

A World Awash in Oil

Saudi Arabia, the world's second largest producer of crude oil after Russia, continues to be in the news – for a variety of reasons. As previously mentioned in these pages (“Arabian Nights & Chinese Dreams,” July 2009), the financial crisis in the Arabian Peninsula is causing great anxiety for many participants. As indicated in our July article, major domestic businesses in Saudi Arabia, namely the Sa’ad Group and the Algoasibi consortium, have defaulted on loans now estimated in the vicinity of USD \$20 to \$30 billion. Collapsing regional real estate prices are being compounded as several regional sovereign wealth funds write down the valuations of their global investments. It appears that efforts to orchestrate a common currency within the Gulf Corporation Council countries (GCC) have largely failed after years of effort. Furthermore, banking supervisors in the United Arab Emirates (UAE) have now asked domestic banks to write down 50% of all bad loans originating from the above-named Saudi enterprises, thus exacerbating problems in local credit markets. Needless to say, all of these difficulties have occasioned lots of finger pointing and name calling, not all of which has been conducted in a gentlemanly way.

Clearly, energy prices, both of natural gas and oil, have been and will continue to be a key to the financial and political well-being of the region. Indeed oil prices, which are close to \$68 per barrel at the time of writing, have not performed in a way that most regional officials would like. “It will take time to make up for the millions of barrels of lost demand,” Saudi Aramco CEO Khalid al-Falih recently explained on Paul Kangas’ *Nightly Business Report*. “But,” he reassured (and it was not clear who he was reassuring), “it will come.” Earlier this summer, Ali al-Naimi, Saudi Arabia’s oil minister, also commented on oil prices: “Investments need a price between \$60 and \$80, and that’s why we chose a fair price of around \$75,” he said. It seems that a combination of domestic Saudi Arabian finan-

cial needs and developments in international energy markets have conspired to transform even the world’s largest crude oil exporter, with reserves of 290 billion barrels and production of approximately 9.7 million barrels per day, into somewhat of a passive price taker, watching gyrations in markets and hoping for higher prices that have not come. Indeed, profound changes in oil markets have upended the old pricing mechanisms and have increased volatility and unpredictability.

There can be no doubt that the global

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energy market has weakened. The experience of \$150 barrels of oil during the summer of 2008 disciplined consumers worldwide. Oil consumption in the US decreased from a peak usage of 17.33 million barrels per day during the summer of 2007 to a peak daily usage of 15.81 million barrels this summer; industrial production has fallen; small cars, from the Toyota Prius to the Smart Car, have come into fashion. Moreover, amidst a general economic downturn, with global economic activity stabilizing well below 2006-07 levels, it is hard to imagine robust energy demand. There have been exceptions: summer Chinese oil imports increased by 8% this year over last. But growth in the developing world has not buoyed oil consumption. Once again quoting al-Falih, “Oil demand con-

tinues to be sluggish in the West... We see an uptick in China, but not sufficient to offset the demand loss.” Therefore, as we enter the fall of 2009, the fundamentals for oil prices are negative. The global economy is still suffering from the aftermath of the credit meltdown, and the largest consumers of petroleum products, namely the United States, Europe, and to some degree Japan, still show characteristics of diminished demand and quite careful usage.

It should also be mentioned that some of the non-fundamental factors which drove commodities to unheard of levels in 2008, and oil to near \$150 per barrel, also seem to be in question. Our clients and friends will recall that during those heady times investing in “commodities” became an asset class decision espoused by many participants – but eschewed by Interinvest. Pundits regularly inveighed on the merits of “investing” in commodities (one formerly only “held” commodities, which neither yield dividends nor grow). Since then, a variety of ETFs cropped up to allow retail investors and, increasingly, institutional ones to easily and cheaply hold cotton, wheat, copper, liquid natural gas, and oil without going to the trouble of having to store the things. The commodity backed ETF business has ballooned to the point that Deutsche Bank’s Powershares energy ETFs are exceeding ‘position limits’ set by the Chicago Board of Trade, which regulates the percentage of any particular generic future contract held by a single player. On some days, for example, the SPDR Gold Trust ETF (NYSE:GLD) is the most traded share by volume on the NYSE. Deutsche Bank has already been compelled to shut down its ‘double long’ 2x levered oil ETF, and speculation that additional ETF closures will occur is rampant. The liquidity offered via ETF vehicles has enabled generic investors increasingly to trade “commodities” in statistical relationship to other asset classes, implying that investors are beginning to view the relationship between

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commodities and, say, equities along logical lines akin to those employed to draw a relationship between stocks and bonds.

