Oil Review

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Oil – marking time –up or down

After all the volatility in Oil over the last six months trading has hit the doldrums. Oil has remained in a US15 range since the beginning of December. All players appear to have moved to the sidelines waiting fresh news that will either drive prices higher or lower. In this report we focus on the current themes to see if we can arrive at the near term direction for the commodity.

As news concerning the financial contagion in the US spread to other economies so to have the expectations for the demand for Oil, which continue to plummet. As a result crude oil inventories in the US and around the globe continue to grow, adding more pressure on the commodity to trade to the downside. As prices remain weak the only panacea to this appears to be in the delivery of the enormous economic stimulus packages Governments around the world are trying to deliver. The question currently being asked is the effect these packages will have on the demand for primary inputs, in particularly for Oil. However, the interesting aspect to this is the expectations on "demand" associated with the stimulus packages. In the US, the package is on its way to being passed, however, we feel that this will not generate as much demand as people expect or at least in the early stages of its delivery. The main reason for this is that the package is a "band aid". The only way the package can be described as supportive is when the toxic debts have been removed or isolated from the Banks balance sheets. This will help liquidity come back to the lending market which in turn will support signs of growth. In addition, do the US effectively want to have a package that stimulates the economy too much as demand to early in the delivery will only fuel price raises, there by extinguishing signs of any potential growth. So, whether or not the package is passed in the US we feel that the balancing act will do little to immediately effect the price action for Oil at the moment. We probably will get a knee jerk reaction higher once passed; however, this move may be limited and not represent a trend change. It is when we turn to China that we feel the most impact to demand will occur that could reverse the current trend. Why?

China is looking at a package of US586 billion to help stimulate her economy. We feel that when momentum as a result of the implementation of the package picks up then this will create demand for primary inputs and as a result demand for Oil. China has a marked difference in her set of circumstances to the US and this can be easily explained in five points:

- China's economy is a "command economy"
- Their reserves are huge so they can immediately act on policy with no debate
- The Banking sector is financially stable
- They have to prepare policy for 20million migrant workers
- Exports in the dual economy account for only about 17% of GDP

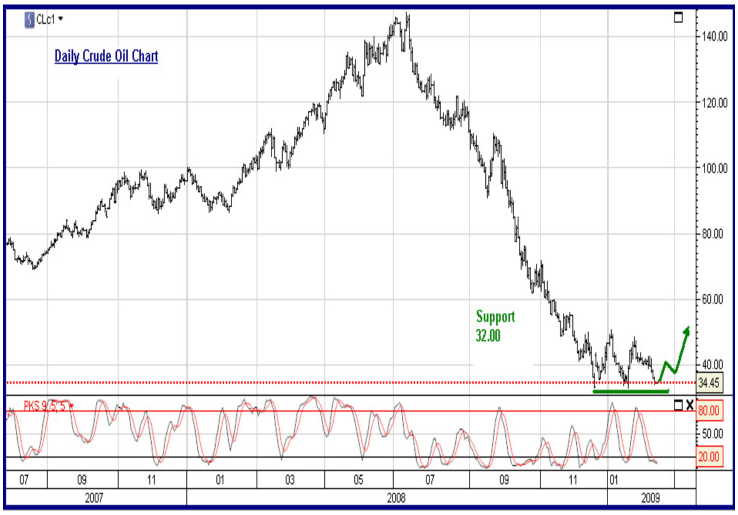
So in effect this package once it kicks into gear should see a solid increase in the demand for primary inputs and as result supply issues may appear across the commodity spectrum. As a result demand for Oil will pick up which will see prices gravitate higher, perhaps faster than expected as we already have motivated vendors cutting supply at every opportunity seeking price stability. What about supply?

OPEC, since prices have been weak have been cutting back on supply, however this has had little effect to arrest Oils decline. We have so far seen 1million bpd cut and looking for a further 1.7million bpd to keep in line with agreements made in December. Oil has declined 70% since the high of US147 which in effect suggests that Members have succumbed to a 70% loss of potential income. One of the main problems OPEC members are facing is that many have expensive expansionary programs under way which have been financed on the back of Oil receipts upwards of US80.00. The shortage of income has to be balanced some how and the only way to bridge this gap quickly, so that liquidity issues do not emerge, is to crimp supply. Cutting supply will ultimately force prices higher so receipt income as a result from sales will pick up and placate liquidity concerns in their economies. The main concern OPEC has is to be able to read demand and supply accurately as a continual economic slow down will continue to dampen enthusiasm for the commodity and the strategy could backfire.

As we head into the next OPEC meeting on the 15th March we expect to see cuts on the agenda again. It's fair to say at present that the demand picture at the moment is clouded, however, one thing is for certain we do not require the same amount of oil we needed twelve months ago but then again twelve months we didn't throwing billions of stimulatory dollars at a recovery. It begs the question does the expected fall in demand reflect a 70% drop in the price, probably not and how quickly could a weak demand scenario turn around?

The market is expected to remain weak and in a range as investors and hedges look for direction. We feel that the market is evenly divided amongst those that continual expect the economic slowdown to sap demand against those that feel OPEC cutting supply will eventually see a floor. One thing is for sure that as governments around the world continue to throw economic stimulus packages at the recessions, eventually demand will pick up and this will translate into higher prices.

Is the technical picture helping to provide any clue as to the near term direction?



The chart certainly paints and interesting picture. We can see that prices are traveling in a sideways fashion. Major support stands at US32.00 and if this is broken on a daily close it opens the way for further loses, however we feel that it should hold. If it does then this is typical of a market building momentum for an eventual move to the upside. Although, we do not yet have a technical buy for the commodity we feel that it is correct to start putting in place a hedging program. If bullish would look at a stop entry level through US42.50 with stops going in below the low of the day of the buy. From an investment perspective we fell that options in particularly long dated ones with strikes at US75.00 into 2010 are well priced and offer a good opportunity.

Happy Trading

Jonathan