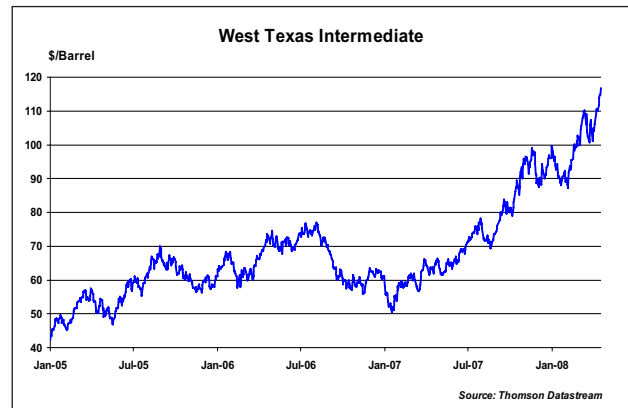


## Oil Prices Have Wide Range of Supports With No Obvious Immediate Catalyst for Major Correction

**Oil prices continue to make new highs.** After having been propelled through the \$100/barrel barrier in February, US light crude is now trading above \$115/barrel.

There are many factors driving up oil prices. The current level, though, appears to be less a combination of demand and demand expectations but rather some supply concerns and, more significantly, the weakness of the dollar plus strong speculative and investment flows.

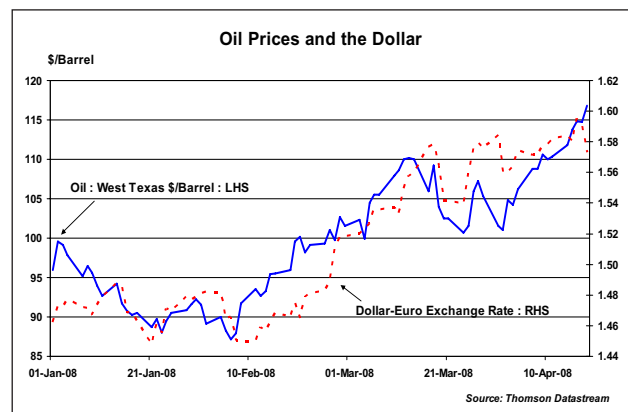
**The extent to which the price is currently being supported by these latter two factors, and thus represents an asset bubble, leaves oil vulnerable to a sharp and significant correction. However,** there is nothing obvious on the immediate horizon to provide the catalyst for such a move. Thus, **while there is scope for a price correction, oil could continue to trade well above the \$110/barrel level and, indeed, it could move higher again.**



### **Oil as a hedge against dollar weakness**

Undoubtedly a major factor pushing up oil prices in recent weeks has been the weakness of the US dollar. Funds have invested in oil (and other commodities denominated in dollars) as a hedge against the decline in the dollar and rising inflationary pressures.

It is almost becoming a vicious cycle. While high oil prices are in part being driven by the weak dollar, the elevated level of oil is itself one of the factors that is helping depress the US currency. Oil has become increasingly expensive for US consumers, adding to the downward pressures on US economic growth.



Higher oil prices have also served as a hedge against the falling dollar for the oil producing countries. These have been resolute in not making any supply side response to high oil prices. Rising prices have, as a result, more than offset the fall in the dollar and thus maintained (and indeed boosted) the purchasing power of dollar denominated oil revenues.

**The dollar is unlikely to give much support to oil, or other commodity prices in the near term.** We anticipate that the dollar will remain weak for some time with no apparent let up in the negative news flow (compared to other economies) and with interest rate spreads continuing to widen against it. Despite an apparently somewhat more aggressive attitude from the G7 towards the sharp decline in the dollar, the euro could yet see fresh highs in the coming weeks and a move through \$1.60 and beyond is quite likely.

