MARKETS

Clearing the view on energy

BY PHILIP BURGERT

Geopolitical, fiscal and economy driven demand questions remain for oil, natural gas and other energy products, while the supply outlook appears increasingly positive.

The 2013 energy outlook still is cloudy for traders and analysts as the U.S. and global fiscal and economic situations remain volatile, but traders and analysts generally expect stable or slightly higher prices in the first months of 2013.

Factors that they cite in their outlooks include still-muted economic growth in the United States and recessionary conditions in Europe and Japan, along with emerging economies like China, India and Brazil that will depend on demand from elsewhere to drive growth.

- Geopolitical spike
- Developing world demand
- U.S. supply growth

Natural gas prices can be expected to stay in a range from $3 to the upper $4 range under a normal weather scenario, predicts Kyle Cooper, managing director of research at Cypress Energy Capital Management LP. Cooper says crude oil — without any geopolitical crisis such as an Israel-Iran conflict — should maintain a $15-$20 range centered in the upper $80 area. Gasoline, he adds, is to a large extent rangebound near current wholesale pricing levels. "Right now the market is pretty close to fair value. The market is relatively well balanced," Cooper says.

Generally higher oil and natural gas prices, however, is the forecast of Spencer Patton, chief investment officer of Steel Vine Investments. "Assuming the fiscal cliff does get resolved, crude oil likely has put in a low ($77.28) that I don't think it's going to revisit any time soon," he says. "I expect it's going to be working its way higher as we work toward some level of recovery."

Patton points to technical bottoms (see "Failed retest" right) that were seen in crude oil on Oct. 4, 2011 and June 28, 2012. "In early November we got to $84, but we didn't get anywhere near [those two lows]. That's something important from a technical standpoint to see that there really is support below $79."

Higher West Texas intermediate (WTI) and Brent crude oil prices also are the forecast of INTL FC Stone Analyst Edward Meir. "Beyond January we should have a pretty decent market," he says. "It's not going to be a runaway bull market, but there will be higher trading ranges for these complexes, mainly because U.S. growth should pick up."

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Recent lack of significant domestic energy demand growth when coupled with the U.S. steadily becoming self-sufficient in energy production can be viewed as factors keeping price spikes in check, according to Mike Zarembski, manager of futures trading for optionsXpress. "However, we have not seen prices move significantly lower given the above average inventories of oil in the U.S. because of a 'permanent' risk premium market participants have placed on oil prices due to possible output disruptions by major producing countries," Zarembski says.

Geopolitics

The biggest ongoing risk premium continues to come from the Iranian nuclear weapons development questions and how Israel will respond. "It's very difficult to ascertain what [Iranian President Mahmoud] Ahmadinejad is going to do," Cooper says. "He's actually calmed down his rhetoric significantly in the last few weeks."

The risk, he adds, is whether or not Israel will mount an air strike against Iran. "That definitely would provoke and spin off a very significant price spike," Cooper says, adding that such a spike would likely not last long. "While Iran might be able to shut [the Hormuz Strait] down for a day or [two], I don't think they have the capability to shut it down for weeks or months. The U.S. Navy would put an air blanket over the coast of Iran and around the Straits of Hormuz so tight that a mosquito couldn't take off."

