# CRUDE OIL
## CURRENT SITUATION AND FUTURE OUTLOOK

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## Oil Prices on the Rise

Crude oil is a vital commodity in today's economic prosperity. Modern economies depend on crude oil for the production of energy (mostly in the form of Gasoline, Kerosene, and Jet Fuel etc.) and a multitude of other products (plastics, synthetic fibers and rubbers, detergents, and chemical fertilizers). The effect of an energy price change is unique as it causes an indiscriminant change in costs on almost all the sectors in the economy. This being said, crude oil has had a 60% run since the beginning of year to tip $98 on November 7th. What does this mean to Oil producers? What does this mean to Oil consumers? What are the repercussions of this on the global economy.

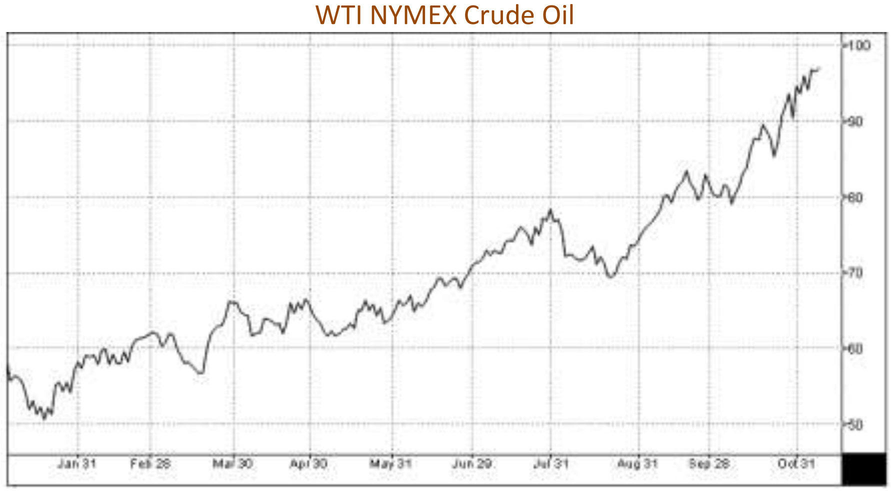
To be able and put forward a proper forecast, the first step would be to understand what are the reasons that made crude make this run when it wasn't cheap in the first place (oil at $60 was already hefty for importing economies and lucrative for producing economies). Many reasons can be attributed to this rise, but there are 5 main reasons for this accelerated drive. These are as follows:

1. Classic Supply/Demand

The crude oil run started off with a classic demand supply crunch on different scopes. Many reasons pushed the prices up starting off with the dropping crude oil reserves in oil producing countries. OPEC and Non-OPEC countries alike are working hard to increase their reserves. Then there is the production crunch as costs skyrocket. New technologies to pump out more oil of maturing fields meant that oil barrels did not cost $6 or $7 a barrel anymore. Costs have risen to over $20 in some cases.

The refining of crude was becoming more and more of a burden. The light crude in oil producing countries such as Saudi Arabia has been mostly consumed and the oil in production is the heavier type. This is more expensive to refine and puts more pressure on refineries as they need more time off for maintenance per year. The second part that pushed the prices up was that refineries were running at close to capacity and it takes time to build new ones (typically 3-4 years). The profits in refining are not exactly excessive and not too many want a refinery in their backyard. This was a problem that was primary in hiking oil prices.

WTI NYMEX Crude Oil




Source: Bloomberg

The delivery of oil was at a peak and the production of tankers was put to the test. Old tankers needed to go out of business and with the increase in demand; new ones had to be built and delivered. There were not simply enough at the time. Once the tankers were delivered, the markets did not come down as the risk of the short in supply still existed.

China's close to a constant 10% real GDP growth, India the same and when thinking of the size of the two economies, no wonder there is a strain on the prices of Oil. China is looking for oil in places such as Africa just to feed its growing need for energy. India too is looking for oil and acquiring rights to look for oil globally.

At the current prices that have spiked over $90, oil companies are not looking enthusiastically to purchase extra oil so as not to be stuck with expensive oil in cases the price drops. A main reason for the prices to drop is the increase in supplies. Lack of extra oil coupled with an approaching winter whether coupled with an increase in consumption caused supplies to drop and in turn prices to increase. This is a viscous cycle that will continue and one of the reasons that led the prices to spike over $98 a barrel.

The development of third world countries caused an increase in Oil consumption. The growth in emerging markets meant that they are in need of energy and this is in the form of Oil and Gas. Although Gas has not been as volatile, Oil has.

The biggest reason as far as the Supply/Demand balance is concerned that have led to this spike is that there is no cushion in production that existed in the 1990s and further-back in the 1980s. Except for a few countries, most producers are producing at or very close to capacity. Some countries have the ability to bring their capacity ceiling up by at hefty margin (Iran, Iraq, Algeria, Libya, Russia, UAE), but this will require both time and investments.

