

1. What is happening in the oil market?

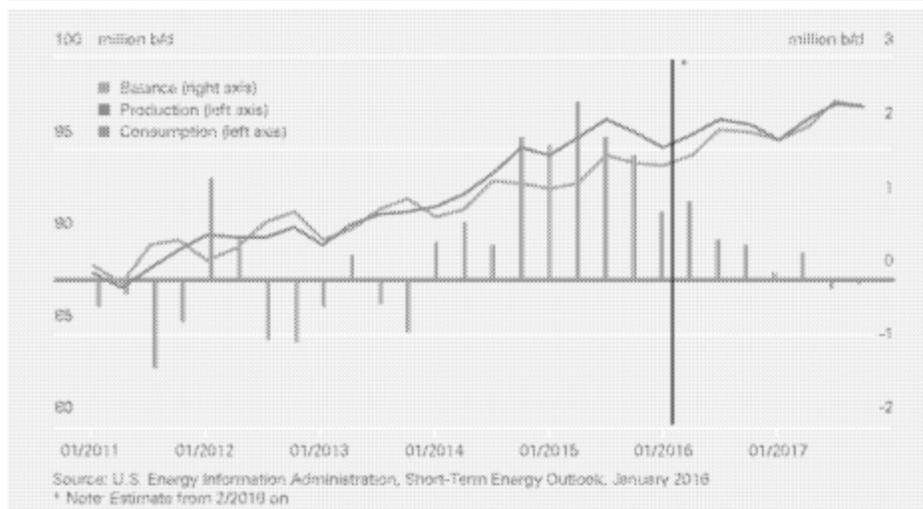
Start with the basics. Global oil supply exceeds current consumption demand by about 1.5m barrels per day (b/d). Mostly, this reflects years of rising production, particularly by U.S. shale producers. Much of this boom was financed with debt, made easier by years of quantitative easing (QE) by the U.S. Federal Reserve (Fed). Consumption has been growing too, but not as much. As a result, inventories are well above historic averages. Inventories will need to shrink sharply before oil prices can begin to rebound.

Oil watchers have plenty to ponder as they try to figure out when this might happen. "This is a very fluid situation", Terry Brennan, Head of Commodities at Deutsche Asset Management (Deutsche AM) readily admits. We have revised our forecasts to an average of about \$40/b for 2016. We expect prices to remain below that level during the first half of 2016, before recovering to \$50 by year-end.

There is plenty of uncertainty, however, ranging on the demand side from the winter weather in much of the northern hemisphere to fears of Chinese demand growth slowing. On the supply side, there is the return of Iran to the market and fears that, for once, growing tensions between Saudi Arabia and Iran could lead to growing, rather than shrinking production.

Already, it should be noted that other observers are more cautious when it comes to inventories. The U.S. Energy Information Administration (E.I.A.), for example, sees the global inventory build continuing for much of 2016, though at a slower rate. Unlike the E.I.A., we believe that inventories should begin to shrink in the second half of 2016 as shale producers may take out up to 1 mb/d of capacity.

Global oil supply, demand and balance



Out of balance - for now

The supply / consumption chart, including forecasts from the U.S. E.I.A., shows that consumption has not been the issue in driving oil prices down. Demand has been growing steadily. This is expected to continue even as sources of growth shift. (China's share, for example, has already declined from 62% in 2011 to about a third in 2015.) Supply has seen an unusual phase of growth, driven by U.S. shale, and, more recently, by OPEC's output increase to currently 32mb/d. A positive balance means that inventories continue to grow.

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