Oil Market Update – June 2014

National Australia Bank

Key Points:

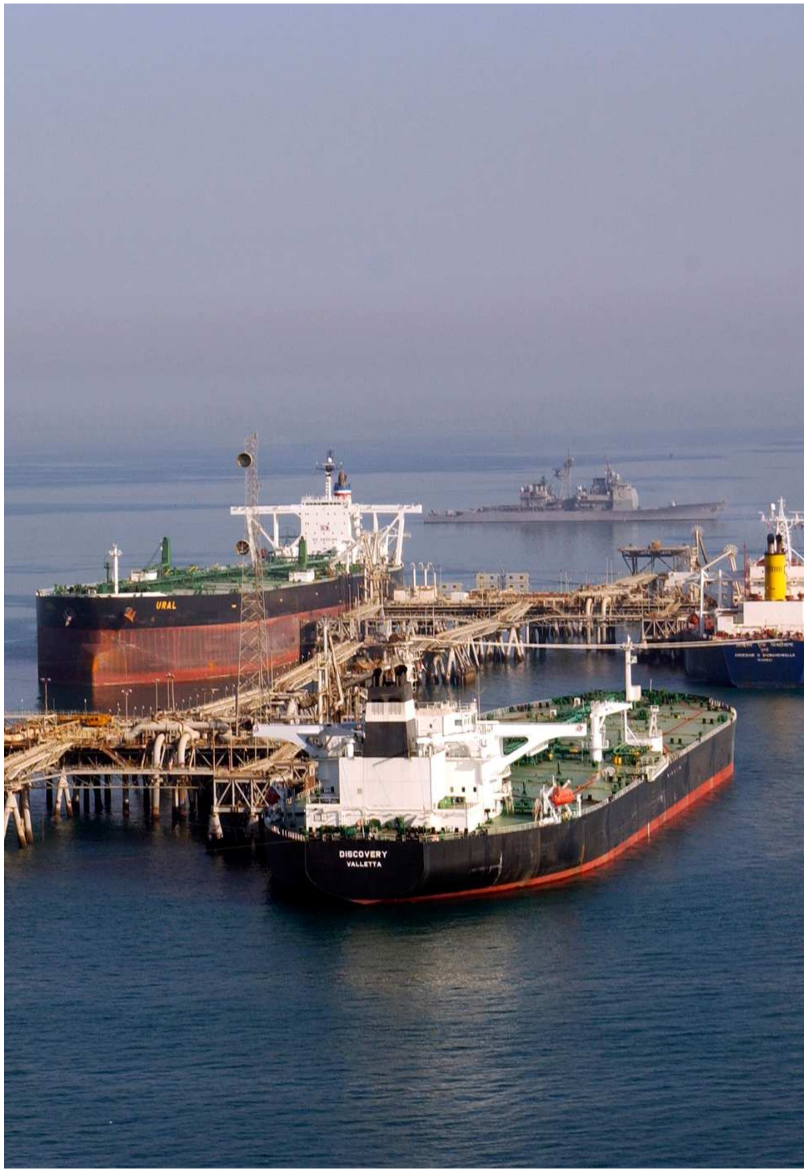
- *The relative price stability that characterised Brent and Tapis in the first half of 2014 has been shaken of late by unexpectedly severe sectarian turmoil in Iraq. After Mosul fell on 10 June, Brent jumped 4% in a week and broke through $115 per barrel by 19 June. While the deterioration in the security situation in OPEC's second largest producer is yet to dent Iraqi oil exports with and prices moderating somewhat in late June, the spectre of further unrest will likely weigh on the minds of investors.*

- *The US benchmark West Texas Intermediate (WTI) has continued to climb relative to Brent since the opening of the southern section of the Keystone XL pipeline in January 2014. The project increased the takeaway capacity from Cushing, Oklahoma to refineries on the Texas coast, reducing the bottleneck which had suppressed WTI.*

- *US production continues to grow rapidly on the back of increased exploitation of shale oil reserves, with production up 15% and imports down 7% year on year to March 2014. US production has now grown 57% over 5 years. Should this trend continue, there will likely be further pressure to relax US export restrictions, although the impact on global dynamics is likely to be small.*

