Crude Oil's Future

www.sucdenfinancial.com

Thursday, 10 March 2016

Research Desk

+44(0) 20 7940 5290
research@sucfin.com

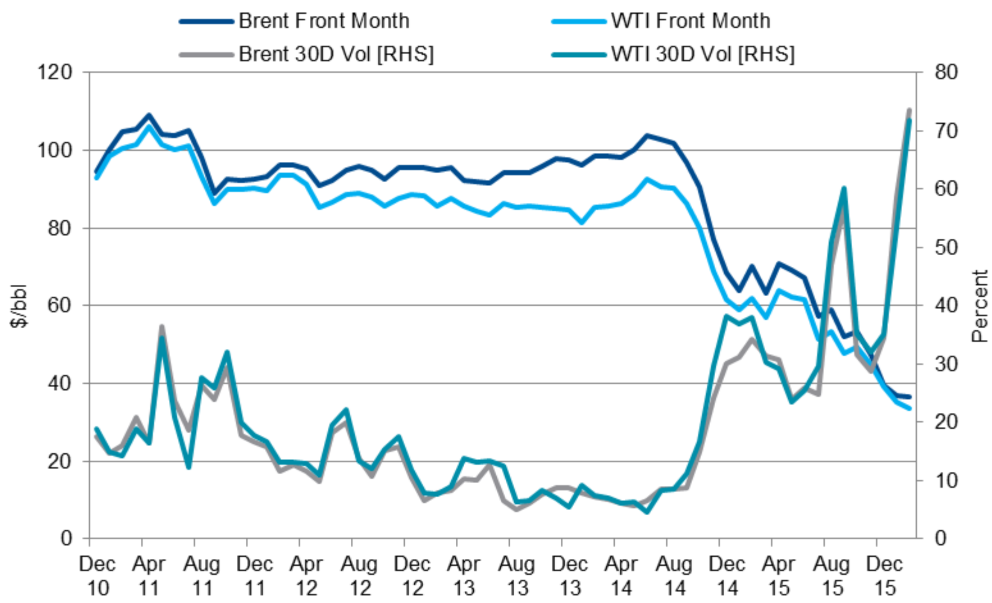
www.sucdenfinancial.com

March 2016

2015 was a year dominated by two major questions, when will the US Federal Reserve raise interest rates and when will the oil market rout end? To the relief of many investors the first of these questions was answered in December last year when the world's most powerful central bank increased interest rates by 25 basis points, doing so for the first time in nine years.

While much of the impact of what was arguably a symbolic hike had already been priced in, global risk assets experienced a patch of significant volatility as investors quickly woke up to the realisation that the era of cheap money was coming to an end.

Crude Oil Prices: *30 day historical volatility spiked higher in H2 2015*



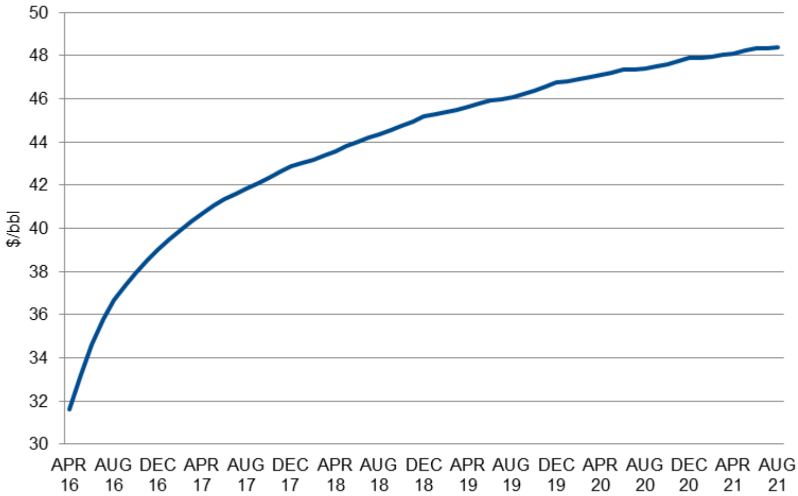
Source: Sucden Financial, Bloomberg

However, the second question remains unanswered and has commanded headlines throughout January, as investors struggle to come to terms with a lower-for-longer outlook in crude oil markets. Double-digit percentage swings on a weekly, and in some cases daily basis, have become more frequent due to the hype surrounding interest rates fading and accompanying volatility spikes; it seems the uncertainty has now shifted to the crude market.

