IeC Experience and Insight on Demand

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THE GREAT GNIDNIWNU BEGINS

Executive Summary

IeC believe a Great Unwinding is now underway of the policymaker stimulus that has dominated markets since 2009. This has been inevitable for some time, with the key questions being around timing and the potential implications.

Developments over the summer led us to conclude that this Unwinding was about to begin. We thus published a series of blog posts describing its key implications.

Today, this Great Unwinding seems well underway. Thus this Research Note looks at the critical issue of the decline now underway in oil prices, and its likely consequences. Brent oil prices have already fallen 18% (from $104/bbl to $85/bbl), since we first warned on August 18 that the Great Unwinding was underway.

The first post looks at supply issues, and focuses on Saudi Arabia's critical need to maintain its 1.3mbd share of US oil demand. The second post analyses developments on the demand side, and the intensifying competition in energy markets. The third post then looks at the likely impact of these changing supply/demand balances on future oil prices.

IeC has won a reputation for independent thinking since it correctly forecast in the Financial Times and elsewhere that the US subprime market would cause a major financial crisis. These posts represent a recent example of our continued ability to see beyond the consensus viewpoint, and to highlight the key issues for the future.

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The blog posts appear here in unrevised form, as they appeared at http://www.icis.com/blogs/chemicals-and-the-economy/

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1. Saudi oil policy shaped by defence dependence on USA

By **Paul Hodges** on 15 October, 2014 in **Oil markets**

The world now faces a supply glut in almost every source of energy, including oil, gas and coal. It is also seeing major increases in output of key products including gasoline, diesel and petrochemicals. Yet as the International Energy Agency has warned, "*the recent slowdown in demand growth is nothing short of remarkable*."

The blog is therefore launching today a 3-part series that looks in more detail at how this New Normal world will develop. It starts today with supply, and will look at demand tomorrow before discussing the price implications on Friday.

The above picture is key to likely developments. It marks the start of the critical partnership between the US and Saudi that has been central to global oil policy since 1945. It shows US President FD Roosevelt (right) and Saudi Arabia's King Ibn Saud (centre) on the deck of the USS Quincy on Valentine's Day, 1945.

Over the next 5 hours, their meeting changed the course of history. The reason was that in 1938, oil had been discovered in Saudi Arabia by geologists working for Standard Oil of New York. In turn, this company became Aramco, and today Saudi Aramco. And Saudi Arabia became the world's largest oil producer, with the largest oil reserves.

America needed the oil to support its post-War development. And Saudi Arabia needed America's protection in case it was attacked. A small nation with enormous wealth is an obvious target for invasion. This became the basis for the "oil for defence" policy which has guided US-Saudi relations for the past 70 years.

But now, of course, America may no longer need Saudi oil. The focus on fracking and increased gas supplies has obscured the more important development, that the US is about to replace Saudi as the world's largest oil producer.

The pace of change has been unprecedented. It was only last year that the International Energy Agency forecast that this could happen in 2015. Today, it is already happening:

- So suddenly the Saudis face a critical question - does the US still need the 1.3 million barrels/day they supplied in 2013?
- And if not, will the US still be prepared to defend Saudi from attack, as it did during the first Gulf War in 1990-1991?
- This is the question keeping Saudi officials and Ministers awake at nights in Riyadh