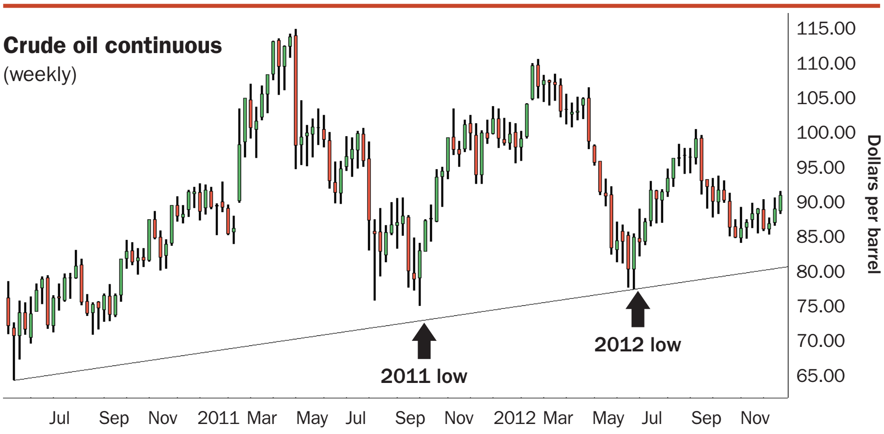
Estimates of how much premium in oil prices comes from Iran vary widely, with Patton placing it currently at $5 to $6 per barrel while Meir places it at $15 to $20.

Meir notes that Israeli Prime Minister Benjamin Netanyahu said in the fall that no action would be taken by Israel against Iran before the spring.

Large increases in U.S. oil production also may be a major factor in the muted response of oil prices to political tensions in the Middle East and Africa while the risk premiums seen for Brent crude prices vs. WTI appear to be offsetting the negative effects of slower European demand growth, Zarembski says. "Brent truly is reflecting global influences on oil prices and the U.S. WTI benchmark is now relegated only to reflecting the current domestic supply and demand factors of the U.S."

FAILED RETEST

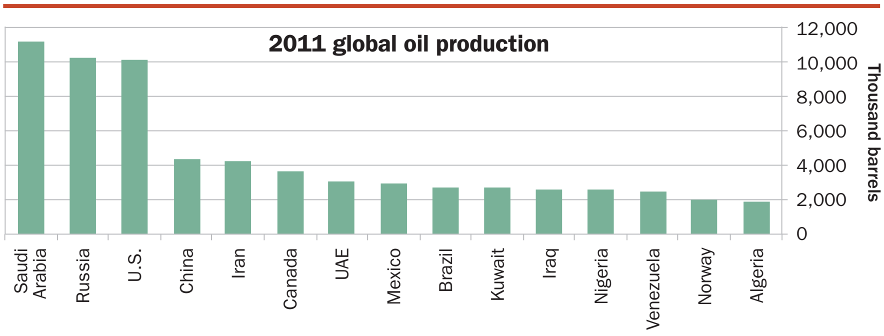
This past summer's crude oil sell off failed to breach the November 2011 low just below $75, which also failed to match the previous year's low.



Source: eSignal

BIG DOG

U.S. oil production was third globally in 2011; the IEA expects the U.S. to be first by 2025.



Sources: DOE, EIA

BRIC demand

More central to most energy outlooks, though, are questions about demand growth. "First and foremost [is] the pace of growth of the global economy, primarily what happens with the emerging market economies," says Dominick Chirichella, founder of the Energy Management Institute. China and other emerging market countries have been the main oil demand growth engines of the world and the developed world has become less significant, he adds.

Asian and developing world demand is crucial to the energy outlook, Cooper says. "The U.S. probably has a slight positive but not enough. So, fundamental factors on the demand side really continue to center on China, Brazil, India and other emerging markets," he says. "To get bullish, you need to see those guys up their petroleum consumption because I don't think it's going to come from the OECD."

Increasing supply, particularly from the United States, also is a growing factor in forecasts, as the International Energy Agency recently predicted the that U.S. crude oil output would surpass that of Saudi Arabia by 2025 (see "Big dog," above).

"Gasoline and heating oil are very well supplied," Cooper says. "We've actually become a net exporter of both finished gasoline and distillate to the tune of [more than] 300,000 barrels a day of gasoline and [more than] a million gallons a day of distillate."

While the oil market remains a global market, he notes that if more gasoline or diesel is needed domestically in the United States, it could be arranged "very, very quickly and very, very easily just by suspending exports."

