

The Tipping Point

Wednesday, April 11, 2012

Global oil prices have been range trading since February this year and we believe that Brent (and WTI) has potentially reached its tipping point and may experience a correction for the month ahead. Our oil demand and supply projections show little signs of tightness for the year, and should geopolitical tensions ease, Brent and WTI prices could easily shed to \$105/bbl and \$94/bbl respectively at end 2012 (see our crude oil price forecast on pg3). In this note, we present five reasons as to why we believe oil prices could potentially correct in the month ahead.

Firstly, Iran's agreement to restart talks with EU and its allies may allow for some easing of geopolitical tensions. In our view, the main catalyst for the easing of oil prices stems from Iran's deteriorating economy due to the economic sanctions placed against it. Specifically, Iran is reduced to accepting payments in any local currency, gold, or even wheat, soybean and consumer products for its oil, or commonly known as "Junk for Oil" program. Denied of hard currency to support the rial and its potential inability to pay for necessities, Iran may be persuaded to conform to international pressures eventually. Should the discussions turn favourable, crude oil prices will face immediate downward pressures. Regardless, should talks turn to naught, France and its allies may release their strategic oil reserves which will effectively depress oil prices.

Secondly, we believe that markets are retreating from risk-on territories, and such is normally followed by falling oil demand and prices ceteris paribus. Such a phenomenon is illustrated by global equity outflows (especially from the developed markets) seen for the past two weeks, as well as a reduction of long positions in WTI contracts for the past three consecutive weeks (see appendix). In our view, much of the risk aversion stems from the lack of hints on additional Fed stimulus as well as Spain which saw its 10-year yields rising above 5.5% due to debt concerns.

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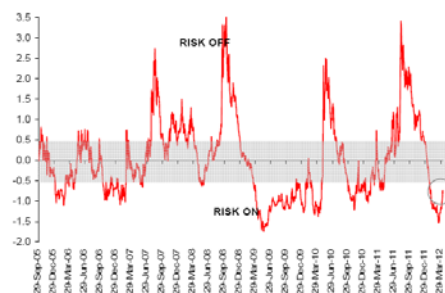
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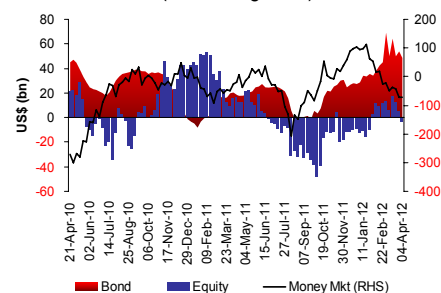
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OCBC FXSI: Market retreats from risk-on sentiments



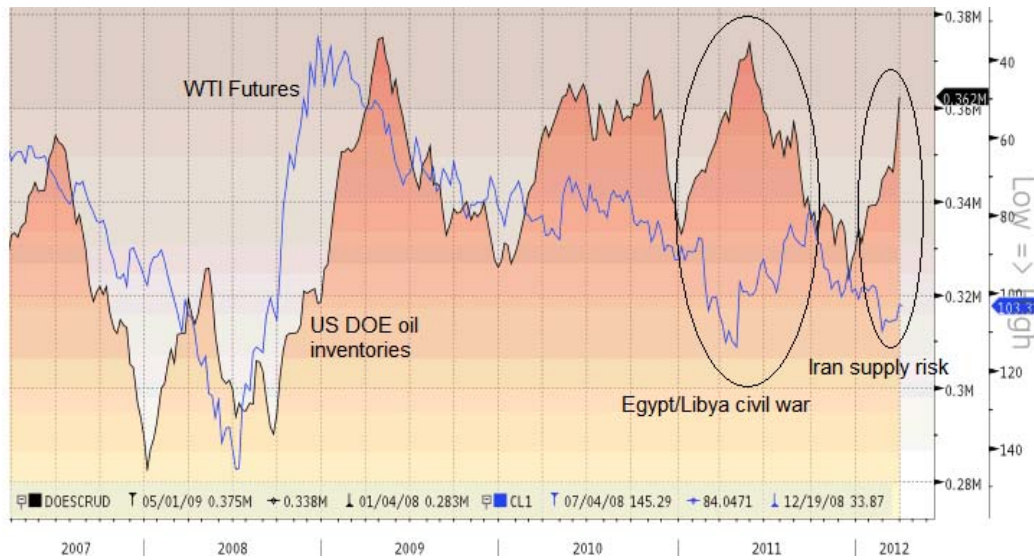
Equity, Bond and Money Market (3m Rolling Sum)



Source: EPFR, OCBC

Thirdly, exceeding high US oil inventories may have reduced supply woes and effectively depressed both WTI and Brent prices. Inventories soared 16 million barrels in the past two weeks, the sharpest gain since 2001. We observed that WTI futures (inversed scale in the graph below) and US DOE oil inventories typically trend together and the only exception was during the Egypt/Libya civil war in 2011 as the market eye on supply disruptions rather than inventories. While the markets currently concern itself over Iran's supply risk, we believe that such a phenomenal gain in oil inventories may convince the markets of ample supply going forward.

