

Still bearish after all these years

Sentiment lords it over fundamentals again as hints of a supply tightness support oil prices

Arriving in Texas a few weeks ago, I was alarmed to feel a distinct nip in the air. Unusually for Dallas in March, there was also a light sprinkling of frost on the ground in the morning. Pushing aside thoughts that it may have been an illusion brought on by overenthusiasm in the hotel bar the previous evening, it was apparent that this was going to be the end of the USA's mild winter - and good news for the oil market. What with the ongoing sabre-rattling over Iraq, this indication of an increase - however temporary - in US oil demand was picked up on by an oil market avid for any excuse to put a floor under prices and, indeed, within a few days marker crude was trading well within OPEC's target range of \$22 to \$28/bbl.

These positive trends were later given a further boost when OPEC agreed to adhere to its existing production quotas through the first half of the year and announced a special meeting on June 26 to review the situation. This was seen as a very definite move by the group, which over recent months has had to resort to attempting to rally support from other major oil exporters in order to underpin prices.

In the end, though, the oil market - at least on the western side of the Atlantic - was perhaps responding not so much to the barely successful production restraint that OPEC had managed to achieve in coalition with non-OPEC exporters, as to the indications of growing supply tightness in the US market. And this came mainly from the brief cold snap and weak refining margins, which reduced refinery runs during much of February and March. There is also the growing litany of supposedly expert predictions of an economic recovery in the US later in the year (which, admittedly, are now beginning to be supported by some indicators). The young whelps who these days man the analysts' desks at the big banks have latched on to this as a foundation for increasingly bullish talk of prices spiking to \$35/bbl or more unless OPEC can come up with additional output by the fourth quarter.

How many times before have we seen the market get carried away on a tide of bullish sentiment, backed only by the flimsiest of fundamental support? We should remember how we got into this situation. OPEC has only managed to engineer a fairly calm path through what was a very difficult period for the oil market by extensive politicking and the creation of a shaky coalition with other producers. No one really knows what's going on in Russia and, once there is a sign of a return in oil demand, then others - Mexico, Norway and Oman in particular - are most unlikely to sit back and maintain their support, as OPEC members have pledged to. There's also new output in the UK to think about. And if these producers allow output to ramp up once more, OPEC members themselves will certainly not sit back and allow their market share to be eroded. One analyst is on record as being concerned that there will need to be a 2m b/d increase in output by the fourth quarter if a shortage is to be avoided - but that was always on the cards (presuming the US economy recovers) and it is well within OPEC's capacity to achieve it.

Unless . . . ah yes, there's always an 'unless'. I pointed out last month that the underlying oversupply in the current oil market matches Iraqi output almost exactly. Since then there have been increasingly hawkish pronouncements coming out of Washington - and supported by some in Europe - about the possibility of widening the 'war on terrorism' to finish off the job that the Gulf War started more than a decade ago. Action could happen sooner rather than later and any shooting war in the Gulf, especially if prolonged, will undoubtedly restrict crude oil exports from the region. Bad news again for tanker operators, I'm afraid, what with rising bunker costs and war risk premiums to contend with.

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