January 2016

BROCK ENERGY REPORT

CRUDE'S CONTINUED SLIDE PRESENTS OPPORTUNITY

The crude oil complex, which has been swept under by numerous negative fundamental and outside market forces, has reached peak bearishness. The market appears to have entered an "exhaustion leg" lower, an environment when seemingly everyone is convinced the market will continue to go lower. What then happens is the market runs out of fresh sellers, and a rebound occurs.

We think a rebound is on the way soon. The question is, when it does occur, and how much of a bounce will there be?

Before answering that, let's look at the factors that have driven the market so low in the first place. The overriding factor has been overwhelming supplies, due to the U.S. shale boom, and to continued increases in world production as no country wants to be the one to cut back and lose market share. World crude oil supplies expanded by 2.6 million barrels per day in 2015, following a 2.4 million increase in 2014 according to the International Energy Agency, which warns the world market could "drown in oversupply" in 2016. U.S. output remains stubbornly high.

These factors are not new and have been driving the market lower for months. A couple new developments in the past month, however, have sent the crude market below its 2008 bear-market lows to the lowest level in 12 years. One is Iran, whose agreement with western nations to end sanctions became official this month. That will soon lead to even more supplies in the world market.

The other factor is a pervading sense of gloom about the world economy. The drop in crude oil prices has in itself helped to create that atmosphere. But the main driver of this gloom is ongoing signs of a slowdown in China, and fears that weakness will continue spreading in developing nations and then the United States. That is further hurting the demand outlook for virtually all commodities, crude oil included.

Going forward, even with low prices, U.S. crude oil supplies are expected to exceed demand straight through 2016 and all the way to the third quarter of 2017, according to EIA. The rate of supply builds are expected to steadily decline during the period, but nonetheless the supply glut will be getting worse instead of better.

The bottom line is that while the market is in line for a potentially significant upward correction, there are too many fundamental factors in place limiting the upside. Barring a geopolitical event, the possibility of which can't be dismissed, it is tough to make the case for a strong market rally that will end the bear market.

THE MONTH AHEAD

Despite the market's downward slide, energy buyers focused on risk management should not be complacent. The current environment provides good pricing opportunities. Our focus is not on picking a bottom, but on this question: Are the markets in the bottom third of their price range for the year? With prices at their lowest level in more than a decade for crude and crude products, the answer is most likely yes.

Thus if you don't have any coverage currently, consider adding some, or at the least be poised to lock in prices quickly on signs the market is turning.

Our positions can change on a moment's notice, so stay in touch for our latest recommendations. Consulting and brokerage clients get ongoing updates with specific recommendations. If you are interested in examining the market in greater depth, consider hosting a Brock in-house energy market overview.

MIDDLE EAST TENSIONS RISE, COULD BE CATALYST

Traders returned from the New Year's holiday to news of inflamed tensions between Iran and Saudi Arabia, including the execution of a prominent Shiite cleric by the Sunni-led Saudi government and Iranians' storming of the Saudi embassy in Tehran in response. Perhaps this was the catalyst the market needed, to spark short-covering and put a bottom in the market?

Obviously that turned out not to be the case. The rally in the first trading day of the new year didn't last the whole morning before prices sunk back into negative territory. It was another sign that the world is not as worried about oil supply security as in the past.

However that does not mean the region does not bring with it the potential for a major market disruption that rallies prices. While the recent flare-up between Iran and Saudi Arabia receded quickly, the situation in those countries and across the Middle East is getting more intense.

Tensions between Iran and Saudi Arabia quickly died down in this instance, but if a military conflict broke out the market would not be so comfortable with the supply situation. There are other threats to the region's stability as well, including the impact of low oil prices on Saudi Arabia's budget. The country has huge cash reserves, but it is burning through them at an increasing rate. If that continues, the government would have to cut back its social programs, a move that could foster instability. Any threat to Saudi rulers would be a game-changer for the market, and while that may seem unlikely, the "Arab Spring" that led to the ouster of several governments in the region also occurred out of the blue. Growing terrorism threats and the emergence of ISIS add an element of instability.

If you are a trader, be aware of the potential for conflict to break out. For risk managers, take this potential into consideration as you set your coverage levels. If the market reverses course on Middle East tensions, the rebound could be sudden and pronounced.

