# Oil heads back to $30/bbl and probably lower

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**Paul Hodges**
**+44 (0) 20 7700 6100, phodges@iec.eu.com**

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**Chart 1: H1's oil price rally is now reversing**


*Financial volumes swamp the physical markets*

There was never any fundamental reason why oil prices should have doubled between January and June this year. There were no physical shortages of product, or long-term outages at key producers. But of course, there was never any fundamental reason for prices to treble between 2009 – 2011 in the Stimulus rally, or to jump nearly 50% between January – May last year. Instead:

- Prices once again rose because financial players expected the US$ to decline
- They realised this meant they could make money by buying oil on the futures market as a "store of value"
- Now, as the US$ has started to recover, they are selling off these positions
- And so oil prices are falling again

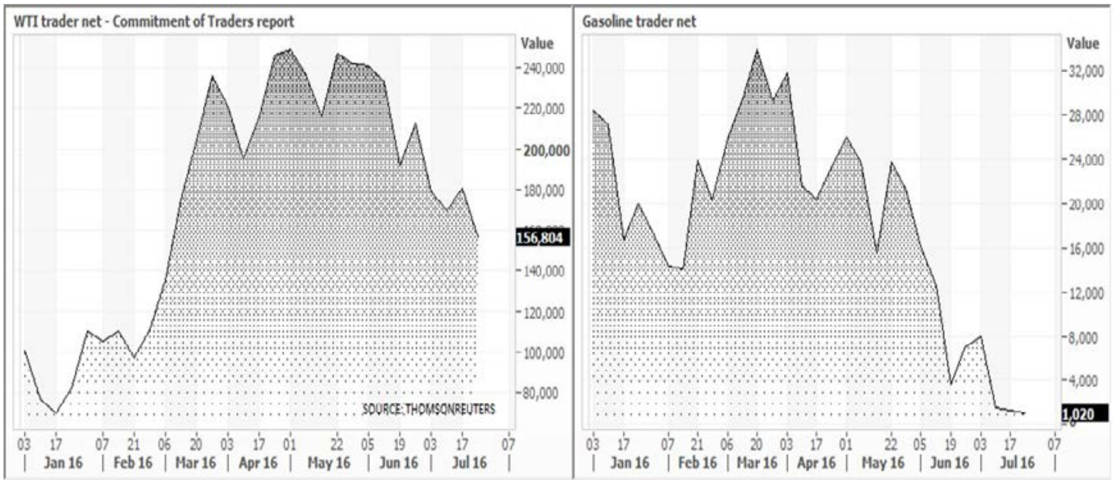
The problem is that the financial volumes swamp the physical market – they were 7x physical volume at their 2011 peak- and so they destroy the oil market's key role of price discovery based on the fundamentals of supply/demand. As we noted in an interview back in March as the rally took off:

*"Now the central banks are doing it again. And so, once again, oil prices have jumped 50% in a matter of weeks, along with prices for other major commodities such as iron ore and copper, as well as Emerging Market equities and bonds. In turn, this will force companies to buy raw materials at today's unrealistically high prices, as the seasonally strong Q2 period is just around the corner. Some may even build inventory, fearing higher prices by the summer.*

*The world is now running out of places to store all this unwanted volume*

*"If this happens, and prices collapse again as the hedge funds take their profits, companies will … be sitting on high prices in a falling market in Q3 – just as happened in January. Only Q3 could be worse, being seasonally weak, and so it may take a long time to work off high-priced inventory."*

**Chart 2: The financial speculators are now taking their profits and selling out of the oil and gasoline market**




Today, as chart 2 confirms, the hedge funds are indeed now unwinding their bets and leaving chaos behind them. As Reuters reports, they have already "*slashed positive bets on US crude oil to a 4-month low*":

- **Russia** has confirmed the myth of an OPEC/Russia oil production freeze is now officially dead
- **US** oil and product inventories hit an all-time high of almost 1.39bn barrels
- **China's** gasoline exports have doubled over the past year, and its diesel exports tripled in H1
- **Saudi Arabia's** Oil Minister has warned "*There are still excess stocks on the market – hundreds of millions of barrels of surplus oil. It will take a long time to reduce this inventory overhang*"

