

July
2009

Crude Oil

Q3 2009 - Outlook



Review

After remaining subdued in the Q1 2009, oil prices changed their trend in Q2, marking an increase of an astounding 40.74% (Q/Q). Prices initially tested a low of \$43.83 in the month of April and then reverted to the six month high of \$66.64 per barrel. The gains were extended further in the month of June as prices hit a high of \$73.23 per barrel. The phenomenal uptrend in the prices was the outcome of varied factors. First in line was the expectation of a recovery in the global economy. This was followed by the optimism for the summer driving season and the depreciation of the dollar index.

In April, the recessionary fears have laid path to the G-20 nations proposing a massive financial restoration of \$1.1 trillion. Following this, Japan also announced a new stimulus package amounting to \$154 billion, to prevent its economy from further deterioration and ignite growth in the region. These measures imbued a sense of economic stability and the hope of bolstering energy demand caught up in the market, leading to increase in prices. Despite such major stimulus plans underway, the recovery in actual demand was time consuming. The economic data both from the US and the Euro zone portrayed a gloomy picture for their economies. The final estimate of GDP Q1 2009 from US came in at -5.5%, thereby indicating the worst recession was still not over. With the largest energy consumer daunting in bleak outlook, the energy markets remained subtle.

However in June the optimism of the summer driving season, raising consumption bar for gasoline provided hope for the oil markets. In addition, the supply gimmicks on the Nigerian front have substantiated the short term uptrend. But the depreciating USD proved to be the Feather in the Cap, as it resulted in prices reaching six month high levels of \$73.23 per barrel.

The dollar index which tracks the USD against the six other majors declined by 1.22% in the month of June, thereby enhancing the appeal of commodities. A softer USD makes look the dollar denominated assets cheaper to invest, thereby attracting investment into the commodities. The dollar index faced viciousness in the quarter as the Federal Reserve policy to hold interest rates at record low levels reduced its appeal. The Federal interest rate is now as low as 0.25%, as the deflationary fear has caught up in the market.

In the second quarter, Energy Information Administration (EIA) increased its demand forecast (M/M) for the Q2 for US, by a slim 100,000 barrels a day. But the expected demand of 18.74 million barrels a day still would represent a 12-year low for the time period.

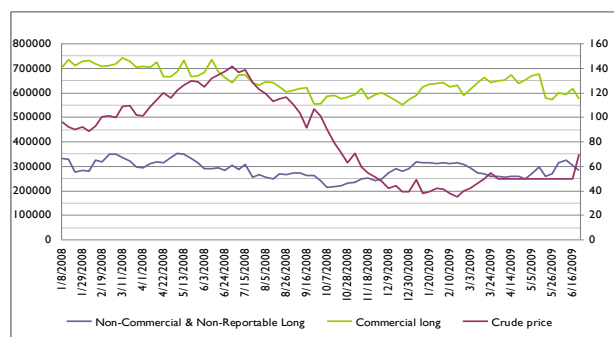
Major highlights of the Quarter

- Oil prices gained by an astounding rate of 40.74% in Q2 2009 continuing their gains in the Q1 of 11.35%. Overall in the first half of 2009 prices gained by a whopping 56.70%.
- Oil inventories, reported by US Department of Energy, declined by 2.56% compared to the 12.77% in first quarter, taking the total increase to over 15.88 % since June 2008.
- The International Energy Agency, an adviser to oil-consuming nations, cut its five-year forecasts for global crude demand because of the economic slump, predicting consumption won't be at last year's levels until 2012.
- The IEA cut its oil demand estimates for every year through 2013 by about 3 million barrels a day, it said in its Medium- Term Oil Market Report.
- US Q1 Gross domestic product has contracted by an annualized rate of 5.5% with the economy facing a major recession.
- The US Federal Reserve holds the target rate unchanged at record low of 0.25%. And is likely to hold them low for a prolonged period in order to revive the economy.
- OPEC extraordinary general meeting was held on the may 28th in Vienna. Although some positive economic indicators point towards the possibility of the recession bottoming-out before year-end, the world is nevertheless still faced with weak industrial production, shrinking world trade and high unemployment: for this reason, the Conference decided to maintain current production levels unchanged for the time being.

Investor sentiment

The CFTC gives an insight into the market dynamics or the commitment of the traders. Based on the change in positions one can gain a view on how the change in participants indicates the future pulse of the market. The total net long non-commercial and non-reportable positions, which provide a good proxy for investor sentiment in near short term, declined by 7.58 % in second quarter while at the same time commercial long positions declined by 2.69% against the 13.14% (Q1) rise, indicating long term pessimism in the market.

