



بنك الإمارات دبي الوطني
Emirates NBD

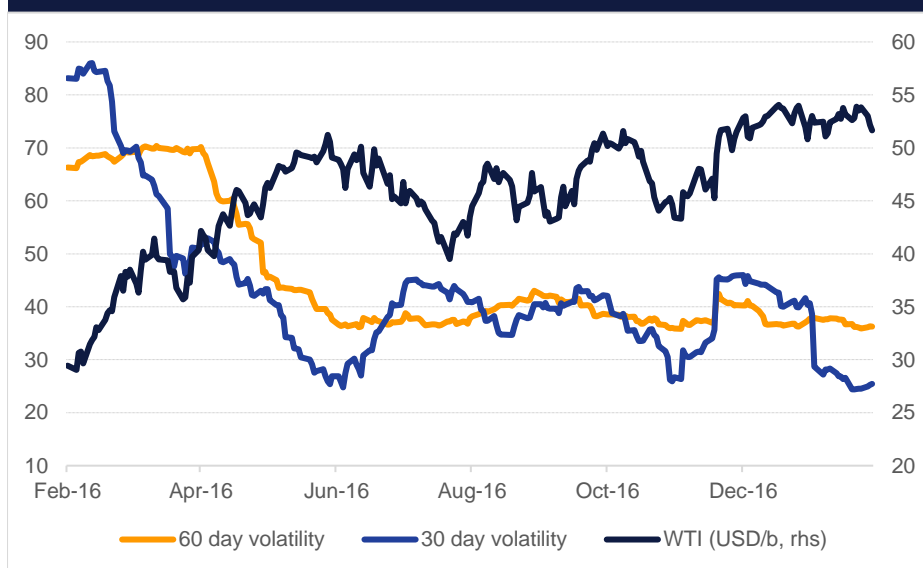
Commodities

8 February 2017

Crude oil update

A quick glance at front month oil futures volatility would seem to indicate that the market is plodding along quietly, balancing the size of OPEC's production cuts nearly exactly with the improving picture in the US oil industry. Compared with a year ago, 30- and 60-day volatilities for front month futures are indeed sharply lower as the market has grown more confident about a trajectory for gently rising oil prices. Longer dated futures (June and December 2017) have been showing a similar flattening of volatility, well below historic median levels. Price volatility in 2015-16 was indeed high but generally over the long-term commodity prices are characterized more by volatility than stability. The soft start to the year (WTI futures are down a little more than 3.5% year to date) may then be a little misleading if oil markets are getting back to 'normal'.

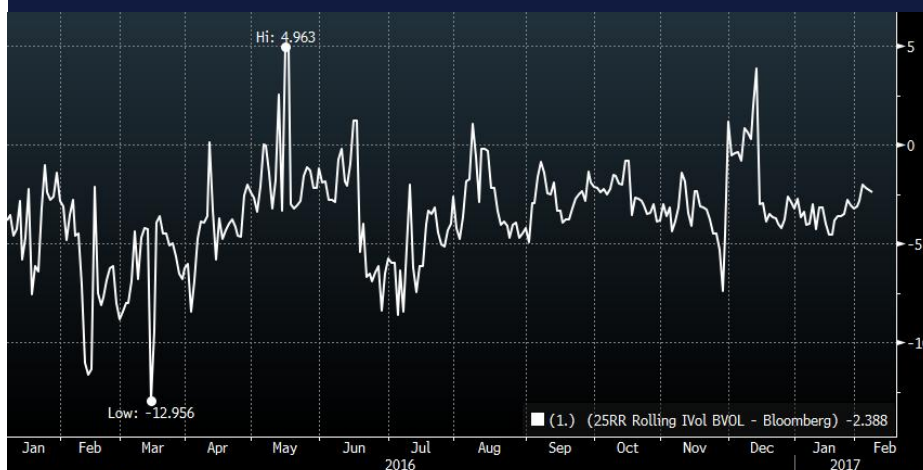
WTI front-month volatility has eased considerably



Source: Bloomberg, Emirates NBD Research.

Risk-reversal strategies are also highlighting these apparently sanguine market conditions. A 25-delta risk reversal on front month WTI has stabilized a little below parity compared with a heavy put premium that the market tipped into last February. Indeed the 25-delta risk reversal has converged strongly to its five-year median and is converging on levels last seen when front month WTI futures were comfortably in the USD 80-110/b range.

