



## Oil Heading Back to \$100

- The S&P 500 fell 2.2% last week, after testing the top of the 1000-1220 'decision box' that we introduced last May as a range that we thought reflected investors' divided views of the economic outlook. Our expectation for resistance at the top of the box had increased over the past few weeks because the S&P 500 had been rising at an annualized trend rate of around 70% since early September, which we viewed as unsustainable, and crowd sentiment had reached levels of extreme optimism, which generally precede corrections. We see the first potential support level at around 1185, which is the 23.6% retracement of the August through November rally and also the midpoint of October's two and a half week consolidation period. The next support levels we see are around 1155 (the 38.2% retracement and the 50-day moving average) and then 1128 (the 50% retracement and the 200-day moving average).
- As we wrote last week, we think accelerating growth in China and India, the two largest developing economies, helps explain crude oil's recent breakout from its year-long trading range to its highest level since the global financial crisis and ensuing great recession. Along with the rapid rise of the middle class in those countries, car ownership is also growing at a brisk rate. As shown in the charts below, courtesy of ISI Group, China's vehicle sales were up 10% month-to-month in October, about 30% over the past 4 months, and up 150% since 2007. At 15.7 million units per year, China's car market is now significantly larger than the US' 12.2 million. India's auto sales are smaller but are also growing rapidly, up 8.5% month-to-month in October and 38.8% from a year ago. While cars are viewed as status symbols in these countries and typically are not driven nearly as many miles as in the US, we think robust emerging market auto sales are bullish for commodity prices, especially oil.

