Oil Review

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Oil—TARP and Oil

It is interesting times we live in….volatility and the financial contagion occurring in the US is playing havoc not only with economies around the world but with our traditional valuation models we have for crude. As we are fast approaching the northern hemisphere winter we normally discuss the inventory builds and whether or not they are enough to placate winter demand. This year with low refining capacity/builds as a result of hurricanes Ike and Gustaf and weak economic demand we have been suggesting that both factors may offset each other in the lead up to winter. However, concern over the financial crisis is causing additional consternations as to the future prices for crude. In this report we focus on the volatility of the market and try and work out what we think will occur with Crude Oil, the USD and the rescue package.

Position taking in crude has been frustrating due to the volatility in the market. To see a 17% up tic in the price in one night suggests how nervous the market really is. The general feeling from players is that the future direction for crude is more reliant on the valuation for the USD and not on our traditional fundamentals. It is interesting to see that recent moves have been primarily linked to the moves in the USD and this in it self is providing additional concerns. Why?

As we are aware most commodities are priced in USD. When a commodity moves we link its move to solid fundamental or technical reasons. Generally, solid economic demand scenarios from India and China have been the main stay to commodity values increasing. The depreciation of the USD over the last couple of years has added weight to this picture; however, we feel that if the USD continues to slide as a result of a lack of confidence in the US financial system then this could be a further nail in the coffin of a safe road to recovery.

Simply put, if prices trade higher as a result of a weak currency rather than good demand dynamics to back it up a “cost push inflationary” environment will emerge. This process remains with us until consumers fail to consume product at the higher prices and stock is left on the shelf. We saw this in Oil over the last couple of months where “demand destruction” was responsible for the price falling from US147.00 to US90.00. Then as companies fail to return sustainable profits due to the slow down, workers are put off and unemployment picks up. The economy slumps and we enter into a period of low/negative economic growth with high unemployment……stagflation. Stagflation in the late 1970s is well remembered and is an economic condition that many believe should be avoided. However, given the current circumstances and the potential for the USD to continue to slide it just may hold the key to rehabilitating the US economy. Why?

The Federal Reserves 700billion USD rescue or Troubled Asset Relief Program (TARP) is designed to restore asset prices by removing the troubled assets from the Banks balance sheet and packaging them up (sound familiar) until economic conditions improve. If the market cannot find some confidence over the plan then the USD will be sold and we potentially will enter into a stagflationay environment. Given the position the Federal Reserve may find it self in, having a stagnating economy would probably be a preferable play to what some commentators are describing as a potential fiscal collapse. So perhaps at the expense of the labor market the preferred position for the Federal would be a stagnant economy. How will this affect the price for Oil?

As mentioned in the opening paragraph we feel that the current contagion is providing a curve ball that is making it hard to predicate the future direction. At the moment given the current fundamental picture we see Oil gravitating higher on the back of lower refining capacity, heightened weather concerns in the Gulf and potential for an unpredictable winter. Concerning TARP we feel that the market will treat any news as being supportive to the price of Oil. If the market shows no confidence, prices will trade higher as a result of a weakening USD and if the market is confident that the package will work then Oil will trade higher as a result of limited supply and stable demand.

Technically, the current range is US90.00 to US147.50 and as we are in the lower part of the range we are preferred buyers of the commodity especially between US98.00 and US103.00. On US100.00 being maintained we can target US 115.00 to US 120.00

Daily Chart

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