WTI Prices should trend in tandem with US DOE oil inventories



Source: Bloomberg

Fourthly, Brent's cheaper cousin, WTI, may have already seen its tipping point. This is seen by WTI rising to almost \$114/bbl at the peak of the Iran and correcting to current \$102.7/bbl. With a relatively strong correlation ($\rho=0.8$ over a 120 day period), this suggest that Brent may take cues from the falling WTI, and exhibit a similar correction in the coming weeks.

Brent may take cues from the falling WTI



Source: Bloomberg

Lastly, technical analysis point to Brent’s immediate downward trend going forward. From a technical perspective, Brent appears to find strong resistance at \$125/bbl and has since traded sideways since February. However, prices have been approaching the 50-day moving average, and should it break, prices may fall towards its 100-day moving average to \$115/bbl. Reinforcing the tipping point hypothesis is the bearish MACD indicator, which also suggest a correction of oil prices (similar to May 2011).

Technical Indicators point to a Brent correction



Source: Bloomberg

Despite the above reasons, a black swan possibility of any military interventions against Iran or a blockage of the Hormuz Strait (increasingly unlikely) will push oil prices above \$200/bbl. Barring such a scenario, we expect Brent and WTI to trend lower in the coming weeks. For Brent, we look for an initial support of \$120/bbl, and should it break, prices should trend even lower to its 100-day moving average at \$115/bbl. For WTI, we feel like prices are already supported at current levels, and a lower support of \$95/bbl may be felt should current support is broken.

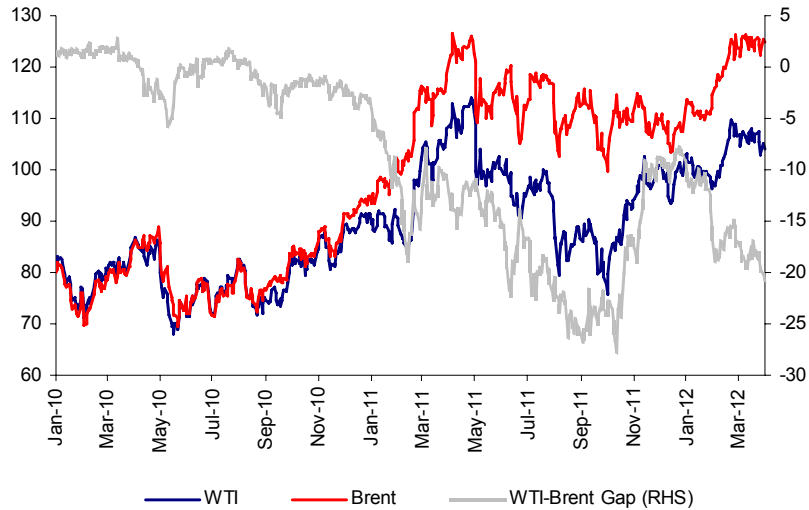
Forecast: Average Crude Oil Prices for 2012 (\$/bbl)

	2Q12	3Q12	4Q12
WTI	\$98	\$95	\$94
Brent	\$115	\$110	\$105

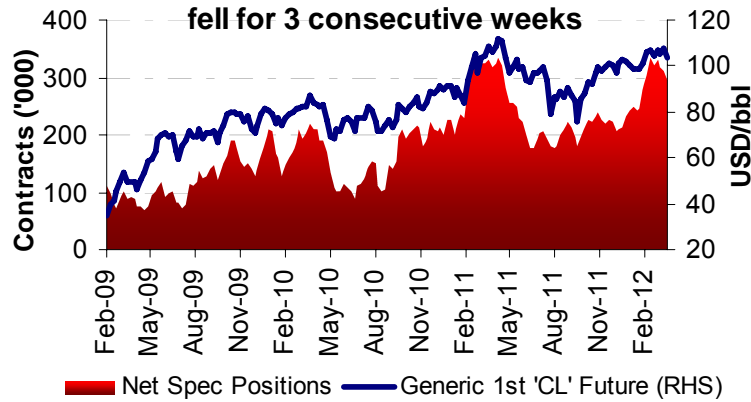
Source: OCBC BANK

Appendix

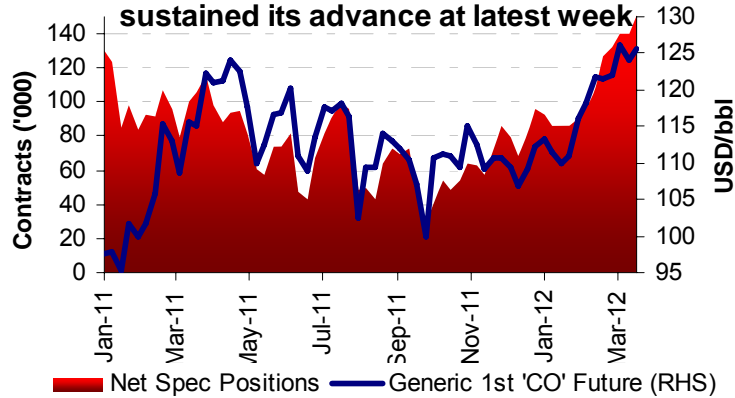
WTI-Brent Gap continues to widen



The bulls retreat: WTI total long contracts fell for 3 consecutive weeks



Net-long positions in Brent however, sustained its advance at latest week



Source: Bloomberg, OCBC

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