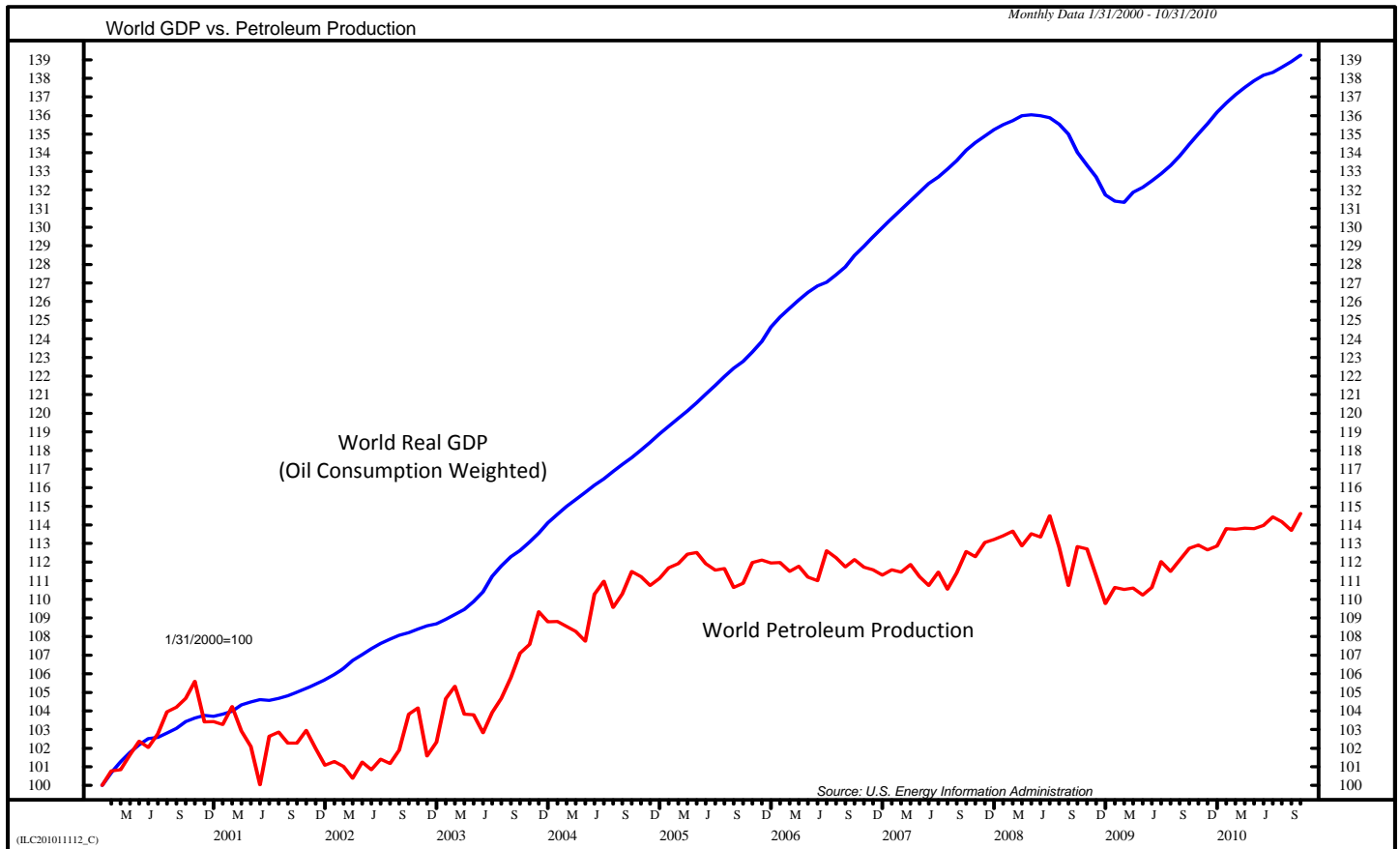


- Saudi Arabia's oil minister, Ali Naimi, who has been a reliable indicator of oil prices since Saudi still has the greatest ability to affect global pricing, has evidently embraced the possibility of higher prices, judging by his recent statement: "Consumers are looking for oil prices around \$70, but hopefully less than \$90. There's almost an anchor now for the price." We think this is a significant change from his previous, more precise statement he made following a late-2009 OPEC meeting that prices of \$70 to \$80 per barrel were "perfect." While his recent statement likely reflects emerging economies' fast-growing energy consumption, we think it also reflects concerns of a significant drop in the value of the US dollar, in which oil is priced, due to the Federal Reserve's quantitative easing program. From a technical perspective, our upside target for oil is \$100 per barrel, which is around the 61.8% retracement of the decline from the July 2008 \$145 peak to the January 2009 \$33 low. The \$100 level also acted as resistance twice in the run up to the \$145 peak.
- China's size and rapid growth have made it a formidable source of marginal demand for energy — the country imported a record 5.7 million barrels of oil per day in September, up 24% from a year ago. This helps explain China's intent to invest in and develop marginal sources of supply around the world, such as in Africa and the South China Sea, where recent naval disputes have flared up. Moreover, China's energy stockpiles are diminishing. China has become a net importer of diesel fuel for the first time since the 2008 Beijing Summer Olympics, when oil climbed to

\$145 a barrel. Meanwhile, diesel inventories have fallen to just 16 days supply at current usage rates, versus 36 days six months ago. Furthermore, as reported in *Barron's* last week: "For the first time ever, China has been investing more overseas in assets like iron, oil and copper than it puts into US government bonds... For 2010, China's non-bond investments around the world, primarily commodities, should hit \$55 billion... China's net purchases of US Treasury securities are likely to fall to \$55 billion this year from about \$100 billion last year."

- China's currency reserves are closing in on \$3 trillion, the bulk of which are in US Treasuries. Although the yuan could be undervalued by as much as 50% on some measures, Chinese officials have repeatedly stated their desire for only modest appreciation over the next few years (despite US exhortations at the G20) to ease China's transition towards a more consumption and services based economy from one dominated by investment and exports. By maintaining such a competitive exchange rate, further reserve accumulation appears inevitable. However, given China's recent credit downgrade of the US with a negative outlook due to "the US' deteriorating debt repayment capability," we expect that China and other emerging markets will increasingly diversify currency reserves into hard assets rather than financial assets like US dollar-denominated Treasuries.
- While China and India are the most prominent examples of growing emerging market energy consumption, we think this trend is broad based. Total emerging market energy consumption is expected to be double 2005 levels by 2030, according to the US Energy Information Administration. This would take emerging market energy consumption to more than 60% of total world consumption from 48.5% currently. OPEC estimates that by 2030 oil demand will reach 106 million barrels per day, versus 84 million in 2010, with 75% of increased demand coming from developing Asia. With evidence that production growth has slowed, higher prices seem unavoidable (see Weekly Chart).

## The Weekly Chart: Oil production lagging economic growth



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