25 delta risk reversal gets back to 'normal'



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Source: Bloomberg, Emirates NBD Research.

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We suspect there is a strong chance that put premiums could widen substantially again the longer front month prices stay in their current range. All indications point to a robust recovery in the US oil industry which will act as a brake on upside and may clear the way for downside risks:

- Inventories are going in the wrong direction. Crude inventories have been building this year at a slightly faster pace than their 10-year average while gasoline stockpiles and distillates have been sharply up on their 10-year average. Stock-builds are normal at this time of year considering the colder weather and lower economic activity in the US but inventories increasing off of 2016's already elevated levels should send another shiver down the spine of the most headstrong bulls.

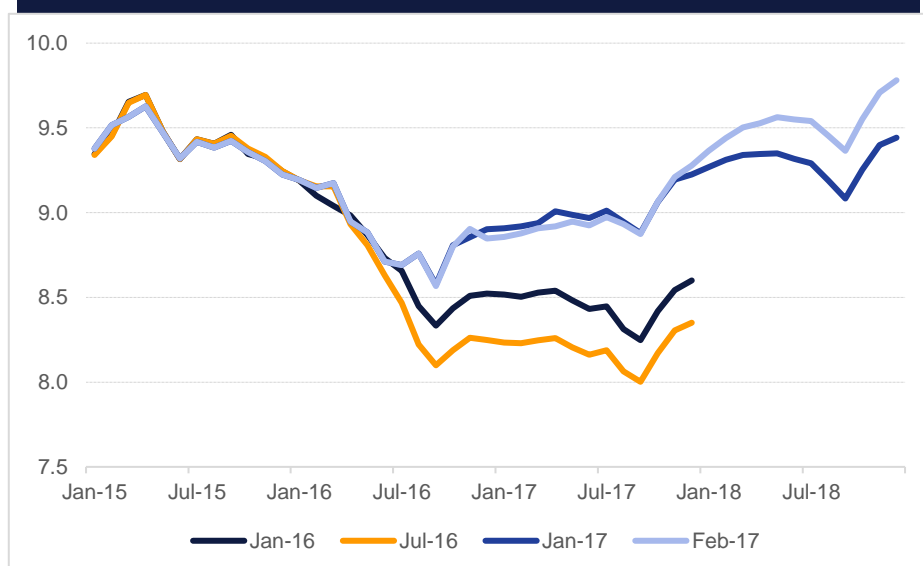
Inventory growth rates for January

	2015	2016	2017	10yr avg
Crude	7.51	3.57	3.29	3.06
Gasoline	5.07	14.89	9.19	7.05
Distillates	6.96	4.30	5.59	2.32

Source: EIA, Emirates NBD Research. Note: % monthly change.

- The outlook for US production is improving, quickly. The EIA has consistently revised upwards its US domestic production forecast: in projections going back to the start of 2015 the EIA has raised its forecast for December 2017 production by nearly 1m b/d comparing the maximum and minimum forecast. In only two months of forecasts this year the EIA has raised its estimate for average 2018 production by 230k b/d.

EIA playing catch up to the market with its forecasts



Source: EIA STEO, Emirates NBD Research. Note: estimates of US domestic production Jan 2015-Feb 2017.

- Investor positioning is at euphoric levels according to CFTC data. WTI managed money longs have hit new record levels two weeks running and the longs outnumber shorts by a factor of around 9. Markets were last getting this long in H1 2014, just ahead of the start of the price slump. Meanwhile producer hedging levels continues to bump around three-year highs. The amount of upside the investor community expects with positioning at these levels may struggle to be borne out, in our view.

- Uncertainty around the border adjustment tax proposal. While the BAT would result in WTI prices spiking to compensate domestic producers for foregoing tax free exports it is still unclear if it will indeed be imposed on the oil industry or would be a universal tax on imports regardless of country-of-origin rather than targeting Mexico or China specifically. If the BAT exempts oil, we would anticipate a sharp negative repositioning toward WTI.

We do remain positive on oil for 2017 on average but caution that this market may be getting ahead of itself. OPEC's production cut is one of the few lone supportive factors and while initial compliance appears to be strong we are cautious how well producers will be able to stick to targets going forward. In our view some more representation of downside risks in futures markets would better reflect current fundamentals.

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