Oil Market Update

National Australia Bank

- **Oil prices weaken in March, reflecting European crisis fears following Cyprus deal, a recovery in North Sea oil production and a return of South Sudan oil exports. Most notable declines were recorded for Brent and Tapis oil.**
- **Global oil demand forecasts for 2013 revised down reflecting marginally lower expectations for global growth on the back of higher uncertainty about the stability of the euro.**
- **We remain relatively optimistic about the outlook for oil prices. The impact of stronger global demand on prices is expected to outweigh the effect of improving supply-side factors over 2013, even when taking into consideration the likelihood of tightened supply from the Middle East.**

Recent Oil Prices

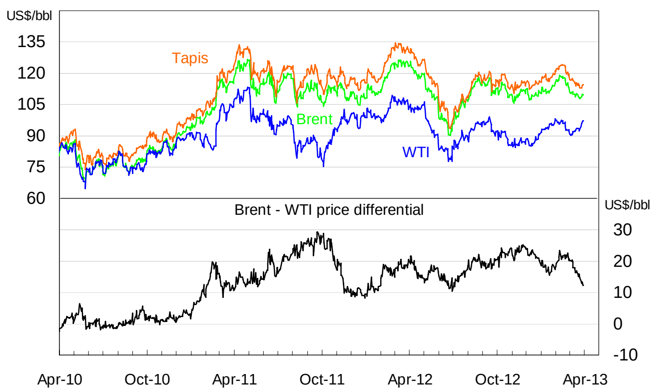
Average oil prices retreated heavily in March despite a price recovery towards the end of the month. The decline in average oil prices followed four months of consecutive rises. Average prices of Brent and Tapis fell by around 6% over the month, to be currently US$110/bbl and US$115/bbl respectively, while the average price of WTI fell by a more modest 2%, to close at around US$97/bbl. The relative strength of WTI compared to Brent over the past month has largely reflected the decline in oil reserves at Cushing – the delivery point for the US benchmark – even despite an overall rise in US stockpiles. Furthermore, European refinery maintenance has lowered demand for Brent, while a surge in North Sea production has also weighed on price. As a result of these relative shifts, the Brent-WTI spread has narrowed to its lowest level since July 2012, to around US$12/bbl.

Oil Prices

	Avg Price (US$/bbl) Mar-13	Monthly % change Mar-13	Mar-12 - Mar-13 % change
Brent	110	-5.9	-12.1
WTI	93	-2.2	3.2
Tapis	115	-5.8	-17.1

Sources: NAB Economics; Thomson Datastream

Daily Oil Prices



Source: Thomson Datastream

Demand for energies dissipated over most of March, with renewed fears of a worsening European crisis weighing on the outlook for the global economy. The announcement of the unprecedented levy to be imposed on Cyprus bank deposits in order to secure bailout funding from the EU saw an immediate pull back in demand for oil, as market participants grappled with the potential consequences of such a move on other already fragile euro-zone economies. The euro fell against the US dollar in response to the news, reducing the appeal of crude oil, while WTI prices dropped by as much as 1.8%. However, pressures to dilute the terms of the bank levy prevailed, with the levy to now only affect deposits greater than 100,000 euros and which are not guaranteed by the state under EU law to be frozen and used to recapitalise the Bank of Cyprus. While the softening of these terms may have been expected to result in a partial unwinding of recent oil price declines, this did not happened, with market participants remaining weary on the knowledge that European authorities are willing to take away individuals' assets to help recapitalise the banking system. More recently, prices of WTI have turned up on signs of an improving US economy; orders for US durable goods rose by more than expected, boosted by automobiles and a bounce back in commercial aircraft. Confirmation that the US economy grew faster than initially expected in the fourth quarter of 2012 provided more confidence around the outlook, helping to strengthen prices. However, the US ISM manufacturing report posted an unexpectedly large drop in March, suggesting the road ahead will not be without volatility. The generally better than expected data suggest the recovery in the world's largest economy may be gaining momentum, which should be supportive for future oil demand.

