News Flash – Finding the Bottom

15 December 2015

As expected, crude oil prices have continued to slide as a result of the global market suffering an abundance of supply and slack demand. OPEC's recent meeting which ended with a failure to set any production target for the cartel, sent any remaining market optimists into full retreat. The message was clear - there will be no change in the current OPEC policy of market share over price for the foreseeable future. The question which now hangs like a cloud over the market is – where is the bottom?

There is an old adage – predicting a market bottom is a fool's errand. So rather than trying to predict the market bottom (i.e., the lowest price for the current cycle) our goal is to predict the possible events which could suggest the market is at or near its bottom.

As a starting point we believe that the current status quo (excess supply and slack demand) will not dissipate easily. On the supply side, each of the world's major producers has little, to no, incentive to alter their current production policy/strategy. Russia, which is currently producing at levels not seen since the Soviet era, is and will remain focused on both generating maximum possible revenue and continuing to gain market share in both Europe and Asia. At present, Russia has no reason to cooperate and coordinate with OPEC. Like Russia, Iraq is also producing at record levels as it slowly recovers from war and fighting ISIL. The Iraqi government, which is in desperate need of revenues, has no reason to curtail production particularly when a substantial portion of Iraq's production (and associated revenues) is controlled by the Kurds. Saudi Arabia, which traditionally has acted as the international crude oil market's "central bank" stabilizing prices in times of crisis, sees no benefit in continuing in this role. Saudi Arabia has been squeezed out of the US market by the rise of domestic shale oil and in Europe by Russia (and others) – it is no longer willing to voluntarily reduce production and its global market share for the benefit of its economic and political adversaries. Iran, who saw its market share plummet as a result of the implementation of international sanctions, is now set to return to the market. From Iran's perspective, it is entitled to reclaim market share lost to other producers as a result of the unilateral imposition of sanctions. Finally, US crude production has risen sharply over the recent years due the application of fracking technology to shale fields located principally in Texas and North Dakota. US production peaked a number of months ago but only declined marginally as shale oil producers cut costs, increased efficiency and continued to produce in order to generate revenues to service their significant debt obligations. Viewing each major crude producers' circumstances dispassionately leads to the inevitable conclusion – in the current environment none of the aforementioned producers will voluntarily curtail production for the benefit of others. The most likely scenario is that US production will continue to gradually decline through the first half of next year. However, any and all declines in US production (due to financial stress on producers) will be more than offset by Iran's reentry into the market. In short, for the first half of next year we expect the market to continue to be materially oversupplied.

With regard to the demand side, we do not see much support for the market either. In the first half of 2016 we expect consumption to be steady at best and possibly slightly lower than current levels. Our view is based on the fact that the US continues to suffer from anemic economic growth which will most

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likely be negatively affected as the US Federal Reserve begins to gradually tighten monetary policy. We expect zero growth from the EU as it continues to struggle with excess debt in its periphery as well as a growing refugee problem. Finally, the economic data from China continues to indicate that its economy is slowing markedly. While we don't expect China to enter into a recession, we do expect China's growth rates to continue to moderate toward those of more developed nations as opposed to the accelerated rates seen in the past decade

In short, for the first half of next year the market will continue to suffer from substantial oversupply and slack demand. In our view, a market bottom will most likely not be triggered by a change in policy from OPEC or from a significant increase in global demand. The more likely trigger will be from a market-related geopolitical event. By this we are not predicting a terrorist incident impacting the global oil infrastructure - these types of events are impossible to foresee. We are referring to a political event (potentially precipitated by the low crude prices for an extended period of time) impacting a producing nation's political leadership. Specially, there are a number of second and third-tier crude producing nations with unstable or unpopular governments (e.g., Brazil, Venezuela, Nigeria, Libya, and Algeria) which are facing growing financial and/or political pressures. In our view, the potential ouster of an existing government in one of these countries may well be the catalyst which alters the current market psychology and galvanizes the other producing nations (both OPEC and Non-OPEC) into an uneasy alliance to support the market. This may or may not come to pass. However, our proposition is that the current status quo between major producers is more durable than most expect and that some exogenous (non-fundamental) event will most likely be required to upend the current state of affairs before pricing can reach its nadir.

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