"…it seems the uncertainty has now shifted to the crude market."

Industry participants have faced considerable headwinds over the past year and with producers unwilling to address the significant supply glut with any material output cuts we've seen the profitability of the sector squeezed. Such a supply overhang in the market has raised a few questions of its own, one of those being whether or not traders can profit from storing crude and ride the futures curve for potentially lucrative returns.

Brent Contango: *Steepest 12 months out then starts to level off*



Source: Sucden Financial, Bloomberg

To assess the profitability of a storage play given the current contango conditions, we need to first provide some market background. Analysing the global outlook for demand and supply, we must consider both OPEC and non-OPEC production. Forecasts from OPEC, the EIA and IEA all broadly agree that the market will balance in 2017, with data suggesting that the first drawdown of oil inventories will likely be in Q3 2017. But what potentially treacherous landscape lies between now and the end of 2017?

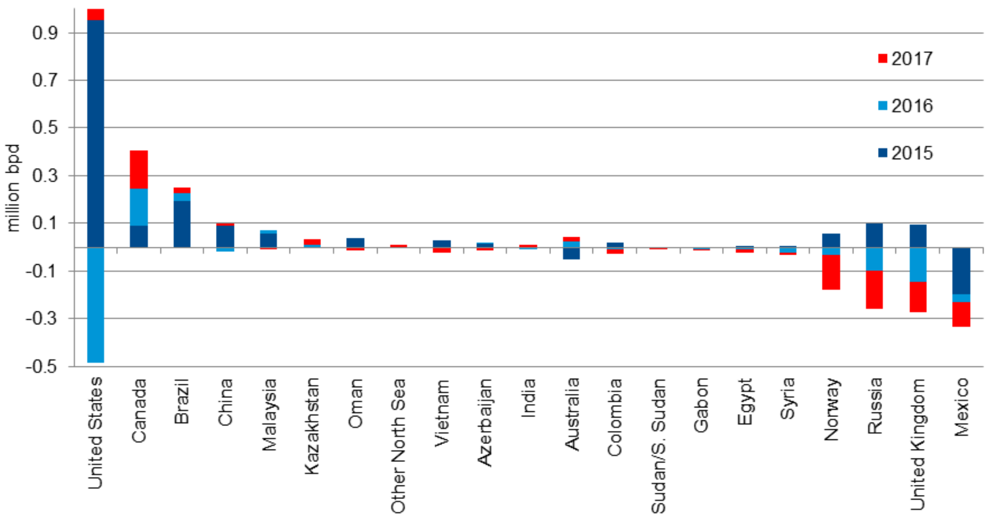
Supply set to outpace demand

"…global inventories have increased by some 1 billion barrels over the past two years and stockpiles are only expected to trend higher…"

With OPEC firmly committed to maintaining its market share and Saudi Arabia no longer willing to act as a swing producer, global inventories have increased by some 1 billion barrels over the past two years and stockpiles are only expected to trend higher throughout 2016, with 285m barrels set to be added this year. So even when production is cut, the stockpiles are likely to effect the price, as clearing the glut could take years. On the demand side, despite the current pessimistic outlook global demand is set to increase steadily in 2016 with both the IEA and OPEC forecasting consumption to be just over 95m bpd, however this would still leave an overhang of roughly 1m bpd assuming no change to the current status quo.

OECD production proved resilient in 2015, stomaching low prices and pumping out 57.6m bpd as North/Central America, Chile, and Canada contributed to the lion's share by producing an average of 19.9m bpd over the year according to IEA data. However, shifting market dynamics suggest that 2016 could see OECD output decline by 0.6m bpd. Most of these reductions will likely come from the Americas, Europe and, Asia/Oceania as lower crude prices curbs capital investment and producers in these regions look to cut production in an attempt to limit oversupply.

Non-OPEC Crude and Liquid Fuels Production Growth: *Growth potential set to slow significantly in 2016 amid lower for longer outlook*



Source: Sucden Financial, EIA

OPEC output resilient as price pressure persists

OPEC members show little indication that they will curb output, contradicting comments from Russia’s Energy Minister, Alexander Novak, who stated earlier this year that Russia were to meet with OPEC in February and discuss a 5% cut in production.

“…as no such agreement materialised, crude oil futures erased recent gains, adding further weight to the lower for longer outlook.”