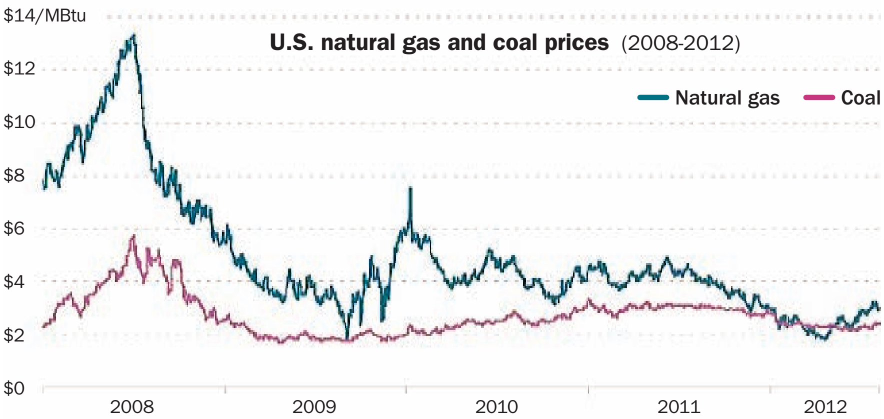
With U.S. oil production expected to continue to rise because of output from shale formations, the U.S. may become nearly self-sufficient in energy production, notes Zarembski. This, he adds, could create a two-tier market for oil prices as is seen currently between WTI and Brent futures prices. "This especially will be true if the U.S. is not allowed to be an exporter of oil in the near future," he adds.

The increasing supply has had the effect of keeping WTI prices below $100 per barrel and, if this success from the exploration and production side of the business continues, the robust supply from the United States will help to dampen some of the risk factors that are always present in the global oil complex, says Chirichella.

Growing supplies of natural gas from shale at falling prices (see "Gas or

GAS OR COAL?

Falling natural gas prices have had a quick impact on coal use by utilities.



Source: Bloomberg New Energy Finance

coal?” above) also have had a quick impact on the coal market as natural gas replaces less economic and less efficient coal-generating facilities, Chirichella notes. But substitution of cheap natural gas for gasoline, diesel and liquefied gas exports will be a slow process and be dependent on natural gas supplies still continuing to grow at the same pace as the last few years and prices for natural gas remaining flat, he adds.

Barring a severe winter or a major cut in production, natural gas supplies could continue to rise. “Even at lower prices, we have not seen a significant decline in gas production, as shale oil producers are producing natural gas as a byproduct. As long as oil prices are high enough to make shale oil production profitable, we probably will see natural gas supplies increase,” Zarembski says.

Natural gas will continue to be a promising investment in the future, but in the near-term, Patton says, don’t expect good results. “If you start building toward the summer season, that’s normally a tough time for natural gas investors anyway,” he says. “I’d just want to be out of the way on natural gas.”

Gasoline and heating oil are seeing inventory levels begin to increase after running tight for most of 2012, Zarembski adds. Profitable crack spreads for some producers are keeping refinery utilization near 90% currently. “So as long as it is profitable, we should see this trend continue,” he says.

Some decline in energy market trading volatility also had been seen in recent months as oil is well-supplied and demand growth has been slow. “We have a stalemate between ample production and stagnant demand vs. the potential for supply disruptions,” Zarembski says.

Crude oil has seemed to have less volatility on a 30-day rolling average than in past times, notes Patton. “We saw a very large volatile trend through the summer months, and since then the average daily move really has contracted. You have seen one or two days where you saw significant spikes. You saw one in November and one or two in October, but for the most part volatility in the crude oil market really has settled down. “

In oil’s case, there may be “a bit more volatility” post-fiscal cliff and slightly higher prices as well, Meir says. “But the upside will be kept a little bit in check because the fundamentals still look very, very comfortable. There is no shortage.”

The bottom line appears to be that despite supply enhancements and demand challenges, fiscal and geopolitical uncertainty likely will prevent a major move in energy markets in the first half of 2013. F