

ASIAMONEY

June 2008 -

COMMODITIES - Soaring oil prices stoke fear of market bubbles

"I like coffee and it keeps me awake, but it becomes a victim of its own success when it stops me from going to sleep because I've had too much," says Sean Darby, Nomura's chief Asian equity strategist in Hong Kong, as he sips from his cup. "That's the same problem with commodities. It's done its job but the bubble is going to burst. It's time to get out and I'm getting ready to short."

More and more analysts are joining Darby in what looks like a spectacular about-face. Until recently, commodity investments were viewed in a very favourable light. Now, people are talking about a commodities bubble, and some predict it is about to burst.

Yet crude oil is one product that would appear to contradict the view that commodities are about to fall in price. Fears of falling oil reserves and growing demand among developing nations, particularly China and India, are causing another round of panic – and speculative investments. Crude oil prices sequentially reached new highs last month, with crude oil futures reaching a record breaking US\$135 a barrel on May 22 – before dipping to US\$127 by May 30.

And even observers who have expressed reservations about commodity prices acknowledge that crude oil could prove to be the exception to the rule.

But it is starting to look as though contrarian views that crude oil will soon follow in the footsteps of other commodities might have some substance.

Edward Morse, chief energy economist at Lehman Brothers in New York, believes that bubbles are emerging in the oil market. "Financial flows have been pushing oil, and to some degree other commodity prices, above where market fundamentals would dictate," he says. "We believe that when oil fundamentals weaken, by late this year and early next year, a financial sell-off could drive prices down even further than fundamentals would warrant."

Yet for all the scepticism of analysts, there are many investors who are confident that oil prices still have plenty of room to rise. And given the growth of investments into oil futures, getting the call right could be the difference between enviable profits and lamentable losses.

Herd mentality

As a whole, commodities have grown in appeal to investors worldwide, partly because the fundamentals of supply and demand have been better for commodities than for equities and bonds in the past year. There is a view too that such demand dynamics will continue to strengthen.

This rise in interest has brought with it sustained investment into commodity index funds. Lehman Brothers estimates that the total assets under management in commodity indices had more than tripled to US\$235

billion by mid-April this year, from US\$70 billion at to beginning of 2006. Of the US\$165 billion increase, about US\$90 billion has come from investors and the remainder from price appreciation. To put it into perspective, the money flowing in over the last two years has exceeded all financial investment into commodities before 2006.

But that, in turn, has led the market to become a victim of its own success. Prices have tended to rise quickly for many commodities, but such gains are typically fickle.

"Investment flows can go pretty quickly. They can be out of the door when the cycle reverses and that's where we are at the moment," says Darby.

There are precedents for this: in the third week of March, the commodities market saw a correction where gold prices dropped approximately 15% and oil plunged almost 6% from March 18 to March 20.

"There is definitely an investor herd mentality that is often at work in driving commodity prices to levels above or below where market fundamentals would dictate," says Morse. "We believe that was at work in March."

According to the New York Mercantile Exchange (Nymex), the world's largest physical commodity futures exchange, oil is the world's most actively traded commodity and its price hikes have been particularly sharp.

Darby says there is a misconception about the immediate shortage of crude oil. While there are genuine shortages in sweet crude (which is preferred by refiners because it requires less refining to yield high-value products such as petrol and diesel), there is plenty of sour crude available. "But certainly the evidence is that a lot of it is stuck on tankers being held in expectations of higher price rises, which is speculation in some way."

Long-term positivity

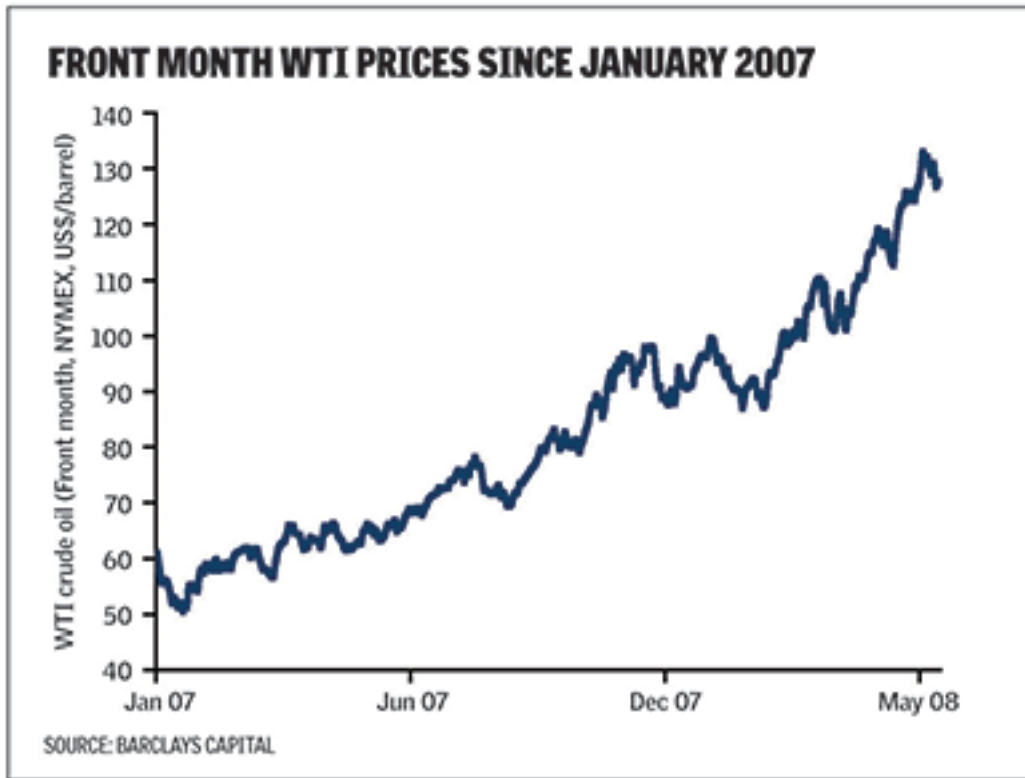
But not everyone is convinced that the ebb and flow of investment plays such a pivotal role in the fluctuation of commodity prices, especially for oil.

