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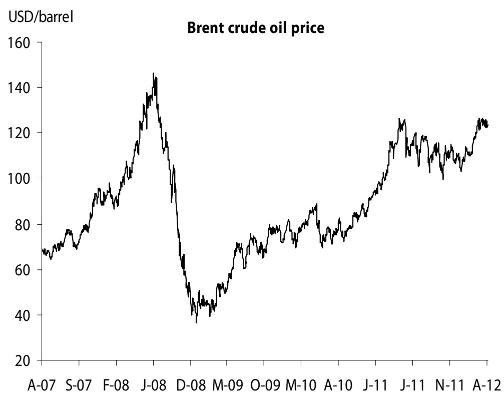
Oil Market: fundamentals and geopolitical risks provide support for high oil prices

- Global crude oil prices continue to remain high relative to historical levels, as geopolitical tensions have put upside risks to oil prices back in the spotlight
- We expect oil prices to hover around current elevated levels over the rest of the year, due to geopolitical tensions, easy money globally, tight fundamentals in the oil market and limited spare capacity.
- We see the risks to our forecasts as skewed to the upside as world oil inventories have not been building despite Saudi Arabia pumping at its highest levels in 30 years and Libyan supplies returning to the market. Tight inventories are leaving the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.

Global crude oil prices remain high relative to historical levels

Over the past four years, oil prices skyrocketed two times to record highs, threatening the global economy. In 2007-2008 the price of oil increased by about $80/barrel, to $147/b, mainly due to concerns over the long-term supply environment of the oil market. In 2011, supply disruptions from Libya sent oil prices to $127/b. With the price of Brent oil now back to $125 a barrel (Figure 1), and geopolitical risks again on the rise, upside risks to oil prices are back in the spotlight. Relative to historical levels, global crude oil prices continue to remain elevated. The price of Brent crude oil is currently about 12% above its level a year earlier and more than 50% above its five year average. It is estimated that roughly $10/bl constitutes a heightened risk premium in the oil market, which is attributed to the tensions between the West and Iran. Oil prices have been lifted also by the general improvement in the global economic sentiment since the beginning of the year, attributed mainly to the release of good economic news in the US and further monetary policy easing in the euro area and Japan. Indeed, the price of Brent shows increased resilience in downward pressures. Verbal intervention from Saudi Arabia's oil minister, Ali Naimi, that it is the perceived potential shortage of oil which is keeping prices high rather than the reality on the ground and that the country has the spare capacity to offset any temporary loss of production, along with talks of an early release of strategic oil stocks led by the US have failed to operate as a ceiling on price, as Brent is still hovering around $125/bl.

Figure 1



Source: Bloomberg

Looking forward, our baseline scenario is that oil prices will hover around current elevated levels for the rest of the year, averaging about $115 per barrel in 2012, since:

- Geopolitical developments, mainly in Iran and Syria, have intensified sine the start of the year, maintaining upward pressures on oil prices.

- World oil demand remains firm, driven mainly by robust demand from emerging market economies.
- Non-OPEC oil production, which accounts for about 60% of world oil supply, continues to disappoint on the back of technical outages in the North Sea and Canada and geopolitical tensions in Africa and the Middle East.
- OPEC's spare capacity has declined to extremely low levels, while OECD industry oil inventories are standing below the five year average for seven consecutive months, suggesting increased vulnerability of oil prices to future supply disruptions.

We see the risks to our forecasts as skewed to the upside as long as there is uncertainty over the threatened closure of the Strait of Hormuz and the way by which Saudi Arabia would fill any gap in supply left by Iran.

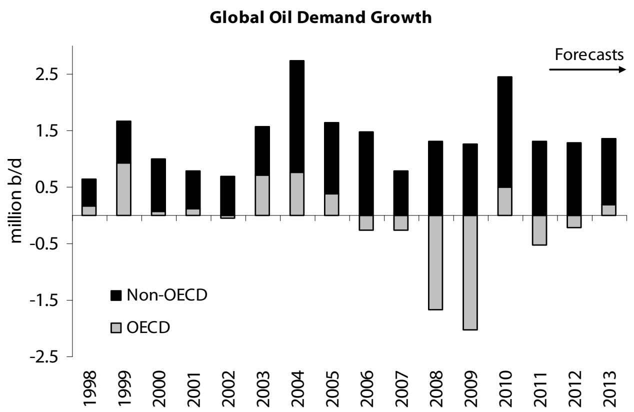
Geopolitical tensions continue to exert upside pressures on oil prices