- *On balance, the fundamentals point to stable to moderately declining prices over the next six months, with the US Energy Information Administration (EIA) projecting that supply growth will exceed demand growth. However, a disruption to Iraqi oil exports could see prices rise.*

- *We project that domestic petrol prices will fall slightly to 149 c/litre in the June quarter and 148 c/litre but will rise from the December quarter and throughout 2015.*



US Navy photo by Photographer's Mate 2nd Class Samuel W. Shavers

Recent Price Movements

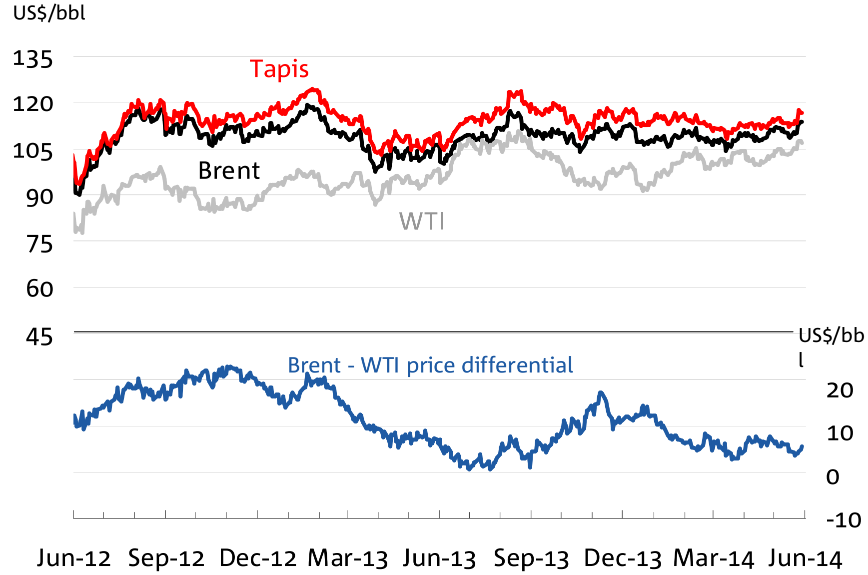
- Brent and Tapis enjoyed relative stability over May, increasing moderately on the back of lower than expected non-OPEC production and improved expectations of future economic growth. Prices remained in a relatively narrow band of US$4.34 over the month, continuing a trend established in late 2013.

- Prices spiked on 10 June, when a rapid deterioration of the security situation in Iraq shocked investors and saw Brent increase 4% over a week and break through $115 per barrel by 19 June. Prices have eased somewhat as most Iraqi production is located away from the fighting and does not appear to be under imminent threat.

- The opening of the southern section of the Keystone XL pipeline in January 2014 increased the takeaway capacity to refineries on the Texas coast. This saw the price differential between Brent and WTI decline 22% in the March quarter as inventories at Cushing, Oklahoma continued to fall. The price differential has stabilised somewhat in the June quarter, hovering just below $7/bbl on average.

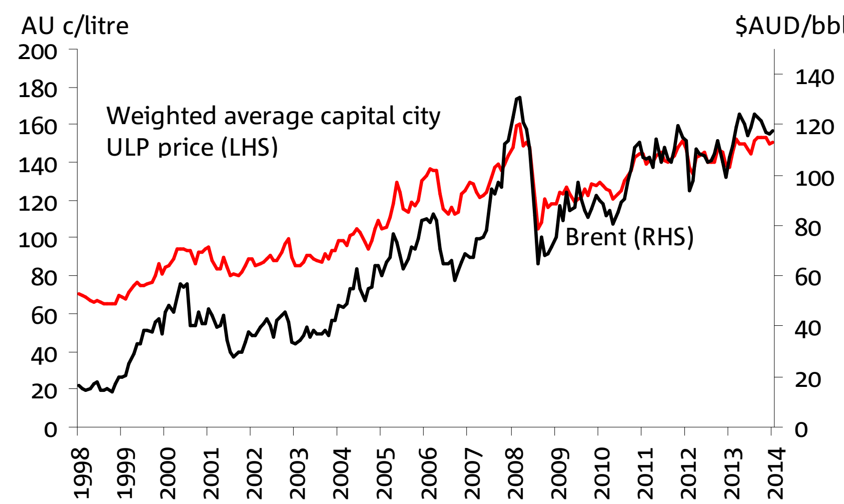
- Australian retail fuel prices declined over the year as the AUD appreciated against the USD. The weighted average capital city ULP price was 150.5 c/litre in May, down 2% since February. However, prices are up 10% compared to the same time last year.

