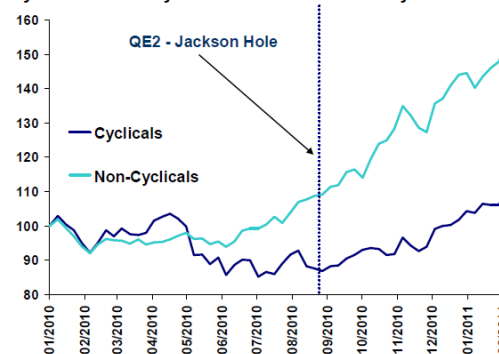


## Special Oil Report: Middle Eastern political tsunami by no means fully priced in yet

- Political instability in the Middle East not to be stopped soon
- Will the rising oil price trigger the next recession?
- Shale gas will rock the world<sup>1</sup> - Poland and Ukraine clear winners
- Outlook 2011:
  - price of cyclicals to increase; energy sector clear beneficiary
  - oil price on the rise to USD 150, trend reversal expected for H2 2011
  - Average Brent price 2011: USD 124/barrel<sup>2</sup>

The risk/return profile for oil-investors was of limited attractiveness last year, both in absolute terms and in relation to equities or other commodities. The performance of the various commodities was very mixed: Whereas the (relatively) non-cyclical agricultural commodities and gold recorded a clear upswing, the classically cyclical commodities (among those copper, oil, aluminium, coal, tin, and nickel) picked up momentum relatively late benefiting from the investors' increased willingness to assume risks. What does that mean for 2011? We expect that the belief in the economic recovery will be reflected in a substantial increase in the prices of cyclical commodities. The energy sector, no.1 underperformer among the cyclicals last year, should emerge as the clear beneficiary of this sector rotation.

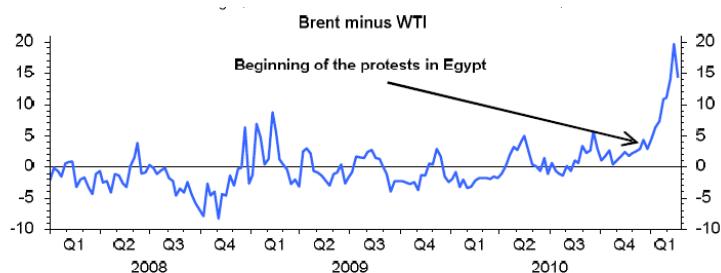
Cyclical vs. non-cyclical commodities January 2010 to February 2011



Sources: Datastream, Erste Group Research

### The Middle Eastern turmoil could lead to an oil price of more than 200 USD/barrel

*"The greatest factor of insecurity is the political developments in a number of Arab states. At present, this is by no means fully priced in yet. I do not expect the situation to calm any time soon,"* analyzes Ronald Stöferle, commodities analyst at Erste Group. Apart from the chaotic situation in Libya, the conditions are becoming worse every day in further major oil-producing countries, therefore a domino effect cannot be ruled out. The latent social tensions should not be underestimated. The rising oil price is fuelling discontent and is driving inflation even higher. Should there be more oil production outages in Libya or Algeria, even if only short-lived, this would de facto exhaust reserve capacities in Saudi Arabia. Moreover, Libyan oil has less sulphur content and is lighter than Saudi oil, and for this reason, it cannot be replaced without problems. Saudi Arabia carries the greatest risk of triggering a steep oil price rise. On the one hand, there are doubts that Saudi Arabia would be able to expand capacities fast enough should worse comes to worst, and on the other hand, the latent risk of a blockade of the most important oil



Sources: Datastream, Erste Group Research

<sup>1</sup> Wall Street Journal, 10 May 2010

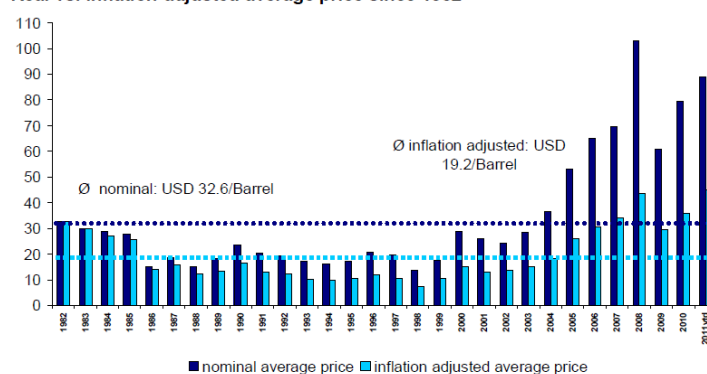
<sup>2</sup> Compared to USD 113/barrel as of 9.3.2011

transport routes (Strait of Hormuz and Malacca) exists. If bottlenecks were to occur on either of the two routes, the oil price would rise to more than 200 USD per barrel.