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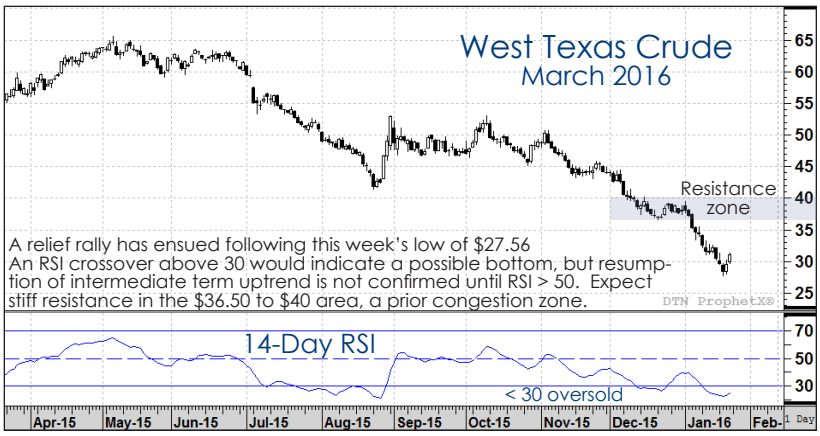
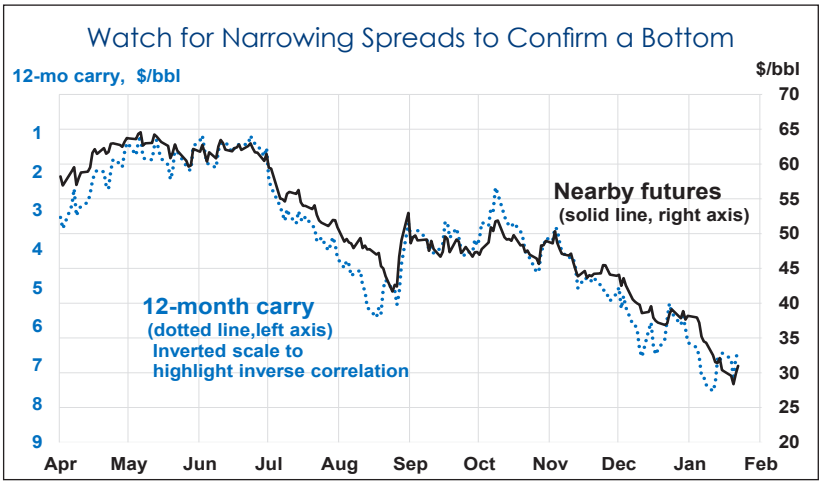
CRUDE OIL

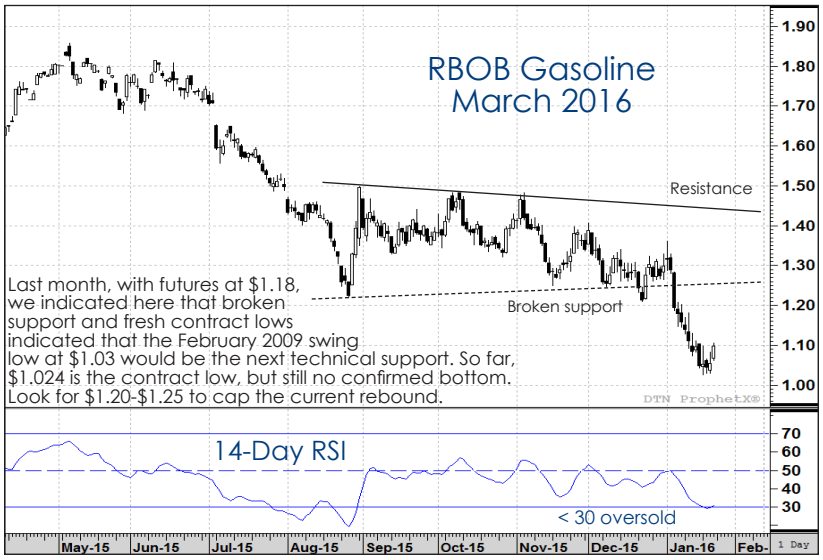
Months of wondering whether U.S. crude oil prices could take out their 2008 bear-market lows came to an end as prices crashed through that level and below $30 to a 12 1/2-year low. The world economic slowdown is causing supplies of energy and other resources to balloon. Technically, nearby futures have continued to lose ground versus deferred contracts, and until this spread starts to narrow there is no sign of a bottom. Prices are attractive, but locking in supplies in deferred months is complicated by their premium to spot prices. If the market rebounds, resistance is in the $36.50-$40 area.