Figure 1: Daily oil prices



Source: Thomson Datastream

Figure 2: Retail fuel prices



Source: RACQ, US Energy Information Administration

Supply side factors: geopolitical considerations in Iraq

- Iraq is OPEC's second largest producer and has the fifth largest proven oil reserves in the world – some 150 billion barrels. It has continued to ramp up production and exports in 2014, producing 3.3 million barrels per day (bbl/d) in May. Most Iraqi oil production is concentrated in the south of the country and is loaded at Basra for export via the Persian Gulf, mostly to Asia, Europe and the US. 2.5 million bbl/d was loaded at Basra in May, up 15% compared to the same time the previous year.

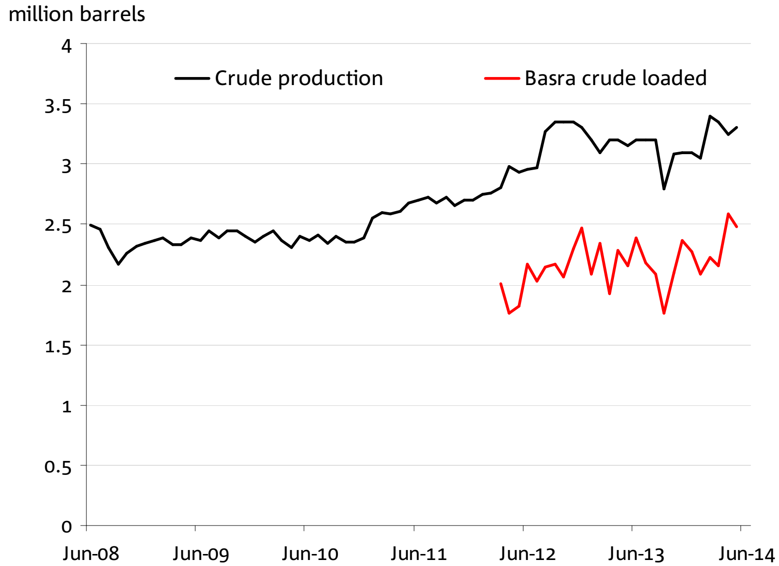
- In early June, Sunni militants from the Islamic State of Iraq and Syria (ISIS) began an offensive against Iraqi government forces. The rapid advance of ISIS militants across much of northern Iraq and in particular their capture of Mosul, Iraq's second city, on 10 June surprised analysts and saw the price of crude jump.

- The immediate impact of the crisis on oil production has been minimal thus far. While ISIS has swept across the Sunni north with relative ease, they face considerably greater resistance in the largely Shiite south, where most oil production is concentrated. Nevertheless, a widening of the conflict to the south would be a significant threat to Iraqi oil supplies and ISIS may target southern oil facilities in a bid to cripple the government financially.

- At this stage, the market does not appear to have placed a high probability on supply disruptions. If the Iraqi government can maintain stability in the south, any impact on crude prices should be modest. With US advisers and armed Predator drones deployed in Baghdad and the strength of the Iraqi army and Shiite militias largely unknown, it is too early to accurately assess whether Iraqi oil supplies will be secure.

- The crisis has allowed the semi-autonomous Iraqi Kurdistan to consolidate their increasing autonomy from Baghdad and move closer to independence. The Kurds currently control 45 billion barrels of proven reserves and have constructed their own pipeline allowing them to sell oil independently through Turkey which is reported to be currently pumping 120,000 bbl/d. While these exports are likely to remain small in the near term, their success could spur investment in undeveloped fields under Kurdish control.

