Managing expectations

Mike Wittner of Société Générale looks at where the oil markets are heading in 2009

Société Générale (SG) has revised its oil price forecasts downward. The short-term outlook we issued in the last quarterly Commodities Review, on 12 December, has so far proven to be reasonably accurate. We said that we expected front-month Intercontinental Exchange (ICE) Brent and West Texas Intermediate (WTI) crude oil to average around $40 a barrel in the first quarter of this year. Despite this, actual and forecast economic growth has deteriorated dramatically in the last two months. This simple fact has caused us to lower our expected oil price path, as we slow the rate of increase.

Our previous forecast for front-month ICE Brent was $56 a barrel for 2009 and $88.50 a barrel for 2010. We have now lowered our forecasts to $51 a barrel for this year and $75 a barrel for next year.

'It's the economy, stupid'

In the last *Commodities Review*, SG's forecast for global gross domestic product (GDP) growth in 2009 was 2.4%, on a purchasing power parity (PPP) basis. After a series of downward adjustments, global GDP growth is now projected at 0.2% this year. This dramatic change was driven by data flow, as the financial crisis has continued to negatively impact the real economy. However, SG's view has also shifted from optimistic to slightly pessimistic, compared to the consensus.

In the 28 January update of its *World Economic Outlook* projections, the **International Monetary Fund** (**IMF**) summarised the situation: 'The continuation of the financial crisis, as policies failed to dispel uncertainty, has caused asset values to fall sharply across advanced and emerging economies, decreasing household wealth and thereby putting downward pressure on consumer demand. In addition, the associated high level of uncertainty has prompted households and businesses to postpone expenditures, reducing demand for consumer and capital goods. At the same time, widespread disruptions in credit are constraining household spending and curtailing production and trade.'

We still expect a strong 'V'-shaped recovery, but it has been pushed back somewhat. SG now expects economic activity rates for the G8 countries (G7 plus China) to be at their worst in the second quarter of 2009; previously, the trough was in the first quarter. We now forecast G8 growth to turn positive in the fourth quarter.

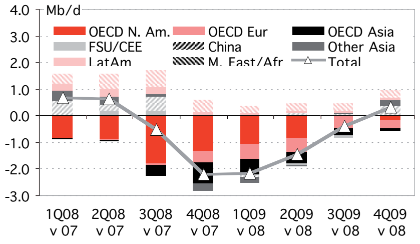
Weaker economy drives contraction

Economic growth is the foundation for oil demand. Therefore, in line with our dramatic downgrade in GDP growth projections, we have slashed our oil demand forecast (see Figure 1). The previous forecast was for global oil demand to shrink by 100,000 barrels a day (b/d) this year; we are now projecting a large contraction of 900,000 b/d in 2009. This consists of a 1.3 million b/d contraction by **Organisation for Economic Co-operation and Development** (**OECD**) countries, partly offset by 400,000 b/d of non-OECD growth.

OECD demand growth has been cut from -900,000 b/d previously to -1,300,000 b/d. The contractions in Europe (-480,000 b/d compared to -230,000 b/d previously)

Figure 1

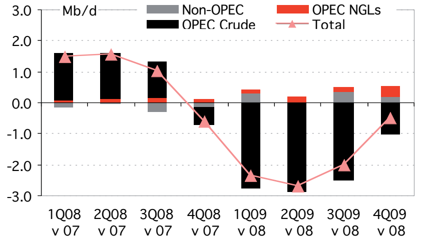
Oil Demand Growth by Region 2008-2009 (year-on-year)



Source: IEA, SG Commodities Research

Figure 2

Non-OPEC vs. OPEC Oil Supply Growth 2008-2009 (year-on-year)



Source: IEA, SG Commodities Research

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and Japan (-360,000 b/d compared to -210,000 b/d) were steepened significantly, based on actual 4Q08 data and lower GDP assumptions going forward.

The story is similar for non-OECD growth, as both recent data and more pessimistic GDP projections affected the demand forecast. Non-OECD demand growth was cut from 800,000 b/d to 400,000 b/d. Key downward revisions include China (110,000 b/d compared to 240,000 b/d previously), other Asia countries (10,000 b/d compared to 140,000 b/d), and the Mideast (210,000 b/d compared to 250,000 b/d). Dramatically lower exports of goods are hitting the economies of China and other Asia, while lower oil revenues are dragging Mideast demand down. There may be more downside to demand in the latter region.

OPEC cuts cause summer stockdraws

Compared to demand, revisions to supply from countries not part of the **Organization of Petroleum Exporting Countries** (**OPEC**) were minor. Non-OPEC supply growth was revised from 350,000 b/d to 200,000 b/d, with the most significant adjustments coming in the mature regions of the North Sea and Russia, where oil company investment budgets continue to get cut. OPEC natural gas liquids (NGLs) output growth has also been revised down from 390,000 b/d to 210,000 b/d, due to delays in gas projects and to a lower forecast for OPEC crude production, which impacts associated gas supply (see Figure 2).

