

DARK

DAYS AHEAD

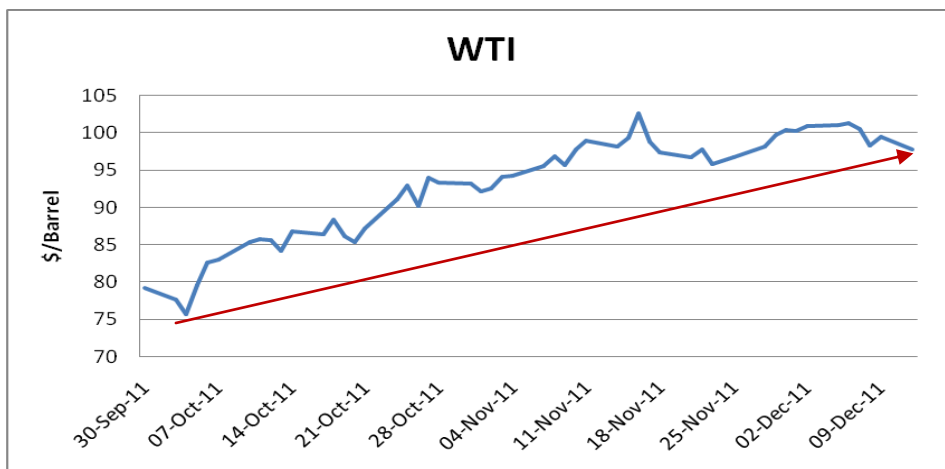


NIRMAL BANG
a relationship beyond broking

Strategy	Sell		Research	
Range	\$96.50-97.50	Rs. 5230-80	Kunal Shah	kunal.shah@nirmalbang.com
Target 1	\$88	Rs. 4950	Somya Dixit	somya.dixit@nirmalbang.com
Target 2	\$85	Rs. 4700	Contact no.	+91 3926 8043/8164

Crude oil recent journey:

Crude oil prices made a high of \$102.59/barrel this quarter after testing low of \$75/barrel in early October and the rally was mainly driven by supply concerns from the Arab nations. A series of supply disruptions have helped to keep the oil prices at such elevated levels despite a weak outlook for the world economy and a decline in global fuel demand.



Source: Bloomberg, NB Research

Oil production in Libya and Syria was shut down due to the civil war. Oil exports from Angola and Nigeria have been hindered by technical issues, maturing oilfields and infrastructure damage. Coupled with operational problems at other fields, Nigerian output has dipped from around 2.2 million bpd. Azerbaijan, the producer of high quality Azeri Light crude, slashed its oil production forecast for 2011 by 100,000 bpd to 930,000 bpd, citing repair works at BP's platforms. Although Russia has seen no output problems, it has been steadily reducing flows to Europe in the past year.

On 14th October, a strong earthquake hit Russia which halted oil shipments to China through East Siberia - Pacific Ocean (ESPO) pipeline which carries around 300,000 barrel-per-day. They also temporarily halted transportation of another 300,000 barrels-per-day of oil to China and Asia-Pacific nations including South Korea, Japan and the United States. So, the upside which we saw during the tenure was due to the expectations of major supply disruptions from Russia.

Further, TransCanada, a Canadian company which proposed a pipeline to carry an estimated 700,000 barrels of crude per day from Canada to Texas Gulf Coast refineries was on cards. This could help to reduce the U.S dependency on Middle East oil. Crude oil prices rallied further on hopes that the proposed plan would help to trim down the built-up of oil stocks at Cushing Oklahoma.

Lately, oil prices were supported with lower inventories from U.S. and the sanctions imposed by U.S. on Iran for developing nuclear weapons.

