Oil: Temporary Calm After the Storm

■ **The downward correction to oil prices was too fast and too large and they could see a further temporary rebound. Nevertheless, market fundamentals remain bearish.**

In October, oil prices surged well above our previous forecast, with dated Brent skyrocketing to USD 52.0pb and WTI Cushing to USD 55.9pb (Chart 1). However, a sharp correction has occurred since then; at the time of writing, dated Brent stands at USD 44.7 and WTI at USD 49.4pb (both having been lower in recent weeks). The oil market had clearly overreacted to the US market specific situation due to hurricanes in the Gulf of Mexico. As the situation returned to normal in this area, supply proved to be greater than traders had previously thought.

Despite those favourable fundamentals, the market's consolidation was probably too quick and a further rebound in oil prices is possible before the end of the quarter. Thus we forecast dated Brent will average USD 47pb during Q4. However, we remain bearish for 2005 given the risk of oversupply at the end of the winter and particularly in Q2. The Brent price could rapidly decline below USD 30.0pb and OPEC producers may have to reduce production quickly to avoid a collapse in oil prices. Then, a moderate reaction (1 mbd cut) would allow a recovery of oil prices to just above USD 35pb for Brent at the end of 2005.

■ **Market overreacted to US specific situation.**

Clearly, oil prices overreacted to the US specific situation resulting from the hurricanes in the Gulf of Mexico. Hurricane Ivan destroyed numerous oil platforms and facilities, reducing US domestic oil production by more than 13% during September. Moreover, the hurricanes also closed US Gulf of Mexico ports. As a result, US crude oil imports declined by more than 21% in two weeks in mid-September. The resultant slump in US crude oil stocks pushed them just below their operational limit (Chart 2). In addition, distillate fuel oil stocks - which include heating oil - declined due to the fall in refineries' utilisation rate (to 83.7% at the end of September) and robust demand for those products (a rise of 9.2% m/m and 8.2% y/y in October).

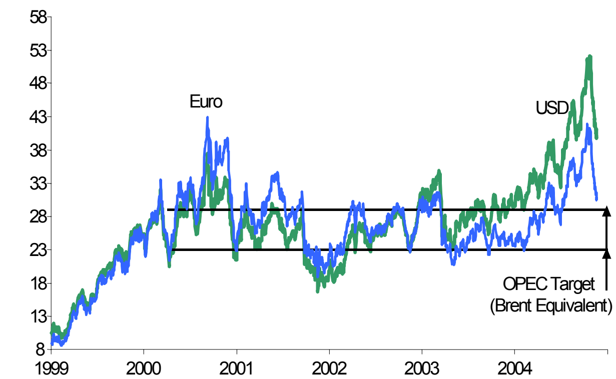
However, the market exaggerated the impact of the hurricanes. When weather conditions returned to normal, US ports reopened and domestic production increased, allowing US refiners to receive delayed tankers and to buy more crude oil on the spot market. As a result, US crude oil stocks were rebuilt rapidly, increasing by 22.8 mb in eight weeks.

Table 1: Oil Price Forecasts (USD/pb, Average)

	Q3 2004	Q4 2004	Q1 2005	Q2 2005	2005
Brent (dated)	41.5	47.0	39.0	33.0	35.2
WTI	43.8	51.0	42.0	35.0	37.7

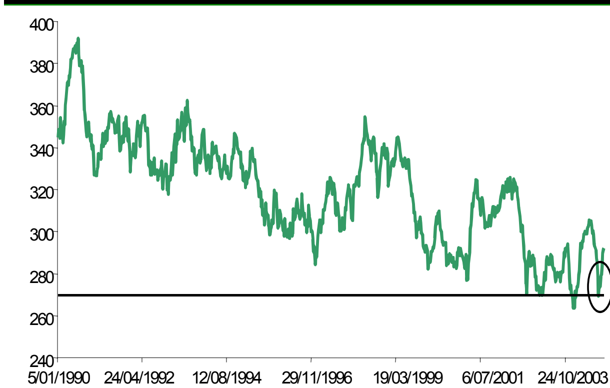
Source: BNP Paribas

Chart 1: Oil Prices Surged Before Collapsing (Dated Brent, pb)



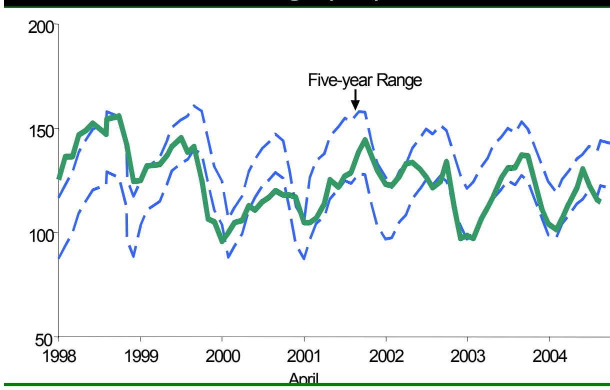
Source: Thomson Datastream

Chart 2: US Crude Stocks Returned to their Low (mb)



Source: US Department of Energy

Chart 3: US Distillate Stocks Below 5-year Range (mb)



Source: Source: US Department of Energy

■ Market re-focussing on fundamentals.