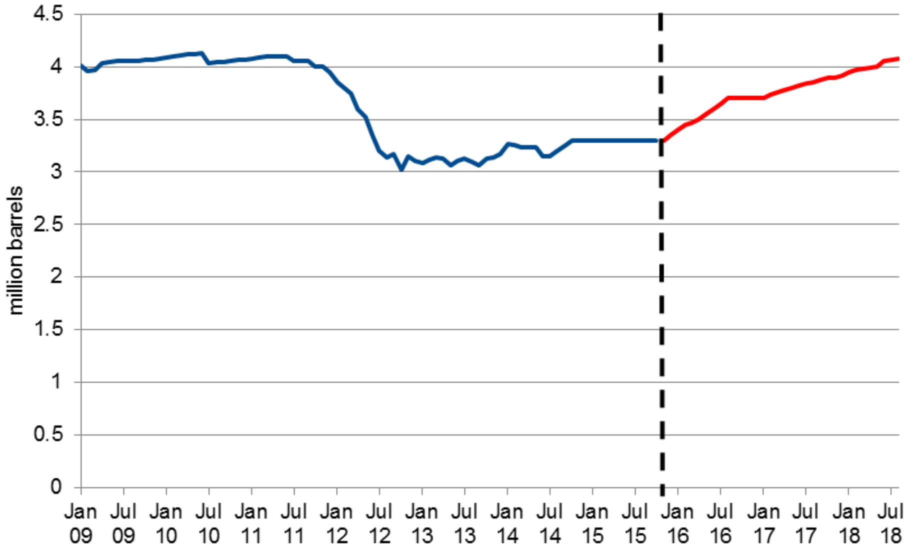
However, a representative from OPEC quickly rebutted the Minister’s comments and as no such agreement materialised, crude oil futures erased recent gains, adding further weight to the lower for longer outlook.

The first two months of the year have been busy ones for oil officials with Venezuela also attempting to persuade other OPEC members to cut production. Admittedly they face an uphill battle and even though Saudi Arabia is not enjoying prices around $40/bbl, they are arguably in a better position than some of the smaller members, owing to a lower marginal cost of production.

The Kingdom knows that any cut in production would either be filled by Iran, which expects to significantly ramp up exports, or the US, where shale producers have focused on efficiency gains to lower the cost of production, which would go against their current mandate of maintaining market share.

Content to pump out as much crude as they can in an attempt to delay investment in alternative energy sources and force US shale producers out

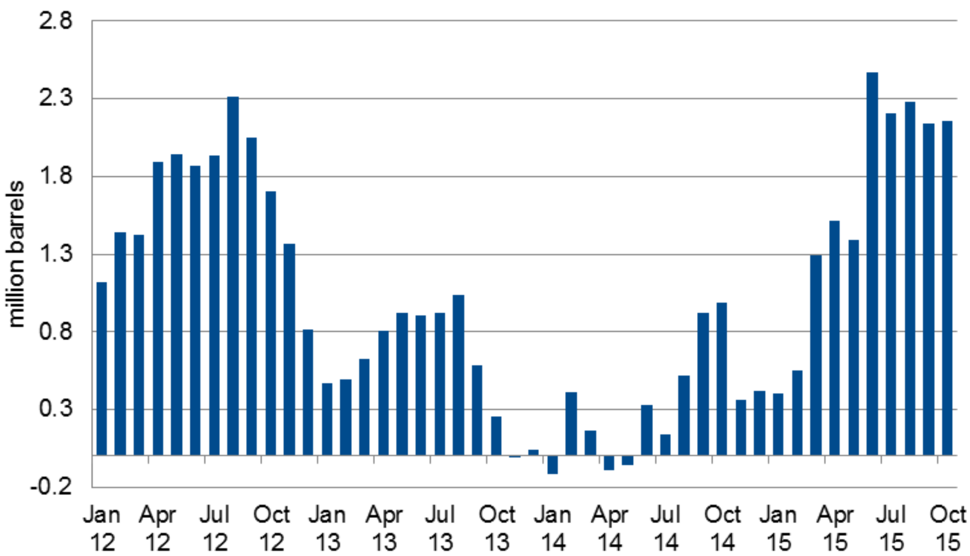
Iranian Crude Production: *Ambitious output plans over the year ahead*



Source: Sucden Financial, EIA

Recent developments suggest that Saudi Arabia and Russia have come to an agreement where production could be frozen at current levels. At first glance this seems like a step in the right direction; however the two oil exporters were willing to freeze production only if all large producers were to do the same. Trust between OPEC members has been called into question in recent months and the tentative relationship the cartel has with Russia only serves to complicate matters.