Geopolitics were the major concern in the oil agenda in 2011, with Libyan oil production coming to a halt. Eventually, Libyan supplies have started to return to the market since the last quarter of 2011. However, this development has not removed geopolitical risks from the oil market, as Iran has brought them back in the spotlight. Growing international concerns over Iran's nuclear program have led the European Union leaders to agree on an embargo on crude oil imports from Iran, with existing contracts allowed to be fulfilled till July 1, 2012. They also decided to implement measures against Iran's Central Bank, such as banning oil related finance. In response to sanctions, Iran is threatening to block the Strait of Hormuz, through which about a fifth (i.e. around 16 million barrels a day) of the world's oil supply pass. As a result, risks of a disruption in global oil supply have increased sharply, given that Iran is the world's third largest oil exporter and OPEC's second largest producer. Even if such a closure did not last long, the effect on prices might be significant. It is worth noting that the price of oil rose by more than 80% in the initial stages of the first Gulf War. The European Union accounts for about 18% of Iran's oil shipments. Thus, if imports are cut off by July 1st, European countries, and particularly the vulnerable Southern European countries which are the ones more dependent on imported energy, may face a significant increase in oil prices. Although the probability of the closedown of the Strait of Hormuz seems rather small, we expect the risk premium to oil prices to persist as long as the focus on Iran remains in the spotlight.

Tight fundamentals are providing support for high oil prices

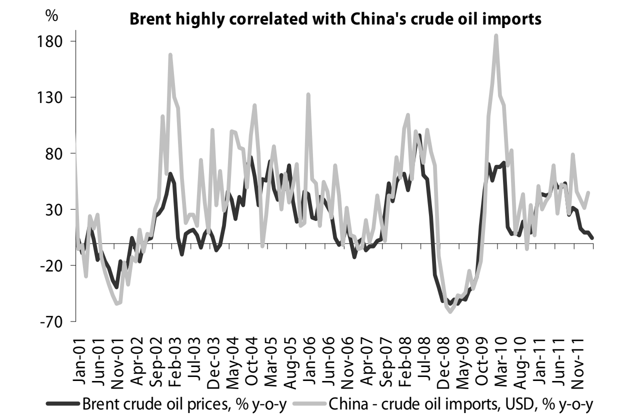
Tight supply/demand fundamentals persist and provide a floor upon price dips and keep oil prices at historically high levels. Looking at the demand side of the oil market, global oil demand is expected to rise by about 1.2% y-o-y in 2012 and 1.5% in 2013, compared to a 10 year average of 1.3%. Solid growth in emerging market economies, which account for more than 50% of global GDP growth and almost half of oil demand, is expected to continue to provide support to oil prices. According to latest US Energy Information Administration's (EIA) forecasts, in 2012, world oil demand growth is expected to come only from non-OECD countries (Figure 2). Meanwhile, oil prices have proved particularly correlated with China's crude oil imports (Figure 3). Indeed, China's demand for crude oil, accounting for more than 10% of world oil demand, continues to surprise to the upside despite the slowdown in domestic economic activity. Although tightening measures aiming at cooling the Chinese housing market have reduced activity in the sector and led to falling house prices, we believe that housing market activity will not become a strong drag on China's economic activity. Indeed, there is enough room for authorities to manoeuvre in order to fight a collapse should that happen. We expect Chinese imports of crude oil to remain high due to additions to its official stocks and consumers' need to restock after running down their inventories last year.

Figure 2



Source: EIA

Figure 3



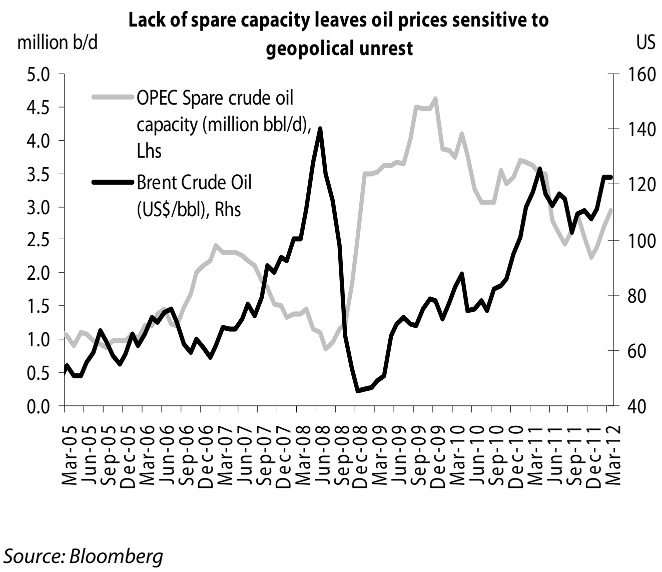
Source: Bloomberg, Ecowin

On the supply side, non-OPEC oil production, which accounts for about 60% of world oil supply, continues to disappoint, as it is estimated to have fallen by 0.5 million b/d in February according to the International Energy Agency (IEA). Technical outages in the North Sea and Canada and geopolitical tensions in Africa and the Middle East reduced output. The IEA estimates that these unplanned output losses have together reduced supply by around 750kb/d in the first quarter of 2012. Projections for current year's non-OPEC supply have been revised down by most international organizations. With non-OPEC production declining, the world has become increasingly reliant on OPEC's production to meet demand.