Over the longer term, though, we are a little more optimistic for the dollar, which could be coming towards the end of its long six year down cycle. Assuming that credit markets stabilise and that the US economy starts to respond to monetary and fiscal stimulus, **there is scope for a modest dollar recovery in the second half of the year which would erode some of its influence on oil and other commodity prices.**

### **Support from investment flows**

Oil is not the only commodity to have been driven sharply higher since the beginning of last year. The commodity boom has been prolonged and broad based across all commodity groups, adding to global inflationary pressures and subduing global growth.

**Investment funds have sought a wide range of commodities as protection against global stock market weakness and volatility, as well as uncertainties created by the current global credit crunch along with the weak dollar.**

As long as markets remain fixated with the problems associated with the global credit crunch, commodities in general (and oil in particular) are likely to remain supported by investment flows as fund managers look for protection and diversification out of risk assets.

### **Strong speculative support**

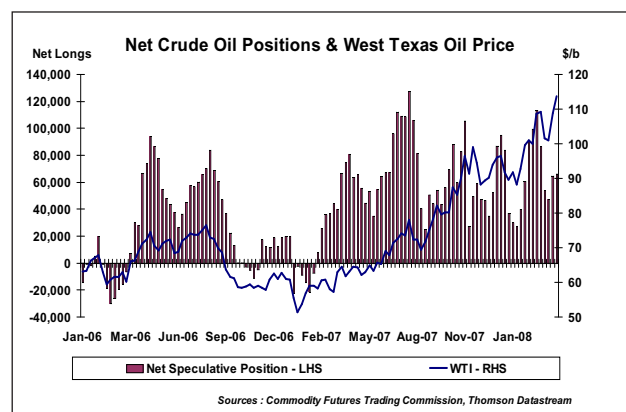
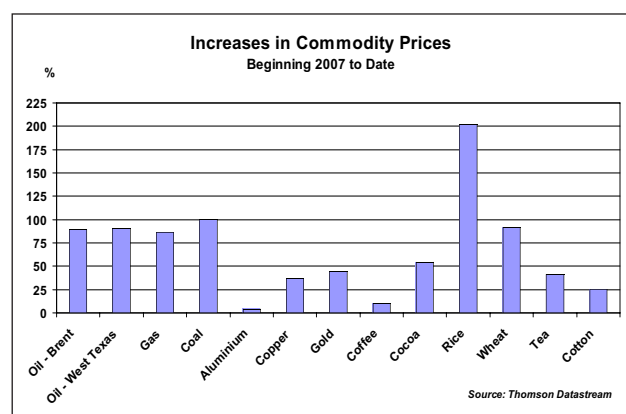
Meanwhile, oil's bull run since the start of last year has been supported by a build up of net long speculative futures positions. Although there has been some scaling back in the extent of net longs, **speculative positions point towards expectations of even higher oil prices.**

### **Supply side concerns outweighing lower demand estimates**

A large part of the current oil price support would thus appear to be due to factors outside the supply/demand balance. However, **the price is also being supported by supply side concerns which are outweighing lower demand estimates, for US consumption in particular.**

### **Demand estimates revised downwards ...**

In its latest monthly report, the International Energy Agency (IEA) has revised its estimates for world demand growth in 2008 significantly lower, to 1.3mb/d, cutting its previous growth estimate by 460,000 barrels a day. This is the largest downward revision to annual growth estimates in seven years. Since January, demand growth has now been revised downwards by 35%, from 2.0m b/d.



A significant part of this lower demand growth relates to the slower economic growth in the US. The US remains the world's major oil consumer. In total, North America accounted for some 30% of world oil consumption last year. However, as a result of the slowdown in the US economy, the IEA have reduced their demand estimate for the region and now estimate that North American oil demand will fall by around 1.5% or 370,000 b/d.

Gasoline consumption is the most susceptible to price and wealth effects. As high oil prices and the economic slowdown impinge on US demand, the US Energy Information Administration (EIA) estimates that this summer's driving season will see the first drop in demand levels since 1991.

World demand, though, remains driven by high demand growth from China and the Middle East, which should more than compensate for falling demand from the US.