Other indicators also suggest greater supply in the oil market than generally perceived. Confirmation that the development in US stocks reflected US-specific factors is provided by the latest IEA data, which show an increase in OECD stocks outside the US. In Q3, and despite the US decline in September, OECD oil stocks were at exactly the same level as last year (2597mb) and have been rebuilt at a normal speed. Despite the surge in demand (5.2% rise in Q2 and 3.3% increase in Q3), OECD stocks increased by 0.6 mbd, on average, during the past quarter and by 1.4 mbd during the past two quarters - reasonable increases given the strength of demand.

The market also clearly overstated the risk of other potential disruptions to supply. Despite concerns, Iraq, Venezuela, Nigeria, Norway and Yukos have all maintained their oil production. Indeed, OEPC increased its production to close to its ceiling (30.0 mbd in October versus 30.5 mbd). That was generally interpreted as a sign of greater risk of shortages but, in this assessment, the market ignored the first signs of a deceleration in demand.

■ The oil market is oversupplied.

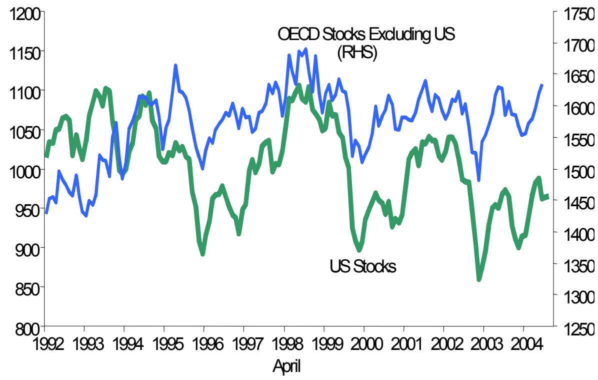
The latest data confirm that growth in oil demand is decelerating in both the US and China. In the US, oil demand grew by just 1.0% y/y in October. Moreover, this rise included the impact of higher consumption of distillate and residual fuel oils. Gasoline demand declined by 1.3% y/y, while industrial demand dropped by 2.5% y/y.

Given the slowdown of growth in world oil demand and the current level of OPEC production, the oil market is oversupplied. Even with 4.5% growth in world demand, OECD stocks should not decline below last year's level over the winter. If demand is slower than this then there should be little decline in stocks. This situation is similar to that in 2000 when there was a similar market configuration. At the end of 2000, increases in OPEC production were too large given the deceleration in growth in oil demand. As a result, OECD stocks did not decline significantly during the winter and were rebuilt rapidly at the beginning of the spring, obliging OPEC to cut its production quickly.

■ Too early to forget the low level of distillate stocks.

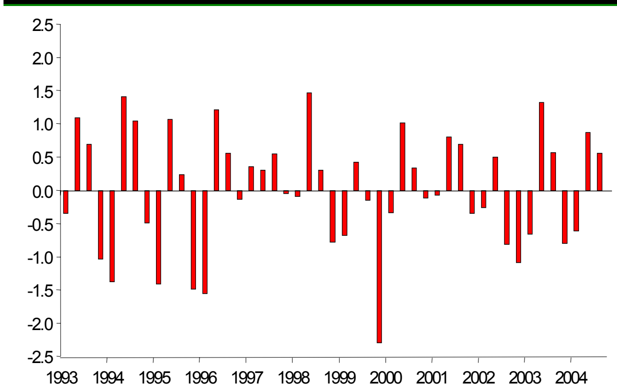
However, the US stock of distillates remains too low just ahead of the winter. US refiners will have to pump in their crude stocks rapidly in order to satisfy increasing demand. Thus, a decline in crude stocks, or any event affecting oil supply, could easily encourage a rise in oil prices with hedge funds rebuilding speculative positions. Thus it is likely that the excess supply of oil will have a more lasting impact on the market at the end of the winter when traders' attention returns to the level of gasoline stocks. As a result, and despite the possibility of a bounce in oil prices near term, we are bearish on oil prices for 2005, expecting an average of USD 35pb for dated Brent.

Chart 4: US and Non-US Stocks Diverge (mb)*



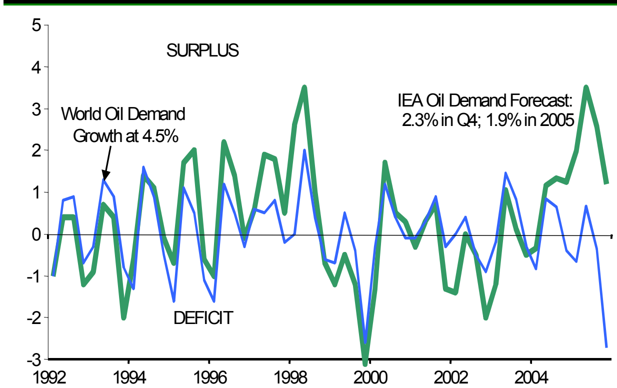
** Excluding government controlled*
Sources: International Energy Agency and US Department of Energy

Chart 5: OECD Stocks Continue to be Rebuilt (mbd)



Source: International Energy Agency

Chart 6: Significant Margin for Error (Oil market balance, mbd)



Source: International Energy Agency