

Oil price outlook and prospects for Exploration and Production stocks in 2011

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Almost all commodities sectors boomed in 2010 as demand from China, India and other industrialising economies continued to grow. We expect that demand for energy from the same regions will continue to be strong in 2011 while supply could remain constrained. The industrialisation of regions of the scale of China and India alone consumes ever-increasing volumes of base commodities and energy, and the large infrastructure programmes which have started will take several years to complete.

Some base metals saw new all-time highs in 2010 whereas oil prices were relatively range-bound until the last month of the year when they started rising strongly. We suspect that this recent surge was due to speculative activity rather than physical demand as oil presented a more attractive relative-value investment than copper or other base metals. Investors looking for alternative stores of value to potentially depreciating dollars have been buying commodity related instruments throughout the year and the announcement of QE2 only encouraged such behaviour further.

A historical correlation exists between changes in the oil price and changes in OPEC production. Some may think it counter-intuitive but OPEC production is a lagging indicator for crude oil prices. When prices rise, OPEC members increase their "quota cheating" thus the cartel's output grows. We believe that OPEC supply will grow in 2011 but demand from Asia will absorb any surplus. Oil prices may, therefore, trade in a higher range next year of between \$75-\$105/barrel. Notwithstanding any volatility due to speculative activity and changes in investors' sentiment, the trend for oil prices remains up.

This should be good news for companies involved in exploration and production activities. Higher average prices mean expanded profitability for producers and greater interest in funding exploration programmes for new deposits. Shares, therefore, of smaller companies controlling large reserves, growing production, strong balance sheets and active exploration programmes should perform particularly well.

Risk warnings

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