There has been plenty of interesting news on the supply side of oil over the past month, such as a the recovery in North Sea oil production, the return of South Sudan oil exports, as well as a build up in US crude inventories. Partly offsetting these supply side gluts was a labour strike at the Gialo oil field in Libya, which reportedly took around 120,000 barrels of crude oil per day off the market, as well as production problems at the Buzzard field in the UK sector of the North Sea. Ongoing geo-political conflict in the Middle East and Gaza strip is expected to provide underlying support to prices over the forecast horizon.

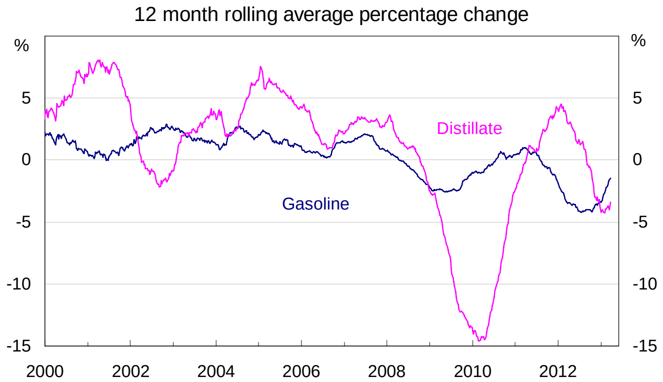
Market Conditions

In its March Oil Market Report, the International Energy Agency (IEA) marginally revised down its expectations for global oil demand for 2013, to 90.7 mb/d, largely reflecting slightly weaker global macroeconomic expectations, changed methodology for the estimate of Chinese apparent consumption and reduced US and Saudi Arabian consumption due to weather related events at the end of 2012. In March, OPEC left its estimate for 2013 crude oil demand growth unchanged from the previous month, at 800 kb/d. A large proportion of this demand is expected to come from China, while OECD demand is expected to moderate over 2013. The OECD sees average world oil demand growth of 89.7 mb/d in 2013, which is a little softer than anticipated by the IEA. Risks remain skewed to the downside, however, with the potential for instability in the euro area to fracture growth in some

Mediterranean countries. Furthermore, US fiscal tightening could cause slower than anticipated global growth, while a sudden change in Japanese policy around nuclear reactors could also cause a reduction in oil demand. As such, any changes to global oil demand forecasts are likely to be down.

Latest data show that demand conditions in the US crude oil market are still soft at present. January 2013 was colder in the US than it was 12 months prior, resulting in more heating oil consumption at the beginning of this year, though this was more than offset by a fall in distillate fuel oil and residual fuel oil demand – a trend which continued into February. Looking ahead, it is likely that the impacts of fiscal tightening on US demand will restrain US oil consumption. While industrial production (IP) activity remains fairly soft, which is important for product demand, it did strengthen in February (up 0.8%), following little growth in industrial production in January. This outcome was broadly consistent with US manufacturing IP, which increased by 0.6% in February. This softness is quite evident in demand for middle distillates, which trended lower for much of the second half of 2012; the pace of decline in demand did ease over the year to February 2013 but overall weakness is still present. Looking ahead, very modest growth is expected, in line with the anticipated moderate recovery in global growth, with recent forecasts by the US Energy Information Administration (EIA) pointing to a 0.3% rise in distillate fuel oil consumption in 2013.

