

RESEARCH

11 November 2009

Global Energy Market Analysis/Forecast

SUMMARY

- » *Back in June we posed the following question – “Are we at the start of another bull market in the energy sector (as a result of increased economic activity) or is the market getting too far ahead of underlying fundamentals? Despite the four months having elapsed we find ourselves grappling with the very same question.*
- » *The reality is that we have yet to see the usual snap-back in economic activity that has marked the end of most modern recessions. Third quarter GDP in the US was an anemic 3.5 percent and was heavily subsidized by the cash for clunkers program as well as other government programs.*
- » *It seems clear that the underlying fundamentals by themselves (i.e., the basic relationship between supply and demand) today do not support current energy price levels or the recent upward trend.*
- » *We believe that we are rapidly approaching the point where fundamentals will either catch up with the market or the market will drop to meet fundamentals.*
- » *Either the long awaited recovery materializes and as a result the price of energy will move swiftly back above the \$100 per barrel level – most likely ending the year in the \$110 to \$120 range or we will experience substantial pull-back towards fundamental pricing levels which mostly likely will be in the range of the \$60s to the low \$70 range.*
- » *There is no doubt 2010 will be a much more difficult year to navigate from an energy procurement/management perspective in comparison to 2009. In our view, the current likelihood between the two scenarios is 60/40 – no/weak recovery versus robust recovery.*
- » *Our recommendation is that consumers should lock/purchase no more than their next 12 months supply requirements (ideally through mid-year 2010) at today’s relatively inexpensive rates and subsequently purchase the remainder of 2010 and 2011 once the market pulls back to meet underlying fundamentals. In the event the more unlikely scenario occurs – i.e., fundamentals improve to meet the market – we would again recommend purchasing the remainder of 2010 and 2011 to avoid being caught in the stampede of another energy bull market.*

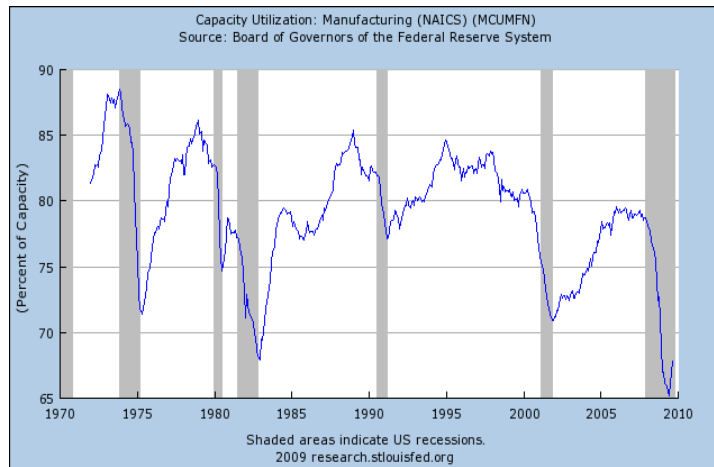
DISCUSSION

In mid-June when we published our last International Energy Report the economic free-fall had subsided and banks (at least the healthier ones) were eager to repay their government loans and the world looked as follows – the Dow Jones index was at 8,500, the price of oil was approximately \$70 per barrel and the gold as was at \$925 per ounce. Today, despite experiencing a fairly subdued initial recovery, we find the Dow Jones index above 10,000, oil trading at roughly \$80 a barrel and gold above \$1,100 per ounce. Back in June we posed the following question –

“Are we at the start of another bull market in the energy sector (as a result of increased economic activity) or is the market getting too far ahead of underlying fundamentals? Despite four months having elapsed we find ourselves grappling with the very same question today.

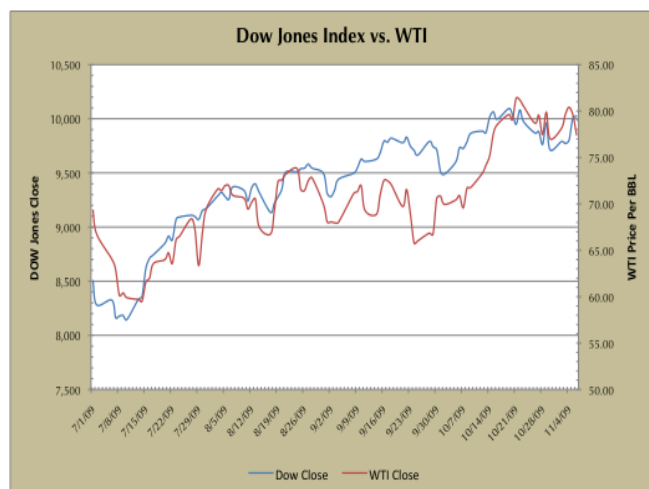
Although economic activity around the globe has stabilized and certain industries (most notably the remaining investment banks) have shown improvement – it is indisputable that current real economic activity levels are well below those of the peak in 2007/8. This can be clearly seen in the US manufacturing capacity utilization rates, which dropped precipitously during the crisis and now sits at multi-decade lows –

approximately 67 percent. The reality is that we have yet to see the usual snap-back in economic activity that has marked the end of most modern recessions – on average, first quarter growth leading out these recessions has been well in excess of five percent. Third quarter GDP in the US, which showed growth for the first time in four quarters, was an anemic 3.5 percent and this result was heavily subsidized by the



cash for clunkers program as well as billions of dollars in other government subsidies/programs. Moreover, unemployment, in both the United States and abroad, continues to grow – US unemployment recently breached the 10 percent barrier – the highest level since 1983. As a consequence, energy inventories (i.e., both oil and natural gas) are at record levels while demand remains subdued in comparison to recent years.

