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Oil's year-to-date rally defies declining demand

Commodity gains 50% this year, in spite of 19-year high in U.S. stockpiles

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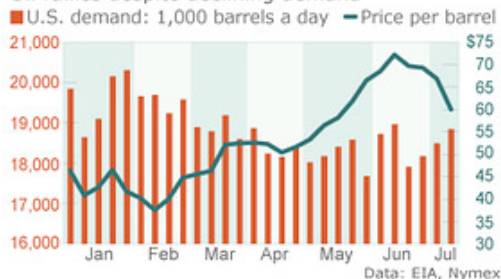
NEW YORK (MarketWatch) -- Weak demand and rising surpluses are increasingly raising questions about what's behind the 50% rally in oil prices this year, just days before market regulators are scheduled to hold hearings on how to limit speculation.

Declining demand in the U.S., the world's biggest oil consumer, has pushed up total inventories of crude oil, gasoline, and other petroleum products to the highest level in 19 years, an analysis of energy data showed. U.S. demand in the first half of 2009 was the weakest in a decade, while global consumption fell in the second quarter to the lowest level in four years.

The increasingly bearish fundamentals are raising concerns over the rally in oil prices. While some analysts say oil's gain was helped by hopes for an economic recovery, others believe it's speculation that has pushed oil higher, and a major correction could pull prices back to around \$50 a barrel.

Prices vs. demand

Oil rallies despite declining demand



Trading patterns in oil futures, jumping to almost \$150 a barrel last year, only to fall back to below \$40 this spring before rising again to \$70, have raised alerts in the Obama administration, which is preparing new rules to curb exotic derivative trading in financial markets.

The Commodity Futures Trading Commission, under the leadership of new chairman Gary Gensler, announced earlier this month that it's considering setting limits in the number of positions speculators can take in the energy futures market. [See full story.](#)

The CFTC will hold a series of hearings starting from later this month, according to David Gary, a spokesman for the Washington-based agency.

"With demand weak and inventories continuing to build, we feel any rally in crude will be short lived," said Tariq Zahir, managing member at futures trading firm Tyche Capital Advisors. Crude's gain is helped by the weaker dollar and speculation and "the fundamentals are largely being overlooked."

Already, since the start of this month, oil has pared part of its 57% gains achieved in the first half of the year. August oil futures closed at \$63.98 a barrel on Monday, down 8.5% this month.

On Tuesday's trading, the expiring August crude contract stood above \$64 a barrel. The United States Oil Fund lost 0.6% to \$34.61. [See Futures Movers.](#)

Oil is still up 43% this year. Mark Gilman, an analyst at research firm Benchmark Co., said oil could fall to the \$40 to \$50 level.

Total petroleum products delivered to the market, an implied gauge of demand, stood at 18.85 million barrels a day in the week ended July 10 in the U.S., according to the latest weekly report by the Energy Information Administration. That's nearly 7% lower than the end of last year.

Overall, in the first half of 2009, oil demand in the U.S. fell to an average of 18.75 million barrels a day, the lowest level in a decade, the Washington-based industry group American Petroleum Institute said last week.

Sluggish demand led to excessive inventories. Total petroleum stockpiles in the U.S. rose for a fifth week in the week ended July 10, standing at 1,115.7 million barrels. That's the highest level since September 1990.

The EIA is scheduled to release its latest petroleum data Wednesday. Analysts are expecting the data to show another week of weak demand and higher inventories.

"There was nothing fundamental supporting prices with consumption down from a weakened economy and inventories well above normal," said James Williams, an economist at energy research firm WTRG Economics.

Crude inventories in the U.S. have been declining in recent weeks, but the drop was more than offset by buildups in inventories of petroleum products such as gasoline and diesel.

While refiners drove up production during the summer driving season, gasoline demand largely fell short of their expectation. Some of the gasoline and diesel that the refiners produced ended up in storage, further boosting inventories.

Global oil demand also declined. The world consumed 83.1 million barrels a day of oil in the second quarter, down 3.7% from a year ago and standing at the lowest level since the third quarter of 2005, according to the International Energy Agency, an energy advisor to 28 developed countries.

"Global oil product demand is likely to contract sharply in 2009, despite the massive stimulus provided by loosened fiscal and monetary policies worldwide," the IEA said in a report earlier this month.

The agency said it remains "skeptical regarding the much-trumpeted" hopes of a demand rebound in the second half of the year, "even if China exceeds expectations."

The IEA also said it anticipates a modest demand recovery in the next year, but consumption will still "way below 2008 levels."

On the supply side, the Organization of Petroleum Exporting Countries, which controls about one third of the world's production, boosted its output in June for a third straight month.

The increase lowered OPEC's level of compliance with their agreed-on output cuts to 72%, according to a MarketWatch calculation. [See full story.](#)

Speculation boosts prices?

Speculators, meanwhile, have actively engaged in oil trading recently. They sharply reduced their long, or buying, positions on the Nymex in the week ended July 7, resulting in the biggest drop in buying positions in four months. [See full story.](#)

The position drop coincided with a 12% slump in oil prices in the same week.

The sharp drop is "not surprising given the recent [position] buildup," said Edward Meir, an analyst at MF Global. "This tells us that there will not be much firepower to drive prices higher."

While traditional speculators go in and out of the markets, big pension and endowment funds in recent years have

also diversified their investments into commodities to hedge against inflation and a weaker dollar.

Some positions grew so large that legislators and analysts said the trend was pushing oil prices to levels that couldn't be justified by fundamentals.

A MarketWatch analysis earlier this month showed that passive investors increased their crude-oil holdings to the equivalent of more than 600 million barrels in June, up more than 30% from the end of last year, likely supporting the climb in oil prices. [See full story.](#)

Some traders said speculators are not to be blamed for oil prices' volatility.

"I know many in the market are tired of speculators getting the blame for things they have nothing to do with," said Phil Flynn, vice president at futures trading and research firm PFGBest Research. ■

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