Even worse is that the world is now running out of places to store all this unwanted product, as Reuters reported earlier this month:

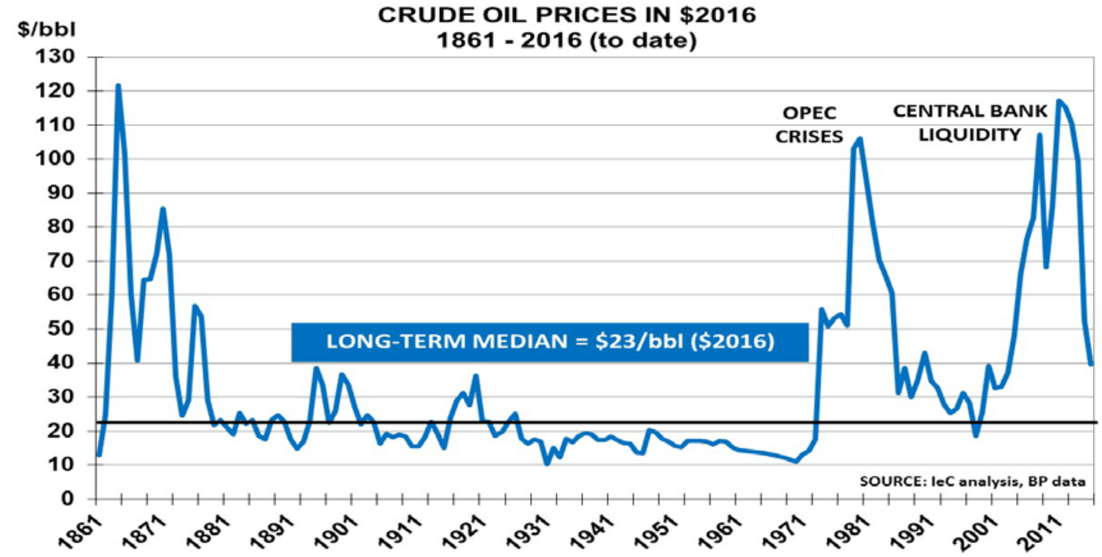
*"Storage tanks for diesel and heating oil are already so full in Germany, Europe's largest diesel consumer, that barges looking to discharge their oil product cargoes along the Rhine are being delayed"*.

Similarly, the International Energy Agency has reported a major backup of gasoline tankers at New York harbor, due to storage being full, whilst there are reports that tankers are having to be diverted to Florida and the US Gulf Coast to discharge.

The recent rally has also proved a lifeline for hard-pressed oil producers, who have been able to hedge their output at $50/bbl into 2017. As a result, companies have started to increase their drilling activity again, and are expected to open up many of the 4000 "untapped wells" – where the well has been drilled, but was waiting for higher prices before it was sold.