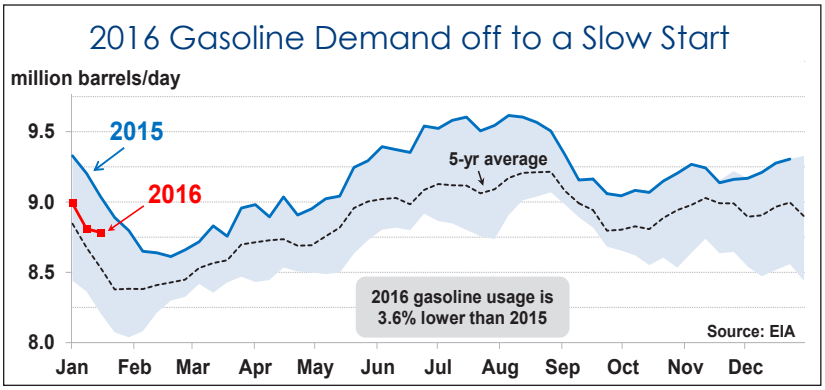
As noted on page 1, EIA expects crude stockpiles to continue to swell. However note that EIA did not predict the tremendous surge in U.S. production that sparked the bear market last year. It is possible that U.S. production starts to contract quickly and takes the market by surprise. It is also possible that the slowdown in the world economy is not as bad as feared.

However these are possibilities, not probabilities. World supplies are burdensome and while OPEC output did dip modestly in December, Iran is promising to boost output by 500,000 barrels per day as sanctions are lifted. IEA expects much of that increase to occur in the current quarter.









GASOLINE

With swelling supplies and falling demand, 2016 is off to a bad start for gasoline bulls. Inventories have exploded, with large increases each of the past three weeks, including a dramatic jump of 10.6 million barrels in the week ended Jan. 1. Stockpiles in the most recent week were up 1.7% from a year ago, and up 5% from the five-year average. (see page 6)

U.S. gasoline demand has started to falter. It has been below year-ago levels for five of the past seven weeks, long enough to indicate a change in the trend after demand ran above year-ago levels for most of 2015. With U.S. car sales setting a record in 2015, the weaker demand may partially be due to newer, fuel-efficient cars hitting the road. Whatever the reason, it is a sign that the demand response to cheap gas may not be dramatic.

Technically the market has not yet shown signs of making a bottom. Fundamentally, a question is whether the U.S. economy starts to suffer from the weakness in China and elsewhere. That would further hurt demand. Near-term, blizzard conditions on the East Coast could hurt usage. Also note that despite the robust U.S. output of crude and petroleum products, crude imports are up 9.6% from the same four-week period a year ago.

TREND: Lower.

