



Oil Review

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16th June 2009

Oil Review - reminiscing on old times

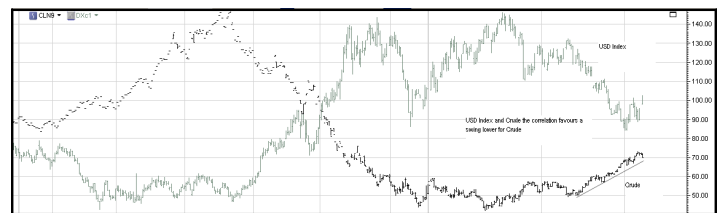
The strength in the Oil market has analysts stumped again, many including ourselves anticipated that the economic weakness as a result of GFC would have more of a lasting effect on demand and the priceso far this has panned out not to be. The market has just surged through US70.00 and with momentum remaining strong, US75.00 seems just around the corner. Question, is it sustainable. In this review we reflect on the previous couple of years to see if we can find the drivers that would help dictate whether this move is sustainable and discuss the possible consequences if the rally is sustained.

The price of oil gyrates on seasonal and geopolitical factors. Obviously, it is hard to forecast geopolitical events however, the seasonal factors are a little more ridged and predictable generally coming in waves of demand for instance between May – June, with the northern hemisphere summer “drive time” demand: then with the Hurricane season in September, premiums start to be built and finally the winter period towards the end of the year caps off the years demand. Depending on the type of season we have will help determine the price for crude.

Over the last month with the commencement of summer drive, demand for crude has seen the market run up by 27% (basis the Sept9 Futures). Petrol at the pump in the US has just reached US4.00 per gallon. In reflection, over the last couple of years the same has occurred during this same period. Seasonally, between May –June in 2007 and 2008 the market has rallied in each case close to 20%; nothing new here. The interesting aspect to the crude market at the moment is that it has traded well above the average expected seasonal gain for the last two years. Considering that we are amidst a recession it is perplexing. Comparing demand and consumption during 2007 and 2008 with today it logically should be lower. In fact this is reiterated through the consumption reports issues by the various Oil agencies, OPEC recently came out and said the consumption through 2009 will be reduced by 1.6 million bpd and IEA suggested it would fall by 2.47 million bpd around the world, which is the largest drop since 1981. If demand is perceived to be lower so why should the price so firm given an anticipated slump in demand. Is it just the value of the USD or is there genuine demand?

As Oil is traded in the USD it seems ok to suggest that if the USD depreciates so would the value of the commodity. Likewise if the USD appreciates then the commodity should depreciate. This is well documented. At the moment we feel that Oil has gone too far and given the fragile state of the economies around the world we could by default of a weak USD see the economic recovery stall as a result of higher

input prices. The IMF recently issued its report on the state of the global economy and urged Governments to keep stimulus packages up as we are by no means out the woods on the recovery. It is interesting to note that we have seen commentary concerning the weakness of the USD and would not be surprised if commodity prices remained strong that we do not see a bout of intervention to stem the USD weakness. The USD we feel should be used by the powers of B” as a tool to dictate the value of commodities. But what about genuine demand?



We have mentioned that seasonal demand is important. At the moment the seasonal factors have already seen crude rally over 27%. This by our estimations is just too much. By looking at previous years the market normally rallies around 20% in normal market conditions during May -June. At the moment we feel that we are 7% overvalued and a pullback to US63.50 would only bring prices in line with the seasons. What about Chinese demand?

China has been importing Oil like commodities at an ever increasing rate. Imports for oil last month were up 5.5%. This story is the same with other commodities into China in particularly base metals. It is interesting to see that growth remains robust. Many market participants are suggesting that in order for China to maintain growth at 8% it requires more energy. This is true given the amount of stimulus packages and infrastructure the nation has embarked on and could be enough to undermine any large correction in the Crude oil market. However any pull back would only see buys enter the market so we feel that dips would be well supported. So what does this mean in reality to the price action?

Looking at the last couple of years we have seen the price for crude trend well whether it is up or down. If Crude was to take out US73.50 then we suggest that the upward direction for crude is intact and it would traded onwards and upwards. This is a likely scenario given sustained economic recovery, seasonal and Chinese demand. However, history has told us that a large proportion of the move has been in line with the USD. If the USD were to firm then as we have a percentage direct correlation to the price of Crude then a pull back is well on the cards. Keep an eye on US69.50. A break of this sends the prices to US63.50 which is our preferred scenario.



By Jonathan Barratt

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