The Bigger Picture

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Oil Price Q&A

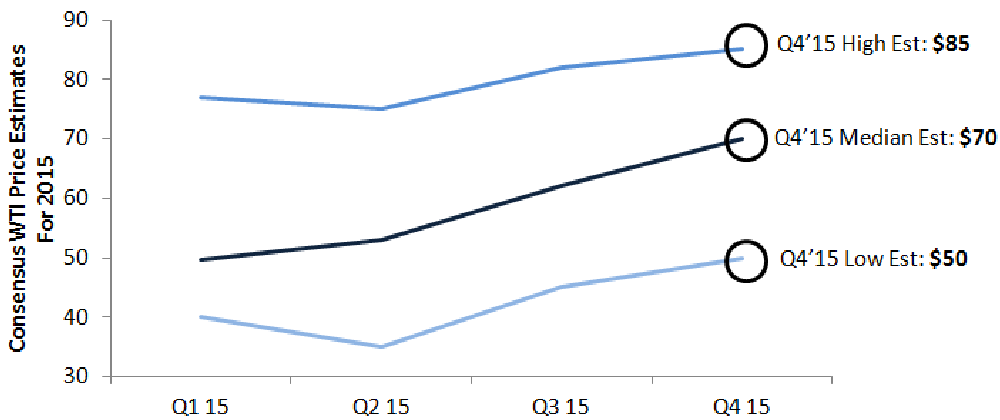
Gint Austrins

After a brief rally to the $53 level from the lows in late January, front month WTI made a new 6 year low today of $42.85. While media coverage on oil prices has been abundant, in terms of where prices head from here, there are about as many opinions as there are possibilities. Given the importance of energy in most client portfolios, we thought it of value to help flesh out some of the key and immediate questions playing out in energy markets today.

What's driving upside/downside consensus estimates for WTI?

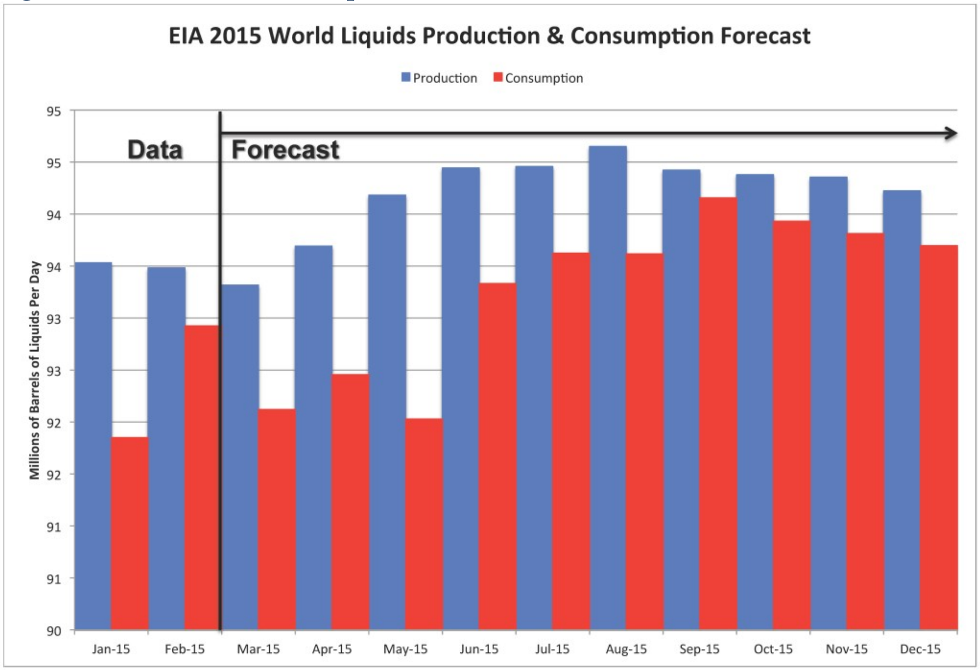
In Figure 1, we have updated the latest analyst consensus estimates for WTI over 2015. While the notion that the average analyst sees oil in the $50-$70 range through-out the year is a topic well covered, we thought it of better value to understand what rational actually drives the top and bottom line estimates.