Meanwhile, OPEC's crude supply rose by 315 kb/d in February led by a sharp increase in Saudi output and a sharp recovery in Libyan production. However, with Saudi crude oil production at a three-decade high in February, OPEC's spare capacity has declined to extremely low levels. As Figure 4 depicts, OPEC's surplus production capacity has historically been a good indicator for oil prices. The lack of spare capacity in crude oil means that future supply shocks would intensify the potential impact on oil prices. Most of this spare capacity is in Saudi Arabia. That means that it will be largely up to the Saudis to cope with future disruptions. To the extent that there are uncertainties about the mechanics by which Saudi Arabia would fill any gap left by Iran when sanctions take place, upward pressure on oil prices will persist.

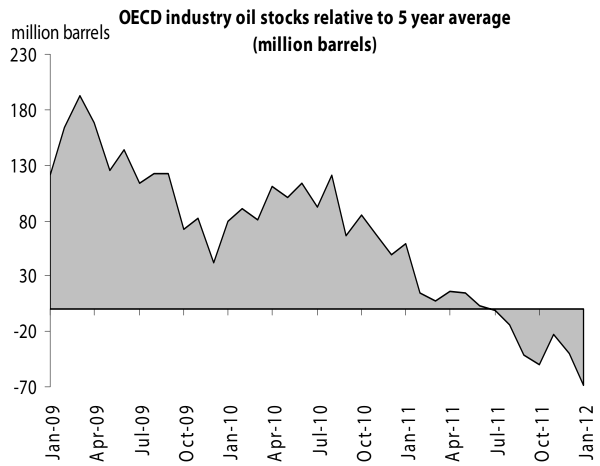
In the meantime, the combination of robust demand and supply shortfalls has resulted in continued drawdowns in inventories. OECD industry oil inventories are standing below their five year average for seven consecutive months (Figure 5). This suggests that vulnerability to supply disruptions and to the ongoing oil demand growth will remain high.

Figure 4



Source: Bloomberg

Figure 5

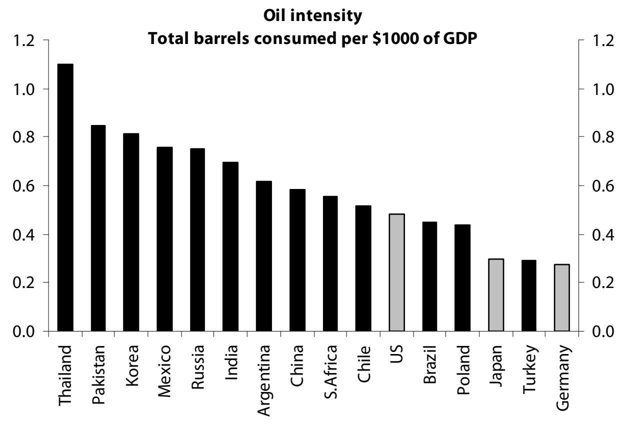


Source: Bloomberg

The impact of high oil prices on the global economy

Although the data flow since the beginning of the year has pointed tentatively to building momentum, the global recovery remains fragile and vulnerable to shocks. Indeed, as long as supply in the oil market is stagnant, demand buoyant and geopolitical unrest likely, the world will be vulnerable to high oil prices. Overall, the vulnerability of each individual country to higher oil prices depends mainly on whether the country is net oil importer, its oil intensity and its flexibility to substitute less expensive sources of energy for oil. As we can conclude from Figure 5, higher oil prices will have a greater adverse economic impact on emerging economies, and particularly on emerging Asia, than on advanced economies, as oil accounts for a larger part of total consumption in these countries.

Figure 5



Source: EIA, IMF, Eurobank EFG Research

According to IMF (2000)[1], a permanent $5/barrel increase in the price of oil will cut 0.2% off global growth after one year. Apart from economic growth, higher oil prices have also a key impact on inflation. The same study indicates that a permanent $5/barrel increase in the price of oil raises inflation after one year by 0.8% in the US, 0.7% in the euro area (Table 1).

Table 1

Estimated effects after 1 year of a $5 oil price hike

	Real GDP	**Inflation**
US	-0.3	0.8
EA	-0.2	0.7
Japan	-0.1	0.3
Latin America	-0.1	0.6
Asia	-0.4	0.7
Emerging Europe and Africa	0.1	0.3

Source: IMF

To sum up, with oil inventories remaining tight and spare capacity still low, rising geopolitical risks will continue to pose upside risks to prices in 2012. In fact, another abrupt increase in oil prices triggered by an additional shock to the global economy would have a severe impact on the global economy, as there is not much room for economic policy to accommodate an oil shock. Meanwhile, the 2008-2009 global recession along with the decline in bank credit availability impaired research and development in new technologies, reducing capacity expansion and, thus, supply growth. This is likely to continue to contribute in reducing the pace of supply growth, adding to upside risks to oil prices. Softer European demand, in our view, will not constitute a major downside risk to oil prices as long as the US economy, the world's largest consumer, keeps on strengthening. We believe that there will be a rising need for higher oil prices to restrain demand in order to keep up with supply problems, pointing to average oil prices of above $100 per barrel over the next years.

[1] *IMF, 2000, "The impact of higher oil prices on the global economy"*

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