Fundamentals of Crude Oil

Demand & Supply:

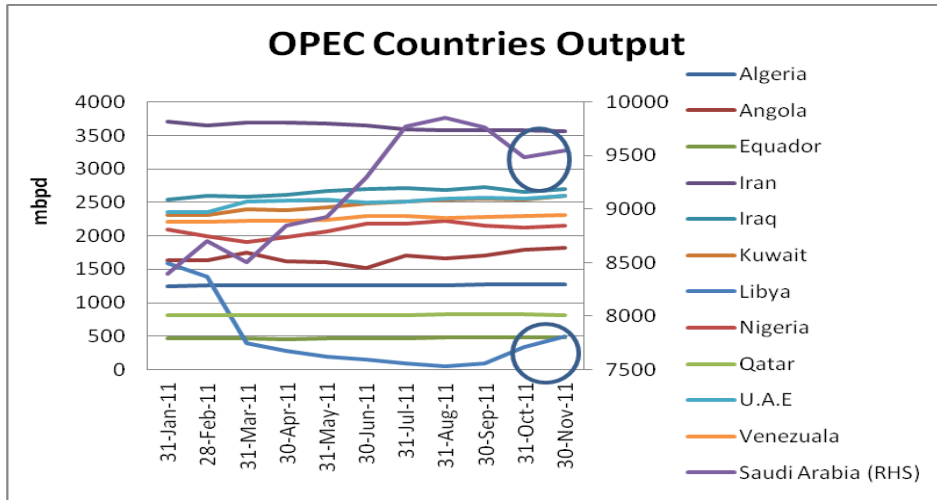
Year	Total Crude Oil Supply (mb)	Total Crude Oil Demand (mb)	OPEC Supply (mb)	Non-OPEC Supply (mb)	OECD Demand (mb)	Non-OECD and rest of the world demand (mb)
2006	84.89	84.51	30.74	47.57	49.34	35.23
2007	85.38	85.63	30.9	47.66	49.16	36.47
2008	86.76	85.7	31.46	48.19	47.45	38.23
2009	84.68	84.76	28.71	48.5	45.47	39.26
2010	87.56	87.75	29.05	50.5	46.15	41.58
2011	89.1	88.86	29.62	50.91	45.57	43.27

Source: Bloomberg, NB Research

Looking at the demand and supply side then the market is in a tight situation. However, the latest figure of year 2011 depicts that the total crude oil supply grew by 1.8% compared to the last year where as the demand grew by 1.2%.

Demand for crude oil has undoubtedly increased over the years. However, the total supply has increased at more rapid pace than the demand which makes the market over supplied. Total demand is 88.86 mb and supply is 89.1 mb. If we add another 0.38 million barrels per day on the supply side as per the commitment from the OPEC oil producers than the market will be highly over supplied making the total supply at 89.48 million barrel.

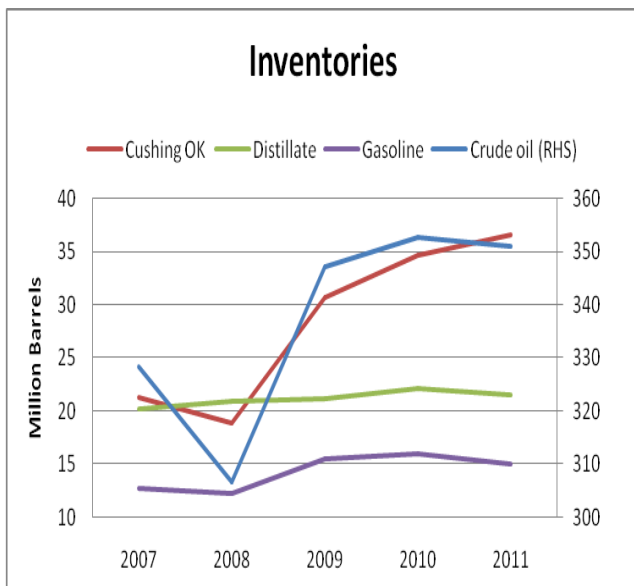
Recently in OPEC meeting oil producers agreed their first new production limit in three years in a deal that settled a six-month-old argument over output levels in Saudi Arabia's favor. The Organization of the Petroleum Exporting Countries agreed a new supply target of 30 million barrels per day. The agreement caps output for all 12 OPEC members for the first half of the year, keeping supply near 3-year highs enough to rebuild lean global inventories.



