AEGON Asset Management

Monthly analysis – February

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The air thins above 100 dollars

After two and a half years, the price of Brent crude is once again being quoted above the psychological barrier of 100 dollars per barrel. On the one hand, the reaching of the 100 dollar level chimes with our medium-term analyses following the disaster in the Gulf of Mexico, with the significant difference, however, that it happened a good deal more quickly than we had expected, and as such the increase was due less to declining yields from oilfields than to inflationary and political fears. Of the current events precipitating the ongoing price rise, a number of factors are making a return, such as those that led to the soaring of the price to 147 dollars per barrel in the summer of 2008. Witnessing the dynamic of the price increase, some economic players fear that it heralds another hot summer on the oil market similar to that of 2008; at the same time, in their judgement, there are significant apparent differences between the situation in 2008 and the current circumstances.

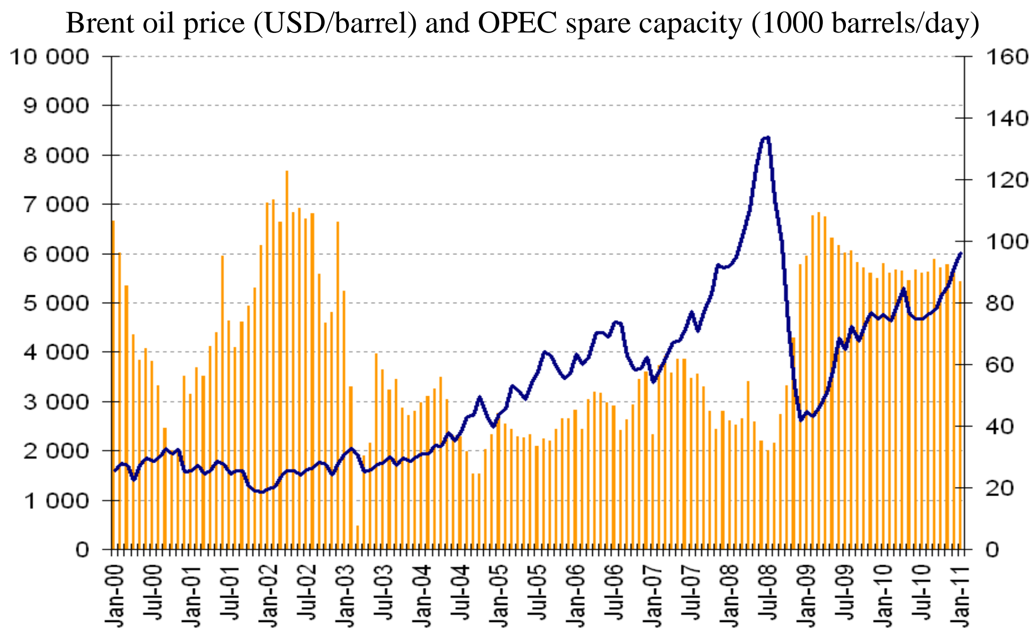
Looking at things purely on the basis of cost models, even oil prices in excess of 100 dollars might have seemed unjustifiably high two and a half years ago, and yet it must be said that in the summer of 2008 there were more short-term conditions in place than at present prompting a further temporary price rise once the 100 dollar mark had been reached. The cost models have been overridden by the low level of free capacities, while China's demand for oil has increased due to state-regulated low prices of fuels and anti-cyclical government growth stimulus programmes. Aggravating these circumstances, the US has begun pumping an unprecedented amount of liquidity into the frozen financial system, while in the Middle East the spectre of armed conflict between Iran and Israel has emerged, a combination of factors pushing the price of crude to historical highs.

Among the starting parameters for the current upward surge in oil prices we find some similar to those experienced two and a half years ago: as far as its effect on the raw materials market is concerned, the renewed printing of money launched last autumn in the US has reappeared in almost identical form. Similarly, then as now, the world is confronting a conflict situation in the Middle East, although its consequences on the oil market may be considerably less serious than the effects of a potential Iran-Israel war, where the closure of the Strait of Hormuz, which forms a narrow bottleneck into the Persian Gulf and handles turnover of 18 million barrels daily, might have proven a reality. The subject of intense coverage in the media in recent weeks, Egypt accounts for no more than 0.7% of total global oil production with its daily output of 600,000 barrels, while the scale of exports is similarly negligible due to domestic consumption. At the same time, the market is nervously weighing a potential escalation of the crisis or the

possible loss of transport routes. The closure of the Suez Canal and auxiliary SuMed pipeline network would undoubtedly intensify fears of interruptions in supply, but at the same time the loss of the transport route for an extended period would not be in the interests of any of the players concerned. For this reason, in light of present events, we do not think it worth assigning any great probability to this happening and instead believe the market may have somewhat overreacted to the supply risks.