Figure 3: Iraq Crude Production and Exports



Source: Bloomberg

Basra Oil Terminal, Iraq

US Navy photo by Photographer's Mate 1st Class Richard J. Brunson

Global supply side factors: exploration and extraction

- A period of relative price stability at elevated levels has offered some confidence to oil drilling companies. The Baker Hughes global rig count peaked at 3,736 in February before declining 10% to May, in line with seasonal factors, but is 6% higher than May 2013. Overall, the rig count shows a moderate downward trend since 2012, reflecting a global environment with limited supply constraints and falling profitability.

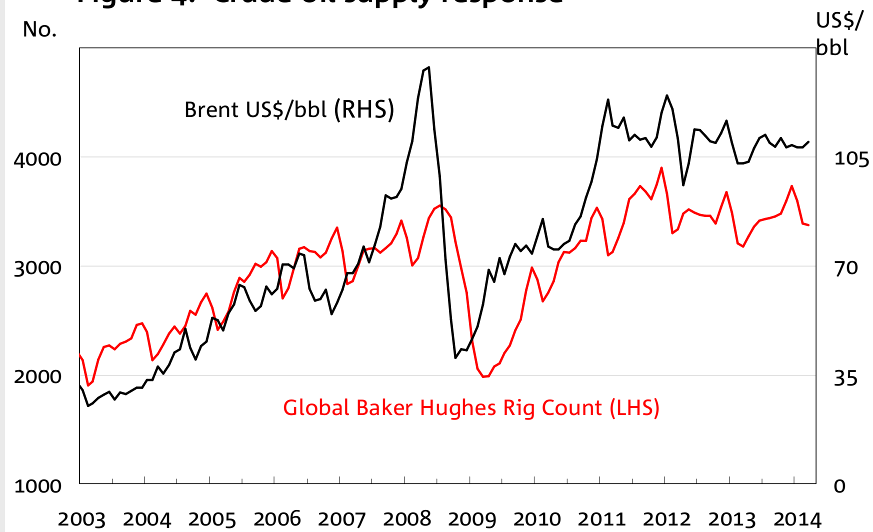
- OPEC reports their crude production to have been 30.7 million bbl/d in May, up on March and April, but slightly down on the first quarter. 2014 production is on track to be lower than 2013, which saw average production of 31.6 million bbl/d according to OPEC and 29.9 million bbl/d according to the EIA.

- The decline in OPEC supply contrasts against increasing non-OPEC supply. The EIA reports that non-OPEC supply averaged 54.1 million bbl/d in 2013 and forecasts that production will grow by 1.1 million bbl/d in 2014. Much of this increase is expected to come from the US and Canada. Data from the Australian Bureau of Resources and Energy Economics indicates that Australian crude oil and condensate production averaged 0.34 million bbl/d in the March quarter. OPEC projects that Australian production will moderately increase in 2014.

- The rapid increase in production from shale and tight oil, particularly in the US, continues to generate interest. In October 2013, US crude production exceeded imports for the first time since 1994 as a result of increased shale and tight oil extraction. Production over the past year is 53% higher than five years ago. The EIAestimates that in 2015, the US will produce an average 8.4 million bbl/d, the highest since 1972 and close to the 1970 peak.

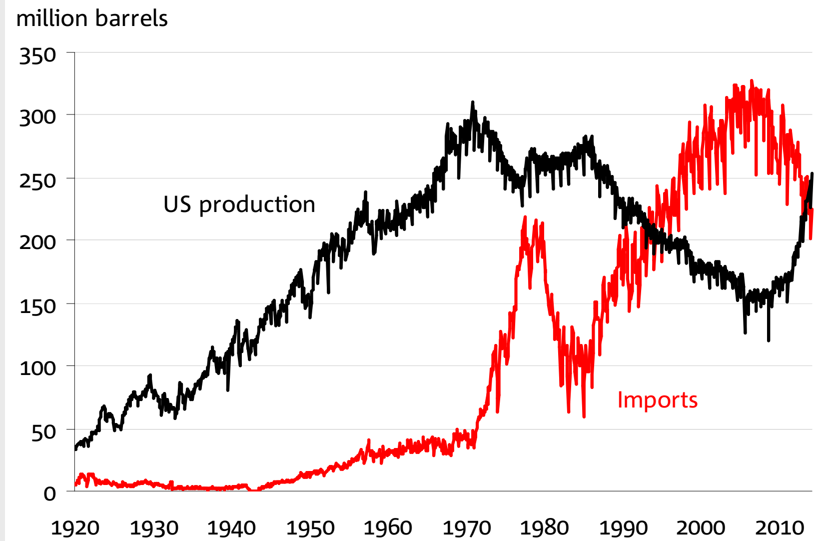
- In June, the EIA reported on technically recoverable global shale oil and shale gas resources. The report estimates technically recoverable global shale and tight oil reserves to be 345 billion barrels, up from only 32 billion barrels in the EIA's 2011 estimate. This optimism is tempered somewhat by disappointments in individual fields. For example, in May the EIA downgraded its estimate of recoverable Monterey shale oil by 96%, highlighting the riskiness of many shale and tight oil plays.

