



THE SPECIALIST IN TRADING AND INVESTMENT

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Conflict in Ukraine

Should the conflict in Ukraine escalate into a larger conflict, or even civil war between the pro-Russian East and the pro-European west, the international community will face a severe challenge not least as it is pitting old cold-war enemies on either side of the conflict. So far, we have seen several attempts by Western governments led by the US to persuade Russia through the use of sanctions to step back from adding further fuel to the fire following its annexation of Crimea.

Should we see a further escalation, sanctions would undoubtedly become more severe as the intent would be to reduce Russia and its oligarchs from operating normally throughout their businesses and also to inflict further damage on the Russian economy, which is already reeling from falling economic activity. Russia would feel the biggest impact together with Ukraine, which is already struggling following years of economic mismanagement and corruption while any disruptions to gas supplies may deal a blow to several European economies as a result of spiking European gas prices despite ample supply into the low-demand season of summer.

In commodity markets we have so far primarily seen gold, crude oil, wheat and nickel react to the unfolding drama in Ukraine. Gold has seen glimpses of safe-haven buying although the support so far has only been seen a few days at a time before selling emerged. Wheat has been supported by worries of production cuts from the key exporting region around the Black Sea this summer combined with worrying weather developments in the US Southern Plains. Crude oil has reacted to the worries of supply disruptions should Russia cut off supplies to Europe in retaliation against sanctions. Nickel meanwhile has reacted to the same potential for supply disruption which comes at a time where a strong rally was already under way in reaction to an export ban from Indonesia, the world's largest producer.

Oil prices may initially spike should Russia cut off supplies to Europe and we have seen on a couple of occasions since the Arab Spring in 2011 how oil prices above 120 USD/barrel almost immediately had a negative impact on global growth. Such a move, however, would be very surprising and incredibly counterproductive for Russia as it receives a huge bulk of its oil revenues from Europe. The dependency between Russia and the Former Soviet Union and Europe has continued to grow over the years, especially when it comes to crude and gas. It is worth remembering that even during the height of the cold war, oil was never used as a weapon between the two sides and the risk of that happening remains relative low.

Although the world is mostly focused on the risk of oil prices spiking higher, there is another dimension in this story, which could completely change the outlook. In 1986, Saudi Arabia suddenly stopped its effort to keep oil prices stable especially after Russia increased oil production at its expense. Saudi Arabia was subsequently forced to reduce production in order to keep prices stable. Once the kingdom began increasing production in 1985 and 1986, oil prices collapsed from around 30 USD/barrel before bottoming at 10.50 USD/barrel in March 1986. The result of this was a massive loss of revenues for the Soviet Union and it most likely played its part in the Soviet disintegration a few years later in 1991.

Today we have a similar situation as the US is sitting on record commercial crude inventories brought about by the shale oil bonanza during the past five years. Adding to this is the Strategic Petroleum Reserve, which at an average cost of 30 USD/barrel, currently hold almost 700 million barrels. The SPR was established after the

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WWW.SAXOBANK.COM SAXO BANK A/S Philip Heymans Allé 15 2900 Hellerup Denmark

Telephone: +45 3977 4000 Telefax: +45 3977 4200 Reuters Dealing Code: SAXO Cvr. nr. 15 73 12 49 info@saxobank.com



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oil crisis in the 1970s to ensure a minimum of 90 days of imports was held in reserve to meet any disruption. Today the SPR is much higher than necessary as both US consumption and imports are falling. The US government has since 1979 prohibited the export of crude oil and should Congress decide to remove this law, the US could become a major oil exporter, not least considering how much of the current oil is accessible by crude carriers in the Mexican Gulf.

A resumption of US exports would seriously alter the global oil market which is already seeing supply growth rising faster than demand and it is not difficult to envisage a drop in Brent crude of more than 25 USD/barrels. This would send chock waves through the global oil market and potentially have the same destabilising impact on Russia as the 1986 action from Saudi Arabia had on the Former Soviet Union. On this basis we find it very unlikely that the "oil weapon" will be used by either sides in this conflict.

Head of Commodity Strategy at Saxo Bank **Ole Sloth Hansen**

Email: olh@saxobank.com

Phone: +45 3977 4810

Ole Sloth Hansen is a specialist in all traded Futures, with over 20 years experience both on the buy and sell side. Hansen joined Saxo Bank in 2008 and is today Head of Commodity Strategy focusing on a diversified range of products from fixed income to commodities. He previously worked for 15 years in London, most recently for a multi-asset Futures and Forex Hedge fund, where he was in charge of the trade execution team. He is available for comments on most commodities, especially energies and precious metals.

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