Looking at the relationship of supply and demand, the important difference from the situation in 2008 is that there are substantial free capacities within OPEC at present (which can be switched to production within one month without additional investments). Following the major reduction in quotas of the OPEC member countries, the value of free capacities increased from the minimum of 2 million barrels a day in 2008 to close to 7 million barrels by 2009, which proved an instrument of key importance in supporting the price of oil. OPEC's free capacities currently remain at around 5 million barrels a day, which still represents a historically high value. OPEC's shortfall in production is also apparent in light of the fact, as revealed in Baker Hughes statistics, that the number of drilling rigs presently in operation is now barely short of the number running before the onset of the crisis.

Brent oil price (USD/barrel) and OPEC spare capacity (1000 barrels/day)



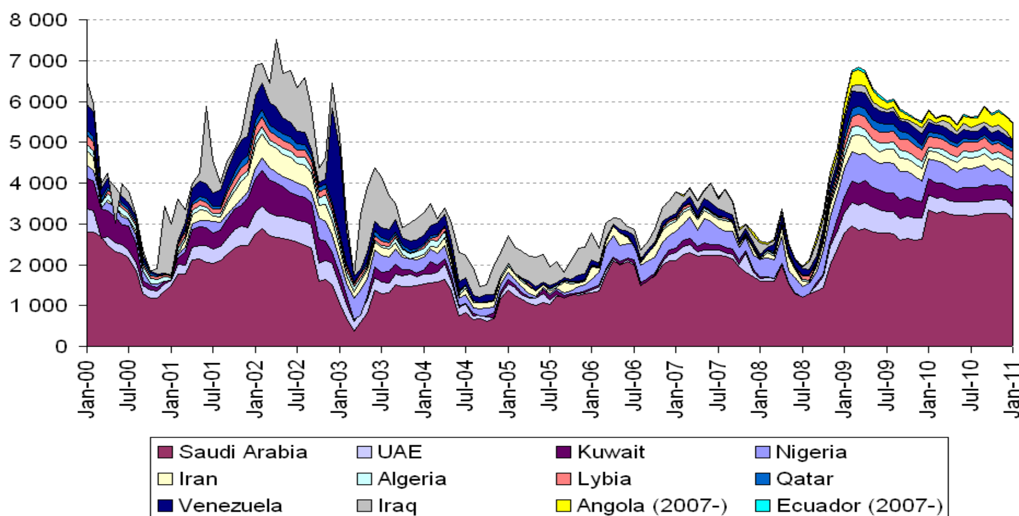
Source: Bloomberg

In terms of OPEC's estimated free capacities, it is clear that Saudi Arabia alone accounts for 60%, while a tighter tripartite coalition of the Saudis with Kuwait and the United Arab Emirates accounts for a combined 80%. It can also be observed that in the case of larger price increases in the past only Saudi Arabia set aside appreciable reserves while the other OPEC member states used up almost all of their available capacity. Based on

the above, an oil price of over 100 dollars per barrel raises the prospect of a slackening in the hitherto exemplary cooperation between OPEC member states. Initially we expect this may become apparent in an informal manner through increases in production in excess of quota, potentially to be followed by a formal quota increase. If this does actually happen, then the oil price will not be able to rise further from its present level, and instead a slow correction may begin as the tense situation in Egypt eases.

As regards an official quota increase, OPEC is biding its time for the moment, arguing that every buyer has access to sufficient supplies of oil. This standpoint is at least partly defensible, if only because no actual physical shortage of crude has occurred in the three decades since the second crisis in oil prices. The supply situation on the market is perhaps better demonstrated by the increase in stocks of WTI crude to record levels at the physical delivery point in Cushing in the United States, primarily due to the expansion in Canadian production. The price difference between North American WTI and the Brent crude used as a guide in Europe has widened to the extreme as a consequence.