Unfortunately for asset allocators who have thoroughly embraced investing in commodities long-term, and particularly for large pools of pension money pursuing this strategy, there are a number of problems which have emerged. Most important is the sense that investors will no longer be able to sidestep or somehow escape from the position limits set by the CFTC and the major underlying commodity marketplaces through the use of swaps. As it has become increasingly clear that the voyage upwards in the oil price during 2008 from \$100 to \$150 a barrel was largely fuelled by pooled money entering this market for the purposes of asset diversification, it has also become clear that certain investment banks were able to accommodate this behavior by arranging swap agreements which effectively sidestepped many rules. On this one, it would seem that politicians have learned rather quickly how to deal with the situation. It is one thing for the price of silver or the price of sugar to shoot up due to speculative action. It is quite another for politicians to witness petroleum shooting up in price to the point where consumers stay at home or take the bus. A political reaction in the form of regulation has come to the swap market, and notice has been served to the relevant players that 2008's run-up was unacceptable.

As a result, commodity prices lately have been shaped by fundamentals much more than in recent years. This explains the weak performance of major energy sector equities, including Exxon (-15.5% YTD) and Royal Dutch Shell (+3.4% YTD), which have lagged even as equity markets have soared. And yet, while the upper and lower limits of energy prices are bound by supply and demand, the "risk trade," which posits statistical relationships between oil, gold, equity indices, and the US dollar, dominates the space in between. Even major geopolitical developments have been overshadowed by the risk trade of late. A near revo-

lution in Iran this past summer, for example, failed to noticeably budge energy prices. Instead of oil spiking, the deflation trade of oil relative to the S&P ruled, and as markets chopped sideways, so did energy prices. Similarly, on September 28, Iran tested long-range missiles capable of accu-

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rately striking the entire Persian Gulf region and stretching as far as Israel (not coincidentally, the 28th was also Yom Kippur, the Jewish day of atonement). Irrespective of the ominous geopolitical developments, the S&P appreciated slightly, and thus, oil prices were bid up in order to maintain the "reflation hedge" relationship between oil and the US stock markets.

The problem of Iran, of course, ought to overshadow the "risk trade" argument so prevalent amongst the bulls in the oil market. Having closely watched the developments of the last few weeks and Iran's adroit abilities to postpone almost at will the G8's attempts to hinder or stymie its nuclear ambitions, we have to include the possibility of a conflagration at any time in the Middle East. The discovery of the pseudo-secret Iranian nuclear facilities and the disclosure by Sarkozy, Brown and Obama of this discovery was not confidence-instilling, as it has not been followed up by any concrete actions, especially as the Russians complained a great deal but suggested firmly that more negotiations

were in order. Unfortunately, it appears likely from our stance that negotiations will likely continue until such a time arrives that Iran successfully detonates a nuclear device. Judging by how efficiently the Iranian government quelled the mini-urban uprising of June 2009, its leadership certainly seems to be proving itself in the international political landscape. The rulers in the GCC, whenever they do not have to deal with their own set of economic and financial problems, must indeed be spending time worrying about these issues. Kuwait, Qatar, Bahrain and, of course, the entire UAE are not far away, and traditional rivalries with Persian powers are not forgotten. It will remain to be seen how the Iranian nuclear situation is dealt with in the months ahead but certainly recent British intelligence reports that the nuclear ambitions of Iran are marching ahead steadily cannot be dismissed. We are equally unimpressed by any agreement whereby Iran allows Russia or France to enrich uranium and make it more readily available for medical or power production purposes.

Although the business press continues to clamor with predictions to the effect that commodities provide a great investment opportunity, and a sure hedge against the effects of the massive money creation underway in the entire world, we emphasize instead that deflation throughout the G-7, and indeed in the Gulf countries as well, is exerting a significant dampening pressure on energy prices. At the same time, the fallout from the commodity bubble of 2008 continues to draw political attention to the operations of the commodities market, a factor further likely to keep prices from climbing too high. In our view, the "bull's case" for an energy price appreciation is not to be found in a discussion of a global deflation, emerging market economy growth, or market bubbles caused by ETFs, let alone "peak oil" or any of the theories popular in July 2008. Rather, the "bull's case" is a most disconcerting scenario, but one which we imagine is keeping the leaders of the Gulf states up at night: Iran. ■ **HB & DZ**