Weekly US produce demand

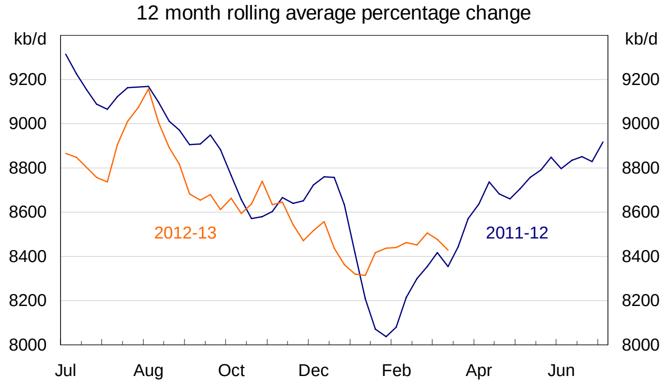


Sources: US Energy Information Administation; NAB Group Economics

While US gasoline consumption remains weak, the decline in consumption has decelerated over the past six months. US gasoline consumption was down 1.6% over the year to February, though it showed some improvement in the month of February, rising by 0.2% (seasonally adjusted). This was the second consecutive monthly rise and suggests that US consumption growth may recover modestly in the first half of 2013 following a period of prolonged weakness. Providing support to this expectation is the recent softening in fuel prices, as well as a strengthening in household wealth due to rising equity prices and a steadily improving housing market, with the highest annual price growth reported in more than six years in January. However, US consumer confidence was volatile in March, after rising sharply in the previous month; the March outcome probably reflected the implementation of the government's sharp sequester budget cuts, although it appears that confidence lifted towards the end of the month as concern over the sequester effects faded.

While the US consumer sector appears to have improved in the early months of this year, it is not necessarily the case that gasoline demand will strengthen as a result. According to consumer confidence data, the US consumer remains concerned about the impact of tighter fiscal policy on economic activity, keeping worries about job security and tax increases in focus. Nonetheless, US auto sales continued to climb in February, with light vehicle sales up by 6.1% over the year, though with new automotive stock far more fuel efficient than existing stock (due to increased sales of small-to-medium vehicles and mandates on fuel efficiency), consumption per vehicle is declining. Taken together, US motor gasoline consumption should remain relative flat through 2013, at 8.71 mb/d according to recent EIA forecasts.

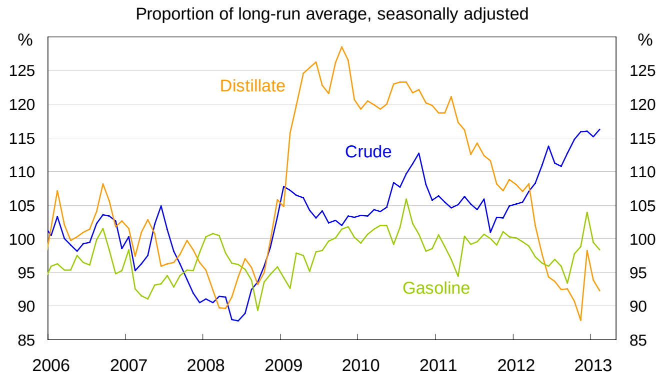
US Apparent Gasoline Demand



Sources: US Energy Information Administation; NAB Group Economics

Changes in US crude oil and product inventories were mixed over February. Crude oil inventories continued to trend higher in the month, to be around 16% above the series long-run average. The rise in inventories possibly reflects a resumption of exports from South Sudan, which was recently agreed to after Juba shut down its entire output for more than a year. In contrast, distillate and gasoline inventories fell solidly in February, to be around 8% and 2% below their long-run averages, respectively. Despite rising inventories, US exports have continued to strengthen in March; it is likely that the recent reduction in Nigerian oil exports as a result of the resurgence in oil theft on the pipeline network has increased demand for US oil exports, while increased energy consumption from Japan and China are also likely to be having an effect. More generally, substitution towards US natural gas as an energy source continues to free up oil supplies for export.