OPEC Production Capacity (1000 barrels/day)

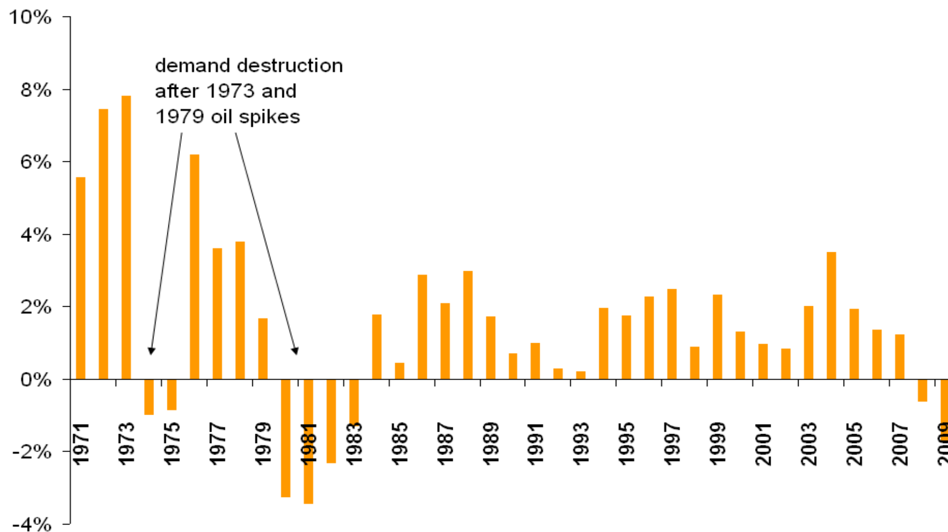


Source: Bloomberg, OPEC

The two to four-year periods following the 1973 and 1979 oil price rises saw a significant drop in demand, not only in the weight of oil compared to GDP as a whole but in the absolute volume of overall consumption. On this occasion, too, we expect that the reductive effect of oil price rises on demand may appear in the second half of the year. At the same time, high raw material prices may contribute to the application of a gradual brake on China’s growth stimulus programmes.

Indications of this are provided by the small but continuous rises in interest and reserve rates, although China's official communications feature an ever-dwindling amount of infrastructural goals expressed in numbers that might signal the cutting back of growth programmes.

Changes in global oil demand (year-on-year)



Source: Bloomberg

The supply side may react in a similarly brisk way to the high prices, albeit by its nature at a slower pace. At the current oil prices, even expensive non-conventional fields can be exploited economically, including deep-sea projects and North American oil shale deposits. Investment-related decisions are traditionally made not on the basis of the market price but far more according to the longer-term oil price expectations of the companies concerned. At the same time, a sustained suitably high price may prompt a host of such decisions and speed up the exploration of oil fields as a result. We expect supply may remain scarce in the longer term, though the pressure will be relaxed compared to what has been experienced thus far. Based on a December 2010 survey by Barclays Capital, the value of investments related to the extraction of hydrocarbons may expand to around USD 500 billion this year, an annual growth of 11% which also constitutes a historical record level.

In mid-January, BP and the majority state-owned Russian oil industry giant Rosneft announced a share exchange cooperation agreement extending to the exploration of non-conventional oil fields on the Arctic shelf. We may recall that in the period 2007-2008, Exxon, Shell and BP were all forced out of key hydrocarbon exploration projects in Russia, which was then gaining strength on the back of raw material prices. The main message of the announcement made three weeks ago is that political risks related to the

renewal of stocks may decrease, for on this occasion Russia – contrary to its previous practice – has admitted Western partners with oil prices riding high.

Despite the 100 dollar per barrel oil price, there are no looming problems with supply, and moderately decreasing demand and expansion of supply are realistic expectations on a time horizon of a few months. With regard to supply it is important to stress that the high oil price may carry consequences: OPEC takes a risk in the event that it still fails to react to any further price increases. While both producers and consumers are satisfied with a price in the range of 80 dollars per barrel, this stability could be upset in the event of even higher oil prices.

The aftermath of the oil price explosions of the 1970s not only witnessed efficiency improvements come to the fore, but also saw the role of oil in power generation finally pushed into the background. In a similarly irreversible manner, high oil prices may now have a counteractive effect on investments in alternative energy. A genuine revolution has taken place in this respect in the three years since the start of the crisis, as plunging module prices lead to the cost of solar energy, even with all the problems it entails, approaching network parity in many regions. The immunity of oil-producing companies is only technical: natural gas, coal and soon alternative energy will prove cost-effective rivals, but for the time being the transmission mechanism that might replace the road transport consumption that accounts for the bulk of oil demand is currently lacking. The threat is real, however, as the technical bridging solutions, once developed, are far less likely to suffer any tight bottlenecks.

In our estimation, while an oil price of 100 dollars a barrel will remain a reality for another 2-3 years, in the short term it has raced ahead of the economic fundamentals, which tend rather to warrant an oil price in the region of 80-90 dollars. If we assume that Russia is not alone in learning from the previous crisis, then we believe there is a good chance of OPEC raising production – partly due to dissension among its member states, and partly with the strategic goal, coming surprisingly from the mouth of a producer, that in the absence of adequate fundamentals in the real economy, the oil price should not be allowed to rise further.

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