Fig 1: Updated Consensus WTI Estimates for 2015



Top line 2015 estimates center around the $75-$80 (over 80% higher from current prices) and are predicated on an improvement in demand and eventual production declines that would balance the market and return pricing to what a "fair" long term oil price estimate was (and what the tail end of the WTI futures curve traded at) prior to declines in prices that started late last year. EIA's latest forecast (seen in Fig 2), shows US production growth tailing off around mid-year (declining US rig counts supports this) and a nearly balanced market by September.

Fig 2: EIA's Latest Consumption/Production Forecast

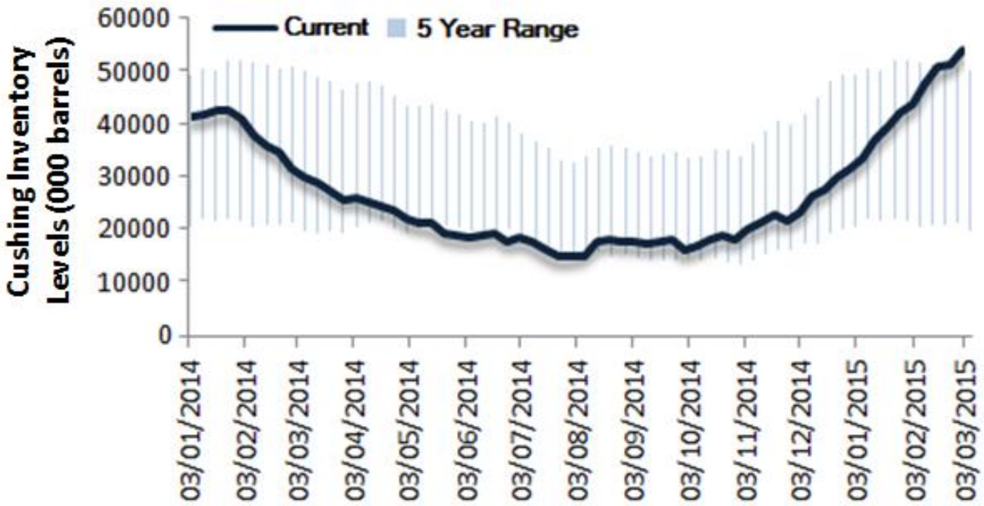


Downside estimates center around the $35-$40 level and consider a scenario where on-land US oil storage reaches full operating capacity and the front month oil contract trades at a level that would make tanker storage (the next marginal storage option) profitable given today's futures curve. Using Soc Gen's recent work as an example, arb traders would need a $17.50 1-year futures contango (where prices 1 year from now need to be $17.50 higher) to profitably take oil out of the market and store it on a tanker today. April 2016 WTI futures have traded in a relatively stable range of $56-$58 - which would put front month futures in the $38-$40 range today.

How much of a concern is US oil storage capacity?

While total on-land US oil storage is one thing, of more immediate concern for WTI futures is storage dynamics at Cushing Oklahoma, the delivery point for NYMEX futures. The latest reading for Cushing stood at 51.5m barrels (just past the 49m barrel 5 year high for this time of year) or ~73% of the current 70.1m barrel maximum working capacity. Over the last 2 months, Cushing has seen an average injection of ~2m barrels per week. If this pace continues, storage levels at Cushing will reach capacity in just over 9 weeks. 9 weeks is not that far away which is why the market is particularly concerned with storage, but the key assumption here is "if" we continue at the same pace of injections that we've seen over the last two months – an event which is less likely. Storage levels typically peak this time of year because refineries are just completing their seasonal maintenance. In addition to that, we had a refinery workers strike that took off up to 20% of US refining capacity. Both of these factors appear to be coming to an end and should slow the pace of injections as we head into summer and peak demand. Therefore, while it is still possible, it is not likely we reach storage limits at Cushing.