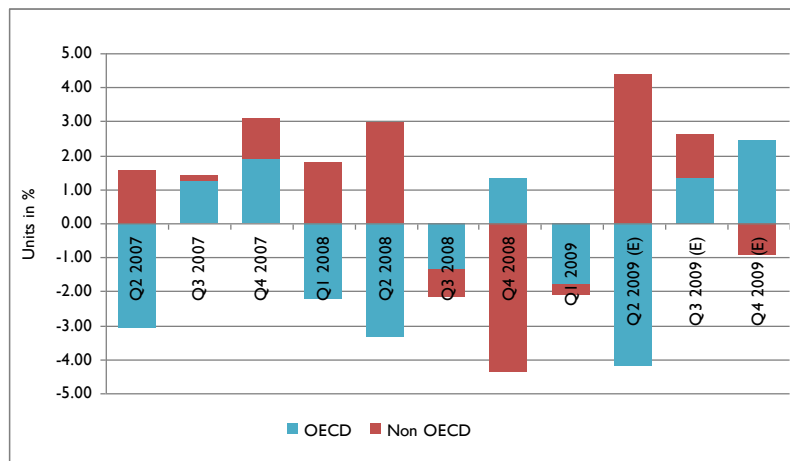
Figure 1: CFTC report snapshot - NYMEX Crude



Oil demand

The influence of the demand on the oil prices has been in the limelight in the recent past. Is it that the rebound in demand has resulted in the recent upsurge in prices or otherwise? The answer is a big no. No significant change in demand has happened in the Q2 which explains or reason out the 40% odd jump in prices. A look into some numbers first –

Figure 2: Percentage growth in oil consumption – region wise

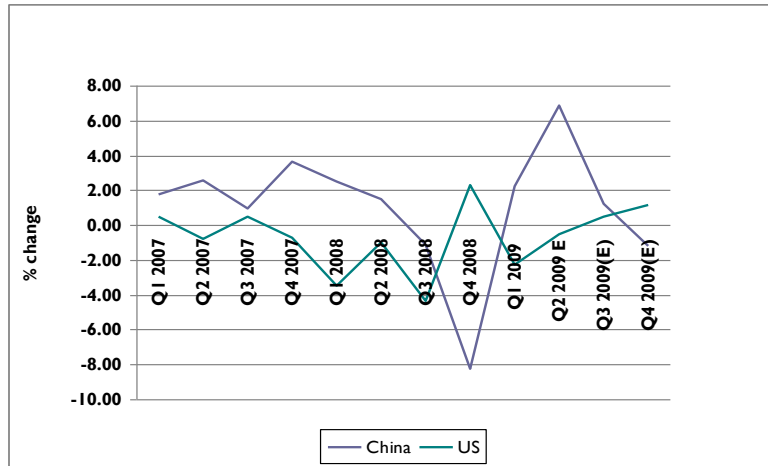


The ongoing global downturn precipitated by the financial crisis has worsened down most of the economic conditions in the developed nations. Unlike the developing nations too have felt the heat but are countered with lower growth rates other than recessionary fears. Every nation is witnessing contracting industrial activity, diminishing growth rates and surging unemployment. Unless these are addressed, the road to revival seems tough.

As per the recent EIA June report, the demand in the Non OECD regions is likely to grow significantly compared with that of the OECD regions. The oil consumption in OECD region is expected to decline by 3.34% contrast to the non OECD growth of 2.97%. Going by the World Bank forecasts for the economies, Developing countries are expected to grow by only 1.2% this year, after 8.1% growth in 2007 and 5.9% growth in 2008. The world economy is likely contract by 2.9% in 2009 compared to the previous estimate of 1.7%. Despite the gloomy picture for this year, World Bank says growth in developing countries, led by India and China, could reach 4.4% in 2010 and 5.7% by 2011.

China and India are one of the major consumers in the world energy market. The rise in the Non-OECD regions is to be lead by china, with an increase of 6.84% in Q2 2009 and 1.22% in Q3 2009.

Figure 3: Percentage growth in oil consumption – china & US

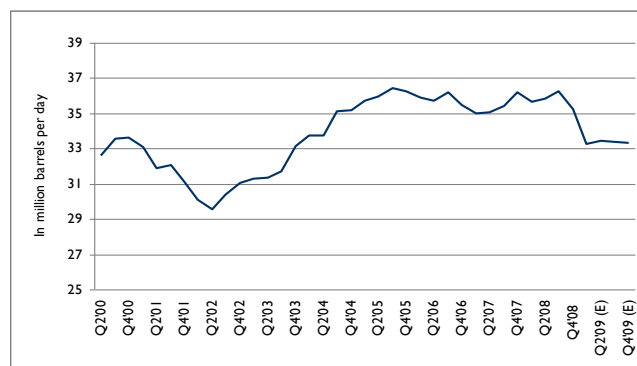


OPEC supply

The OPEC has refrained in the last quarter to take any decision on the production cuts, citing the persisting down trend in the global economies which may be heightened with higher energy prices. The rise in energy prices are likely to severe the downtrend and prolong the ongoing global recession. With this in view the OPEC have abstained from any production cuts, however it cited that a \$70 per barrel would be favorable levels for the producers. The organization will closely monitor the market scenario and review the decision in the next ordinary meeting scheduled to take place in Vienna on Sep 9th 2009.