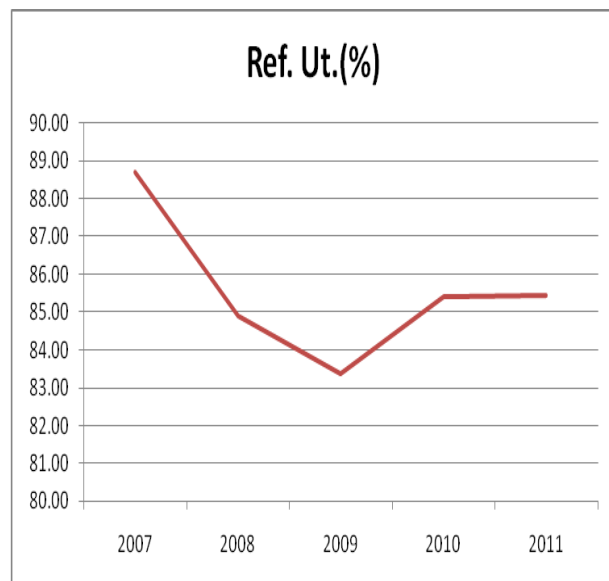
Source: Bloomberg, NB Research

The deal in the recent OPEC meeting is roughly in line with current production from the Organization of the Petroleum Exporting Countries and formally recognizes a big increase in recent output from largest producer Saudi Arabia.

When compared to average production of 29.5 mbpd this calendar year leaves sufficient supply for the market. However, the demand forecasted by IEA for the first quarter of the next year is around 29.7 mbpd and for the second half 28.5 mbpd which would automatically increase the inventory levels at the warehouses. Major contribution will come from Saudi Arabia and Iran as they are already outperforming with their production and still has a bit of space for producing more. We saw recently that Saudi Arabia and Iran have pumped up their supplies to meet the demand.



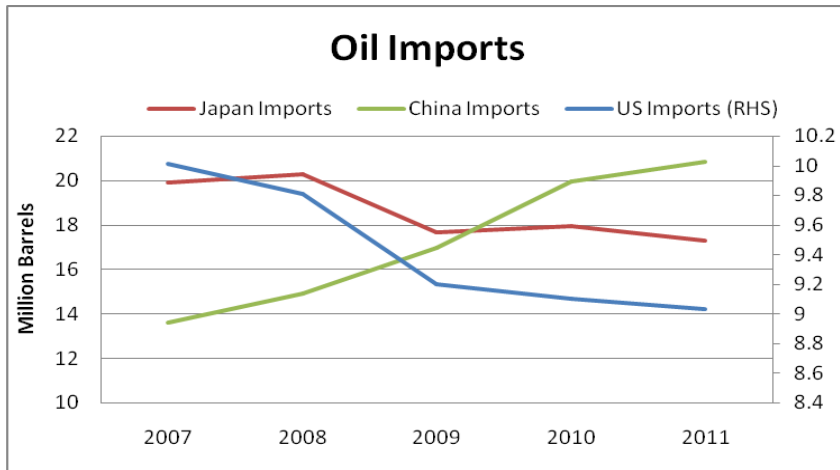
Source: Bloomberg, NB Research



We witnessed sharp inclination in the stocks of crude oil and its by-products in comparison with the post crisis level. The inventory buildup was mainly because of lower demand across the world and global economic recovery is slower than forecasted which is hammering the demand of crude oil.

Refineries are not being utilized at the optimum levels as they were running before the crisis. Looking at the Utilization rate we see demand destruction in the crude oil which may drag crude oil prices lower.

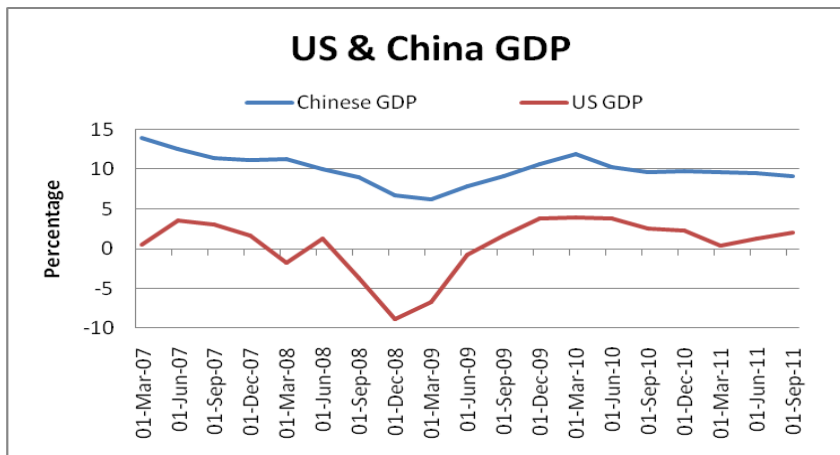
Imports:



Source: Bloomberg, NB Research

Imports of crude oil are declining constantly which indicates that the demand for crude oil is not picking up from the developed nations. The major oil importers are US, China and Japan and the imports are slowing from these economies. In the coming season we expect much lower demand from US and Japan. China is the only nation whose imports are rising but that too at slower pace.

World Economy:

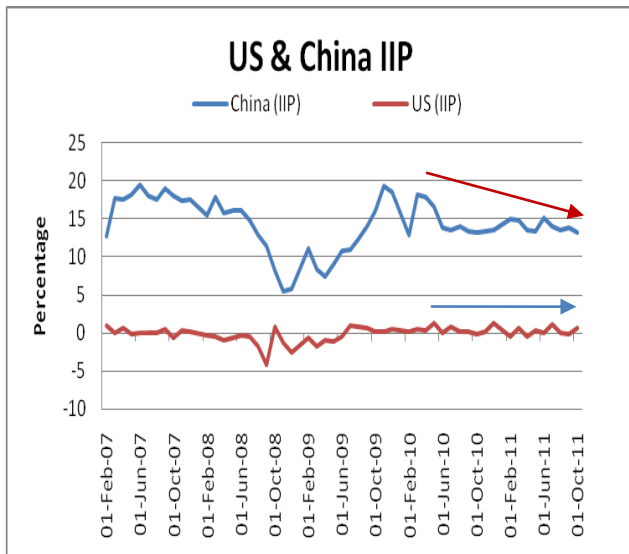


Source: Bloomberg, NB Research

Developed economies have been into double dip recessionary phase since the last quarter which resulted in minimal growth rate in the nations across the world. The majority of emerging markets are facing the heat of inflationary pressure and to combat that all the central banks are raising their interest rates by compromising their growth rate.

IMF has also decreased its 2011 and 2012 growth outlook for the world as the financial turmoil of Euro zone debt crisis is weighing on the world economic output. This further makes us believe that the global recovery is in an unbalanced situation and there will be a more of slowdown in the world economy especially in Europe which will dampen the world oil demand.

Industrial Production:



Source: Bloomberg, NB Research

We have seen a major slowdown in the industrial production and retail sales of top two consumers of crude oil. Chinese industrial production has dropped from 18% to 13% since Feb 2010 and on the other hand US industrial production is not showing any growth.

Going further we do not expect any major improvement for the next quarter as the slower growth will be chained to the ongoing crisis and credit crunch in the banking system as well.

Outlook:

Crude oil market is over supplied and pledge by OPEC to increase the output to 30 mbpd will put pressure on oil prices. Possibility of geopolitical tension has resulted in \$8-10/barrel premium in crude oil prices. Slowdown in growth of emerging markets and fear of recession in Euro zone is limiting the upside in crude oil futures. China, world's second largest consumer of crude oil is slowing down, mainly due to the contraction in manufacturing PMI's and drop in the industrial production. The *Beijing Morning Post* reported that, according to real estate agency Home link, by November at least ten cities (including Shanghai, Shenzhen, Nanjing, Suzhou, Hangzhou, Changsha, and Changchun) had seen developers slashing prices on major projects and promises to pay the difference to previous buyers. Drop in property prices is a concern which may drag Chinese GDP down further. The ongoing debt crisis have resulted in credit crunch in Euro zone banks and further strength in dollar will also weigh on crude oil prices. Looking at macroeconomic and demand, supply scenario we feel upside in crude oil prices is not sustainable.

We remain bearish on crude oil with a downside target of \$86-88 per barrel and in INR terms we see it to correct to the levels of Rs.4800 per barrel.

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