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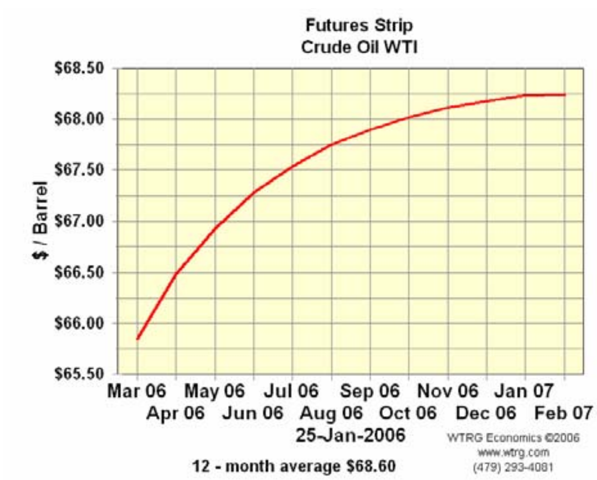
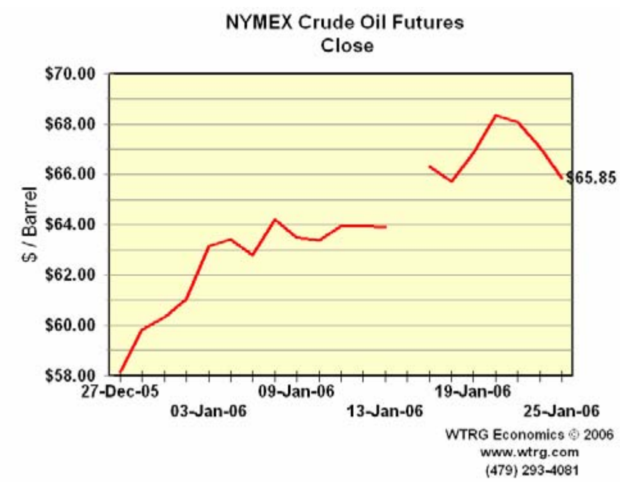
Is the Crude Oil Bubble Popping?

With the housing bubble seemingly beginning to leak, it may not be surprising that some of the other 'bubbles' could now begin to show signs of a fade. The most obvious and the most difficult one to call is crude oil, but the old saw that markets often behave to inflict the maximum amount of harm on the most participants is well worth consideration. Many macro economists trace the origin of asset bubbles to an over-indulgent Fed reluctant to "prick" the effervescence, but that is an issue for policy makers. For investors, the future behavior of crude oil prices may be important for several reasons, the most important of which would be its impact on consumer spending. Another would be the impact of a decline in crude prices on pension fund managers and other institutional investors who have recently acquired a "stake" in the commodity world, as part of a strategy of diversification. With crude oil now the fancy of many of these portfolio managers, who otherwise are "non-commercials," would it really surprise anyone if crude oil first declined mildly and then took a Brody? Indeed, if the oil bubble collapses, it could be those very same managers who will find out that "oil is a greasy business," as Calouste Gulbenkian ("Mr. Five Percent") was once alleged to have said. At the least, timing the peaks and valleys of the oil market has been the undoing of more than one investor.





Not so long ago, in the throes of the post 'Katrita' panic, natural gas soared over $15, but is now below $9.00. Is its partner in crime, crude oil, soon to be overtaken by similar forces? We think there is a very good case for the early stages of an evanescing crude bubble. Why?

First, weather plays such a critical role from December through March. Inventories of crude and heating oil build in the run-up to winter, and the gasoline make is reduced to favor heating oil. But space heating needs and additional electrical power generation can be sharply reduced when the weather in the Northeast becomes unusually mild as it appears to be doing this year. Second, inventories of crude and products have been built to levels that approach the 'highs' of the past five years. That reflects the market going into contango after a long period of backwardation. It has "paid to store." In addition, the forward curve that measures the price of crude over the next few years seems to be telling market participants that this oil shock is different and that it is going to last a while. Finally, geopolitical developments in Iran and Venezuela, both significant crude exporters, hint at the possibility that the "oil weapon" will be unsheathed once again. Episodic troubles in Nigeria heighten the tensions as do vagaries of supply in the former Soviet Union. A perfect storm for crude oil and the result has been record high prices (at least in nominal terms).

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In our view, however, what has made this long rise since 2004 sustainable has been the new found romance that commodities in general, and crude oil in particular, have had for investment managers outside the oil world proper. Diversification and the hunt for yield in an otherwise low yield environment have convinced many of these managers to become active holders of an oil position, often through derivatives provided by the larger investment banks. A portfolio manager who goes "long oil," via a derivative, creates by that action an incentive for the seller of the derivative to offset part of the sale by hedging out some of the risk going forward. Other things equal, that elevates the forward oil curve. Asset prices, however, need ongoing flow demand to sustain their current levels and that's where the potential for an air pocket in crude oil prices may lie. These same portfolio managers will tell their respective boards that they are not 'speculating' in oil, particularly when their positions are showing gains, but if the oil market begins a sharp retreat, how many of them will add to their now considerable length. Some may even bail out. With plenty of inventory to go around, that will give commercials pause about acquiring more inventory.

Some evidence that this may be going on at present can be seen in the declining refinery runs, the build in crude and products inventories and hints…just hints for the moment that the Chinese Dragon may be taking a breather from its breathless pace of the past few years. We buy the argument that the absence of spare capacity both in crude and refining can create plenty of reasons why the crude and products market can stay elevated, but if financials and "China" are the fundamental reason while crude oil shot up to the mid 60's, well after the sustained price ascension of 2004 and 2005, a prudent investor might want to take on some extra caution. Volatility in crude oil futures has increased recently, a signal that can be read both ways for future crude prices. Today's threats by Iran prior to the next OPEC meeting together with express worry by the Saudi's that oil prices have gotten "too high" round out the picture. It appears that spare capacity has grown a bit over the past year and any pull back by the emerging giants of Asia to acquire extra inventory can add to the pressure for a sudden sharp shock downward.

If a sharp reduction in crude prices does come, economists who now worry that 2006 may be a year of weakening aggregate demand might applaud a break in crude prices. That would be a fatuous dream in our view. First, as is evident over the past two years, the consumer in the U.S. continues to drive in spite of significant price rises at the retail pump. Second, despite the cries of woe coming from GM and Ford and promises to reform, they are still making and selling gas guzzling SUV's and light trucks. If you have any doubt, look at the EIA projections of MPG's going out a few years. Our best forecasters see no relief in sight in terms of average miles per gallon.

What a sharp break in crude prices could do is to slow down the hunt for new oil, particularly in difficult places. That would be a tragic inference in our view. The world is not about to convert to a hydrogen economy in the very near future. Oil demand will indeed grow over time as emerging markets continue to grow and become even bigger consumers. And the ability of democratic governments to drum up a sensible energy plan for the future is non-existent. A sharp break in crude prices might dissuade both the hunt for new oil and growing conservation on the part of oil users. The worst case would be a temporary respite lasting a few months or a year or two, but that is another aspect of doing the maximum damage to the most market participants.

What is different this time, however, are the "financials." They have gotten into the game over the past few years and are now a significant part of the "new flow." In our view, that new incremental demand can evaporate if crude oil prices hit an air pocket and go through a sharp correction. Caveat emptor applies to portfolio managers too! Buying oil futures is not a game for the timid or the inexperienced. Today's strong rally took back some of the week's recent losses, but in our view, the test is coming.

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