As per the recent EIA report, the production of OPEC (crude oil portion) in 2009 is likely to average at 28.49 million barrels down by 2.79 million bbl/d from previous year's levels of 31.28 million bbl/d. In Q2 2009, the OPEC crude supply has averaged at 28.64 compared to 31.4 million bbl/d in Q2 2008. For the quarter ahead, the crude oil supplies are projected to be 28.41 million bbd/l in Q3, declining by 0.8% thereafter.

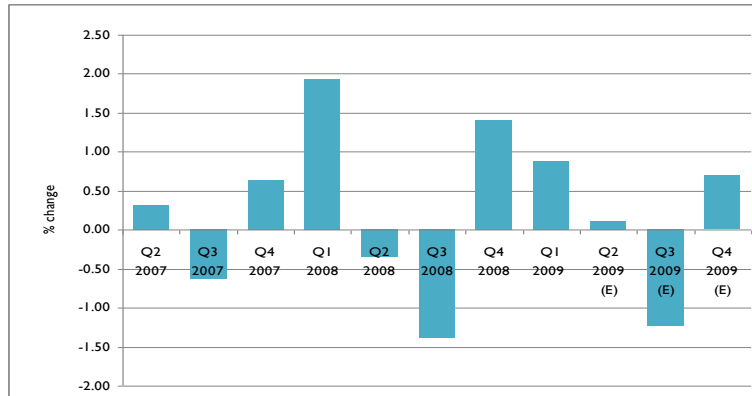
Figure 4: OPEC crude oil production (q/q)



Non OPEC Supply

The non OPEC supply has been seen as an important source of supplies as it constitutes to almost 60 % of the total world production. Nevertheless the OPEC remains the king maker, as majority of the oil reserves are concentrated in the region. In Q2 2009, the Non-OPEC supplies averaged to 50.39 million bbl/d up by almost 0.12% compared to Q1 2009. Further on the supplies from the region are likely to decline in Q3 by 1.24% to average at 49.77 million bbl/d.

Figure 5: Change in Non-OPEC crude oil production (q/q)

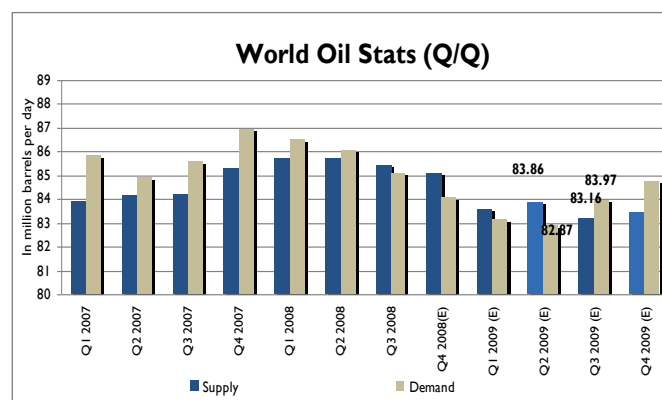


Total oil balance

The market fundamentals like the demand and supply hold their importance as they keep prices in check and deter them from major haywire movements. The recent run up in prices from the Q2 lows of \$43.83 to highs of \$73.38 per barrel is merely on the basis of the dollar depreciation and expectation of demand recovery. However in reality there was no major change in demand numbers, in fact the world oil demand declined by 0.25 million bbl/d in Q2. However the recent report of the EIA projects an increase in demand for the Q3 by 1.1 million barrels to 83.97 million bbl/d.

The world oil balance for the year 2009 is likely to be at 0.18 million bbl/d deficit, with demand at 83.68 compared to supplies of 83.5 million bbl/d.

Figure 6: World oil balance



Fundamental outlook

After going through the nitty-gritties on the fundamental scenario, the demand and supplies will be crucial determinants of the price action in Q3. The major setback in the oil demand was experienced in the OECD region, as it is likely to account for almost 67% of the total decline in world consumption (Q3 2009) with US and Japan leading the way. However the overall demand for the Q3 is increasing compensated by the rise in the Non OECD regions. While on the Supply front the Non OPEC supplies are likely to fall with delay in projects and OPEC production is likely to remain less constant.

