

Prices Decline as Sentiment About Economy Weakens

Second Quarter 2012

Oil prices declined in the second quarter, with a barrel of West Texas Intermediate (WTI) selling for just below \$85 in June and Brent trading near \$100—both well below 2011 prices (*Chart 1*). WTI averaged \$106 and Brent \$125 in March.

Retail gasoline and diesel prices also declined from levels seen in the first-quarter Energy Update. As of mid-June, the national average price for a gallon of regular-grade gasoline was \$3.53, slightly below year-ago levels (*Chart 2*). In June, the Energy Information Administration (EIA) lowered its 2012 forecast for the national average price for regular-grade gasoline. Officials anticipate \$3.56 a gallon, 23 cents less than in the March forecast.

Crude oil isn't the only commodity whose price sharply declined in recent months. A variety of metals, textiles and other industrial inputs also fell (*Chart 3*). The Commodity Research Bureau's metals sub-index, measuring the prices of copper, steel, lead, tin and zinc, tumbled 7.5 percent in mid-June from the end of March. This broad commodity decline suggests price moves are not industry specific but driven by global economic concerns.

Supply Rises in May

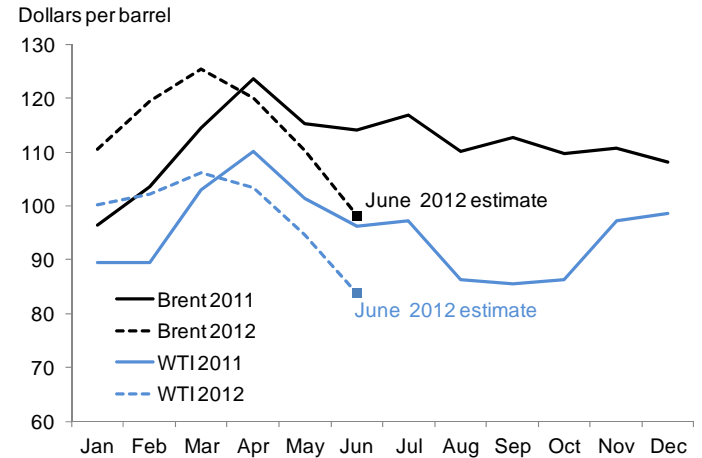
The global supply of oil products increased to 91.1 million barrels per day (mb/d) in May 2012 from 90.9 mb/d in April, according to International Energy Agency (IEA) data. Liquids production from non-Organization of the Petroleum Exporting Countries (OPEC) sources accounted for the entire rise.

Non-OPEC production is forecast to reach an all-time high of 54 mb/d by the fourth quarter, driven by increases in North American production. Unplanned outages, however, continue to affect non-OPEC sources, reducing second-quarter output by about 1.2 mb/d. These disruptions are expected to subside to around 1 mb/d in the second half of the year.

OPEC supply declined marginally in May, down 0.2 mb/d to 31.9 mb/d. Increased output from Angola, Nigeria and Libya partially offset decreases in Saudi Arabia and Iraq.

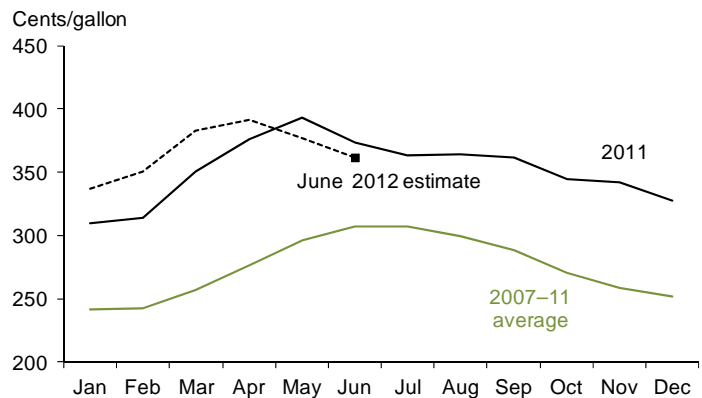
Imminent sanctions on Iran appear to be impacting that country's exports. Exports were about 400,000 barrels per day lower in April than in February and March, according to

Chart 1
Crude Oil Prices Down Sharply in Second Quarter



SOURCES: Wall Street Journal, Financial Times.

Chart 2
Gasoline Prices Continue to Ease in May and June



SOURCE: Energy Information Administration.

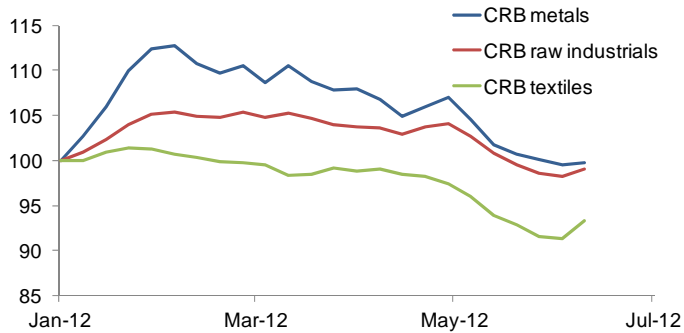
IEA estimates. Some of the oil not exported likely went into onshore and offshore storage facilities. As full sanctions are imposed, the IEA estimates that Iran will have to cut actual production by about 1 mb/d in the second half of 2012 as onshore and offshore storage reaches capacity.

