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Lessons From The Oil Price Fall

The massive $100 per barrel decline in oil prices since July is prompting the same kind of questioning and search for answers as the price surge that preceded it. In 2006, PIW carried an article by David Hufton, managing director of oil broker PVM Oil Associates, "The Price Of Oil Market Transparency," that explored some of the key ingredients and contradictions of the price rise (PIW Apr.10'06,p7). His was a minority view at the time, but it turned out to be remarkably prescient. In the article below, David Hufton returns to the subject and draws lessons for the oil market and for Opec from the current situation. We have also included some excerpts from his April 2006 article.

There can surely no longer be any argument that in the summer of this year we witnessed the bursting of an oil price bubble, created by speculative excess built on leverage, fueled by the easy availability of credit. Commonsense economics proved to be correct, and the evidence was always staring the market in the face. It is obvious that if you throw more bids at any object its price will go up.

That is exactly what happened in the oil bubble. Electronic exchanges created easier access to a market previously denied to fund money, and as a result there was an explosion in pent-up speculative demand. Fear of supply shortages in the face of blistering developing country demand and peak oil alarmism drew in speculative players who recognized a sexy story when they heard one. Hot money leveraged on persuasive fundamentals and the rest is history. The Wall Street research teams provided bags of tables, charts and costings that appeared to justify $100/bbl oil, then $120/bbl and ever upward. The cost of providing the marginal barrel was deemed to justify whatever market price existed.

You will find most oil traders agreeing with the common sense view that if you throw huge sums of new money from hedge funds, pension funds, exchange traded funds and all sorts of other vehicles at the oil market then it will force prices higher and draw in additional money from momentum-following trading systems. The arrival of electronic futures exchanges responding to the clarion call of transparency provided the mechanism for this new money to find its way into oil. The virtue of transparency is price clarity, but it comes with baggage. It draws in nonindustry participation, steers prices away from simple physical supply and demand fundamentals, and increases volatility. Advocates of electronic carbon trading as a panacea for global warming, beware.

When London's International Petroleum Exchange went fully electronic in April 2005, the average daily volume of contracts traded on ICE Brent and Nymex WTI crude oil futures stood at 290,000. Nymex went electronic on Globex in August 2006. By spring 2008, contract volumes on these two exchanges, plus the ICE WTI contract, had reached an average of just under 1.2 million per day. Futures volumes over the period moved from a multiple of 3.4 times global physical oil demand of 85 million barrels per day to 14 times. In the run up to the summer of 2008, as prices were nearing their peak, futures exchanges were transacting at the rate of 1.2 billion b/d! WTI futures volumes alone over the same period moved from 200 million b/d to 800 million b/d, precariously supported by a declining underlying WTI physical production of only 300,000 b/d. That's a multiple of WTI derivatives to underlying physical supply of nearly 3000 to one!

The physical supply and demand for oil was eclipsed by the futures demand and supply. As in many other markets, the derivative overwhelmed the underlying physical commodity and the price signals were distorted. A whole new layer of supply and demand was added to physical supply and demand. Prices reflected futures supply and demand, not physical supply and demand, and futures supply and demand reflected all manner of elements, varying from fear of supply threats to peak oil alarmism, onto equities and dollar hedging, geopolitical concerns, technical signals and the like. The price bubble reflected an overwhelming demand for oil futures. One day it had to change into an overwhelming supply.

The bubble burst in mid-July. The market ran out of oxygen and collapsed even more rapidly than it had inflated. You can run quicker downhill than uphill, and it's the same with markets. It took 17 months for prices to move from $60/bbl to $147.50/bbl, but only four months to move back down again through the same range. The billions of dollars that ran into the market poured out in a vast process of deleveraging. Of course, there is a credible fundamental story to explain the move down — just as there was on the way up. The bear story has been all about economic meltdown and demand erosion. Supply shortages are no longer to be feared in a global recession and in a world where the decoupling of China's economy has proven to be a myth. Just as leveraging took us up to $150/bbl, deleveraging has brought us down to $40/bbl.

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Lessons For The Oil Market

Prices fell because confidence evaporated. To fundamentalists, the price rally had been running on empty ever since the market went above $80/bbl and certainly beyond $100/bbl. It was a subject of frequent discussion, whenever PVM had groups of oil industry clients together, that it was impossible to justify a level beyond $80/bbl. Speculative money did the rest, and whenever momentum arrives technical systems kick in and take it to the extreme. Such systems are unemotional and do not carry the baggage of fundamental concerns. They go wherever the momentum takes them, up or down. They do not care that they may be ruining businesses or sending the wrong signals regarding long-term supply and demand.

At $147 on WTI, the music stopped. The bursting of the US property boom triggered a collapse in confidence across the board. Fannie Mae and Freddie Mac needed bailing out, and suddenly the warnings of excess struck home. The US property price spiral had been fed by a credit boom that permitted leverage levels never previously available and which also fed the commodities bubble. The penny dropped, sellers appeared, prices fell, margin calls increased, credit lines were squeezed, risk aversion became fashionable, liquidity became king, and so the price spiral went into reverse. Speculative supply exploded.

The props holding up oil prices were removed one by one. The US subprime crisis pricked the oil bubble. Once prices started falling, momentum systems reversed direction and the whole pack of speculative cards collapsed. It was only a matter of time before this happened. Prices would have collapsed at some point, recession or no recession. The oil bubble was but one in a long series of speculative bubbles.

The problem the industry now faces is the arrival of a full-blown recession, adding to the price collapse that began when the speculative rollercoaster ran out of steam. Some would argue that the run-up in oil prices contributed to the recession, and that is probably the case — but it is the financial crisis created by housing and credit problems that is at its core. The financial crisis has turned into a real economy crisis, and oil demand has collapsed. It is falling real oil demand that is now at the heart of the oil crisis.

Speculative demand collapsed first and has been joined by a collapse in physical demand. The first on its own would probably have seen the price downdraft stop at $70-$80/bbl. The simultaneous impact of the second has taken prices a lot lower. Price elasticity would normally kick in to underpin demand, just as it kicked in to remove demand earlier this year, but any such effect is being swamped by the demand erosion that comes from slowing economic growth. In any normal market, supply would be cut off by falling prices, but where supply is under the control of a cartel such mechanisms are emasculated. In simple economic terms, prices will keep falling until physical and/or speculative demand kicks back in, or supply is brought into line with the new level of demand.

Lessons For Opec

With credit lines severely reduced and risk appetite suppressed, speculative volumes will not reach last year's levels in the near future. However, the mechanisms are still there — electronic exchanges are here to stay and commodities remain an accepted asset class in which to invest. With no prospect of a physical demand reprieve in the near future, and assuming no act of God or terrorism to curtail supply, the only hope of a price rebound rests on Opec. It must use its supply weapon to turn short sellers into buyers.

Opec now understands the power of speculation. It must nudge the odds of the electronic oil casino back into its favor. Members need to fully implement currently agreed cuts and announce a third one that will change the mood of the market and turn the excess of speculative supply into an excess of demand. Opec must harness the speculative forces that took WTI to $147/bbl. It has an enormous job on its hands. Remember, this is the organization that does not even trust its own members' production estimates. To turn speculation to its advantage, it needs to make a big and very convincing additional cut. This is not a market in which to be overly cautious, as those governments fighting the financial crisis have discovered. Actions need to be bold, decisive and followed through. A 2 million b/d supply cut, followed through by clear evidence of compliance and supported by a 500,000 b/d cut by Russia, should achieve the $75/bbl level they are looking for.