The billion dollar bailouts are likely to take world economy on the recovery road and the optimism before this is likely to help oil prices to remain firm in the present quarter. The crucial event during the quarter will be the OPEC meeting in Vienna on Sep 9th 2009. With Energy Organizations increasing their demand forecasts slightly, demand recovery phase may not be far away now. A matter of concern will still be the pace at which the economic recovery of the regions.

In the short term going by the COT report the decline in the total net long non-commercial positions is likely to spell weakness. In the later half the prospects of economic recovery is likely to bring about more demand for the crude oil. Over all for the Q3 2009 the view remains higher fundamentally.

Technical outlook

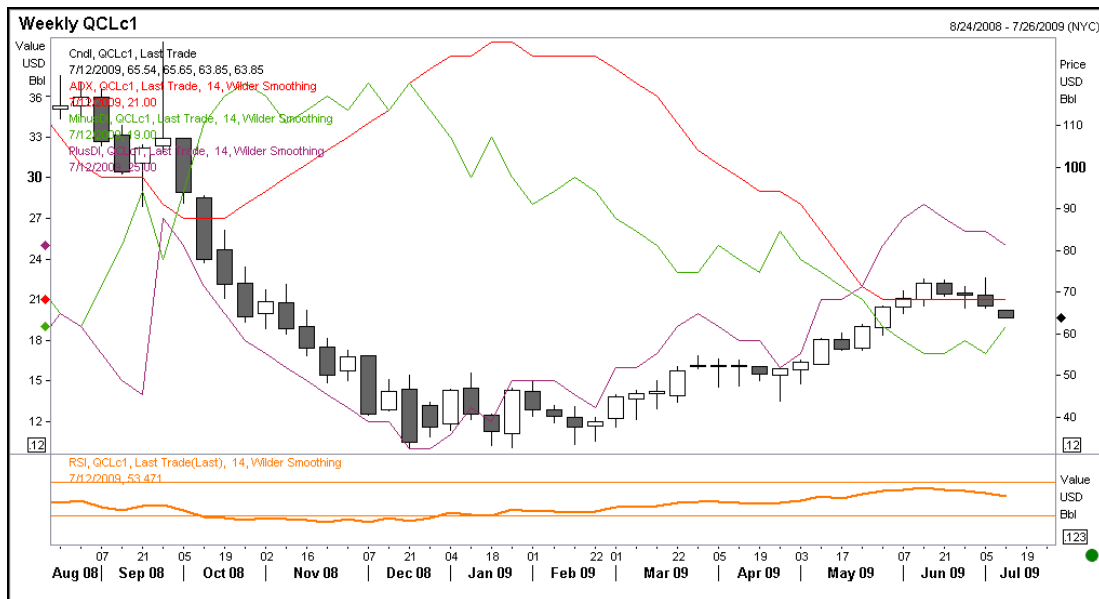
After a significant fall of more than 78% from its life time high of \$147.27 levels, Crude prices recovered till 38.2% Fibonacci retracement levels of 147-32 move. Crude oil prices posted a reversal after testing a low of \$32.4 in the month of December 2008 supported by a falling wedge pattern (discussed in our snap shot 10th March) and cup and handle (discussed in our snap short and crude oil Q-2 report) later to support the continuation of a short bull trend.

Off late: Market has been trading under its major resistance of 38.2% retracement levels of \$147-32 move along with its 10 quarter exponential moving average which lies around \$76 levels. Currently Crude prices are consolidating the recent gains and some corrective trade is also witnessed as the recent rally has pushed the market into over bought zone.



Further, various indicators and patterns signal a down trend having support of \$60-\$59 levels. The Fibonacci projection (\$147.3, \$32.4) also comes around \$58.3 levels.

Apart from the other indicators, **ADX** (average directional indicator) is also not signaling any strength in the market. Though its +DI and -DI so far has not signaled the selling signal as well.



Our stance: As various indicators are signaling further weakness in short term, we expect prices extending the corrective trade with major support at \$60 levels before resumption of any Bull Run. However, if market fails to sustain above the important support at \$60, one can expect increased selling towards \$50.

****Major support in MCX >> 3000, 2880-2800 then 2500**

****Major resistance in MCX>> 3310, 3400 then 3528 keeping INR constant at 48.0000**

Recommendation

(NYMEX- Crude) Sell in the range of \$68-69 targeting \$60 then \$54 with stop loss above \$73.3.

(MCX-Crude) Sell in the range 3264-3300 targeting 2880 then 2600 with stop loss above 3500

OR

(NYMEX- Crude) Buy in the range of \$54- 56 targeting \$73 then \$80 with stop loss below \$49.

(MCX-Crude) Buy in the range of 2600-2700 targeting 3200, 3500 then 3800 with stop loss below 2350.

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