News Flash – Straight Up?

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In February prices dropped to a low of $27 per barrel. At the time, many analysts and trading firms were predicting prices would continue to fall back into the teens. This, of course, did not happen because markets do not move in straight lines ad infinitum. On the contrary, prices rallied and today reached a new six-month high with WTI and Brent closing at $46.75 and $48.10 respectively. The rebound in prices has been both unexpected and powerful – leaving most market watchers with the following question - why?

The bounce in crude oil coincides with the bounce in global equities prices. After a difficult start to the year, global equities and commodities markets have rebounded largely on the hopes of continued stimulus from the world's major central banks and a rebound in Chinese growth. Moreover, there have been continued discussions of some nebulous production agreement between OPEC members and Russia. Although most market analysts, including us, believe that the likelihood of a production agreement that reduces the amount of supply in the markets is negligible, strategically timed leaks of an impending deal have been supportive to the market.

Despite continued central bank largesse and unceasing rumors of some sort of a coordinated action by major producers, over the past weeks global crude oil inventories have continued to grow. In the US commercial crude oil stocks have increased from 482.3 million bbls at the start of the year to 540 million bbls as of last week. These figures represent all-time highs for the United States.

The markets seem focused on continuous yet gradual production declines in the US as well as intermittent interruptions in supply from Canada (due to wild fires in and around the Fort McMurray area) and Nigeria (due to political unrest). Crude oil production in the US since January has declined from 9.2 million b/d to 8.8 million b/d. The market, however, has completely overlooked significant increases in the recent months from both Iraq and Iran. Iraq recently hit a new production record of 4.55 million b/d which represents a 300,000 b/d increase from the start of the year while Iran has raised its production to 3.56 million b/d an increase of 680,000 b/d from the beginning of the year. In short, production declines from the US and intermittent outages from around the world are being more than offset by increases from these two OPEC powerhouses. Moreover, the recent firing of Ali Al Naimi indicates that Saudi Arabia will continue its policy of pursuing market share over price and continue to produce at elevated levels despite calls for a cut from weaker OPEC members. Russia, appears similarly inclined to pump the maximum amount of crude possible as evidenced by it recently eclipsing a production record set during the Soviet era.

In light of the above, it is our view that the recent run up in prices has been driven largely by technicals and momentum – not underlying fundamentals. Although the rebound may have some fuel remaining, we believe that the market will most likely undergo a strong reversal in the coming months and we will once again trade in the low $30's and quite possibly retest the lows from earlier in the year.

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