OPEC Monthly Output vs. Quota: *After consistently producing more than expected OPEC decided to abandon its production quota*



Source: Sucden Financial, Bloomberg

"…can the global demand increase fast enough to stop the world from drowning in oil?"

Even though some major producing countries might be starting to entertain the idea of slowing production, this isn't guaranteed so we ask, can the global demand increase fast enough to stop the world from drowning in oil? There are a number of factors that suggest that a subdued demand outlook may be the best-case scenario and with weaker global economic growth, the expected increases in consumption cannot make significant inroads into the oversupply.

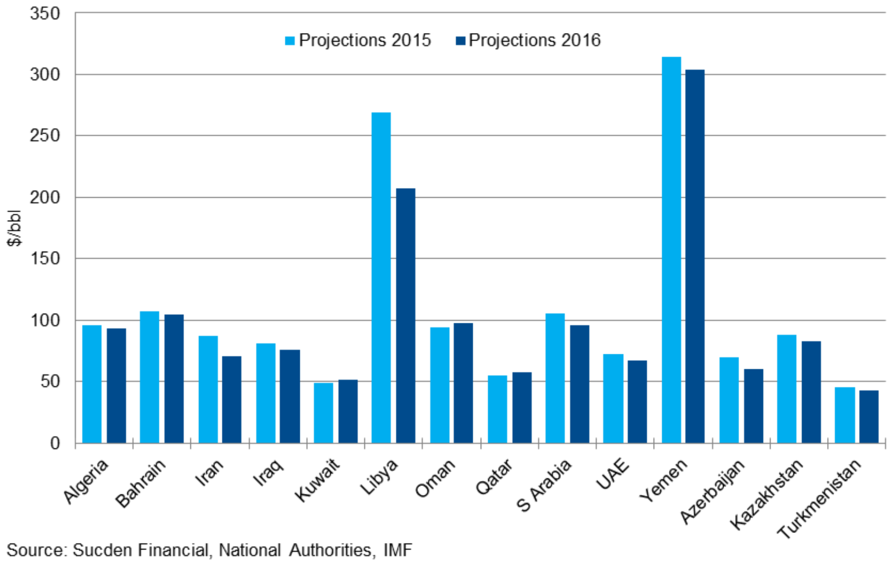
"We expect demand from China to tentatively increase by 0.3m bpd this year…"

Weaker emerging markets, notably China, Brazil, and Russia, the latter of which is a direct result of lower crude prices, as well as mild winter temperatures throughout Europe, Japan, and America have all dented the demand outlook for crude oil. Concerns regarding China's economy are topping the list and with growth in the world's second largest economy on the way down despite policymaker's best efforts, the slow transition to a service oriented economy will reduce the demand for crude oil. We expect demand from China to tentatively increase by 0.3m bpd this year, however given the recent market volatility and burgeoning debt pile, we could see these forecasts revised lower if the situation continues to deteriorate.

"…we could see additional spending cuts not only in Saudi Arabia but also in other oil-rich emerging markets."

China's slowdown is not the only concern on the demand side; Saudi Arabia seems to be causing headaches on this front as well. Price pressure has dented Saudi's bank balance significantly, to the point where they were purportedly considering selling shares in their crown jewel, Saudi Aramco. This worsening macroeconomic environment has caused the government to heavily cut subsidies, further impacting demand in the short-term. Figures suggest that Saudi demand will rise by only 45K bpd to 33.3m bpd this year, significantly lower than last year's figure which saw demand expand by 125K bpd. With petrodollar income under pressure we could see additional spending cuts not only in Saudi Arabia but also in other oil-rich emerging markets.

Projected Fiscal Breakeven Price: *Budgets in the Middle East under pressure from low oil prices*



Source: Sucden Financial, National Authorities, IMF

Some bright spots on the horizon

We do see some positive news as far as global oil consumption is concerned. India released impressive growth figures last month cementing its place as the world's fastest growing, big economy as data showed their economy grew by 7.5% y/y last year.

The World Bank has forecast a further increase of 0.3% in 2016 to 7.8% y/y, and with this growth we shall see a healthy increase in the demand for crude oil.

