Riding the rollercoaster: What's next for the crude oil market?

Since July 2008 the oil market has seen a high degree of volatility, with prices falling from a high of $147 per barrel to approximately $35 per barrel in February 2009, and subsequently rebounding to more than $70 in June 2009.

Recession and recovery

In 2008, the demand for oil fell at its fastest rate since 1982 as the recession took hold, with demand predicted to fall further into 2009 – the more optimistic predictions expecting a rebound late in the year or by early 2010. The next twelve months are shaping up to be no less challenging in the oil market, with all eyes on the speed and extent of the global economic recovery and its implications for crude prices.

> Demand for oil in 2008 fell at its fastest rate since 1982

Throughout the first half of 2008, it was claimed by the world's main oil producing nations that the surge in oil prices was principally due to the actions of financial speculators buying crude in the expectation of making a healthy return on investment, supported to a degree by healthy supply-demand fundamentals. The first half of 2009 has seen another - but more exaggerated - break down in the correlation between market fundamentals and crude prices. This time the market has rallied despite the largest drop in oil demand for a generation, participants looking to the financial markets for direction and sentiment as optimism over when the recession will end.

As such, there are already warnings that the price of oil is headed for a correction as the excess of supply over demand becomes apparent. Indeed, having reached more than $70 per barrel in June, oil's price has lost ground and fallen towards $60 following new economic data from the US and the EU showing that – while the corner may have been turned in terms of the recession – the speed of any recovery remains very much in doubt.

> All eyes are on the speed and extent of the global economic recovery and its implications for crude oil prices

Four million barrels of crude removed from the market every day

At the same time that demand has been falling, OPEC has been scaling back its production levels since September 2008, making progressive production cuts since then and – on paper – removing more than four million barrels per day of crude from the market as a result. However, the ability and willingness of OPEC members to comply with new obligations on output has proved limited, with around 80% of the output reduction having been achieved to date. This outcome has been attributed to a combination of the nature of the production process for oil and existing contractual positions held by members, but also a reluctance to scale back output at a time of recession when crude export revenues are even more important. It is this failure by OPEC to meet its own production limits that has led to reluctance by the group to make any additional cuts in 2009 – the last one taking place in December 2008. It has also led to the group revising down its expectations for the oil price from a range of $70 to $80 per barrel to one in the range of $55 to $65 per barrel, indicating that the lower bands are acceptable and realistic given the prevailing market and economic conditions.

The speed and severity of oil's price fall poses the greatest long-term problem

However, it is the speed and severity of the fall in the price of oil that poses the greatest long-term problem for the oil industry, given that it has led to a massive scaling back in investment in exploration and production across the world. Such a move, although commercially sound, runs the risk of causing another spike in market prices as global demand recovers in response to an economic recovery given that investment programmes cannot be started overnight. In addition, a rapid expansion in energy demand may also cause the price for raw materials and inputs – notably metals – to increase, leading to a supplementary increase in prices and costs. The past few months have seen OPEC, the Paris-based International Energy Agency and the US Energy Information Administration all revise forecasts for 2009 to reflect the expectation that while the demand for oil will still drop, it will not do so by as large an extent as had been predicted earlier.

As a result, a global oversupply in the oil market could well become a shortage very quickly, causing fundamentals to push prices up. At the same time, as we have seen so far this year with the oil market tracking stock prices, crude could quickly become a 'one way bet' in terms of price direction – resulting in the same kind of speculative investment that was seen in the first half of 2008. While legislation has been proposed in the US that would limit traders' ability to take speculative positions, as well as the G8 calling for studies into how to control oil market speculation, this is a long way off and its effectiveness will be open to question given that there will be exemptions under any new rules.

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While end users have benefitted from lower prices as the oil market has fallen, this door swings both ways and users should prepare for any rebound in prices as and when the global recession comes to an end.

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