Figure 4: Crude oil supply response



Source: Thomson Datastream; Baker Hughes

Figure 5: US monthly crude domestic production and imports



Source: US Energy Information Administration

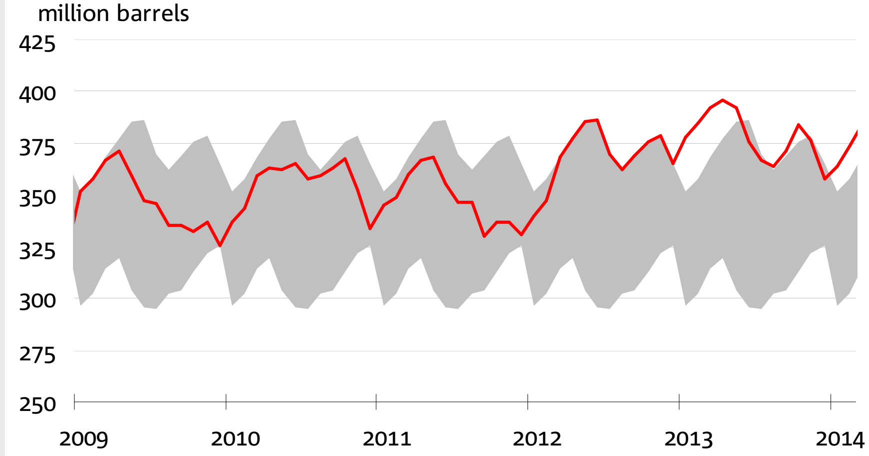
Supply side factors: refining, inventories and exports

- US commercial crude oil stocks increased by 3% in March to 384 million barrels as the northern spring brought milder conditions. Winter crude oil stocks were at or above the 2008-12 maximum in spite of unusually an unusually cold winter in the eastern US. Upward pressure on stocks caused by strong growth in domestic shale and tight oil plays and milder weather appears to be offsetting falling inventories in Cushing.

- Product markets across major oil refineries producers were mixed in June. WTI refining margins ticked up above US$9 in mid June, having fallen below $5 by 10 June. Brent producers were not so fortunate, margins have been declining since March and are now barely in positive territory.