Undoubtedly, the more protracted the US economic slowdown becomes, the greater are the risks of a spillover to the Chinese economy. However, as yet, there are few signs that the US led economic slowdown is dampening the rampant growth in the Chinese economy. Indeed, the latest data show the volume of Chinese crude oil imports up by 25% yoy in March to give a 15% yoy increase in Q1 this year.

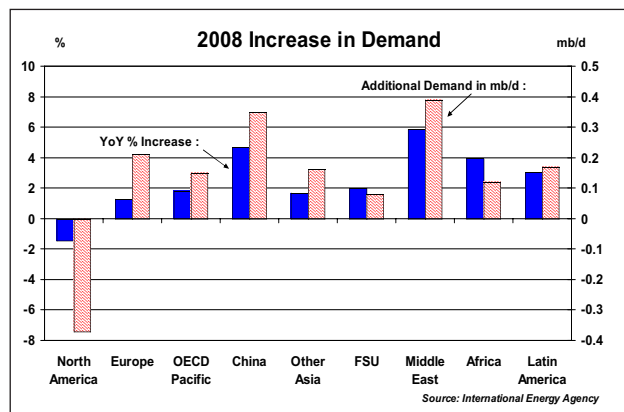
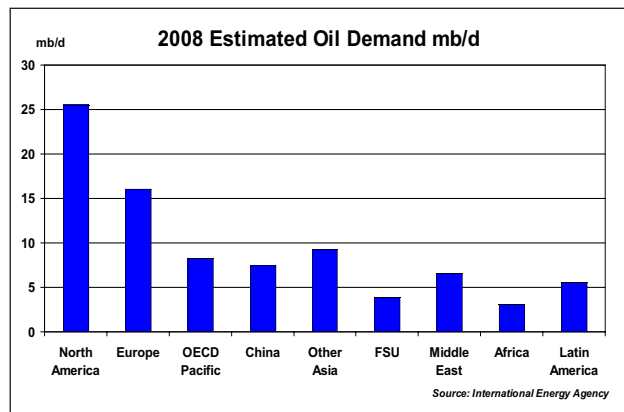
We anticipate that the US economy will start to recover in the latter half of this year as the impact of monetary and fiscal easing begin to be felt. **However, the risks to oil demand would appear to remain to the downside, not only in terms of the US but also China.**

### ... But also supply concerns

**While demand estimates have been trimmed substantially, this has not been sufficient to relieve growing supply side concerns.** Global demand growth has outstripped growth in non-OPEC oil production in each of the last five years. Non-OPEC production is growing by less than had been anticipated (production from Russia is showing its first decline in a decade accompanying sharp falls in output from mature areas such as the North Sea and Mexico). Thus, this trend looks set to continue in 2008.

At the same time, the IEA has reported that OPEC cut output by about 350,000 barrels a day between January and March. Further output cuts are likely in April as OPEC responds to normal season demand patterns. Demand normally declines in Q2 from Q1 levels. Q1 is the quarter that normally sees the highest demand of the year due to the Northern hemisphere winter.

Despite repeated urging from Western economies, **OPEC members have given no indication that they intend to respond to current high oil prices by boosting output.** The recent downward revision from the IEA trims back its world demand estimates to broadly in line with OPEC's own estimates, and OPEC believe there is enough production to satisfy this demand. OPEC blames current high prices on the weak dollar, speculation and political factors and insists there is no supply short-fall. The oil producers last met in March and are not scheduled to meet again until September.





With OPEC apparently reluctant to raise output, **supply concerns are likely to continue to provide support to oil prices, in the absence of any further significant downward revisions to demand estimates.**

**Any near term disruption to supply**, such as the current problems in Nigeria, **only serves to highlight the long term supply concerns and provides a further support to oil prices**

An indication of these long term supply concerns is given by the shape of the crude oil futures curve. The entire curve is currently trading well above \$100/barrel.

