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Publication	The Economic Times: Chennai | Kolkata
Date	16.01.17
Description	Column: Jayant Manglik, Religare Securities

Crude may Peak to $70 on MCX in H2, Hedging Advised

ET Column

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In one of the most unexpected market moves in 2016, crude oil prices shot up. The reasons, speed and trajectory of the price rise took market participants and analysts by surprise. After all, prices have been falling since over two years, fundamentally due to lack of demand in a low-growth world economy with the situation aggravated by increased crude oil supply from Opec members furiously engaged in a production race. This race was led by Saudi Arabia which frequently and publicly announced its intent of keeping production high, presumably to ensure low prices which would make US shale oil units unviable and restore prices to higher levels.

So what caused prices to move up suddenly, crowned by a 25% rise in the last two months of 2016? After beginning the year at $ 37/barrel, prices crashed to below $ 27 in February before moving up steadily to $48 in September and then the sudden jump to its peak of $ 55 in December 2016.

This was a roller-coaster ride and the December price was double of the lows touched in February.

Even for a commodity as volatile as crude oil, this movement was a new challenge to users (practically everybody, in some form), investors, traders and analysts. The inflection point came in November when three unexpected things happened at once. One, the Opec countries united, met and agreed to their first production cut since 2008. Second, large non-Opec producer countries like Russia aligned with Opec in the production cut announcement, again a first since 2001. Third, Trump became President-elect of the US and announced an aggressive growth plan while naming a senior oil executive as Secretary of State, the US government arm which deals with foreign policy.

So, Opec will cut production by 1.2 mbpd and non-Opec allies by 0.558 mbpd, making a total of about 1.8 mbpd which is enough to impact prices. As a reference, Opec produces 34.2 mbpd out of the almost 98 mbpd global production, which is at a record high so far. Also, IMF's world GDP growth forecast of 3.4% against the 3.1% earlier means that demand will increase.

But there is a flip side too which can keep crude oil prices in check, in fact drive them down yet again.

The immediate one is the strengthening of the US dollar which was at a 14-year high recently when measured against a basket of major currencies. Since crude oil is denominated in the US dollar, a rising dollar makes it more expensive for other countries to purchase, thus discouraging demand.

Second, higher US bonds yields after the recent Fed rate hike acts as competition for large investments which may otherwise have been made in crude oil. Third, US shale oil will start pumping again as prices touch $ 60, increasing supply. And most importantly, there is no guarantee that the Opec/non-Opec allies will stick to their committed production cuts – and there is no transparent way to audit it. Historically, such agreements have seen many leakages and have not lasted long. Conflicting ideologies and domestic political compulsions usually play a part in pulling such coalitions apart.

In summary, if the Opec/non-Opec production cut agreement holds out, we're looking at new price highs in 2017. Technically too, a price peak of $ 70/bbl or ₹4,700/bbl on MCX looks likely in the second half of the year. So, as an oil importer, hedging is highly recommended.

For traders, strategies should be biased on the buy side and only spikes should be seen as short-selling opportunities. Crudely put, prices should go up in 2017 which could well be the year of crude oil.