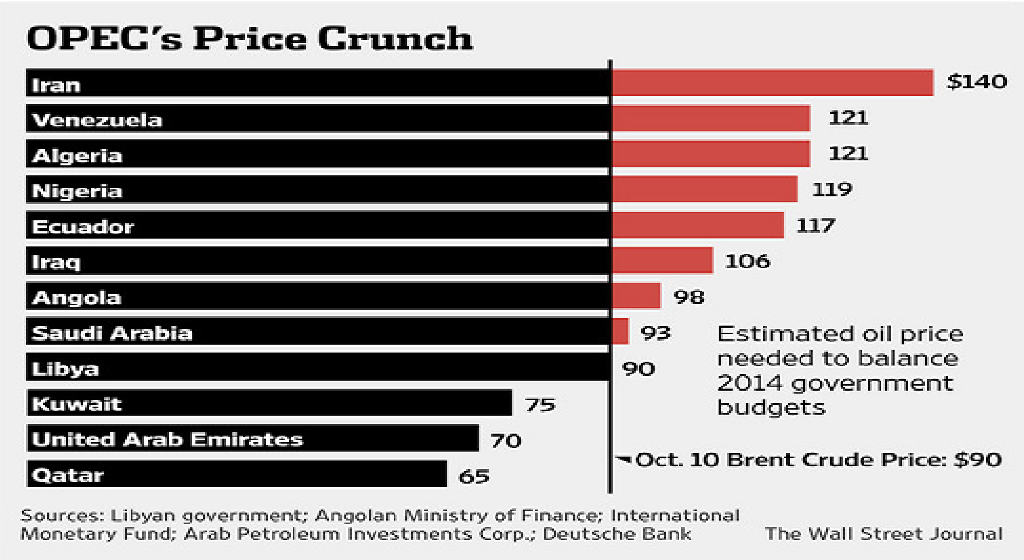
And it is no idle threat, with the Caliphate terrorising everyone to the north, and the potential for problems in a range of neighbouring states such as Iraq, Syria, Yemen and Iran.

Nigeria has already lost its entire export position to the US, yet until recently it was a Top 5 supplier of 1.3mbd. The rest of Africa, including Libya, Angola and Algeria, will soon be in the same position on current trends.

Tomorrow, the blog will focus on the other side of this question, namely what has been happening to demand.

2. Saudi Arabia faces New Normal dilemma as oil demand slows

By **Paul Hodges** on 16 October, 2014 in **Oil markets**



Yesterday's post described how OPEC oil producers are seeing their export sales to the US start to disappear. But this, of course, is only one side of the story. As the chart from the Wall Street Journal shows, Saudi needs a $93/bbl oil price to balance its budget. Most of OPEC needs a higher price. Only Kuwait, UAE and Qatar need less.

Most analysts choose to focus on this question. But important though it is, it is not the key concern. We are in the New Normal - where demand growth may no longer exist, and suppliers have to fight for market share. As the International Energy Agency has warned recently, "*the recent slowdown in demand growth is nothing short of remarkable*."

A moment's thought, after all, reveals that there is no point in having a high price if it becomes purely nominal. **Saudi, and the other OPEC countries will have no income if they cannot sell their oil barrels.**

The coal market provides a vivid example of the problem. 50 years ago, it was common to assume the world was running out of coal. Today, however, coal is being left in the ground, as it is no longer needed.

ASIAN OIL DEMAND IS NO LONGER ON A GROWTH PATH

Developments outside the US provide a vivid wake-up call. Already Asia has become unable to accept cargoes of Russia's highly valuable Sokol oil. The economic slowdown, and increasing African competition, means the market is over-supplied. So it has been forced to travel to California to find a home.

Even worse, from the producer viewpoint, is that Asian governments are being forced to cut back on fuel subsidies.

China has been doing this for some time, and now indexes domestic prices to world levels. India began cutting them last year, and the new Modi government is now increasing them to world levels. Indonesia will have to follow and increase them by 23%, as the end of the commodities boom makes it impossible to fund subsidies.

Already the subsidy cuts have slowed India's growth in diesel sales to zero, from 6% – 11% growth in the past. Clearly the pattern is now being repeated across Asia.

And one immediate result is that Indian refiners are demanding better terms from Saudi and Iraq. Bloomberg reports payment terms are likely to be extended to 60 days – essentially a price cut by another name.