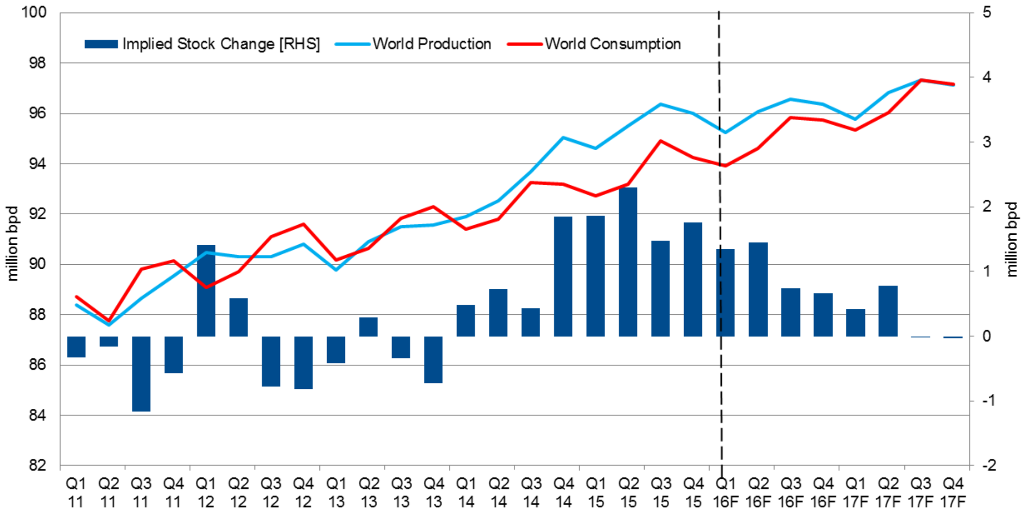
Oil consumption for the third largest economy in Asia rose by 8.3% y/y in December 2015 alone. Demand for gasoline, as a result of impressive car sales figures, which recorded a 14th consecutive month of growth at 12% y/y in December, with analysts predicting the market to grow by a similar figure during the next financial year starting April.

India's Minister for Petroleum and Natural Gas, Dharmendra Pradhan is keen to push on with ethanol blending and is set to introduce a 5% blend rate by September this year. If this policy implementation is successful, who is to say they won't increase the blend in years to come, impacting the countries demand for gasoline.

"Forecasts suggest that Indian crude oil demand will pick up any slack from China in the future..."

Forecasts suggest that Indian crude oil demand will pick up any slack from China in the future, with India set to surpass China by 2040. The IEA world energy outlook expects China's oil demand to rise by 5m bpd by 2040 contrasting an expected 6m bpd increase in Indian demand by 2040.

Crude Market Fundamentals: *Market balance expected in Q3 2017 as a rebound in demand gathers pace*



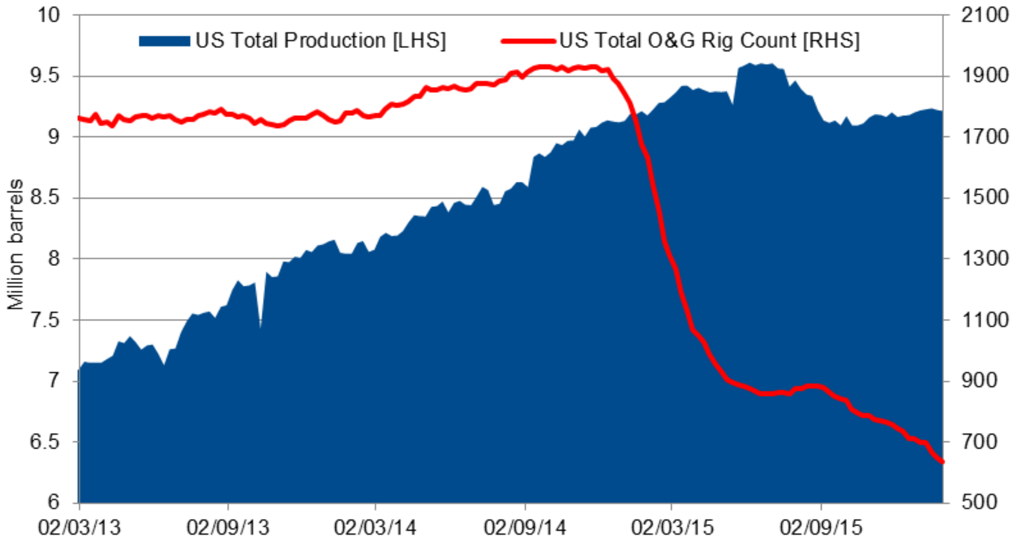
Source: Sucden Financial, EIA

A slight boon for oil producers is the cost of producing shale, granted America's efficiencies have improved substantially and costs have been driven lower, however this cost reduction has not been fast or big enough to compete with conventional producers.

