

# Crude dollar trade

*Chris Thorpe of HCEnergy follows the trends in the crude oil market*



Chris Thorpe is a Managing Partner with HCEnergy LLC.

HCEnergy is a dealer of commodity options, swaps and futures with offices in New York and Zug, Switzerland. Its energy advisory practice focuses on hedging, trade execution and risk management.

Contact:

Chris Thorpe, CFA

HCEnergy LLC

Tel: +1 212 774 5963

Email: cthorpe@hceenergy.com

**T**he crude oil price rebound over the last 18 months has been truly remarkable given a mostly feeble global economic recovery. It was only May of this year when we tested the \$70-a-barrel level only to refute it and quickly resume a path higher to well over \$80 a barrel. The fact remains that demand growth has only partially recovered and has been supported by government stimulus worldwide. Even the emerging markets' growth rates are not back to their pre-meltdown levels. So why has the market supported a return to \$80 crude? Should transportation companies worry that fuel prices may go higher from here? The answer lies in both the US dollar, which is at risk of further devaluation, and in the crude oil supply picture, where growth does not have the potential to meet a robust recovery without the risk of higher prices.

The global demand picture is becoming clearer with recent third quarter (Q3) 2010 reports suggesting that the UK grew by an annualised 3% and the European Union (EU) as whole was not far behind. Other developed economies are also reporting positive growth with improving consumer spending whilst developing countries indicate high single-digit growth. Although exact growth figures are difficult to pinpoint in emerging markets, they continue to feature plenty of available capital for new projects and investment. The low cost of borrowing across the G7 has helped provide that capital and has fuelled a global rebound that has had a direct impact on markets and pricing including upward pressure on petroleum prices.

## Inelastic demand

Perhaps due to the inelastic demand nature of some consumer goods in the United States, we have seen price increases (modest inflation) – most notably in energy and food. Indeed, the market for housing still exhibits the symptoms of a post-binge hangover and may limit consumer spending growth. But for now what's interesting is that a prevailing negative investor sentiment has been overcome by improving consumer spending. This has trickled down to energy demand for transportation of goods. Thus despite a hobbling economy, demand is actually improving for energy consumption.

With this in mind, commodity prices may creep higher despite what may appear to be zero or negative inflation, all else being equal. The spectre of deflation has placed the **United States Federal Reserve** in a position where it will employ novel methods

**'Should transportation companies worry that fuel prices may go higher from here? The answer lies in both the US dollar, which is at risk of further devaluation, and in the crude oil supply picture, where growth does not have the potential to meet a robust recovery without the risk of higher prices'**

to fend off the risk of deflation and prolonged unemployment. Longer term quantitative easing (now known as 'QEII') is unfolding as expected with the Federal Reserve announced purchase plan of \$600 billion of US Treasuries. By purchasing large amounts of longer-duration US Treasuries, it will decrease long-term US dollar interest rates, and likely weaken the US dollar versus other major currencies. A weak dollar generally results in higher crude oil prices in US dollar terms.

## Low cost of borrowing

The low cost of borrowing in the United States and elsewhere not only makes leveraged investment attractive but also may promote investment in financial assets and physical assets such as commodities as a way to hedge against US dollar depreciation and inflation in the future. With few exceptions, commodities have rallied in the last quarter, potentially pricing in an expectation of a weaker dollar. To hedge against further weakening of the dollar, those exposed to crude oil prices using a benchmark denominated in US dollars will need to hedge dollar depreciation or against crude oil price appreciation. Most major energy benchmarks are denominated in dollars, which creates a secondary risk for hedgers if they do not at least calculate the currency risk implied by their energy exposure. This macro economic risk is hard to evaluate, but we can at least identify it and prepare for various outcomes.

If currency risk wasn't hard enough to pin down, there is a greater risk of crude oil going higher due to other key issues. As demand growth seems to be finding some stable rate of improvement, the pressure on prices to increase will come from the

supply side which might not meet current demand growth. Recall the theories of Dr M. King Hubbert, known for his peak oil theory which describes that production will peak at a certain point then decline until depleted; the increase in production may not meet demand at the most modest levels of expected growth. I will explain why.

#### **New sources of crude oil**

The world is very dependent on traditional sources of excess supply capacity in crude oil. The most prominent supplier is the **Organization of the Petroleum Exporting Countries (OPEC)**, which has historically been able to call on an available surplus capacity at short notice. Yet this important buffer in supply has dwindled and OPEC producers' ability to add more barrels in the short term is increasingly limited. The other key geographic sources have been the North Sea, Mexico and Russia which are not subject to OPEC production quotas. Those areas currently produce at capacity and have diminishing potential to add new supply. North Sea and Mexican outputs of crude oil are rapidly being depleted and Russia has returned its production levels to those seen prior to the currency crises in 1998 with no expectation for new supply growth. If traditional sources become less significant, can the newer sources and non-OPEC supplies be trusted to provide the necessary volumes when they are needed? The answer to this question will challenge Dr Hubbert's theory that a peak of supply will be reached globally, and then enter an inevitable period of depletion when demand growth outstrips supply growth.

We are left with a few supply wild cards or higher cost alternatives. Non-conventional supplies, including Canadian

**'A prevailing negative investor sentiment has been overcome by improving consumer spending. This has trickled down to energy demand for transportation of goods. Thus despite a hobbling economy, demand is actually improving for energy consumption'**

oil sands, on-shore shale rock formations wells and liquefied petroleum gas (LPG) from conventional wells, may provide important sources of crude and petroleum liquids at various costs. The Canadian oil sands alone are an important source of new supply but have development limitations due to the high cost of extraction and conversion of the heavy asphalt-like product to liquid crude product that can move through a pipeline primarily to the American market. The smaller volume shale rock land exploration is lower cost but provides smaller potential volume of crude and petroleum liquids versus natural gas. And alternative fuels such as natural gas and LPG play a part of supply growth, yet not enough to bridge the gap.

Even with new projects, non-OPEC suppliers cannot impact supply growth significantly. Though Canada, the US, Brazil and the former Soviet Union (FSU) are increasing production and alternative fuels are making progress, the level of annual supply growth is only between 200,000 barrels a day (b/d) and 300,000 b/d. This is quickly offset by growth declines in Mexico and the North Sea that are dropping annually by a combined 500,000 b/d, according to the **PIRA Energy Group**.

There are other less quantifiable bottlenecks for new supply growth. As a result of the **BP Macondo** oil spill, off-shore drilling in the United States and other countries may be delayed or restricted due to political agendas or environmental limitations. Even if projects do continue, weather and other safety factors may limit output potential in the near term. Looking beyond the Gulf of Mexico, even investments in the deepwater fields near Brazil's coast may get delayed following the Brazilian government's announcement of its intention to nationalise some of the oil revenues. Therefore, the time lag to supply growth remains in question.

#### **Timing is everything**

With economists gaining confidence that the worst is over in the credit markets, the risk of a severe downturn has diminished. If global demand improves as we are currently seeing, supply growth has to exceed expectations and avoid typical and periodic disruptions. With political issues, weather, investment climate, and technology all key inputs in the equation, the likelihood of a higher oil price should be considered, especially when coupled with a weaker US dollar in a long period of economic recovery and loose money.

**'Most major energy benchmarks are denominated in dollars, which creates a secondary risk for hedgers if they do not at least calculate the currency risk implied by their energy exposure'**