<u>2. Uncertainties, Terrorist Attacks, and weather putting pressures on supply</u>

The events that occurred since 2001 were only fertile for the oil to increase in price. Since 2001, the Middle East which is the world's largest oil producing region has suffered several crisis. The problems in Iraq, Palestine, Lebanon, and looming crisis in Iran caused an upward strain on the price of Oil. Although Lebanon and Palestine are not oil producers, they did have an effect on the price of oil.

Nigeria's supply of bonny oil has not been constant as problems including vandalism on pipelines and kidnapping of employees have caused interruptions in supplies of one of the world's most desired oils (very low sulphur content and high API Gravity). This has caused a hike in the price of oil. Problems in Mexico's supplies have caused an increase in oil prices. The hurricanes that hit the Gulf of Mexico have also caused interruptions in supply. The seasonal weather changes put pressures on supply.

Iraq has the capacity and reserves to produce in excess of 4million bpd. This is not the case though. This is a farfetched production level and the Iraqi ministry of oil has to deal with internal instability, an out of date oil apparatus and constant interruptions to oil exports. Their more optimistic estimates is to meet 3mbpd in the future.

As the cushion of supplies has slowly eroded, weather started to play a bigger role in the price of oil. With a 4m or 5mbpd cushion, a cold winter couldn't mean much. Just increase production by 2mbpd and you are fine. Not the case anymore. Pumping 2mbpd at the mean time might be easier said than done. Producers might be able to pump them from one country but the next day they go offline as a pipeline gets attacked in another country. If the oil is available what quality is it and are the means to transport available? These risks mean price is going up.

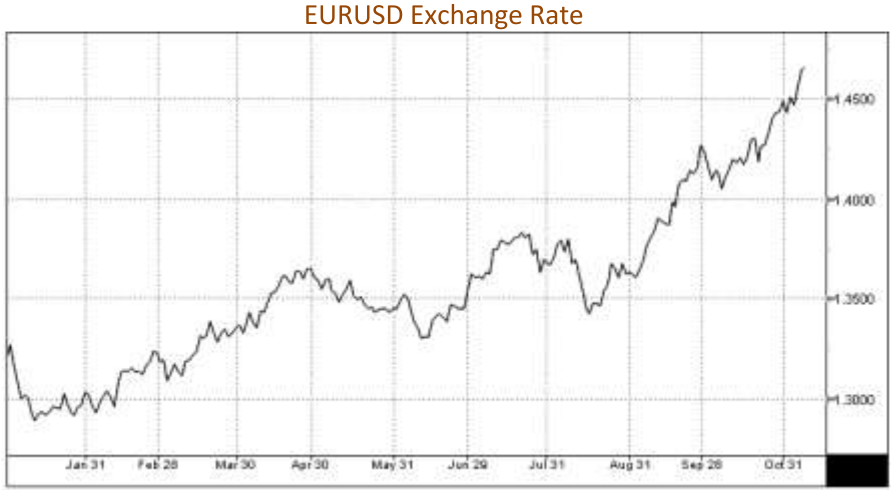
3. Oil Futures Trading

As the above factors are evident to most traders, billions of dollars have been dumped in Oil Futures, mainly going long on the oil. This trading in itself is a factor of moving the prices higher and higher. The trading in anticipation that there is little oil and the risks are high given that Oil in itself is a needed commodity has increased dramatically the share of speculation to bringing the price of Oil to its current levels.

4. US Dollar Weakness

According to some Analysts, and since the Oil is traded in the US Dollar, the weakness or strength in value of the US Dollar should be related to the price of the Barrel of Oil. This argument could stand. Again, according to others, this argument stands up to a certain level and not taking into consideration speculation. In other words, the correlation between the price of the barrel and the US Dollar should be for the price of the barrel inclusive of all risk premiums for delivery of the commodity. The 20% or 30% or 40% that is speculation amongst financial traders should not be part of the deal.

EURUSD Exchange Rate




Source: Bloomberg

The reasoning is that the producers should not be rewarded for an exchange adjustment and a price premium that is not part of the commodity value being delivered. At $40 a barrel both points of view can be argued. At $98 a barrel, both these points of view are just hypothetical. The dollar dropped by about 10% from the beginning of the year. The Crude gained over 60% since the beginning of the year. There is a vast disparity between the two and this shows that although the depreciating dollar is affecting the Oil prices it is the smallest factor of all the previous ones.

5. Oil is oil

Something as energy efficient (relatively) as oil and easily transportable as oil is part of the reason it is gaining value. Find something with the characteristics of oil and it will lose its shine. The failure to find a suitable alternative is part of making black gold so expensive.

The oil's current levels have repercussions on both oil importing and exporting countries.

**Price volatility on Oil Exporting Countries**

When the figures revolve around 10% or 15% increase in exports or price, the resulting liquidity can be handled well and planned for accordingly. The benefits to economy can be maximized and the damages can be minimized. This has not been the case with the 60% run. As is, excess liquidity was becoming a problem in the main exporting block (GCC block) when the oil was at $60. The 60% jump to $98 will only bring with it further headaches including a liquidity swamp and not to mention Inflation. Finding proper venues for this much of liquidity is not achieved this fast when most of the countries are not ready for it years in advance.

