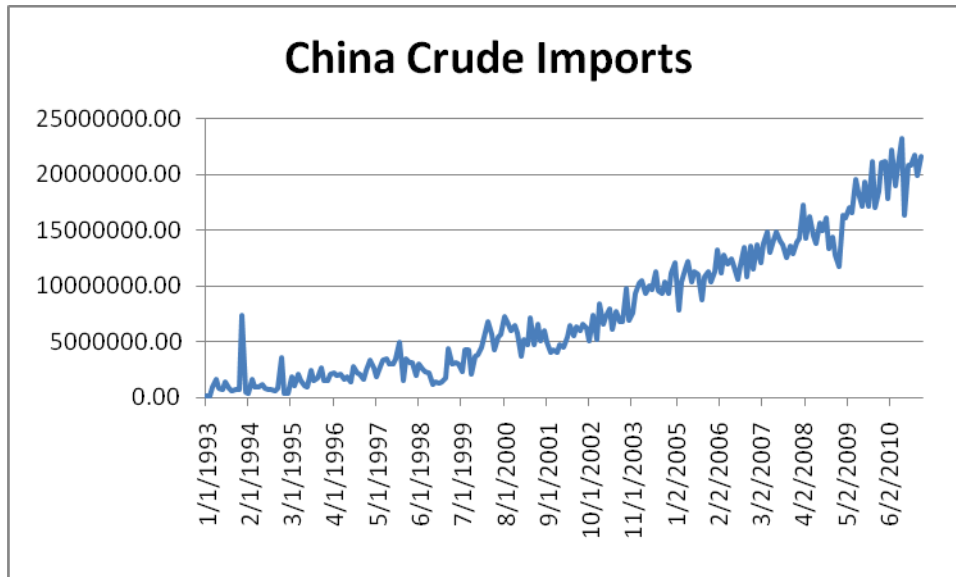


Source: Bloomberg, NBSPL



Source: Bloomberg, NBSPL

In normal circumstances, Crude oil prices move in tandem with the US 10 yr. benchmark yields which essentially reflect the growth and inflationary expectations. Any surge in US yields on the back of growth and inflationary expectations tend to support crude oil prices as the US is the largest consumer of this form of energy. However, the recent dip in US yields has not corresponded with crude oil prices as the supply concerns from Middle-east has lent tremendous support to the prices. But with further slide in US yields coupled with cool-off in supply concerns is likely to bring this equation back to life.

**Chinese Crude Oil Imports:**

Source: Reuters, NBSPL

China is the world second largest consumer of crude oil. In the last two years, China's monthly crude oil imports have surged from 14 million tons to 21.50 million tons, more than actual consumption China has been stocking oil for the strategic purpose also. In a move to knock inflation, one of the prime issues for Chinese central banks, they have raised their interest rate four times and raised their reserve ratio requirements by eleven times post October, 2010. Rising cost of capital, sharp drop in money supply and these aggressive interest rate hikes may cool off industrial activity. We expect demand of crude oil may drop in coming months from China and we feel Chinese crude oil imports may drop by 8-10% in coming months.

**Outlook:**

In spite of the strong upward movement that we have seen in the crude oil prices, there are many impediments which may reverse its upward trajectory. According to the latest monthly 'Oil Market Report' published by the International Energy Agency, the preliminary data for early 2011 already showed signs of slowing oil demand. Demand destruction has taken over from geopolitical risk, which would put downward pressure on crude oil prices. Saudi Arabia has cut its oil production back to pre-crisis levels pointing out the poor demand. All this could be interpreted as sign that high prices have started to dent consumption.

We believe, despite ongoing turmoil in Middle East, weakness in dollar and strong set of economic reports from U.S. crude oil prices are not moving up. But on other hand possible slowdown in China due to higher inflation, drop in demand of gasoline in the world's largest consumer and end of quantitative easing (qe2) program may result in liquidation in crude oil futures. We are of the view that crude oil prices may test levels of \$100/barrel - \$98/barrel and may not be able to trade above \$117.5/barrel.

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