### **US refinery cutbacks supporting prices**

With high prices depressing demand, US gasoline stocks rose last month to their highest level since March 1993. However, on the back of weak demand and poor profit margins, US refiners have cut back on production.

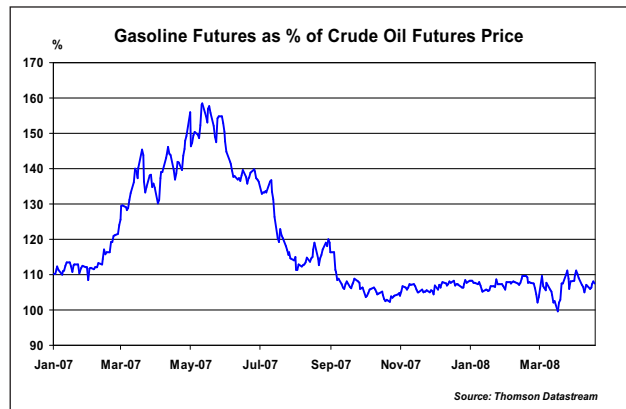
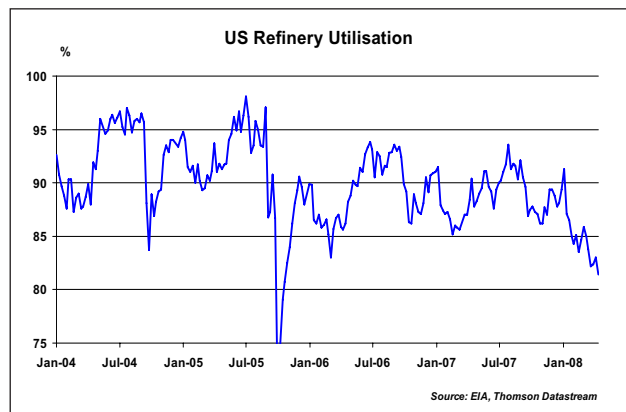
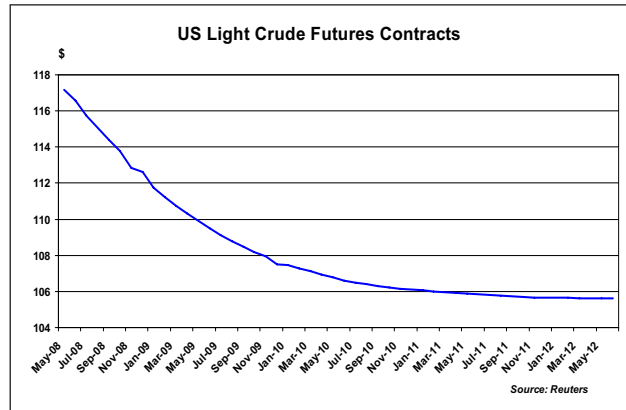
**US refinery utilisation has dropped** to its lowest level since October 2005, in the aftermath of hurricane Katrina which is **helping to reduce stock levels and thereby support product prices.** Margins have been eroded by a significant fall in gasoline prices relative to crude oil prices which gives little incentive to increase gasoline production and boost stock levels.

### **No immediate catalyst for a correction**

The strength of supports for the market makes it difficult to forecast an early oil price correction. Indeed, it is difficult to see what in the near term might act as the catalyst for such a move.

Over the medium term, as the US slowdown increasingly impinges on the European economy, and if and when there are signs that the Asian economies are also being significantly impacted, this will dampen demand for oil and other commodities. Meanwhile, slower growth in the eurozone should eventually enable the dollar to recover some ground against other currencies.

Thus, **while the extent to which the oil price is being underpinned by the weakness of the dollar and speculative flows leaves it vulnerable to correction, in the near term the price could remain well supported and, indeed, could move higher from current elevated levels. However, as with any asset bubble, if and when the correction comes, it could be sharp and sudden.**



**21st April 2008**