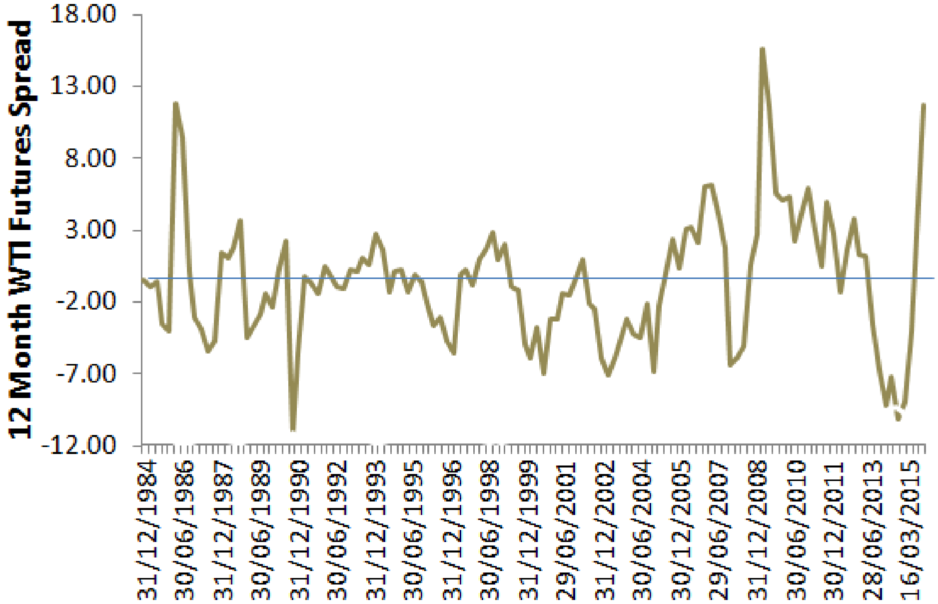
Fig 3: Cushing, OK Current and Historic Storage Levels



Why isn't consistently dropping US rig counts having a positive impact on oil prices?
While lower drill rig counts will eventually translate into lower production, falling rig counts have seemingly had no effect on current (and growing) US oil production which recorded 9.37m barrels per day last week, the highest weekly reading since at least 1983. Given high production levels, the market is at this point more concerned with high inventories than it is with rig declines. Having said that, while keeping the most efficient wells running and re-fracking old wells has helped producers temporarily grow production without drilling many new wells, eventually those existing wells will start natural declines and production will have to decline .

WTI futures contango appears to be at an extreme, is there a potential trade here?
In what is reflective of ample immediate domestic supply, the WTI futures curve has indeed gone from a case of backwardation last year to extreme contango (where farther dated contracts are more expensive than nearer dated ones). The +12 month spread closed today at +11.67, a level matched only by the financial crisis of 2008 (see Fig 4). However, while we do think contango will eventually ease, the timing of this is difficult to predict and volatility notable elevated because of resilient US production levels and elevated storage levels. We would wait until storage injections at Cushing top out before considering this trade.

Fig 4: +12 Month WTI Futures Spread



Market Snapshot

At close on Friday, November 11, 2014

S&P TSX	14862.76	+131.26	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	663.84	+1.16	Canadian $ (US cents)	.7828	+0.0004	90 Day T-Bill	.57	.034
DJIA	17977.42	+228.11	Gold (Spot)-US$	1153.20	+0.80	2-Year Bond	.53	.65
S&P 500	2081.19	+27.79	Oil (WTI-Dec.)	43.88	-0.96	10-Yr.Bond	1.425	2.072
NASDAQ	4929.51	+5.75	CRB Index	210.11	-0.58	30-Yr. Bond	2.066	2.645

Thought for the Day

"An investment in knowledge pays the best interest."– Benjamin Franklin

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