OPEC continues to cut production aggressively. From the June 2008 peak to January 2009, crude output was cut by 2.9 million b/d; 2.2 million b/d of this occurred between October and January, and one million b/d took place just between December and January. We believe that with the last round of cuts, effective from 1 January, the cartel has finally caught up with the global demand contraction. With time lags for implementation and tanker transport, onshore OECD crude imports and stocks should be visibly reduced in the second quarter and even more so in the third quarter.

'Oil prices have recently been driven more by oil market fundamentals, and we expect this to continue'

Turning from bearish to neutral

Since December, the broad-based deleveraging and risk aversion, which had previously put downward pressure on oil prices, has faded to neutral, as illustrated by the stabilisation of the US two-year Treasury yields (see Figure 3). Conservatively, we have maintained our previous assumption that deleveraging could still be negative in the first quarter of 2009. Many large US hedge funds deferred investor withdrawals from the fourth quarter of 2008 to the first quarter of 2009, and this could still be a factor in the oil markets. However, we now have a higher degree of conviction in our forward-looking assumption that financial flows will be neutral for oil in the second quarter of 2009, and could turn modestly supportive in the second half of this year, after the economy hits bottom.

For the oil markets, this means that oil prices have recently been driven more by oil market fundamentals, and we expect this to continue.

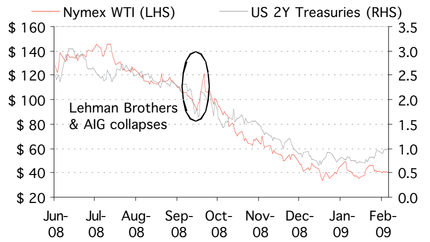
2009 and beyond

The short- and medium-term oil price outlook boils down to a macro call. In this oil market, which we characterise as a classic battle between weak oil demand and OPEC supply cuts, the key point is that even OPEC only reacts to oil demand. OPEC controls short-term crude supply, not product demand. We are now forecasting lower prices because we expect weaker economic and oil demand growth (see Figure 4).

As with our previous forecast update, the key fundamental driver behind prices will be the counterseasonal global stockdraws in the second and third quarter, although the second quarter draw is less than our earlier projection. As a result, crude prices should be broadly steady in the second quarter, as compared to the first quarter. However, the third quarter draw will push Brent crude prices to \$55 a barrel, from \$45 a barrel in the second quarter. The fundamental tightening will coincide with the economy hitting bottom and the end of deleveraging, as discussed above. Based on improving economic and oil demand growth, we forecast continued gains in Brent crude prices to \$60 a barrel in the fourth quarter and \$75 in 2010. Next year is forecast to be a transition year for the economy and for oil demand. Beyond 2010, we continue to expect crude prices to return to a \$100+ a barrel environment, based on healthy Asian-led demand growth bumping up against supply constraints.

Figure 3

Deleveraging and Risk Aversion: Nymex WTI vs. US 2Y Treasuries



Source: Bloomberg, SG Commodities Research

Figure 4

SG Oil forecasts (Mb/d)

Mb/d	2007	1Q 08	2Q 08	3Q 08	4Q 08	2008	1Q 09f	2Q 09f	3Q 09f	4Q 09f	2009f
OECD demand	**49.2**	48.9	47.2	46.6	47.3	**47.5**	46.7	45.4	45.9	46.7	**46.2**
Non-OECD demand	**36.9**	37.9	38.5	38.6	37.7	**38.2**	38.0	38.8	39.0	38.6	**38.6**
World demand	**86.0**	86.8	85.7	85.2	85.0	**85.7**	84.7	84.3	84.9	85.3	**84.8**
*Non-OPEC supply	**50.7**	50.9	50.7	50.0	50.6	**50.5**	51.2	50.7	50.3	50.8	**50.8**
*OPEC NGLs	**4.5**	4.6	4.6	4.7	4.7	**4.6**	4.7	4.8	4.9	5.0	**4.8**
*OPEC crude	**30.3**	31.5	31.4	31.5	30.5	**31.2**	28.8	28.5	29.0	29.5	**28.9**
World supply	**85.6**	87.0	86.7	86.2	85.8	**86.4**	84.6	84.0	84.1	85.3	**84.5**
Stock change	**-0.5**	0.2	1.0	0.9	0.9	**0.7**	-0.1	-0.2	-0.7	0.0	**-0.2**
WTI NYMEX (\$/bbl)	**72.24**	**97.82**	**123.80**	**118.22**	**59.08**	**99.75**	**40.00**	**42.50**	**55.00**	**60.00**	**49.38**
Brent ICE (\$/bbl)	**72.61**	**96.31**	**121.07**	**117.15**	**57.49**	**98.09**	**45.25**	**45.00**	**55.00**	**60.00**	**51.31**

Source: Historical data - IEA. Forecasts - SG Commodities Research. Note: IEA historical data is based on the monthly Oil Market Report dated 11 February 2008. * Indonesia left OPEC on 1 January 2009. In this table, it has been excluded from OPEC supply starting in 2007, in order to facilitate historical comparisons. Non-OPEC supply includes processing gains and biofuels