Global oil consumption growth had already slowed to 1.2%/year before these changes, as the blog discussed back in July. Western oil consumption has been falling for some years, with even US consumption falling 0.6%/year since 2008. And this trend is likely to continue:

- US Dept of Transport data highlights that "as we age, we drive fewer miles"
- Similarly, the world is now entering its "peak car" moment, where sales will start to decline
- High prices have also spurred moves to gas, and to increased fuel efficiency

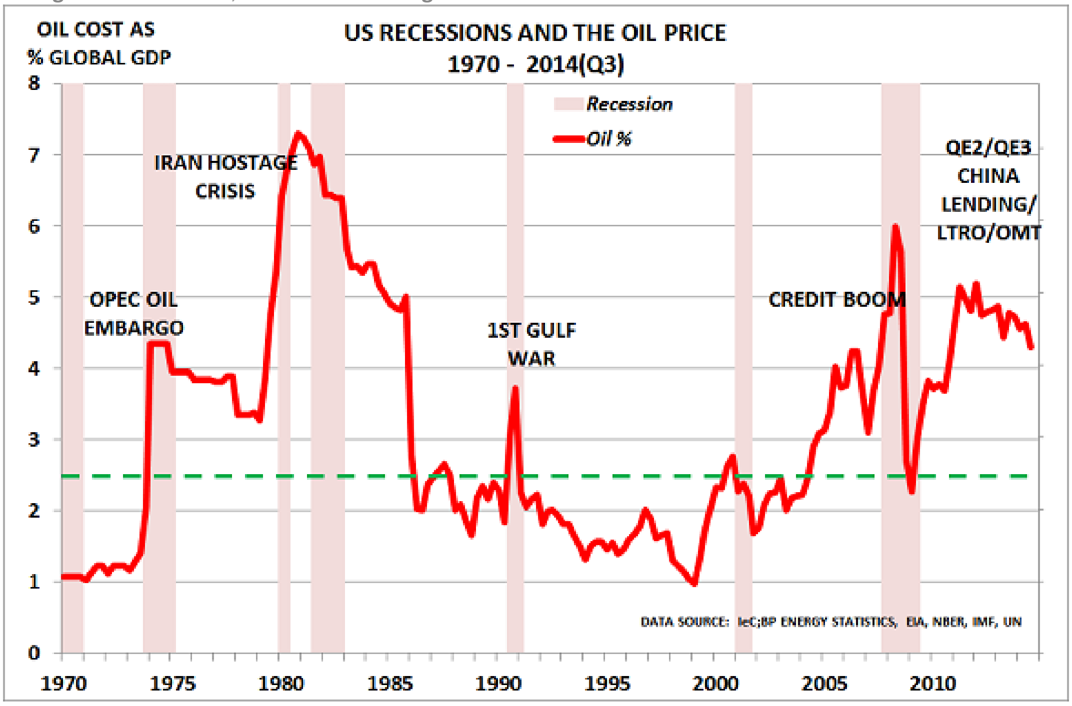
Thus oil producers are now effectively in a battle for market share. This is not only between themselves, but also against other forms of energy such as gas and renewables. Those who lose, like coal producers in the past, will have to shut down.

Saudi Arabia knows this. And its reliance on the US for its defence needs means it has to be amongst the winners.

Tomorrow the blog will look at the key question of what these changes in supply and demand balances will likely mean for prices.

3. Oil prices have further to fall as Great Unwinding continues

By **Paul Hodges** on 17 October, 2014 in **Economic growth**



Oil prices are highly likely to fall further, not rebound, over the next few months. That is the blog's conclusion to its 3-part analysis of likely developments in oil markets.

Having looked at the outlook for oil supply and demand over the past 2 days, today's post looks at the key question of 'what does this mean for oil prices'?

The key is that the Great Unwinding means markets will return to setting prices by reference to supply and demand.

This will be a major change. As the above chart shows, policymakers' stimulus programmes have instead meant that oil prices (red line) have been at levels which always led to recessions (pink column) in the past. The difference this time has been the flood of low-cost money from the central banks, and China's massive stimulus programme.