Shale producers do indeed incur higher costs and with WTI crude hitting a 12-year low on the 11th of February at $26.21/bbl, it's fair to say shale producers are not having a good time of it. Producers in the Permian Basin and Eagle Ford are going to considerable lengths to cut costs, in order to minimise the losses they make with production in the latter region expected to drop by another 50,000 barrels a day in March bringing the total to around 1.22m bpd. Perhaps the lack could then be picked up by conventional oil, suggesting that OPEC's strategy to try and push the shale industry to the point of collapse may finally be working.

"Producers in the Permian Basin and Eagle Ford are going to considerable lengths to cut costs…"

US Crude Oil Production: *Improving shale efficiencies have kept output relatively stable despite the collapse in rig count*



Source: Sucden Financial, Baker Hughes, Bloomberg

Amid the lower price outlook, tanker companies benefit

Oil tanker companies are one of the few bright spots in the shipping industry as customers around the world take advantage of the record low crude price and stock up on oil. Despite the rise of shale, the US is still a net importer with US inventories currently 100m over historical levels. Refineries continue to face an uphill battle with warmer than usual seasonal temperatures and lower margins but the global trade in crude oil remains healthy, benefiting the tanker market.

Clearly this is good news for tanker demand; however, over the course of the year we predict the industry may run into some issues. When the stockpiling stops and buyers no longer feel they need to purchase significant quantities of crude, tanker demand is likely to suffer as a result.

Recent mild weather temperatures have hindered demand for fuel oils and distillates, ensuring stockpiles remain at elevated levels. Adding to these headwinds is the expectation of a significant amount of DWT entering the market during the course of the year.

"…data from Clarksons has seen orders for new tankers increase 14% y/y in 2015."

Shipping data from Clarksons has seen orders for new tankers increase 14% y/y in 2015. These could come to market at a time when consumers are drawing down their ample inventories and as a result demand for tankers could tail off. Tanker demand in this situation is largely dependent on where the stocks are being built up and where they will eventually be used. If producing countries are the ones building up inventories then demand for tankers will remain buoyant, but again, with a lacklustre demand outlook we foresee significant headwinds.

12-Month Dirty Time Charter Rates: *Tanker rates have come down sharply in January as a significant DWT is expected to hit the market*

Source: Sucden Financial, SSY, Bloomberg

The supply of vessels will be a key feature of 2016 and with a busy pipeline for new builds coming on line throughout the year, far above what is currently needed, the excess of DWT could increase the validity of floating storage plays on any material decline in the daily time charter rates.

"The rally in time charter rates for dirty tankers throughout 2014 and 2015 has come to an abrupt halt this year…"

This scenario could soon become a reality, with global crude oil production persisting at high levels coupled with a lacklustre demand outlook; daily tanker rates could experience additional headwinds. The rally in time charter rates for dirty tankers throughout 2014 and 2015 has come to an abrupt halt this year and there looks to be testing times ahead as the last 4 months of 2015 saw orders placed twice as fast, at 11.4m DWT for the last quarter of the year.

The Baltic and International Maritime Council reported that 35m DWTs were ordered last year, of which there were 66 VLCCs. With subdued scrapping figures and 63 VLCCs being delivered this year alone, tanker supply is estimated to exceed demand by about 50 VLCC equivalents, pushing rates even lower. Currently the daily time charter for 300 DWT dirty tankers on an annual contract stands at $47,000 and we could see this decline sharply once these ships enter the market.

With the tanker market already well supplied and with steady additions to the fleet over the next 12-18 months, under current projections it seems likely that tanker rates will fall further – could they be destined for the same fate as the dry bulk market? This does however largely depend on a couple of factors: when the market rebalances, onshore storage facilities reaching capacity, and the location of these stocks.

Could current market dynamics present an opportunity?

Given the market fundamentals and the current contango market dynamics, we have assessed the profitability of storage plays in the crude market. Casting our minds back to market conditions during the 2008-2009 financial crisis, we recalled a number of traders and producers taking advantage of the slump in near term futures.

