

Vigilance on World Oil Price Trends Important

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Apparently, oil price has faded from news headlines after peaking around US\$147 per barrel in July last year. Having said this, the oil price has gradually climbed from its low of \$30/barrel to around \$50/barrel in recent weeks. To many, this raises the question of where the oil price is heading next. To answer this, a lot can actually be learned from the shape of the crude-oil futures curve, which is a line graph of forward prices of different months of delivery.

Last year, spot prices of oil fell below their futures prices, causing the futures curve to form a shape known as "contango". This means that forward prices for closer delivery dates are lower than those of further delivery dates (the opposite development is called "backwardation"). For example, during Q4 2008, the time spread - the difference between 12-month and one-month forward prices - was as high as \$30/bbl, which prompted the name "Super-contango".

What caused this super-contango? Following the global economy meltdown, oil demand declined more rapidly than supply, pushing down spot prices and widened the time spread. Though this development opened an opportunity to arbitrage away the super contango, tightening world liquidity meant that any investment that requires high lump-sum upfront is difficult because the strategy needs cash to buy physical crude and store it until the delivery time.

Usually, there is a very close relationship between the shape of futures curve and the change in crude inventory. Contango typically indicates that crude stock is accumulating (and backwardation is vice-versa). Hence, the fact that the super-contango has subsided to a normal contango (ie, the decrease in the 12-month-one-month time spread) in recent weeks may imply that inventory accumulation is diminishing. Thus, a reassessment of global oil demand supply condition is in order.

According to International Energy Agency (IEA), the rebalance of the oil market is in progress as global oil demand is improving, at least from the household sector in OECD countries. Although industrial demand has continued to shrink, recent signs of stabilising in Global Purchasing Manager Index (PMI) may indicate future improvement of industrial demand for oil.

On the supply side, non-Opec output continues to decline while Opec remains strict on its production target. Prospects of tightening world oil supply therefore raises concern on future availability of energy as well as potential increased price volatility. The flatter contango, thus, could be signal from the markets that oil demand will soon outpace supply, especially if the economy recovers at the end of the year as many people have anticipated.

Of course, lots of uncertainties remain. But, what's certain is that the world's oil is limited and that tighter oil market makes its price more vulnerable to any shocks, be it rising demand or supply disruption. Higher oil price, whatever its cause, could re-emerge as a threat to oil-dependent economies, like Thailand, that are in a fragile recovery stage from the present global crisis. Sooner or later, we will need a serious energy master plan that truly strengthens our economic resilience against the next oil price shock.

(Views expressed are the author's own.)

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