### Will higher oil prices cause the next recession?

*“The high price of oil is definitely a threat to economic growth,”* comments Stöferle. As soon as the price per barrel of crude rises over USD 100 lastingly, it may be assumed that OPEC will drastically expand extraction to avoid throttling the economy. *“Therefore, we believe that most risks are upside for the oil price.”* Even if supply to the market is not yet sufficient, the bush fire of revolution could spread further and drive the oil price to new highs especially in the first half of the year. Erste Group Research analysts expect an average price of USD 124 per barrel of Brent in 2011. A rule of thumb states that a 10% oil price increase lowers GDP of the US economy by around 25 bp. According to IEA<sup>3</sup>, the share of spending on oil in 2010 was 4.1% of global GDP. Should the price rise lastingly over USD 100 in 2011, the ratio would rise to almost 5% which represents a critical level for the economy. At an average price of USD 120/bbl Brent this would mean 6% of GDP and at USD 150 the share would increase to 7.5% of GDP. As it is clear that OPEC wants to keep the economy going in any case, in such a scenario it may be assumed that production will be increased.

Real vs. inflation-adjusted average price since 1982



Sources: Datastream, Erste Group Research, sharelynx.com, Bloomberg

### Rise in commodities in 2010 caused by zero-interest policy

The economic stimulus measures taken by governments and central banks throughout the world and the zero-interest policy of an almost global scale were behind the continued rise in commodities in 2010. Therefore, the further development of the oil price depends heavily on whether a third quantitative easing<sup>4</sup> programme will be implemented by the Fed. The Fed has stressed the positive effects of higher stock prices many times. Commodities also profit from higher risk tolerance. *“The very high positive correlation of the stock market and the oil price can hardly be explained by conventional supply and demand patterns. Monetary policy has probably become the most important factor for commodity markets,”* explained Stöferle. Furthermore, years before elections have always been ones with clearly positive tendencies on US stock markets. Since the correlation between US stocks and the oil price is stronger than ever this year, the environment for oil prices is expected to be positive.

### Peak oil will lead to shale gas, with extraction in Poland and Ukraine

*“We will soon reach the maximum rate of oil extraction for conventional oil,”* explained Stöferle. *“There is no doubt that the discussions regarding peak oil are more than just about spreading panic.”* Around 64 countries have already reached their sustainable maximum rate of oil extraction. Natural gas, especially shale gas, will become the fastest-growing fossil fuel of the future in the view of Erste Group analysts. As it burns cleaner than coal or petroleum and has also advantages with respect to CO<sup>2</sup> caps, natural gas can easily replace oil. Over the coming three to five years, prices are expected to be in the range of at least 7 to 10 USD per mmBTU<sup>5</sup>. *“The extraction of shale gas reserves in Europe will gain enormous significance,”* foresees Stöferle. Lively exploration and acquisition activities, especially in Poland<sup>6</sup> and Ukraine<sup>7</sup>, are expected in the coming years. China also plans to more than

<sup>3</sup> International Energy Agency of the OECD

<sup>4</sup> This monetary policy of the central bank is applied when the central bank' interest rate is already at zero or close to zero and monetary policy is still needs to be expansive.

<sup>5</sup> The measure used for natural gas is usually mmBTU (million British thermal units). 1 BTU corresponds to the amount of energy needed to heat one British pound of water by 1 Fahrenheit. 1mmBTU corresponds to almost 239 kWh.

<sup>6</sup> If they were only remotely as big as currently predicted unconventional gas resources in Poland, Poland would turn into a net exporter of gas within just a few years. Commercial production could commence already in two to three years, although any significant volumes will probably only be produced in seven to ten years. Initial drilling results in the South Eastern part of Poland (Markowola) have confirmed the high expectations. Drillings are currently executed in Lebien (3 Legs Resources), Slawno (BNK Petroleum), and Markowola (PGNiG).

<sup>7</sup> Geologists have found striking similarities between the Lublin Basin and the Barnett Shale in Texas suggesting a substantially higher potential for shale gas exploration than in comparable deposits in the USA. Experts also expect sizeable shale gas and CBM reserves in the Dnieper-Donetsk Basin. There seems to be political support too; as confirmed by Yuriy Boiko, Minister of Energy, who within the next five years wants to produce an additional 20bn cubic metres of natural gas from shale gas and CBM, which is equal to half of the gas imports from Russia.

double the share of gas in the coming decade. At present, 80% of energy demand is covered by coal, while gas only covers 1%. Unconventional gas is expected to play an important role and by 2020 it should cover 30% of China's gas needs. In this sense, the Erste analysts view gas – above all shale gas – as one of the most attractive investment options in the energy sector.

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