

Do the fundamentals

Chris Thorpe of HCEnergy looks at the changing nature of the fuel market



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When it comes to making predictions and forecasts in the fuel market, it may be that fundamentals just don't matter anymore. Market factors that influence price have become increasingly affected by macro-economic drivers beyond petroleum supply and demand equilibrium. The near-instantaneous speed of data and the ubiquitous nature of electronically distributed real-time information allow more market participants to react immediately, therefore decreasing volatility and essentially eliminating traders' ability to profit from inefficiencies in the market.

From a price management perspective, do we really need to know anything at all about the direction of energy prices or do we simply accept the view that we don't know and prepare for the worst case scenario? Although market conditions may be explained by fundamental information gathering, the global petroleum market has too many potential influences that impact prices in both the short and long-term. It could be that predicting prices or budgeting is simply a 50:50 bet, odds that are far too poor for most business planning.

Fundamental data, market research and forecasts come at a significant cost. A small business can easily spend \$250,000 a year on subscriptions for data and research while larger businesses can spend into the millions. Add to that the in-house analysts or economists who have to read and decipher the reports and the numbers start to really add up – and it is only once it is processed that data can be considered useful information for senior management and decision making. Studies show that business managers tend to be overconfident in their decision-making process in the first place, whether due to anchoring, data mining, past experience, or gut feeling. Data mining can also distort views and create illusions of control. For example, a manager who has forecast a budget may selectively seek out data to support his argument, where he should instead be seeking data to refute it and qualify its reliability. So increasing amounts of data and analysis in price forecasting may simply increase the chance of creating an illusion of confidence.

This is not to imply that fundamental analysis should be put aside or discarded. Without fundamental data, it would be almost impossible to examine the state of the market and use perspective to make informed decisions. We should continuously review and study fundamentals to put the world into

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context. Keep in mind, though, fundamentals can support both a bullish case and also a bearish case. I would argue that petroleum markets are likely tipping toward the bullish case due to the fact that the growth rate of supply cannot likely keep up with the growth rate of demand. The bears would argue that there will always be a replacement product or technology that will provide an economic solution to diminishing petroleum supplies. Indeed, fundamentals play an important role in this debate and provide a basis for understanding as we view the future and form our business strategies. As we prepare, however, do they allow us to have a clear view of where the price will be?

It can be argued that there are just too many other factors that impact price in the short-term, which is often viewed as three to 24 months in the future. From a trader's perspective, when it comes to reducing price risk and hedging for the future, the guiding principal is to use the most liquid instruments in order to have some kind of efficient price discovery and trade execution. Liquidity ensures a reasonable price upon entry or exit of a trade. Indeed, fundamentals provide the basis for buyers and sellers to create an orderly market. When hedgers look beyond the liquid points of trading, the ability to manage price efficiently diminishes rapidly. Fundamentals also play a large part of the dynamics of local markets and when it comes to physical transactions in the spot market, or at least they should.

In global petroleum markets, the difference in price for similar products between geographic markets is known as the basis spread, or simply 'the spread'. Theoretically, the difference in price for the same product in two different markets should

1 things apply?

be equal to the freight cost between the two markets (taxes ignored). However, this is rarely the case in any market as arbitrageurs or traders can quickly take advantage of any price disparities by moving product to the highest bidder. Local factors lead to large changes in price spreads for many reasons that may not be predictable by any model, research or data. For example, a cold snap may freeze a waterway and limit supply, or fog may halt movements in a port of delivery. Delays in supply may create short term price spikes that would have never been predictable. Large refineries also have a major impact on prices when unforeseen plant outages crimp the supply of refined products. And new refineries tend to be larger scale, which leads to even greater volume and price impact when they are stalled by fire, weather or even labour stoppages, as was seen in 2010 in the French refinery hubs of Fos-Lavera and Le Havre. Indeed, fundamentals impact which product or geographic price point will be affected most. But are these local market issues leading the market or merely a distraction from the big picture? Increasingly, the most important fundamentals may be based on investors, not supply and demand.

The tide of cash that has risen in investor and fund accounts has flooded most commodity markets, especially in the case of petroleum. If you dared to short the market when interest rates in the US were approaching zero, you likely had a very tattered profit and loss statement for 2010. Investors' changing desire to own energy-based commodities is particularly difficult to estimate. Funds are often disliked and misunderstood as they tend to have opaque strategies and 'black box' or model driven trading tactics. When they enter the market, they bring large trade volumes and when exiting liquidate instantly as we experienced in the May 2010 'flash crash' (when the *Dow Jones Industrial Average* plunged more than 900 points on 6 May on worries about the credit crisis in Greece, before quickly recovering ground). They may be a nuisance or perhaps just answering investor demand, but they are anything but predictable and often not fundamentally driven. While investor behaviour remains fickle, traders tend to stick to text book discretionary trading strategies. Similarly, market tacticians use charts to illustrate how the past is a tool to forecast the future simply based on pictures of data. Although mostly discarded by academics as an illusion, many traders use charts because it is common practice and therefore it impacts market action. To some of the large professional trading houses and

large global investors, day-to-day fundamental analysis may not have a significant role.

Often, directional views of the market deny that there is a 50:50 chance of markets going higher or lower at any point in time. It is hard to fathom at times that prices can go down, whether it be housing or crude oil. Quite naturally, we avoid allowing our predictions of the future to be overly pessimistic. Perhaps this is normal human behaviour, although we know it to be unsound. Recent events also affect our methods of using information based on our own experience, such as using a gut feel or a rule of thumb (often referred to as a market heuristic). In the case of fuel consumers, when prices are high, they predict they will go lower or back to 'normal'. In the case of homeowners, they predict that their homes will increase in value back to the price they paid at least. Yet there may be no fundamental economic reason that prices will change in the time period expected. Even for markets where fundamentals have a larger impact, such as natural gas or electricity where storage options are limited, prices can vary well beyond expected fundamental value.

Fortunately, the derivatives market provides a window into the cost of insuring future prices. The market prices both directions, allowing us to bet against it and make money or limit our risk. For example, a fuel consumer may accept a floor price for the coming year 10% below the spot market price and collect a premium for doing so.

Timing, as they say, is everything. You may be right, too early or too late. So if you cannot predict the future with any certainty, do fundamentals really matter? Data and research potentially provide a false sense of security and overconfidence about the future, simply because realised market price is likely to be influenced by random events. Well-executed hedging allows us to manage our risk, or limit our bad luck. You may hear reasons for prices being at a certain level, ranging from the running joke that there are 'more buyers than sellers' to the more esoteric notion of 'funds' trading in the market. Neither reason provides great insight to where fuel prices are or will be. While physical supply can be managed with contracts, storage and supply diversification, the same is true for prices and costs, regardless of fundamental market conditions. In the case of market prices in the future, it is best to be prepared for the worst case scenario or assume that your forecast may be dead wrong. If the 50:50 bet doesn't go your way, you should have protection in place or have a plan of action at the ready.

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