Demand Forecasts Reduced

The IEA's global oil demand estimate for 2012 was reduced by 0.1 mb/d in June to 89.9. Although lowered, the total is still an increase over 2011 levels by approximately 0.8 mb/d, or 0.9 percent.

Chart 3 Other Commodity Prices Decline in Second Quarter

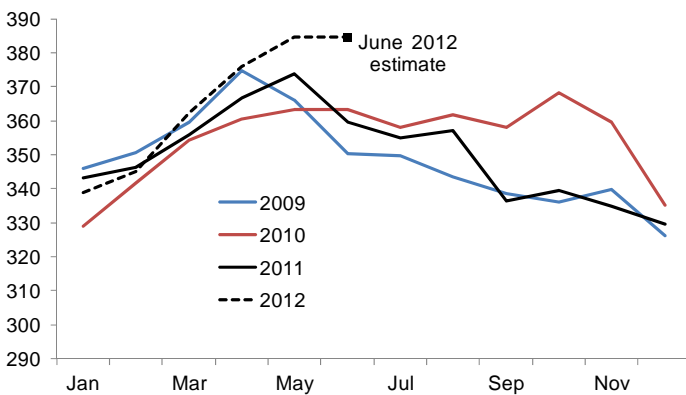
Index, Jan. 6, 2012 = 100



SOURCE: Commodity Research Bureau.

Chart 4 U.S. Crude Oil Inventories Reach High

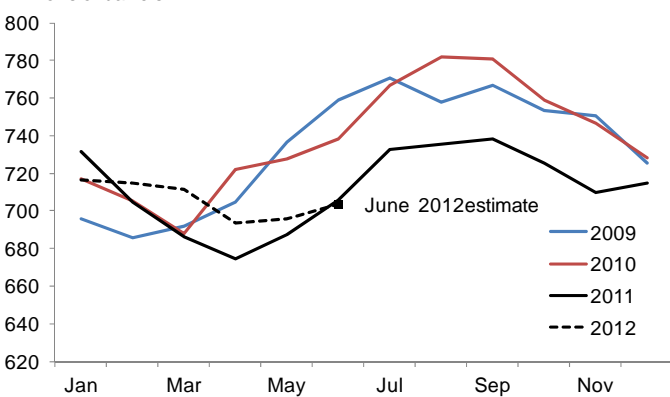
Millions of barrels



SOURCE: Energy Information Administration.

Chart 5 U.S. Inventories of Crude Oil Products at 2011 Levels

Millions of barrels



SOURCE: Energy Information Administration.

Demand across the 34-nation Organization for Economic Cooperation and Development (OECD) in 2012 is expected to fall 0.9 percent year over year, due primarily to a 2.4 percent decline in Europe. U.S. demand is also expected to slip 0.9 percent this year.

In contrast, demand in non-OECD countries is forecast to increase by 2.8 percent in 2012 after rising 3.1 percent in 2011. Among these countries, Chinese demand growth has slowed recently but is expected to return to more normal levels in the second half. The IEA anticipates that Chinese

demand in 2012 will be 3.6 percent higher than in 2011, lifting annual average consumption to 9.7 mb/d.

Crude Oil Inventories Elevated

U.S. oil inventories are at elevated levels. Inventories typically build in April and May during spring refinery maintenance season; however, crude stocks are abnormally high (*Chart 4*).

While crude inventories have risen significantly, product inventories have not, remaining virtually unchanged from the same period in 2011 (*Chart 5*).

Natural Gas Prices Rise Slightly

Natural gas prices were up in May and early June from April lows but remain at depressed levels (*Chart 6*). The average price in the first half of June was near \$2.30 per million Btu (MMBtu), down slightly from May but higher than the sub-\$2 average in April.

Two factors drove the increase: reduced natural gas output, and increased consumption of natural gas used for power generation. Production from shale, the primary driver of increased natural gas output in recent years, declined as producers curtailed activity in response to low prices, data from the EIA show. Additionally, power plants have substituted natural gas for coal at a surprising rate—electricity generated from natural gas is expected to rise to just over 30 percent of all generation in 2012, up from about 25 percent in 2011, according to the EIA.

Lower production is reflected in inventories, which increased at a fairly constant rate after bottoming out sometime in spring. So far this year, the rate at which inventories have grown is noticeably slower than in previous years. Inventories remain well above seasonal norms, but the excess has slowly fallen this quarter.

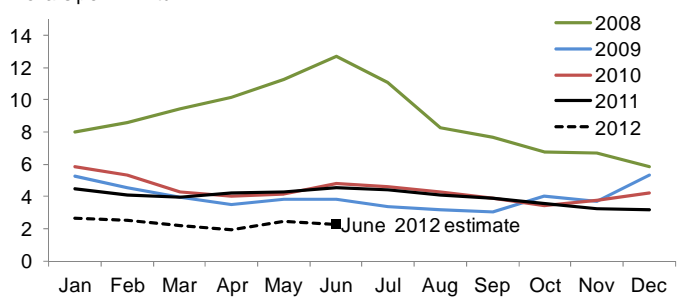
—Jackson Thies and Michael Plante

About the Authors

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Chart 6 Natural Gas Prices Remain Depressed

Dollars per MMBtu



SOURCE: Wall Street Journal.