

The Great Oil Price Fixes And How To Trade Them

Simon Watkins

SAMPLE

Oil And Long-Term Global Economic Cycles

Markets are subject to the manifestation of a wide variety of patterns; the key to trading success is identifying what they are and how to extract the optimal value from them.

In the simplest of terms, they can be looked at in terms of duration: there are short-term patterns that mostly relate to technical analysis and there are longer-term ones that generally relate to broad economic factors (such as interest rates, inflation, GDP growth and so forth).

However, even beyond these, **there are broad-based long-term cycles** that relate to all of the above: **in technical analysis terms, for example, the Elliott Wave** (as described in the *Technical Analysis* section) is a good example; and in **economic terms the convergence of an economy** from 'frontier' market status to 'emerging' and then to 'developed' is another (as analysed earlier).

With regards to the oil price, all of these patterns and correlations find more resonance than in any other commodity market.

Oil Price Cycles

In general terms, it is apposite to note that previous cycles in the oil price were marked to a high degree by long time lags between when capital was spent and when production increased. However, the advent of widespread, well-funded shale technology has narrowed this time lag and concomitantly, given very high decline rates, producers' ability to quickly throttle back production has also increased, which has provided the market with more levers for rebalancing in terms of credit, equity and cash flow.

The short-cycle nature of shale and its ability to ramp up production quickly requires that price pressure remains in place long enough to sideline the large amount of low cost capital available until that rebalancing occurs, as highlighted earlier, and the entire industry is re-pricing as costs decline and further efficiency gains are made. The level of uncertainty cannot be underestimated as these dynamics spill over into the price of commodities, currencies and consumption baskets around the world (as shown in the *Correlation* sections), with major long-

term market and economic implications, which also find material directions from longstanding macroeconomic cycles.

Current Cycle Vs 1986, 1981/82 and 2009/10

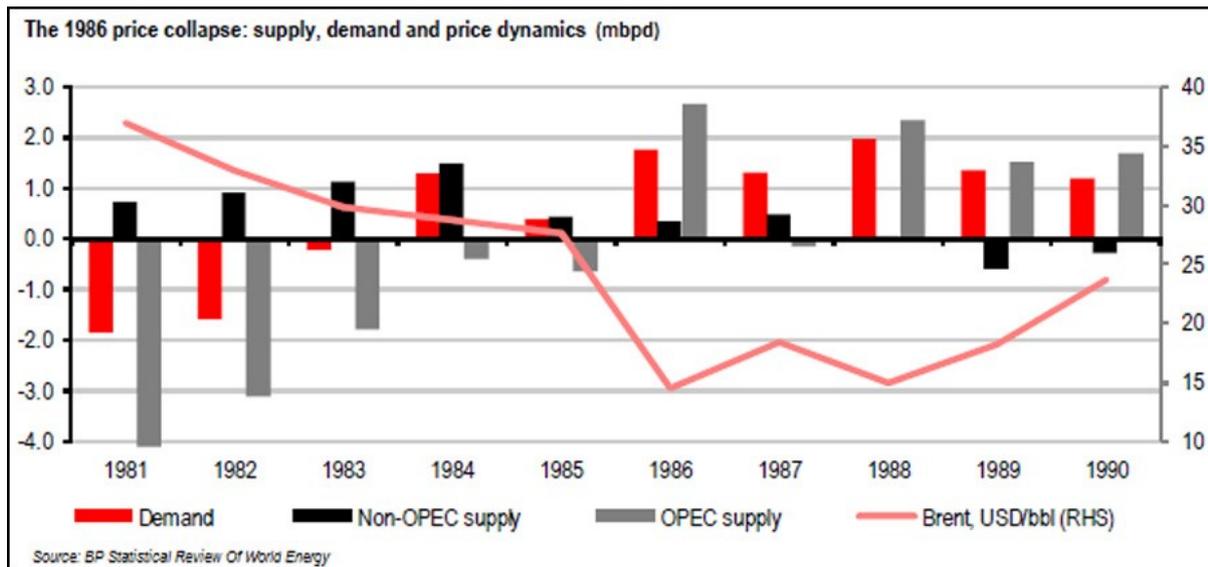
The current pattern of oil price trading is perhaps most closely similar to that of 1986 in that it was also a predominantly supply-driven sharp decline in prices, rather than to the 1981-82 and 2009-2010 drop in prices, which were primarily demand-driven as the recessions led to a fall in global demand of more than 3 mbpd. At the time, non-OPEC production was growing as well but the combined impact of both of these factors was offset by a sharp fall in OPEC volumes. As the world emerged from the recession global demand recovered gradually, adding around 1.5 mbpd in total over the period 1983-85, but this coincided with a period of strong non-OPEC growth, which in turn added 3 mbpd over the same period and put further pressure on OPEC's market share.

