



Creative Global Investments

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Objectivity
Integrity
Creativity

“Lower for Longer”

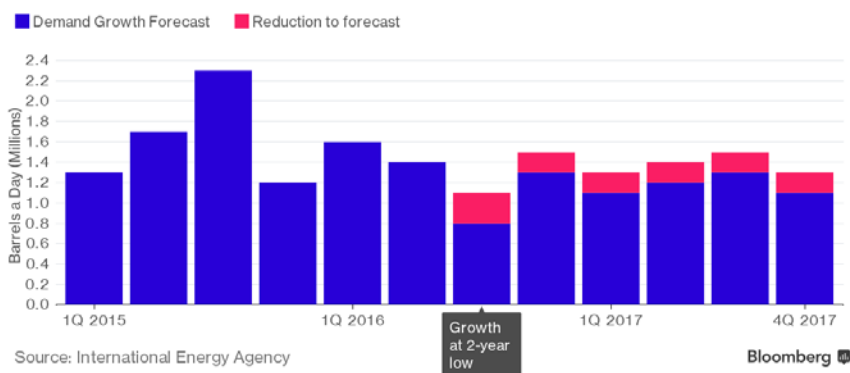
As oil slides toward \$40 per barrel, it must be time for the bulls to revive the rumor of an oil price freeze by producers. However, there will be no production freeze negotiated. This weekend’s informal meeting of OPEC and non-OPEC members coincident with an energy conference in Algiers will accomplish nothing. If OPEC couldn’t agree on a production freeze at \$26, what has now made it more likely to do so at \$46?

We’ve opined that the only way a coordinated production freeze can be reached is if the major producers become convinced that they [and all the others] were maxed out on capacity—making the implementation of a production freeze totally irrelevant. That’s hardly likely with Nigeria about to bring 500,000 b/d back on line, Iran trying to ramp production another 300,000 b/d and Libya claiming to double shipments from 300,000 b/d within a month along with another 350,000 b/d by the end of the year after a recent deal between Libya’s National Oil Company and the Libyan National Army. Anyway, mutual suspicion is far too high for a production freeze to happen.

The International Energy Agency trimmed projections for global oil demand next year by 200,000 barrels a day to 97.3 million a day. It reduced growth estimates for this year by 100,000 barrels a day to 1.3 million a day, citing a “dramatic deceleration in China and India” this quarter coupled with “vanishing growth” in developed economies. World oil stockpiles will continue to accumulate through 2017, a fourth consecutive year of oversupply, according to the IEA. Just last month, the agency predicted the market would return to equilibrium this year.

Consumption Conundrum

A surprise slump in demand growth this quarter means a longer wait for markets to rebalance.



Wednesday’s U.S. Energy Information Administration weekly numbers are likely to give traders another jolt. The consensus view is that crude inventories will decline by another million barrels while imports rise by a roughly equal amount. We believe that crude inventories will not decline but build as refinery shutdowns have reduced demand for crude and import shipments previously delayed due to Hurricane Hermine begin to reach port. Those imports have the potential to climb much higher than pre-storm levels now that seasonal temperatures in Saudi Arabia have peaked, providing the Saudis with the opportunity to redirect as much as 600,000 b/d to export markets as domestic demand fades. Distillates inventories will continue the recent pattern of substantial builds, calling into question the real state of the U.S. economy. A worse than expected inventory report could be the catalyst to send oil down to a retest of \$40 per barrel. In the aftermath of OPEC oil ministers emerging from yet another meeting with “nothing done” on a production freeze, a return of sub-\$40 oil looks assured.

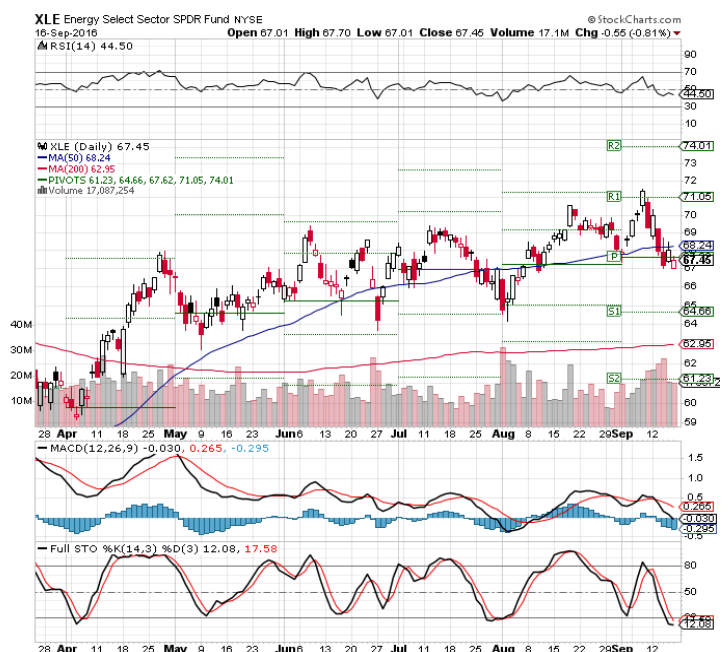
It is worth revisiting what we wrote back on August 17th: “Those oil bulls hoping for a sustained breakout in WTI crude oil prices beyond the current short-covering rally are destined for disappointment as refiners dial back output, domestic drillers continue to pump and imports flow unimpeded into the U.S. Inventories will stay elevated. As we’ve asked previously, if oil is headed higher over the next twelve months, why are producers so willing to hedge their output now after passing up the opportunity to do so last year at higher prices? As crude oil futures push up against overhead technical resistance just above \$47 on the daily chart, we expect prices to roll over and head lower.” And that is exactly what happened as seen in the adjacent chart. A break below \$40 is fast approaching.



The outlook for oil stocks has not improved from a month ago when we last commented on the sector. Oil looks like its headed lower to test \$40 and stock prices will typically follow oil prices. We see no reason to change our view that investors will soon be presented with a better entry point. Fading bullish sentiment for the sector has yet to bottom.

The mixed domestic economic data of the past two weeks has created doubt among market participants

about the vigor of the U.S. economy, which further chips away at market sentiment. The drop in oil prices could further depress market sentiment as trading gets underway this week (unless momentarily saved by the stray rumor of an oil production deal), pulling equity prices lower as uncertainty builds ahead of Wednesday's interest rate decision by the Fed. Should markets continue to be dragged lower heading into Wednesday's rate decision, we'd be tempted to buy the dip because it's not just oil, but interest rates that we believe will be "lower for longer". We've repeatedly stated that we expect the Fed to remain on hold until December, when it will execute a symbolic quarter point hike to retain credibility. If we're correct that the FOMC will also disclose an extension to its rising interest rate timeline (as we discussed in our US Strategy report last Thursday), the stage may be set for a sharp snap-back rally from oversold conditions as fear over shrinking liquidity and rising interest rates dissipates. However, as noted earlier, we would still expect oil stocks to underperform in the short term.



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