"The 75% decline in front month Brent crude futures presented a unique opportunity…"

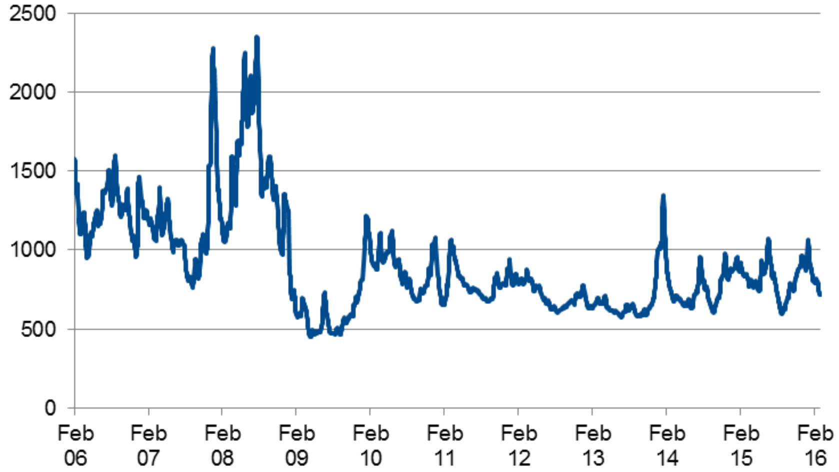
The 75% decline in front month Brent crude futures presented a unique opportunity; at a time when dirty tanker rates were trending towards historic lows (the Baltic Dirty Tanker index bottomed out around 477 in April 2009 before a brief jump towards 650 in June only to register a fresh low of 474 the following month), traders could take advantage of the floating storage play.

At the lowest point for the Baltic Dirty Tanker index in early 2009, the May twelve month contango in front month Brent futures was $10.61/bbl. Given the specific gravity of Brent crude around 0.835, a VLCC with 300K DWT would be able to carry around 2m barrels of crude oil, yielding just over $21m from the 12 month contango at that time.

"Those among us who timed the trade perfectly would have netted substantial profits from a relatively simple trade."

Time charter rates for 300K DWT VLCC's were around $38,000/day and after costs totalling $13.87m for the year, this trade would have made roughly $7.35m, less wages, bunker fuel, and other associated costs. We can see that some healthy margins were to be had. Those among us who timed the trade perfectly would have netted substantial profits from a relatively simple trade.

Baltic Exchange Dirty Tanker Index: *Traders could profit from the recent dip*



Source: Sucden Financial, Bloomberg

Of course this glance back in time benefits from hindsight, what we now aim to discover is whether these same market dynamics work in today's climate. Brent prices have come down substantially over the past year and with crude once again in the headlines we've run the numbers to see if and when floating storage plays would be profitable.

"The contango this time around isn't as steep as it was in 2009…"

The contango this time around isn't as steep as it was in 2009 owing to a substantial supply glut as global storage facilities fill up, while the market remains awash with crude as OPEC continues pumping out near record levels and shale producers in the US show no signs of slowing down (yet).

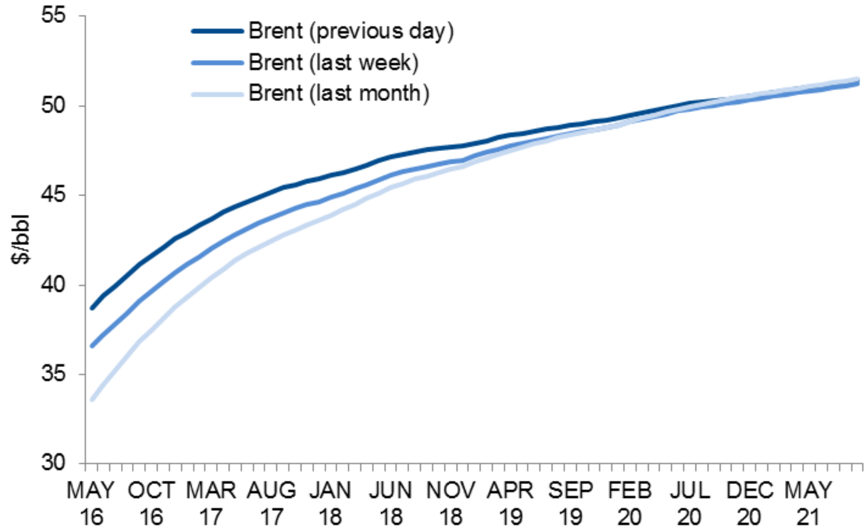
The May twelve month contango for Brent is currently around $6.50 and has been trading more or less around this level over the past few weeks. If we were to apply the same calculations to current conditions the success of this trade would indeed be called into question. Twelve-month time charter rates for dirty tankers currently stand at around $47,000/day, or just over $17m for the year.

