



## Oil Review

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Oil – OPEC goes for cuts

On Friday 24<sup>th</sup> October OPEC's 13 members in an emergency meeting agreed to cut production by 1.5 million bpd. It then suggested that if prices do not stabilise it will do it again at their next official meeting on the 17<sup>th</sup> December. Some would argue that the cut by OPEC is all about protecting profits and that in the current economic environment it is not a responsible action to take. In this review we look at the current state of supply and demand and put forward the case that perhaps OPEC's decision is not totally baseless.

As the economic world unfolds into a recession we are seeing that the initial "demand destruction" which started after we peaked on July 11 at US147.20 is gaining momentum as the general economic conditions continue to deteriorate. So what is "demand destruction"? Demand destruction is a term coined to explain the effects of a sharp change in consumer consumption patterns due to higher prices. It is simple supply demand dynamics at its best. So far the world's largest consumer of oil, the US, has seen daily consumption of crude decline by 8.5% for the same period last year and miles driven have declined by 5.6% when compared to the same period last year. Adding weight to this decline in demand is the effects of the "credit crunch". In reality the real effects of this are yet to filter through the economies however the market is doing its best to try and factor it in so it looks the volatility is here to stay.

Volatility in the Crude market has been extraordinary to say the least to think that just three months ago we were on record highs and now we are trading 56% below this level is testimony to the adverse conditions we have to cope with. The volatility in its self is causing concerns in particular from the corporate world as consumers have to deal with the fluctuations in their hedges.

Hedging...damned if you do and damned if you don't...they say that not to hedge is to speculate, however, these days with the such wild swings it can become a constant drag on cash resources, just ask United Airlines. [United Airlines](#) incurred a third quarter net loss of US\$779 million, of this \$519 million in non-cash, net mark-to-market losses were incurred on the carrier's fuel hedge contracts as a result of the recent drop in the price. There are many well documented scenarios of hedges that go pear shaped; however, one thing is critical if you do not have the resources to fund the hedge then at some stage in the future you will be called on for more margins. If you can not cough up on these then the position is liquidated and the loss realised.

Another aspect to the falling prices which need to be addressed is that as the oil prices continue to fall we see that an ever increasing number of projects are being shelved as they become uncommercial to exploit with low prices and the credit crunch. New deep drill exploration projects, oil from coal, oil from sands all being shelved. As an example Suncor Energy one of the biggest players in Oil sands have shelved a \$16.5 billion Voyageur project. The concern we feel is that projects are being cancelled due to short term concerns, however longer term we still have the same issues that forced Oil to a peak of US147.

**Currently we can produce 86million bpd easily, what will happen when we get over this recession?** We are back in the same court.... volatile prices and the Oil trending higher as we concern ourselves with diminishing reserves and growing economies.

When OPEC announced its cut they said that it would have a minimal effect on the market and they were 100% correct. We feel that OPEC members have more on their plate concerning credit issues rather than the price for Oil. However their action in fact will act as a break on the fall of the commodity in doing so will provide time for other players to access the market and to make proper value added decisions for hedging, exploration and development.

Where do we think the price of Oil will go? Tough question....apart from the volatility which we feel will remain with us for sometime we suggest that the downside is limited to the extent of the recession. At the moment the trend is firmly down and up until we see a light on the horizon over the extent of the contagion we remain cautious. If you feel like use that the sell off is in over kill mode then we like buying some call options and tucking them away as if a recovery starts to get traction then I am sure that we will enter old supply stories and prices will raise.

[Daily Oil Chart](#)



Technically, good support comes in at US50.00 and momentum indicators are getting close to a low. Oil does however trade in spikes and this is just another example, however once the market gets back to solid fundamentals it generally starts to trend higher. The key is when to buy and how much.... we are slowly accumulating calls.

Happy Trading

Jonathan Barratt

Please do not hesitate to call concerning any of the above. I can be reached on direct call 1300 660 734.  
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