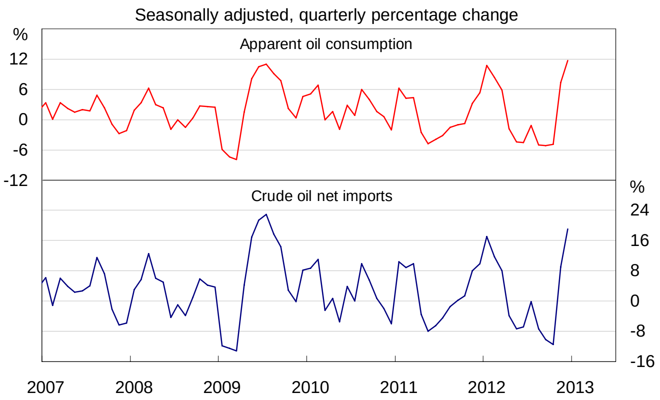
US Inventories*



* Observations for January and February 2013 are EIA estimates
Sources: NAB Group Economics; US Energy Information Administration (EIA)

Chinese data have generally disappointed relative to expectations in early 2013 casting some doubt on the prospect of a rapid recovery in the economy in the first half of this year. A sharp decline in Chinese imports has raised questions over the strength of domestic demand, although it is still difficult to interpret data due to Lunar New Year effects. Nonetheless, external demand has been a surprisingly bright part of the economy in recent months, with the trade surplus coming in above expectations in February (at US$15.3bn). Industrial production eased in the first two months of this year, broadly in line with a softening in manufacturing PMIs, although flash estimates are showing signs of improvement in March. The auto industry is continuing to gain momentum with growth picking up to 12.4% year-on-year (adjusted for LNY). On the public front, government investment stimulus appears to have been scaled back a little over recent months with central government spending growth clearly slowing. Nevertheless, our estimates of fixed asset investment growth show that investment momentum has remained steady, and the National People's Congress confirmed that the government will maintain its proactive fiscal policy stance. On the household side, nominal retail sales growth has remained relatively disappointing, decelerating to 12.3% over the year, which is at odds with the recent improvement in consumer confidence. However, fixed asset investment still appears reasonably resilient, even despite the recent introduction of curbs in the real estate sector by the government in an attempt to prevent a property price bubble. While we are yet to see a complete turnaround in the Chinese economy, we still see Chinese growth strengthening to around 8¼% over 2013, albeit with increased downside risk.

Chinese Crude Oil Demand



Source: Thomson Datastream

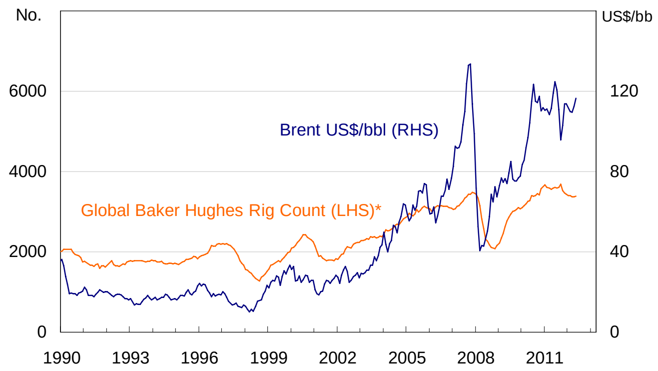
The latest data on oil demand have been surprisingly strong given the relative softness in Chinese economic indicators. Growth in apparent crude oil demand as well as net imports of crude oil lifted sharply in the final month of 2012, to be growing at close to levels last seen in early 2009, when the government was heavily stimulating the economy following the global financial crisis. However, the strength in oil consumption partly reflects the temporary seasonal stockpiling of inventories in the lead up to the Lunar New Year (LNY) in February. Given that prices of oil have moved higher in 2013 and that we will see some unwinding of inventory build up in the post-LNY period, it is likely that consumption growth will fall back in coming months. Nonetheless, with Chinese manufacturing activity returning to a mildly expansionary phase, exports and domestic demand improving and auto sales growing strongly, oil consumption growth is expected to remain relatively robust over 2013.