It seems clear that the underlying fundamentals by themselves (i.e., the basic relationship between



global supply and demand) today do not support current energy pricing levels or the recent upward trend. A material portion of the recent price movement can be attributed to investors seeking safety from the declining US dollar and fear of future inflation. These investors are placing oil in the same basket as precious metals and attempting to use it as a hedge against the loss of future purchasing power. However, in our view the principal rationale for the recent energy price rally has been effusive optimism among investors/speculators of an imminent rebound in global economic

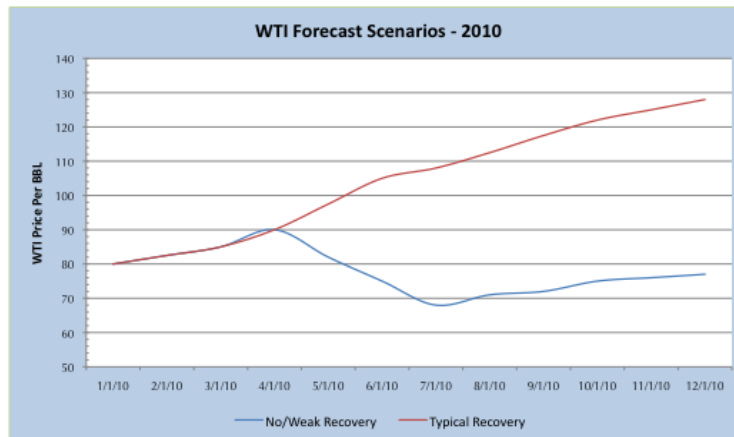
activity. This same optimism is driving the rebound in global equities – the accompanying chart clearly indicates that for the past four months the oil and US equities have clearly been moving in concert. Accordingly, in our view, the answer to our question turns on whether the global economy rebounds materially in the coming months. We believe that we are rapidly approaching the point where fundamentals will either catch up with the market or the market will drop to meet fundamentals. Unfortunately, this equation is binary and in our view most likely to resolve itself in the first half of 2010. We address the two potential scenarios below.

In the event the global economy achieves or exceeds the market's anticipated growth expectations in the coming months, investors/speculators who have been supporting the current pricing levels will be handsomely rewarded. Any extended decline in energy stockpiles (no matter how small) will set off a fury of buying based on the theory that the world's energy supplies are once again no longer sufficient to satisfy both the developed and developing world – i.e., the BRICs economies -- requirements. Market pundits and the media will again focus on the tightening supply/demand balance and every real, or perceived, supply disruption (usually coming out of the likes of Nigeria) will be used as justification to press energy prices higher. Moreover, the weakness of the US dollar as a result of overly accommodative monetary policy by the US Federal Reserve and the fear of future inflation resulting from the growing debt burden in the US will only add fuel to this fire.

Should however, the global economy not show the expected growth rates in the coming months and disappoint these investor/speculators we believe that the weakness in the US Dollar and the fear of inflation alone will not alone be enough to support current pricing levels. Unlike other commodities like gold, platinum and silver which institutional investors and individuals alike purchase and store in uncertain economic time – oil does not share this same quality. For oil there is a physical limit as to the maximum global storage capacity (although this physical storage limit proved to be larger than originally projected due to the use of available tankers as additional storage). At present oil producing countries are pumping well in excess of current global demand – the residual is being stored for future use/sale. In the event the global economic recovery fails to materialize or remains anemic, unlike gold, platinum and silver which have unlimited storage capabilities, we will either reach global storage capacity or oil producing nations will be forced to materially curtail production. We believe the latter solution will be hard to implement due to the financial requirement of these countries. In either case the price of oil will fall substantially and align itself more closely with underlying fundamentals.

As we stated earlier, our analysis leads us to the conclusion that the forecast options for 2010 are binary. Either the long awaited recovery materializes and as a result the price of energy will move swiftly back above the \$100 per barrel level – most likely ending the year in the \$110 to \$120 range or continued contraction/anemic economic growth will result in a substantial pull-back towards fundamental pricing levels which mostly likely will be in the range of the \$60s to the low

\$70 range. It is our view resolution will come in the first half of 2010 – probably during the second quarter once the market has had the opportunity to digest economic data from Q4 2009 and Q1 2010.



There is little doubt that 2010 will be a much more difficult to navigate from an energy procurement and management perspective in comparison to 2009. In our view, the likelihood between the two scenarios is 60/40 – favouring the weak/no recovery option.

Although we have experienced a significant increase in the price of oil in recent months (which most likely continue into the first quarter of next year), the price of electricity and natural gas in most local markets, on the short end of the pricing curve (*i.e.*, durations of 1 year or less), has increased only marginally and remains relatively inexpensive. The real impact of recent optimism is being felt more acutely further out on the pricing curve. The UK energy market is a good example of this phenomenon – summer 2011 pricing for electricity and gas supplies is going off at a premium of 15 percent and 30 percent respectively over 2010 prices. Clearly these prices will pull in considerably next year should the no/weak recovery scenario outlined above come to pass. Consequently, we are of the opinion consumers should look to lock in no more than their next 12 months supply requirements (ideally through mid-year 2010) at today's relatively inexpensive rates and subsequently purchase the remainder of 2010 and 2011 once the market pulls back to meet underlying fundamentals. In the event the more unlikely scenario occurs – *i.e.*, fundamentals improve to meet the market – we would again recommend purchasing the remainder of 2010 and 2011 to avoid being caught in the stampede of another energy bull market.

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