**Price volatility on Oil importing Countries**

Two problems arise for these countries. The developed countries with floating hydrocarbon prices will see them rocket and they have. This has had a negative effect due to the depletion of disposable income. Doubling the costs of car fuel per month is not exactly a joke. This can be a factor that attributed to the rising defaults in home loans in the USA.

For developing countries that are oil importers they have two problems. Energy is subsidized in many of these countries and as energy is a big part of any budget for the year, if energy price is off by 60% will require a lot hard work to be able and bring enough revenues to cover this extra payment. If the price disparity is passed on to the consumer like the USA or UK, the consumer in these countries will not be able to afford a car in many cases or heating oil in winter. It is a double edged sword.

**International Forecast**

A few have suggested that Oil is cheap and not a bonanza at the current price. Many more think It is expensive though. Maintaining the current levels or surpassing them will in no doubt be leading to economic slowdowns. Economic slowdowns don't happened in one day. They build over months, but when they do, demand will drop. If it gets to a point that an economic turnaround has to occur to halt a trader from making money, it could be a while before we see oil this high again. An economic slowdown level is way different than a psychological level for a commodity price. But then again, Oil is a needed commodity and its need will not diminish unless a viable alternative is found.

**Regional Forecast**

Oil effects the middle east as it does the rest of the world. Most of our region's countries though are oil exporters and have witnessed a boom in the last five years as oil prices have risen by over 300%. Massive projects have been built and many more are in the pipeline. In addition to real estate, expansions could be seen especially in the Tourism sector (UAE, QATAR) and Industrial Sector (Saudi Arabia).

Oil has been as of a Vice as it has been a virtue to the GCC countries. The GCC has been taking strides in diversifying its sources of revenues. As the price of oil increases, it becomes harder to move away from a lucrative revenue source. Nonetheless, the GCC has been pouring investments in other sectors.

**Jordan and the Oil Dilemma**

Jordan on the other hand has witnessed investments from the GCC region. These investments are basically the excess liquidity from the GCC that needs placements and Jordan is one of the potential destinations. This has caused a boom in the real-estate and development sector and saw a growth in the tourism sector with several hotels and resorts in the pipeline.

The increase in oil prices has on the other hand put a strain on the budget as the prices of oil derivatives are partially subsidized by the government. The recent jump in the oil prices will be very detrimental to the budget as it adds hundreds of millions of dollars to the budget. The actual figure is $2 billion added to the cost of oil incurred by the government that has to be paid. Even at discounted prices on partial oil deals from Iraq, this figure will not drop drastically and hover around $1.5 billion at best case scenario (at current prices).

Oil moving to $125 will be catastrophic for a country like Jordan. That is $3.25 billion in cost for the government to come up with as it will be difficult be passed on to the consumer. Even with a more optimistic drop of $80, Jordan will still find itself in a bind. The bind will be slightly milder and the burden less worrisome but nonetheless the problem will still exist. The rise in energy prices at such a pace is a hindrance and cause problems to all economies at varying degrees.

**Moving Ahead**

From here, it is varying opinions and a lot of guessing. To begin with, there are several points of consensus. First: a global economic slowdown will be catastrophic for the oil producers as it will force a slowdown on the supply side and a domino effect through all the economies of the developed world. Second: an Oil price over $110, as previously said, will lead to an economic slowdown. Third: Neither the Producers nor the Consumers are looking forward to an economic slowdown.

The real dilemma that every economy is being faced with can be briefly summed up as follows: Are the markets well aware of this fact or is it the same old cat and mouse game, as in - the price will keep on going up until it causes a turnaround in major economies, after which it will crash by 40% or 50%. It happened before and may happened again. Every time markets go up this high, traders say “this time it’s different, demand is different, supply is different etc.”. It may prove not to be different after all.
A scenario of $110-$125 is becoming more and more unlikely by the day. The USA is in dire problems due to the sub-prime losses in its real-estate market dropping in value and with the end nowhere in sight. The real-estate defaults and subprime write downs are only expected to increase in the medium term. The stock market is in its worst downward spiral in years and the gasoline is jumping above $4.00 a gallon (JD0.75 a liter) at the pump.

Europe is not faring better as the currency's appreciation is taking its toll on forecasted growth and the exports are slightly cooling down with imports increasing. Asia is not far behind, with even China feeling the pinch of an oil priced this high and taking so long to cool down. Oil has been trading over $80 a barrel for over 3 months.

A scenario of sub $50 Oil again will require many factors to occur. The supply risks have to all be sorted for good. Iraq has to be stabilized and Iran's disputes solved. Vandalism on all the world's oil supply apparatus halted or at least minimized to an acceptable level. A farfetched scenario but nonetheless, one that will assure no risks to supply for years to come and thus an increase in supply more than demand. This will lead to a genuine increase in production capacity.

A realistic price for oil that has been set by the last spike is in the 70s range. It is a range that has proved beneficial to both the producers and the consumers. The $60s and $70s range will both give the current consumers a 30% break on the price of oil and at the same time give most oil producers over 500% margin of profit, which is ample liquidity for them to finance their economic growth and prosperity.

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