



Agustino Fontevecchia, Forbes Staff

Bringing You The Bull And Bear Case From The Markets Desk

2/17/2012 @ 4:20PM | 7,356 views

Perfect Storm In Oil Markets: Iran & China Will Keep Prices High

Crude oil has gone on a nice rally in February and a perfect storm has brewed that promises to take it higher. [Markets](#) have underestimated how tight global oil markets truly are. Supply-side issues, particularly the problems around Iran, and demand-side issues, especially very strong Asian and Chinese demand, will help take prices higher. A weak U.S. dollar adds a final drop that could take U.S. prices to \$118 a barrel by the fourth quarter of 2012, according to [Barclays](#).



Given market fundamentals, expecting an oil price pullback appears far-fetched - Wikipedia

After essentially going sideways in January, crude prices picked up and rallied in February. West Texas Intermediate contracts for March delivery, currently trading at \$103.52 a barrel, have gained on eight of the last ten trading days while Brent, the international benchmark, recorded six positive sessions over the same time frame and was at \$119.62 as of 4:20PM in [New York](#) on Friday.

The short-term outlook is extremely bullish, according to Dennis Gartman. Looking at term structures, WTI has seen its contango formation tighten while Brent, in clear backwardation, has seen it widen. (A futures term structure is in contango when shorter-dated contracts are cheaper than longer-dated ones; backwardation, the opposite formation, is considered extremely bullish, as demand for shorter-dated contracts bids the price even higher in the short-run).

While U.S. dollar prices are nowhere near the astronomic highs reached in 2008, [Financial Times](#) commodities editor Javier Blas makes the point that in euros, Brent prices are just about to break that mark. "The cost of Brent rose this week to a three-year high of €91.70 per barrel, less than 2 per cent below the all-time high of €93.50 a barrel set in July 2008. A euro-denominated record high for oil prices could be set next week if the current

It's not just a weak euro, though; the Greenback hasn't been all that strong lately either. Since January 16, the U.S. dollar index has fallen more than 2.6%. A weak dollar is generally correlated with higher oil prices.

Delving further into fundamentals, both supply and demand factors promise to push crude oil. Despite a weak global economy, Asian demand for oil is expected to rise by 0.98 million barrels per day (mbd) this year to 29.33 mbd, after a 0.82 mbd increase in 2011. A third of that comes from China, the region's powerhouse, the rest coming from India, Korea, Japan, and the rest of the fast-growing Asia-Pacific region. That's 92% of the global demand increase expected for 2012, as European and North American demand slide.

On the supply side, the biggest short-term threat is Iran. There are several factors at play here, starting with the intensification of the Syrian conflict, which "increasingly taking on elements of a proxy war," according to Barclays, as the Assad regime is seen by many as one of Iran's only Arab allies left.

Israeli-Iranian relations are currently red hot, as the recent string of attacks on Israeli diplomats and Iranian scientists makes clear. While Iran's capacity to hold a closure of the Hormuz Strait is limited, and the U.S. has moved substantial firepower to the area, "determining the likelihood of [a conflict] is extremely difficult," as NusConsulting's Richard Soutanian put it. "Market prices currently reflect a significant risk premia for the potential of a supply disruption from a geopolitical event. However, the amount of risk premia currently included does not fully account for an actual event/supply disruption," explained Soutanian. From the Barclays note:

Our view remains that policy and circumstances are now both running fast enough for policy accidents and unintended consequences to play a role. In other words, in our view, the probability of the situation becoming "hot" in some way that affects the oil market is now significant and perhaps rising, in a way which makes the maintenance of too entrenched a short position in the market increasingly difficult.

Finally, non-geopolitical supply-side losses will continue in 2012. Barclays expects non-OPEC supply to grow by a paltry 0.37 mbd, compared to a 0.07 mbd decline last year, as technical problems in the North Sea (Buzard Field) team up with falling Norwegian oil production, and softer outputs from Argentina, China, Indonesia, and Australia.

The undeniable shale play boom in the U.S. is definitely a significant event. But it would be an "oversimplification" to think that increased oil production at the Bakken, Eagle Ford, and other major shale fields can lead to lower prices, particularly as Asian demand surges and there are shortfalls elsewhere. "When all other supply centers are performing to their full potential, then oil shales could perhaps make a difference at the margin," explained Barclays. It will, though, be bullish for oil and gas services companies like [Halliburton](#) and [Schlumberger](#). Consolidated E&P names like Exxon and Chevron, given their diversification, will have a harder time cranking out profits.

At the end of the day, oil market fundamentals paint a clear story. Crude oil term structures suggest bullish formations for the near term, while a weaker U.S. dollar is feeding higher prices. Asian demand will remain strong, offsetting falling U.S. and European demand. Supply is faltering a little, but enough to have an effect, underestimated by market participants, while the situation around Iran promises to keep global markets on the edge of their seats.

Expectations that a global slowdown might bring global prices down are nothing more than wishful thinking.

This article is available online at:
<http://www.forbes.com/sites/afontevvecchia/2012/02/17/perfect-storm-in-oil-markets-iran-china-will-keep-prices-high/>