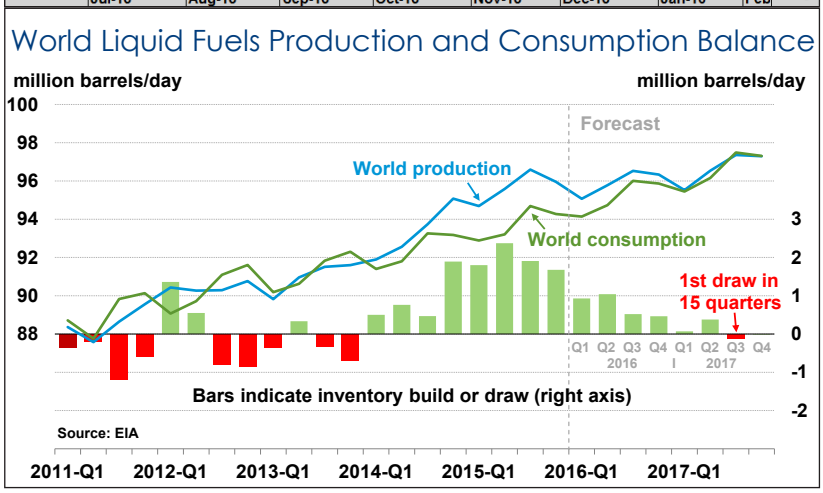
HEATING OIL

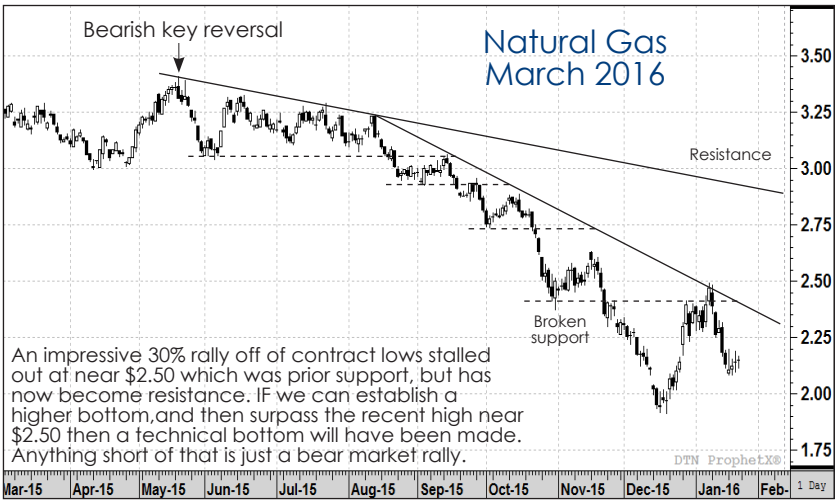
This was the first market in the crude complex to break through its financial crisis lows, and while it leveled off in the second half of December, just as it had in the second half of November, the downward slide resumed as the calendar turned to 2016. Finally, on Jan. 21 the market posted a bullish key reversal, and with some follow-through the market now has some potential underlying support at 86 cents.

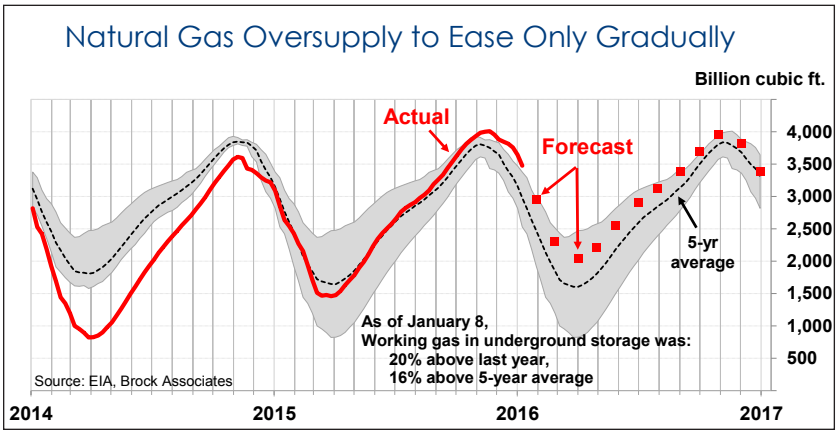
While speculators may ride the trend, hedgers need to weigh the risk at these levels. How much downside risk is left? In our view the upside risk is greater. Often the time to buy isn't when you think the market is about to rally, but when you think it is done going lower. However with distillates inventories about 20.5% above the a year ago and 17.3% above the five-year average, there is certainly a limit to the upside as well.

A more normal winter weather pattern may help stabilize the market as heating demand rises. U.S. distillates stockpiles did decline in the week ended Jan. 15 for just the second time in two months. As the chart at right shows, total world liquid fuels supplies are not expected to contract until the third quarter of 2017, which would be the first drawdown in 15 quarters.

TREND: Lower.







NATURAL GAS

Natural gas rebounded off a 16-year low, rallying through the holiday season and first week of January before retreating. A more normal winter weather pattern following an unseasonably warm start helped underpin the market, and the rally was fed by short-covering amid oversold conditions. While this market has showed some signs of making a bottom, confidence in that remains low until it takes out its January high at $2.50.

The seasonal drawdown has begun, but as the chart at left shows the EIA forecast is for supplies to bottom out above the levels of the past couple years, setting a higher base as stockpiles build again. Supplies at the end of the winter heating season (March 31) are expected to be 38% higher than year-ago levels. That will keep the market under pressure as natural gas production is expected to increase slightly again in 2016 according to EIA.