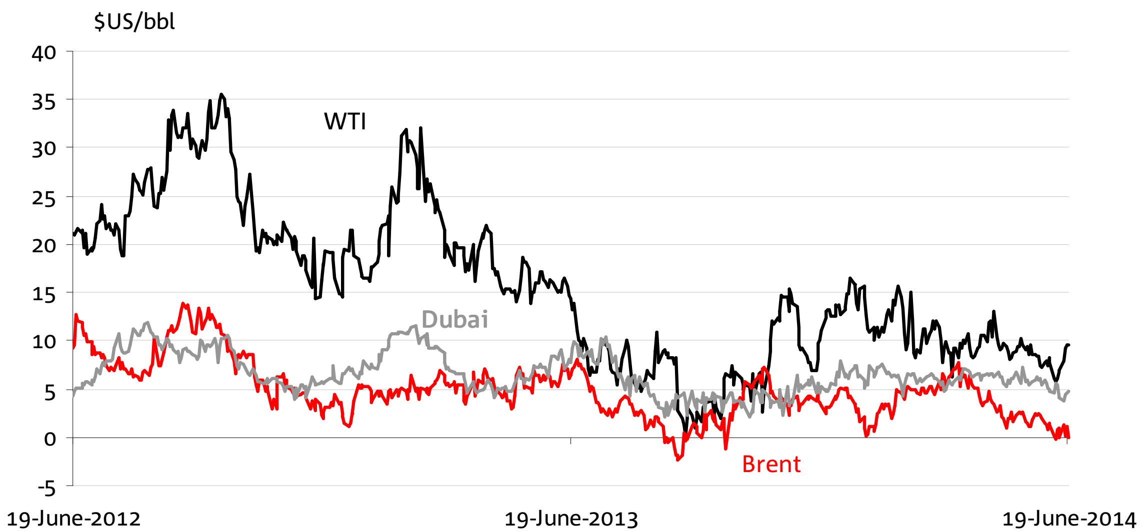
- Oil exports from the US have been heavily restricted since the 1970s oil crises, but with oil production rising swiftly there is increasing pressure for the US Government to relax or entirely remove these restrictions. The US government is now permitting the export of lightly processed condensate, which may allow exports to increase further over the coming year.

Figure 6: US commercial crude oil stocks



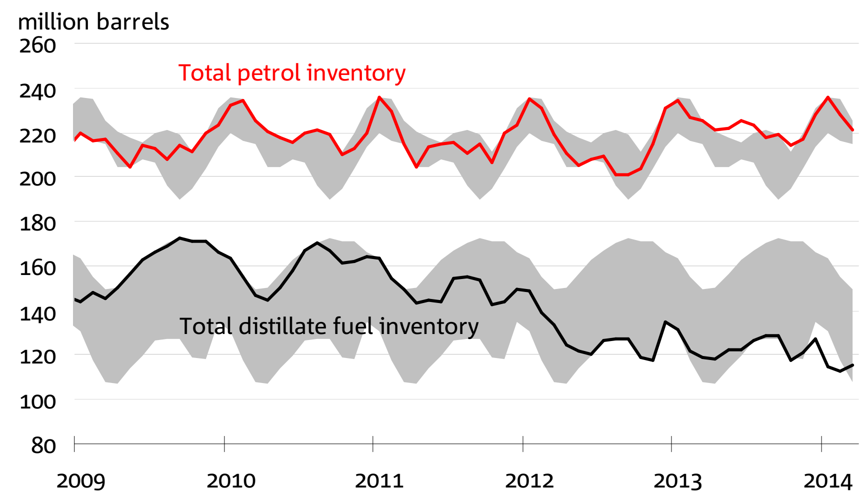
Note: Grey band around storage levels represents the range of monthly average minimum and maximum levels from Jan. 2008 - Dec. 2012
Source: US Energy Information Administration

Figure 7: Refining margins



Source: Thomson Datastream

Figure 8: US petrol and distillate inventory



Note: Grey band around storage levels represents the range of monthly average minimum and maximum levels from Jan. 2008 - Dec. 2012
Source: US Energy Information Administration

Demand side factors

- Recent US economic data has been mixed. The economy is now estimated to have gone backwards in the March quarter due to an estimated slowdown in inventory accumulation and an unusually harsh winter. In May, unemployment remained unchanged at 6.3% although employers added 217,000 jobs in the month. Indicators point to a bounce back in the June quarter, with recovery expected to continue over the rest of 2014 and into 2015. We expect growth of around 2¼% this year and 3% in 2015.

- QE tapering is expected to continue through 2014 with the asset purchase program to end in the December quarter. No change in the fed funds rate is expected until around mid-2015. The risk is that when tightening starts it will be quicker than expected.

