

COMMENTARY

Black gold set to shine

UOB ASSET MANAGEMENT

In the last few decades, countries all over the world have seen rapid industrialisation and income growth among their populace. If there's one resource that lies at the heart of this development, it is oil. Today, fossil fuel is used to power ships, automobiles and many of the factories found in low-cost countries. For this reason, many analysts expect oil consumption to rise in tandem with continued industrial activity. UOB Asset Management gives a quick overview of the supply and demand dynamics driving the oil market and the prospects in the years ahead.

Oil traders have good reasons to cheer. Black gold has been on a month-long winning streak that saw its spot price break out of the narrow trading range of US\$72-US\$78 to hit about US\$91 a barrel on Jan 3. Given the healthy macro backdrop, some analysts now say the oil price could even reach US\$110 a barrel as early as next year.

This upward movement can be attributed to the confluence of year-end factors that helped to stir up buying interest. The onset of a cold spell over the Northern Hemisphere, easy credit conditions in the United States and buoyant consumption from emerging markets (EM) have contributed to the increase in energy demand in the final weeks of last year — a contrast with the generally lacklustre Organisation for Economic Co-operation and Development (OECD) demand that weighed down the market for the most part of 2010.

STRONG DEMAND FROM EMERGING MARKETS

Perhaps the biggest factor behind oil's remarkable rise is the rapid growth in EM. The rapid industrialisation in many of these markets saw consumption of energy resources grow at an alarming pace between 2004 and 2009. Despite the 49.4 per cent rise in crude oil prices (WTI Cushing) between 2004 and 2009, primary consumption of energy in EM

jumped by 30.2 per cent during the same period, reaching 5.15 billion tons of oil equivalent in 2009; of which China alone accounted for 62.2 per cent of the increase between 2004 and 2009.

Indeed, China and India were the world's second- and fourth-largest energy consumers respectively, in 2009, and both economies are highly dependent on energy imports. During 2009, China had the largest absolute value of mineral fuel imports within developing economies, with net imports of mineral fuels rising to US\$103 billion from US\$33.5 billion in 2004. India had the second-largest imports of mineral fuels among EM in 2009 with the value of net imports of mineral fuels almost doubling between 2004 and 2009 to US\$50.9 billion.

DEVELOPED WORLD'S CONSUMPTION HELD FIRM

Besides the EM, consumption in the industrialised economies is also an important factor in the oil market, as the developed world still accounts for the bulk of oil consumption today. For example, the OECD countries consume up to almost two-thirds of worldwide daily oil consumption, despite having grown at less than half the pace seen in the developing countries.

Additionally, the developed economies use oil much more intensively than the developing economies, and Canada and the US stand almost alone in the consumption of oil per head.

For example, oil consumption in the US and Canada equals almost three gallons per day per capita, based on estimates from the Energy Information Administration. Oil consumption in the rest of the OECD equals 1.4 gallons per day per capita. Outside of the OECD, oil consumption equals 0.2 gallons per day per capita.

ROLE OF SPECULATORS IN THE OIL MARKET

In recent years, there has been growing focus on the role of speculators on the oil market, and deservedly so. This is especially after spot oil prices shot up to a record

high of US\$147 a barrel in 2008, even though most of the developed world was in recession.

One commonly cited reason at that time was the sharp run-up in open interest, based on data from the Chicago Futures and Trade Commission. Between 2003 and the first half of 2008, paper demand for New York Mercantile Exchange (NYMEX) crude jumped 238.8 per cent, compared with the modest 9 per cent growth in physical demand. And in 2008, when oil hit its record levels, the paper market dwarfed the physical market by 13.8 times. Total open interests surpassed equivalent of 3.15 billion barrels on May 13 — a 425-per-cent jump since year 2001.

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Given these dizzying numbers, it was not surprising that many saw the speculators as largely responsible for driving up spot prices in oil. Speculative monies can drive the complex higher as liquidity constraints ease. Meanwhile, exchange traded fund inflows can also push the longer dated futures up, pulling the front month along as physical traders take advantage of contango trades.

POSITIVE OUTLOOK FOR OIL PRICES

We believe that oil prices will continue to drift higher on tight demand-supply imbalances this year.

The bullish outlook results partly from the persistently strong demand for raw materials in EM, while the economic prospects in the US have improved. Equally supportive is the advent of the second round of quantitative easing (QE2) which results in higher demand for oil as a natural hedge.

Meanwhile, OPEC has chosen to stay on the sidelines, instead of adding to supply in response to the run-up in prices. This signals that the cartel may wish to see more inventory draw downs, which is supportive of our bullish call on energy. ■