On the supply side, non-OPEC crude oil production was up 167 kb/d in December, reaching 43.7 mb/d. This was mostly offset by a reduction in OPEC crude oil supply, which fell by 141 kb/d to 32.1 mb/d in the month as output from Saudi Arabia, Iraq and Libya fell. According to the EIA, non-OPEC liquids production is expected to increase by 1.2 mb/d in 2013, with North America accounting for almost three-quarters of the projected growth over the next two years because of continued production growth from US tight oil formations and Canadian oil sands. EIA projects OPEC crude oil supply to decrease by 0.4 mb/d in 2013, largely reflecting a pull back in production from Saudi Arabia in response to non-OPEC supply growth.

Exploration

After seasonal adjustment, the Baker Hughes global rig count was up by 0.3% in February, while over the year, the rig count was down by 5.8%. Exploration activity tends to follow prices with a lag of around six months, suggesting that prices having eased over the middle of 2012 are contributing to the recent decline in the rig count. With this in mind, we think it likely that the rig count will be fairly stable over coming months.

Crude Oil Supply Response*

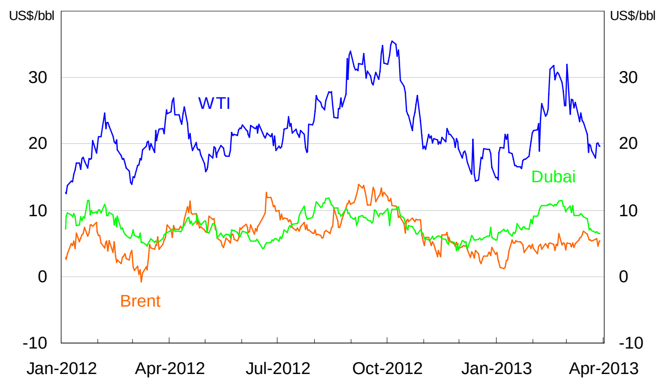


* Seasonally adjusted
Sources: Thomson Datastream; Baker Hughes

Product Markets

Refining margins have weakened significantly for WTI, with the WTI crack falling from a recent peak of US$32/bbl at the beginning of March, to be currently below US$20/bbl. The widening in the WTI crack largely reflects elevated crude supplies, which have risen to the highest level in nine months. Middle distillates crack has also fallen since mid-February, while refining margins have remained broadly unchanged at a low level for Brent. Brent margins have come under pressure over recent months reflecting less competition among US East Coast refiners due to falling prices of US inland domestic crude oils. While previously East Coast refiners had little alternative but to close down operations on higher prices of Brent, they now seek rail access to low-cost inland domestic supplies.

Refining Margins

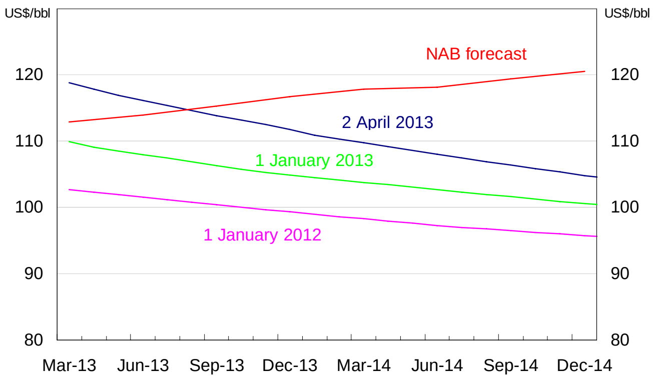


Source: Thomsons Datastream

Futures Prices

Future curves for Brent crude oil have shifted up over the past year or so, pointing to the continuation of a market concerned about near-term supply on the back of geo-political risk. This is reflected in the Brent crude futures curve, which remains in backwardation, the steepness of which has increased a little since the beginning of the year.