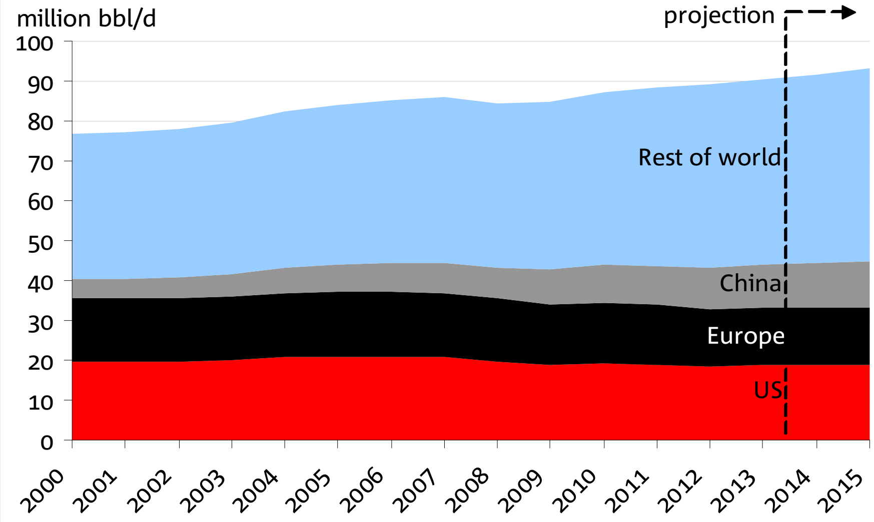
- In the June quarter, US petrol and distillate consumption is up on average compared to the same period in 2013. The 12 month average change in product demand climbed into positive territory in August 2013 for petrol and September 2013 for distillate and has continued to climb over 2014.

- Partial economic indicators point to a stabilisation in China's economy in recent months. This has been reflected in Chinese oil imports, which stood at 26,082 th tons in May, up 2,132 th tons compared to the previous May. Refined product imports continue to decline as China increases refinery capacity.

- Elsewhere, Eurozone manufacturing and service sector PMIs showed the European recovery stalling in June, with activity slowing rather than accelerating as expected. Moderate sub-trend growth continues across the emerging market economies of East Asia.

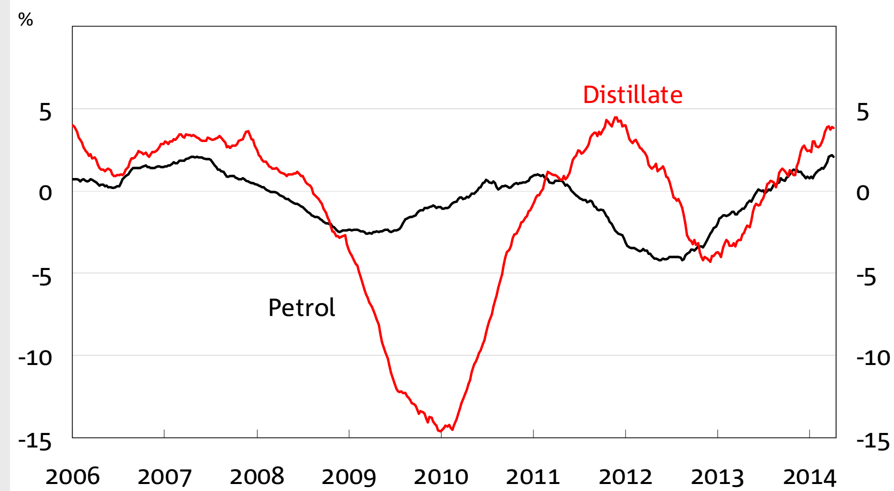
- The EIA forecasts that world liquid fuels demand will increase 1.3 million bbl/d to 91.8 million bbl/d in 2014 and 93.1 million bbl/d in 2015. The International Energy Agency forecasts, somewhat more bullishly, that demand will increase to 92.8 million bbl/d in 2014, but does not provide a 2015 forecast.