These artificially boosted prices, and also demand to some extent. But now their impact is reducing as the Great Unwinding takes place. Thus it is becoming clear that:

- Oil prices will have to return to more normal levels if producers want to halt the loss of market share to gas
- Even a price of $50/bbl would only slow the adverse trends in supply and demand for producers, not reverse them

Those hoping that prices will rise are essentially betting on a geo-political upset to occur. One obvious risk is that Russia resumes its military adventures in Eastern or Central Europe. Its economy is highly dependent on oil and gas exports. So it could decide to threaten invasion, or cut off gas supplies to the Ukraine to force global prices higher.

SAUDI MUST RETAIN ITS US SALES VOLUME

In the absence of Russian or other geo-political intervention, Saudi Arabia will likely be key to the future direction. Its priority must be to secure its US sales, even if this means head-to-head competition with N American production. Otherwise, as discussed on Wednesday, it risks losing its defence alliance with America.

As our colleague John Richardson has noted, the new US production probably has break-even costs around $40/bbl, so will be hard to shutdown. But Canada's oil sands could be vulnerable to a prolonged period of prices below $50/bbl.

Thus as Reuters reported last week, the Saudi strategy is becoming clear:
"Brent crude oil fell to its lowest since 2010 on Friday, dropping below $90 a barrel as Saudi Arabia said it upped production last month, increasing speculation of an OPEC price war. Fast-rising oil output in North America and tepid economic growth had raised expectations the Organization of the Petroleum Exporting Countries will cut output when it meets in November to stem a near 25 percent price slide since June.

"But on Friday Saudi Arabia said it had raised its oil production by 100,000 barrels per day in September, raising doubts the world's top exporter will be prepared to take unilateral action."

In reality, Saudi has very few strategic options. Readers with long memories will recall that it tried playing the role of 'swing supplier' in 1980-1985. It cut production from 10.2md to 3.6mbd to support prices. But, of course, the rest of OPEC simply increased their output to take advantage of Saudi's lost volume.

Saudi is unlikely to make the same mistake twice. And they can afford to take the pain, as prudent management means the Kingdom's gross budget deficit is only 2.7% of GDP.

Investors and companies who expect a 'business as usual' scenario are thus in danger of missing the key issue. They need to prepare for more volatility and further price falls. One reason is simply that a key impact of today's falling prices is to reduce apparent demand even further:

- Companies' first reaction has been to reduce inventories to minimum levels all down the various value chains
- Most have also stopped trying "buy on the dips" as the result till now has instead been to "catch a falling knife"
- Banks are also becoming nervous, calling in loans as the value of their collateral reduces with the oil price

Plus, of course, there is the potential impact from forced sales of all the so-called 'contango oil' stored in tanks and ships around the world:

- Traders have taken advantage of the US Federal Reserve' low-cost lending policy to store up to 50 million barrels
- As prices fall, this gamble on higher prices is not looking so clever
- So we can expect this to lead to panic sales, as people try to clear their positions.

CONCLUSION
It would have been much better if central banks had left well alone in 2009, and allowed markets to do what they do best, namely balance supply and demand. But they didn't. Instead they chose to try and boost growth by boosting asset prices in financial markets. In turn, these distorted price signals led oil producers and their major customers to over-invest in new capacity.

Now as the blog has long feared, it will be those of us living in the real world outside financial markets who will have to pick up the pieces from their mistake.

IeC Experience and Insight on Demand

About IeC: IeC is a London-based strategy consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.

Paul Hodges
is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.

Paul is Chairman of International eChem (IeC) and non-executive Chairman of NiTech Solutions Ltd. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloralkali, and was Executive Director of a $1 billion ICI business. Paul is a Freeman of the City of London and is a graduate of the University of York, and subsequently studied with the IMD business school in Switzerland

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