"To break even at current dirty tanker time charter rates we would need the contango to be at least $8.60…"

With such a shallow twelve-month contango this trade would not only be called into question but would prompt losses of around $2m. To break even at current dirty tanker time charter rates we would need the contango to be at least $8.60.

However with global crude storage facilities nearing capacity, global crude oil production remaining at elevated levels and a sluggish demand outlook across the US, Asia, and Europe, a drastic steepening of the futures curve may be unlikely.

Shift in Brent Crude Contango: *Participants will require a well-timed entry*



Source: Sucden Financial, Bloomberg

Similar parallels can be drawn with the WTI contango, which has widened throughout the second half of 2015, boosting the demand for onshore storage facilities. The typical cost for crude oil storage runs between 20-50c/bbl/month with costs at Cushing, Oklahoma as much as 80c/bbl/month. While little can be done to materially impact the fundamental outlook for crude over the coming year, a rapid decline in dirty bulk prices could improve the dynamics of this trade.

"…it would seem that the current market conditions, while not favouring a floating storage play, are optimal for an onshore storage one."

From the above analysis it would seem that the current market conditions, while not favouring a floating storage play, are optimal for an onshore storage one. The contango conditions across the oil market given an abundance of both production and stock levels, combined with a tentative global supply/demand outlook have kept the contango in check.

Baltic Dry Index: *A sign of things to come in the dirty tanker market?*

Source: Sucden Financial, Bloomberg

"…we would need to see a meaningful upward revision in the 2016/17 demand outlook before we could confidently state that a floating storage play is worthwhile."

Given today's conditions in global shipping markets and under the current supply outlook we would need to see a meaningful upward revision in the 2016/17 demand outlook before we could confidently state that a floating storage play is worthwhile. With daily time charter rates for 300 DWT dirty tankers currently around $47,000 according to SSY data, under the assumptions used above we would need to see at least a $9 May/May calendar spread in Brent futures and even then, it would only eek out modest gains.

"…the second half of this year is forecast to see a significant number of new builds come into the frame."

Much more likely is the rapid decline in dirty tanker time charter rates as the second half of this year is forecast to see a significant number of new builds come into the frame. Fearnley Securities estimates this year alone will see an oversupply of 50 VLCC equivalents, far in excess of what current global demand assumptions require and likely to act as a drag on time charter rates. Barring any material downward revision in the demand outlook and under the (now very likely) assumption that we will not see any surprise upward revision to forecasts, if we were to see shipping costs decline to their 5 year average of $28,000 per day, then the floating storage play turns a healthy margin.

For now though, market participants would do well to keep a close eye on the ever shifting market dynamics for the opportune moment.

London

Sucden Financial Limited
Plantation Place South
60 Great Tower Street
London EC3R 5AZ

Tel: +44 (0) 20 3207 5000
Fax: +44 (0) 20 3207 5010
Email: info@sucfin.com
www.sucdenfinancial.com

Hong Kong

Sucden Financial (HK) Limited
Unit 1001, 10/F.
Li Po Chun Chambers
189 Des Voeux Road Central
Hong Kong

Tel: 852 3665 6000
Fax: 852 3665 6010
Email: hk@sucfin.com
www.sucdenfinancial.hk

Moscow

Sucden Financial (Russia)
Sucden Financial Limited
Representative Office
Orlikov per. 3 'B'
Moscow 107139

Tel: +7 495 796 96 40
Fax: +7 495 796 96 41
Email: russia@sucfin.com
www.sucdenfinancial.ru

Disclaimer

Sucden Financial Limited is authorised and regulated by the Financial Conduct Authority.

This is a Marketing Communication. The information in this report is provided solely for informational purposes and should not be regarded as a recommendation to buy, sell or otherwise deal in any particular investment. Furthermore, the information in this report has not been prepared in accordance with legal requirements designed to promote the independence of investment research. All information in this report is obtained from sources believed to be reliable and we make no representation as to its completeness or accuracy. This report is not subject to any prohibition on dealing ahead of the dissemination of investment research. Accordingly the information may have been acted upon by us for our own purposes and has not been procured for the exclusive benefit of customers. Sucden Financial believes that the information contained within this report is already in the public domain. Private customers should not invest in these products unless they are satisfied that the products are suitable for them and they have sought professional advice.