Figure 9: World liquid fuel consumption – EIA projection



Source: US Energy Information Administration, NAB Group Economics

Figure 10: Weekly US product demand: 12 month average percentage change



Source: US Energy Information Administration, NAB Group Economics

Price outlook: market expectations

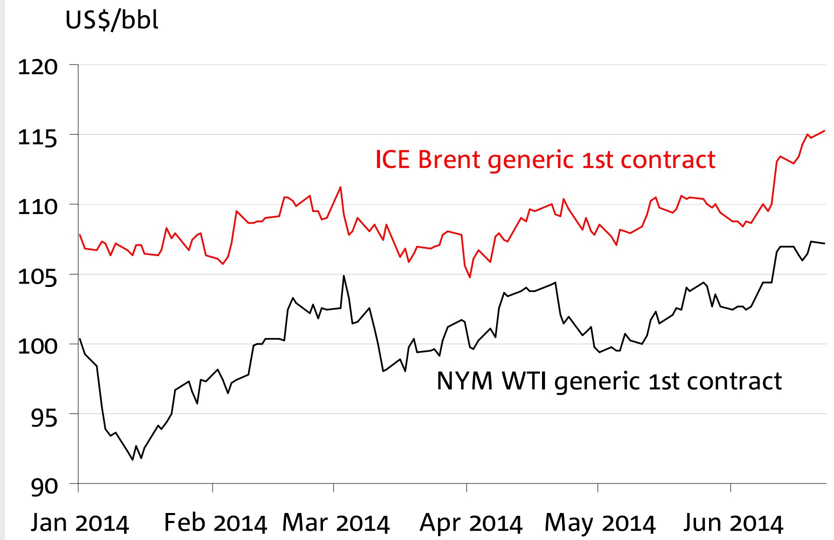
- The EIA projects that supply growth is likely to exceed demand growth over the next two years, pointing to moderately lower crude oil prices. Market fundamentals point to moderately lower prices over the medium term.

- The CBOE crude oil volatility index, which measures market expectations of crude oil price volatility over a 30 day period, has generally continued a downward trend over the June quarter to 15.6 at the end of May, with a spike to 18.8 on 20 June caused by Iraq. Nonetheless, the index remains at close to its lowest level in five years and has begun to subside in the week following 20 June.

- After remaining stable for most of the June quarter, futures prices jumped in mid June. The ICE Brent generic 1st contract surpassed US$115 per barrel, having previously been range-bound between US$105 and US$111 per barrel in the first two quarters.

- Backwardation of WTI futures increased in late May as inventory withdrawals from Cushing increased due to improved takeaway capacity. The US government is now permitting the export of lightly processed condensate, which could further narrow the WTI-Brent spread.

Figure 11: Brent and WTI generic contracts



Source: Bloomberg

Figure 12: CBOE crude oil volatility index (OVX)

Source: Bloomberg

Oil price outlook: NAB forecasts

- The deterioration in the security situation in Iraq has the potential to send the price of crude considerably higher. This could trigger higher Saudi Arabian production and possibly even a coordinated release of International Energy Agency emergency stocks. This risk is balanced against the minimal impact on Iraqi supply thus far and the deployment of US advisers and air power.

- We consider that absent geopolitical factors, crude prices are likely to moderately decline over the medium term as supply growth exceeds demand growth.

- On balance, our central case forecast is for Brent to rise to US$112/bbl in the June quarter before declining. Our central case for WTI is for a lower peak of US$104/bbl in the June quarter, with underlying growth from the December quarter 2015 as the WTI-Brent spread declines in line with higher US exports. These estimates are based on a minimal supply disruption in Iraq.

- We forecast that petrol prices will fall to 149 c/litre in the June quarter and 148 c/litre in the September quarter before climbing in the December quarter and continuing to climb in 2015 as the AUD declines against the USD.

- The 2014-15 Commonwealth Budget proposed the reintroduction of fuel excise indexation. The measure faces headwinds in the Senate, where it is likely to be opposed by the ALP and much of the crossbench. If it becomes law, indexation would have a small impact initially, increasing over time.

	Spot	Actual	Forecasts							
	27/06/2014	May-14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
Brent (US$/bbl)	114	108	112	111	107	105	105	105	105	105
WTI (US$/bbl)	106	99	104	103	101	100	100	100	101	102
Tapis (US$/bbl)	116	114	115	114	111	109	109	109	109	109
Singapore gas oil (AUc/L)	NA	NA	82	79	76	75	76	76	76	76
Petrol* (AUc/L)	NA	151	149	148	151	152	153	154	155	156

Source: NAB Economics, RACQ, Thomson Datastream

Group Economics
Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities
Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Phin Ziebell
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

Industry Analysis
Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

International Economics
Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research
Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia
Economics
Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Equities
Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand
Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe
Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Senior Credit Strategist
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532