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Market Facts

Crude Oil's Forward Curve, Inventories & Price

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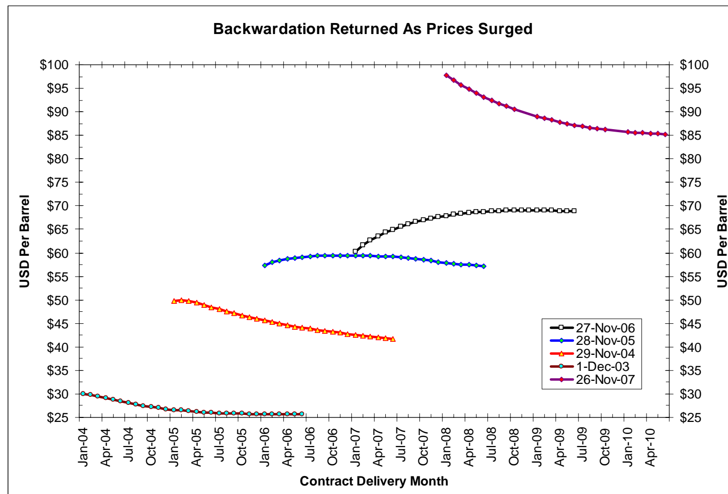
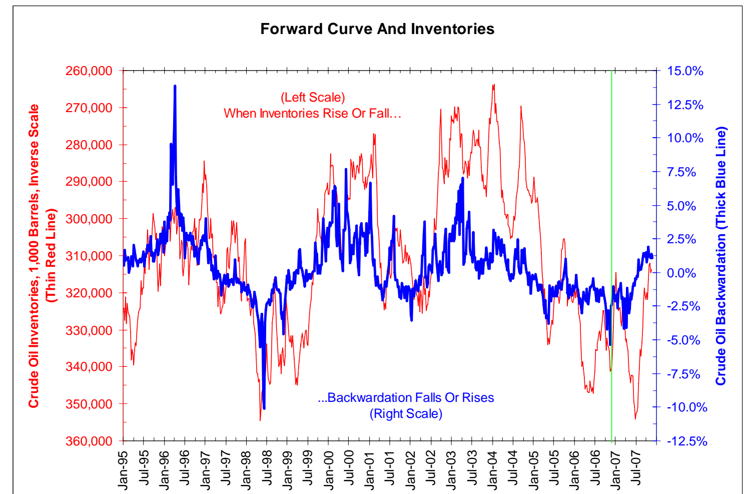
We concluded an identically entitled November 2006 Market Facts (original boldface):

> *The global refining picture is capacity-constrained. Restated, it would be illogical for producers to compete on the basis of lower price as refiners are unable to increase throughput.* ***Inventory accumulation is providing the bid at the margin at present, which in turn is supporting price.***
>
> *This must be news to those who report the latest inventory data so breathlessly.* ***Rising inventory levels represent demand, not supply to be disposed of at a lower price.***

That analysis explained why the first thirty months of the forward curve of crude oil futures in 2006 (black line with white markers, left-hand chart) were in contango. Financial theory holds an extracted commodity such as crude oil should rise in backwardation.





Conclusion

We have returned to backwardation for the 2007 forward curve (purple line with red markers in chart above). This should mean the inventory accumulation noted in 2006 (thin red line, inverse scale, right-hand chart) should have reversed into a drawdown, and that has been the case. U.S. inventories are now 27 million barrels per day lower than they were a year ago (green vertical line).

As we noted in an October Commentary, the combination of increased backwardation (thick blue line) and narrower refining margins is going to keep global inventories under destocking pressure.

The ability of oil producers to increase production significantly is constrained in the short-term and is less than the potential demand growth vector in the long-term.

What we have seen over the past four years is a situation where rising refining margins and deeper contango put an inventory-building bid under the market…and a situation where falling refining margins and deeper backwardation coincide with rising consumption to put a demand bid under the market.

If it seems that prices are going to rise regardless of refining margins and the forward curve, that is correct barring one of two developments. The first exists only in a fantasy world, and that is global petroleum production moves to a higher level and stays there. The second is a deep global recession that cuts demand growth.

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