The 1986 price collapse: Supply, demand and price dynamics (mbpd)										
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Brent avg., USD/bbl	38	37	33	30	29	28	15	18	15	18
Global demand	61.2	59.4	57.8	57.6	58.9	59.2	61.0	62.3	64.2	65.6
Non-OPEC output	36.9	37.7	38.6	39.7	41.2	41.6	41.9	42.4	42.4	41.8
OPEC output (inc. NGLs)	26.0	21.9	18.8	16.9	16.5	15.9	18.5	18.4	20.7	22.2
OPEC share	42.5%	36.9%	32.4%	29.4%	28.1%	26.8%	30.4%	29.5%	32.2%	33.8%
change y/y										
Global demand		-1.8	-1.6	-0.2	1.3	0.4	1.7	1.3	2.0	1.3
Non-OPEC output		0.7	0.9	1.1	1.5	0.4	0.3	0.5	0.0	-0.6
OPEC output		-4.1	-3.1	-1.8	-0.4	-0.7	2.6	-0.2	2.3	1.5
change %										
Global demand		-3.0%	-2.7%	-0.4%	2.2%	0.7%	2.9%	2.1%	3.1%	2.1%
Non-OPEC output		2.0%	2.4%	2.9%	3.8%	1.0%	0.8%	1.1%	0.1%	-1.4%
OPEC output		-15.9%	-14.3%	-9.7%	-2.4%	-4.0%	16.7%	-0.9%	12.7%	7.3%

Source: BP Statistical Review Of World Energy

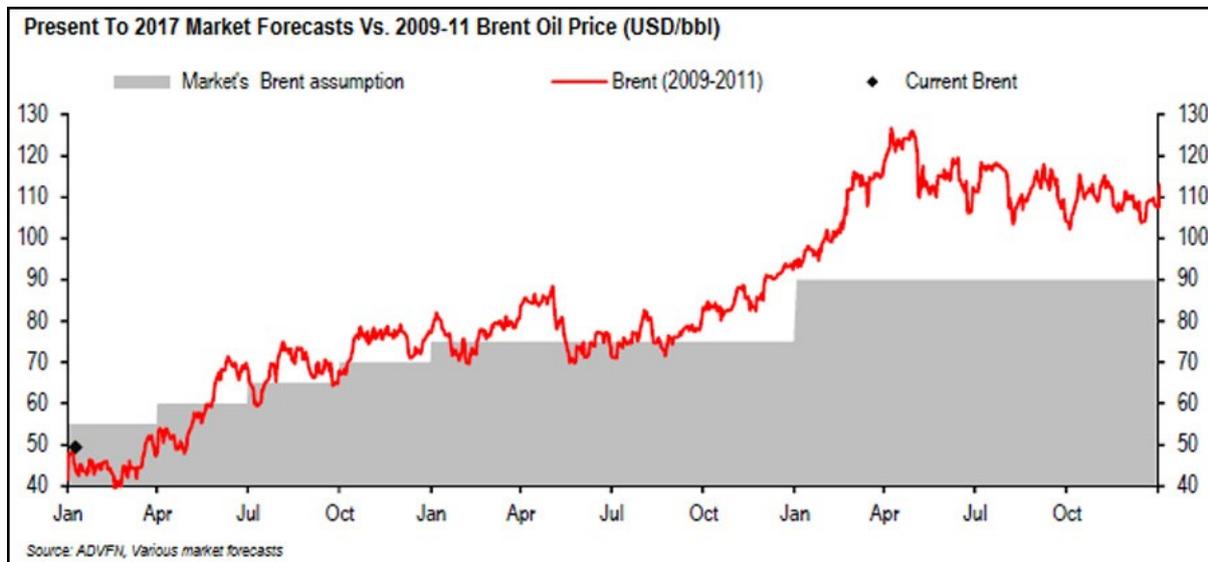
Within OPEC, combined production from Iraq and Iran had fallen by more than 6 mbpd through 1979-81, with the impact of the Iranian revolution and the start of the Iran/Iraq war. However, it then recovered by nearly 1.5 mbpd from 1981-85. The bulk of the sharp cutback in total OPEC output over this period was borne by Saudi Arabia, which cut output from roughly 10 mbpd in 1980-81 to average only some 3.6 mbpd in 1985. **However, in 2H 1985, in the face of steady growth in non-OPEC supply, Saudi Arabia abandoned its role as swing producer and pushed instead to regain market share, growing output to over 5mbpd in 1986; very similar to the stance on its swing producer role that it has taken in recent months.** For OPEC as a whole, output rose by some 2.6 mbpd in 1986.

Overall, then, the result of this process was a collapse in Brent prices to a 1H86 average of sub-USD13/bbl vs a FY1985 average of close to USD30/bbl. However, this in turn spurred a prolonged period of demand strength, with global demand growing by an average of 2.4% over the period 1985-90. In addition, the crash in prices had a dramatic effect on non-OPEC investment levels, with the result that non-OPEC showed minimal overall growth in the second half of the 1980s.



In this current oil market cycle, **there are a couple of reasons why prices are more inclined to revert to higher levels than occurred relative to 1985-88.** Firstly, although total non-OPEC output is currently around 20% greater than it was in the mid-1980s, it is also far more mature (the early/mid-1980s was the peak growth period for UK North Sea output and the previous peak for output in the US), so the non-OPEC production base now has much greater inherent decline rates due to this maturity and is thus more prone to a slowdown in investment.

Secondly, OPEC discipline is likely to be driven by the dramatic rise in crude prices required for economic stability in the various OPEC members (see earlier), with most market players thinking that, in the long run, prices of at least in the USD90s/bbl are needed to fill these requirements for countries such as Saudi Arabia and many of the other key OPEC producers.



Of, course, **in the short- to medium-term, much depends on Saudi Arabia on the supply side and, in this respect, the Kingdom recently announced a budget that is based on USD60-70/bbl of Brent but even this is subject to substantial uncertainty as to what the country's cost basis is.** The riyal is pegged to the US dollar but Saudi imports European goods that have substantially declined in cost due to the falling euro. Saudi also imports agricultural

products that have prices heavily tied to the Brazilian real and basic materials heavily tied to the Australian dollar. Iron ore is also facing efficiency gains, as is copper. So clearly, even a country like Saudi Arabia faces substantial uncertainties in balancing external and fiscal budgets due to commodity price pressures.

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