However there has been a strong demand response to weak prices, particularly from the industrial sector. EIA projects demand increases of 3.5% in 2016 and 2.5% in 2017 as new fertilizer and chemical plants come on line.

TREND: Despite the holiday season rally, the trend remains lower with no bottom confirmed yet.

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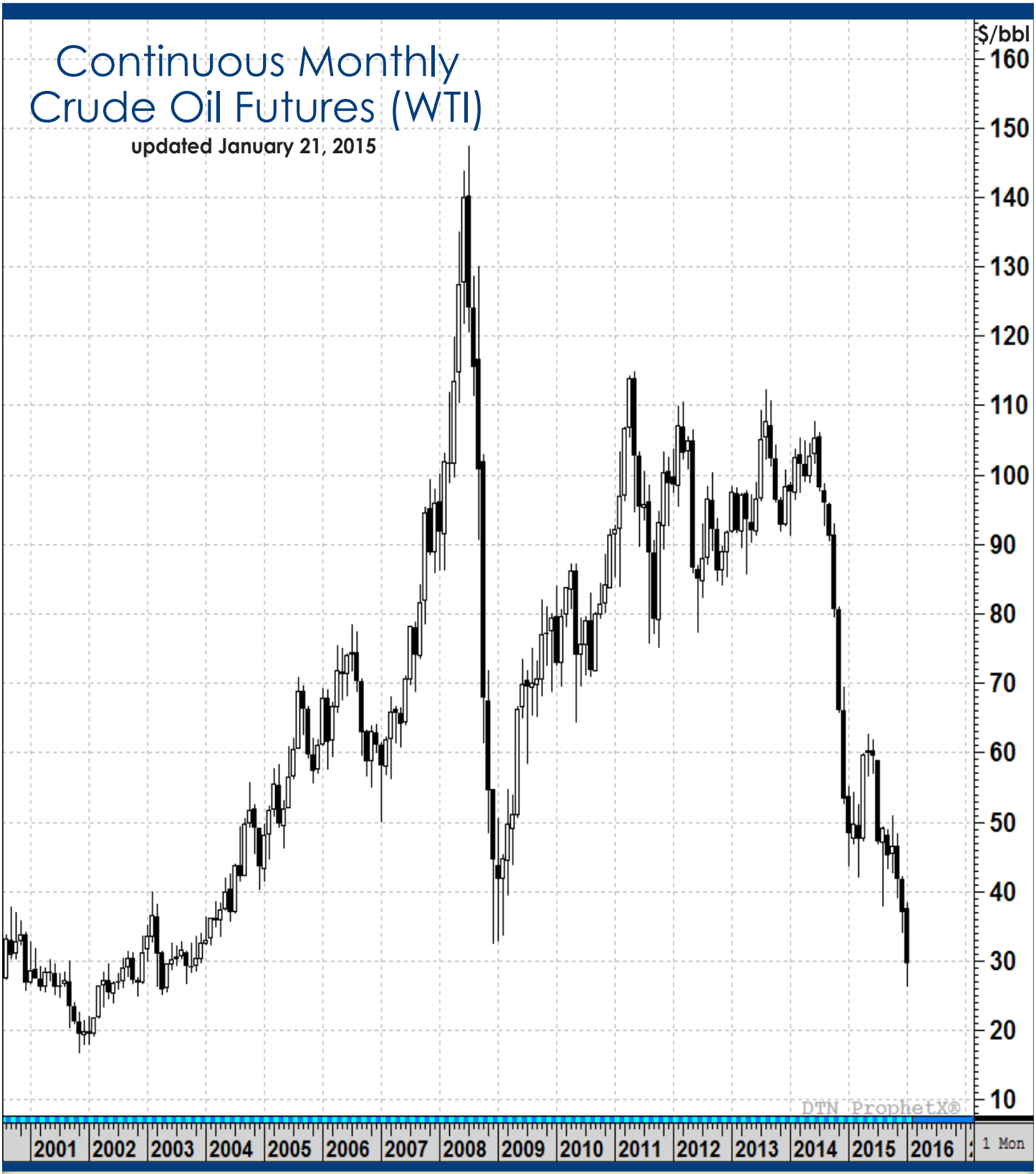

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