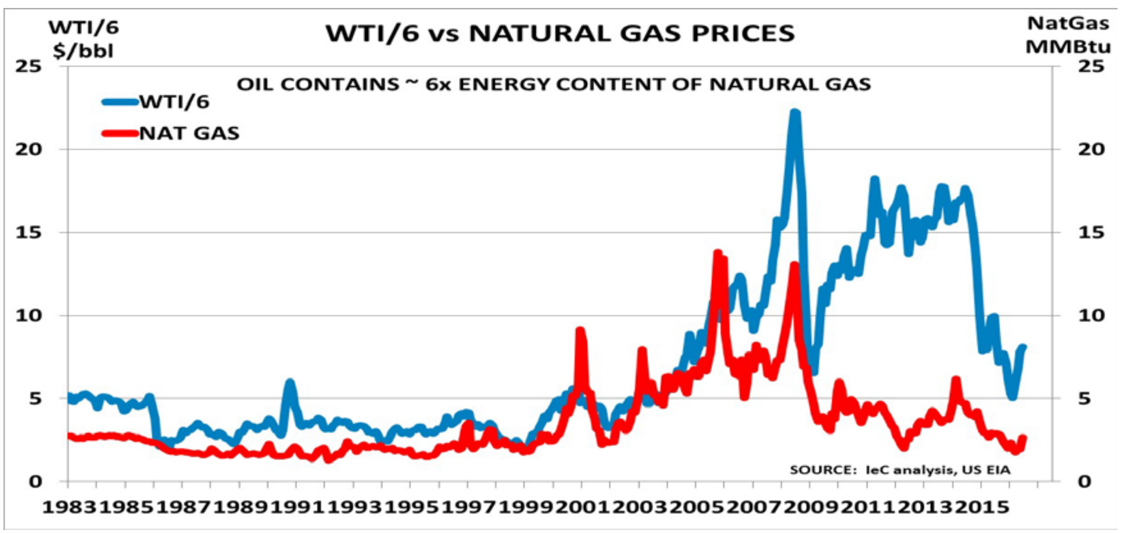
*Wishful thinking still dominates oil price forecasts*

**Chart 3: The stimulus-led oil price rallies have been an exception to historical trends**




Yet wishful thinking still dominates oil price forecasts. $50/bbl has replaced $100/bbl as the consensus view, even though in February this year, only 3.5% of global oil production was cash-negative at $35/bbl – just 3.4mbd. Today's figure is likely even lower, as costs continue to tumble. Plus, of course, BP's long-term data on oil prices confirms that the median price since 1861 is $23/bbl in $2016, as chart 3 highlights.

**Chart 4: Oil prices are returning to their historical relationship to natural gas in terms of energy value**




In the real world, oil prices have already fallen nearly 20% from their $53/bbl peak in June. Unless the US$ starts to fall sharply again, it seems highly likely that prices will now revisit the $30/bbl level seen earlier this year. Given the immense supply glut that has now developed, logic would suggest they will need to go much lower before the current supply overhang starts to rebalance.

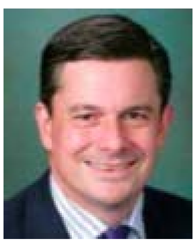
This would present a major challenge for the $3tn of energy market debt that is based on earlier consensus assumptions of $100/bbl and double digit economic growth in China. It would also return oil prices to their historical relationship to natural gas, as shown in Chart 4, and have major implications for the $160bn of US chemical industry investment now being made on the basis of a long-lasting "shale gas advantage".

# 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 an appointed member of the World Economic Forum's Industrial Council, a Freeman of the City of London, a graduate of the University of York, and subsequently studied with the IMD business school.



## Daniël de Blocq van Scheltinga

Was the first foreigner to be granted permission to run the finance company of a top-tier Chinese State Owned Enterprise, when establishing and managing ChemChina Finance Company. Previously, Daniël held a variety of senior positions in corporate and investment banking, including as Asia Pacific Head of Chemicals and Asia Head Asset Based Finance for ABN AMRO.
He has lived in Hong Kong for 16 years, and continues to spend much of his time in China, advising both international and Chinese firms, as well as leaders in the public and private sectors. Daniël is a graduate of Leiden University in the Netherlands, holding a Master of Law degree with a speciality of International law.

## James Gruber

Is a 14-year veteran of financial markets, having covered them as a leading fund manager, stockbroking analyst and journalist. Most recently, he spent 20 months as the founder/publisher of the widely-followed investment newsletter, Asia Confidential, which focused on key macroeconomic issues facing the Asia Pacific region. Prior to this, he was a Portfolio Manager for Asian Equities at AMP Capital, managing Asian and China A-share funds totaling US$1bn, for two years.
The performance of the China A-share fund was ranked no. 1 globally over one and two years during his time there. For five years prior to this, James was a senior research analyst at leading Asian brokerage, CLSA, where he covered multiple sectors in Hong Kong, Australia, Malaysia and Indonesia. He began his working life as a news journalist at the Australian Broadcasting Corporation.