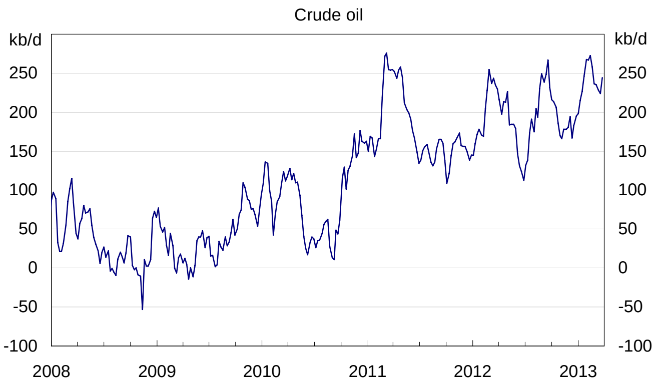
Brent Crude Oil Futures Curves



Sources: Bloomberg; NAB

Reflecting pricing along the forward curve, net long positions held by managed money have declined since the middle of February. According to Bloomberg data, net long positions are down almost 30 kb/d since peaking in mid-February, although at around 245 kb/d, remain quite elevated. Essentially, the position of managed money in the market means that there remains potential for further sell-offs should fear about European crisis worsen or geo-political risk factors dissipate. Overall, the recent decline in net long positions implies limited near-term upside price pressures from somewhat elevated levels.

Net long positions held by non-commercial participants

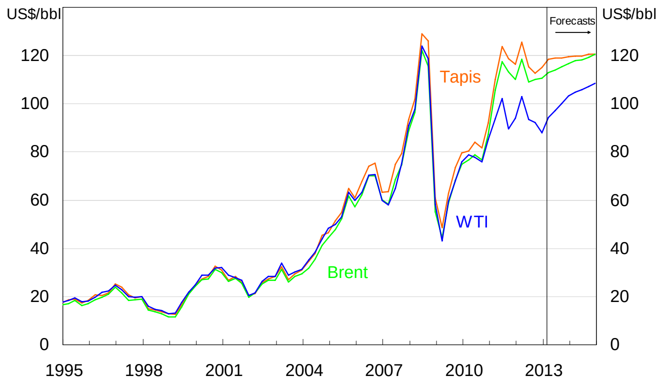


Source: Bloomberg

Oil Price Outlook

We remain relatively optimistic about the outlook for oil prices, with technical and economic indicators pointing to more robust global demand compared to last year. On the supply side, improving production from non-OPEC countries is expected to more than offset reduced supply as a result of continued geopolitical tensions, which will dampen price rises. We have kept our forecast for Brent prices unchanged from our last update a month ago. We expect to see continued conflict from the Gaza strip adding to Brent prices in the near to medium term, but worries about a potential European crisis following the recent flare up in Cyprus as well as the impact of austerity on activity in many of the advanced economies will keep prices somewhat contained. Near-term prices of WTI have been lifted marginally reflecting the recent decline in oil reserves at Cushing as a result of North American producers avoiding selling crude via the Cushing delivery point. We expect inventories at Cushing to recover over time but WTI prices may continue to benefit from the shortage in the near term. The gap between Brent and WTI prices is expected to gradually narrow over the year ahead. Overall, we see the price of WTI lifting to around US$103/bbl over 2013, while the price of Brent is expected to lift to around US$117/bbl by the end of the year.

NAB Oil Price Forecasts



Sources: Thomson Datastream; NAB Group Economics

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Quarterly Price Profile

Oil Price Forecasts – Quarterly Average Terms

	Actual	Forecasts						
	Mar-13	*Jun 13*	*Sep 13*	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*
Brent US$/bbl	113	114	115	117	118	118	119	120
WTI US$/bbl	94	97	100	103	105	106	107	108
Tapis US$/bbl	119	119	119	119	120	120	120	120
Petrol AUc/L*	139	149	147	147	143	141	139	138

Sources: NAB Economics; RACQ; Thomson Datastream

*Estimate only; full quarter not yet available

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