Oil Prices Going Up, But Maybe Not Back Down

By Jacob Bunge, Financial Correspondent
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CHICAGO (HedgeWorld.com)—When crude oil hit $100 per barrel at the onset of the new year, some declared it a fluke, a lone trader making a grab for his spot in the history books with a trade that almost immediately lost money. But before long, oil was testing the century mark again, most recently on Tuesday [Feb. 19], when West Texas Intermediate crude closed at $100.01 per barrel on the New York Mercantile Exchange, the first close ever in excess of $100. The following day, oil traded as high as $101.32.

Although the cost of oil has yet to best 1985’s adjusted-for-inflation record of $103.35 per barrel, it seems only a matter of time, and several big names in energy trading see no immediate end to the ever-higher bubbling of prices. T. Boone Pickens Jr., chairman of the $4 billion hedge fund BP Capital LP and an oil investor from way back, said on CNBC Thursday [Feb. 21] that he expects the price of oil to fall $10 to $15 per barrel in the second quarter of the year, but by the second half of the year, a barrel of crude oil will once again fetch more than $100 and exceed current highs.

In a similarly themed Financial Times article published on Feb. 19, Jeremy Grantham, chairman of Boston-based GMO LLC, said he didn’t see oil prices coming down and staying down anytime soon: “…with China and India growing so fast, it is hard to see oil going back to old trend lines,” he said. When it comes to long-term trends, Mr. Grantham has history on his side, having foreseen meltdowns in Japanese stocks, tech companies and the housing market well before they became news, as well as the ascendance of emerging markets.

Mr. Grantham isn’t the first to question whether the law of gravity still applies to oil prices, as reserves grow ever-smaller and prices seem to jump at every headline. In the past week, markets became nervy following threats from Venezuelan President Hugo Chavez, who said that his country would stop exporting oil to the United States if Exxon Mobil Corp. continued to pursue its lawsuit against Venezuela after the company's interests there were nationalized last year. Mr. Chavez later said his threat wasn’t serious. But oil prices bounced again on Tuesday when an explosion and fire at a Texas refinery owned by Alon USA Energy Inc. injured four workers.

Events like these, and the increasingly large ripples they send through the oil markets, indicate just how inelastic the supply for crude has become. As of Dec. 31, 2007, U.S. oil inventories had declined to 289.6 million barrels, their lowest level in two years and the seventh straight drop. As of the end of 2006, the United States consumed nearly 20.7 million barrels of oil per day, according to the U.S. Energy Information Administration. Oil stocks in Europe have slipped as well, as demand from China and India steadily grows.

“\"When you have such low spare capacity, like we do now, the market is always one headline away from oil spiking another $10,\" said Hilary Till, principal of Chicago-based Premia Capital Management and research associate at Edhec Business School's Risk and Asset Management Research Centre. "Each marginal barrel is very important." On the other hand, she added, any increase in spare capacity could send prices down $30 per barrel in a heartbeat.

Does Mean Reversion Still Apply?

But how much higher can oil prices go before mean reversion eventually sets in, and prices fall into line with historical averages? It’s an open question, but Ms. Till noted that some observers hold that such rules may no longer hold true for oil. One of these is Mr. Grantham, who wrote in a July 2005 newsletter that he did not believe oil was in a standard, mean-reverting bubble, and probably would not recede below the high water mark any time soon. At the time, that was $50 per barrel.

In the newsletter, Mr. Grantham wrote that he and others at GMO had identified 30 bubbles, all but one of which—oil—
eventually returned to the preexisting trend in their respective markets. Oil, he wrote, represented a paradigm shift.

“There are several unique features of oil that make it a likely candidate for a paradigm shift,” Mr. Grantham wrote in 2005. “Key is the conflict between strong global demand—buttressed by the growth in China and India—and a finite oil reserve. Countries have had equally rapid growth before, but they were Japan, then with a 100 million people, and South Korea with 30 million. Now we are going to find out what happens when two 1.2 billion pound gorillas try to do it together.”

Hélyette Geman, professor of finance at Birkbeck, University of London and ESSEC Graduate Business School, has come to the same conclusion as Mr. Grantham. In a fall 2005 paper titled “Energy Commodity Prices: Is Mean-Reversion Dead?” Ms. Geman wrote that, considering the trajectories of natural gas and oil prices in recent years, it is reasonable to say that mean-reversion has gone by the wayside, and she forecast a $100- per-barrel price on the horizon.

Three broad factors could take upward pressure off oil prices, according to Ms. Till. Energy production from established alternative sources like nuclear and coal power could increase; environmental restrictions could be loosened, allowing increased oil production; or global consumption could see a drop, brought on by an economic contraction. While oil prices have nearly quadrupled in dollar terms over the past six years, she said, none of these three factors has yet occurred in any meaningful way, making it an open question as to how high oil prices will go.

"From my perspective as a trader, when you see oil prices go to about $100 [per barrel] and there doesn't seem to be a consequent contraction, you start to think that's a tolerable level, with the way the economy is structured now," Ms. Till said.

Other Traders’ Perspectives

John McLane, president of Scottsdale, Ariz.-based Mobius Asset Management, said the only thing that would bring oil prices down and keep them there would be China, India, the United States, Europe and Brazil all running out of money. "I say that in jest, but it's true," he said.

Mr. McLane, who runs $2.5 million in the Mobius Asset Management Energy Program, said emerging economies are gathering wealth and using it to fuel their continued industrialization, and in the past, such industrial revolutions usually have not been five- or 10-year phenomena. "I'll probably be dead and gone before [that period of times] is over," he said.

Tony Montini, an energy trader at Chicago-based Attain Portfolio Advisors LLC, is one who still believes in oil's adherence to a mean. Mr. Montini said that all sectors of the commodity markets are currently running up on fears of inflation, and once those inflationary worries subside, oil will revert to its "normal mean," which he said was probably in the $60- to $70-per-barrel range.

The latest surge in oil prices, Mr. Montini said, may have been driven by rumblings from the Organization of the Petroleum Exporting Countries that its members may vote to cut oil production at their next meeting, as well as refineries’ seasonal fuel reformulation ahead of the spring.

Mr. Montini oversees energy trading in APA's Phoenix Energy Portfolio as well as several other diversified commodity-trading programs, and he said the rise in oil prices has not had much effect on these programs' operation. Volatility, however, has been a factor, with long-term trades becoming riskier than they have been in the past.

At Mobius, Mr. McLane runs a systematic technical energy program that's both short term and long term in nature, trading trend and countrend themes. Like Mr. Montini he hasn't changed his trading methodology as oil prices climb higher. However, he, too, has seen the time horizon of his trades vary more and more as volatility picks up.

"When I first started putting this together years ago, I was looking for trades that were weeks in duration, and potentially months in duration," Mr. McLane said. "Now the trades I'm looking at are two to four days in the short term, and out to a week to two weeks in the longer term. And I would say that the longer-term trades are the minority, rather than the majority."

JBunge@HedgeWorld.com

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