"You'll need an imaginably large amount of money to create a 12-month dislocation in price," says Michael Coleman, managing director of Aisling Analytics, a Singapore-based hedge fund. "The flows can have some short-term impact but the price of oil is so high because people are really worried about where supplies are coming from over the next five years."

Like Coleman, many investors are more confident about oil than analysts. They argue that recent volatility in crude oil prices is only to be expected amid broader financial market turbulence, but maintain that the commodities super-cycle, or prolonged price rise, is intact. "There's a lot of volatility associated with that so that's what investors have to understand if they're going to be in it," says Brad Cole, president of Cole Partners Asset Management, a natural resources fund of funds in Chicago.

"The real driver of this bull market is the industrialisation of developing Asia," Coleman continues. "You're ready to call the top of this secular bull-market when you think the growth in China and India is plateauing. If you don't think so, then you might get cyclical sell-offs, but you're not moving into a secular bear market."

It's not hard to find other investors who side with the commodity bulls.



David **Bensimon**, a technical analyst who recently set up Polarcap Prosperity, a boutique hedge fund in Singapore, writes the PolarView report, which predicts precise price fluctuations based on a "phi sect" theory he devised. This technique leads **Bensimon** to conclude that oil will work its way back to US\$85 a barrel in the next 12 months, before mounting a huge upswing to US\$420 a barrel by 2015.

He made his fund's first trade by shorting crude oil futures at US\$126 in mid-May, netting his US\$4 million fund its first profit in the process. "I would be more comfortable buying oil at good levels than selling oil because my larger view is oil is on the upswing," he says. "In the short side, it'll only be a modest position. I don't like to trade from the short side in the context of the larger bull-trend, but it was in the area of my long-held expectation for an immediate top so it was worth a trade." He wrote about the US\$128 price objective in *Polar Perspectives*, his book published in 2006.

Rodney Lake, senior investment analyst at George Washington University's endowment fund, is bullish on oil prices too. "We think there's room [for prices] to go up. Even if the US is in recession, prices don't seem to have very much downward pressure. There was some lately but it's being turned around. There's going to be a continued upward story."

The key appeal of oil and other commodities for Lake and fellow endowment fund managers is that they act as a hedge against inflation, so day-to-day price shifts tend to be less of a concern. The university's endowment fund has approximately 2% to 3% direct exposure to commodities and 20% to energy holdings such as stocks of oil and gas companies or private equity structures. It is anticipating annualised returns in commodities of between 15% and 20% this year.

The National University of Singapore's endowment fund, which has S\$1.29 billion (US\$946 million) in assets, also invests in commodities, but mainly as a hedge against inflation and in line with its asset diversification approach. It typically holds between 5% and 7% of its assets in commodities, and if price hikes take the

allocation substantially above that level it tends to trim its holdings via a balancing mechanism.

"In all our investments, including commodities, we can accept the mark-to-market volatility and the downside risk, but what we try to avoid is permanent loss of capital," says Wee Sin Tho, chief strategist of the National University's endowment fund.

Strong fundamentals

But some investors are more cautious in their outlook on oil. Mike Wittner, head of oil research at Société Générale in London, thinks that a small price correction could occur but that Asia-led demand will eventually underpin some big price rises. "We think that as the year progresses, the fundamentals will reassert themselves," he says. "But the mild [global] economic slowdown and solid oil fundamentals mean that oil prices, even if we see a bit of a correction, won't go below US\$110 [a barrel]."

"It's hard to be too bearish," he adds. "I'm not saying US\$150 a barrel is out of the question. If we play the game of plus or minus twenty five dollars, we'll have a better chance of seeing US\$150 before we see US \$100."

Others point to the long-term story where fundamentals and investment turnover intersect. The run-up in prices over the last 12 months is different to previous surges, which were characterised by stable far-forward prices but significant near-term appreciations. In recent months the back-end of the curve, which covers forward prices going out to five years, has increased as well – sometimes even more than the front-end.

"This is an important shift in terms of perceptions of the markets as to where the prices have to be to bring the market back into balance," says Yu Yingxi, a commodities analyst at Barclays Capital in Singapore. "The combination of long-lasting positive demand and supply dynamics are starting to be reflected in the recalibration of perceptions of long-term prices. We very much believe that oil prices, despite the strong move higher, are still some distance from the long-term equilibrium."

In other words, don't expect to see oil ever falling to rates of under US\$50 a barrel again.

Downturn dynamics

Certainly oil has become a more expensive resource, but that doesn't mean that the predictions of ebullient investors will turn out to be correct. One uncertainty about future oil prices is the impact of supply.

"We see market weakness ahead for the next three years," says Morse. "After that it is anyone's guess. We don't have enough data on when the new supply responses in Russia and Brazil and other deep-water fields will be triggered. Saudi Arabia has just indicated that it believes oil prices should be around US\$65 to US\$70. That's an important indication of how deep the downturn might be."

Morse forecasts that Brent crude oil will trade at an average of US\$103 per barrel this year, with a structural downturn taking hold in the fourth quarter, exacerbated by speculators losing confidence in oil prices. Unless the Organisation of Petroleum Exporting Countries refuses to boost production, 2009 prices should soften, falling to an average of US\$83 a barrel. It was trading at US\$127 on May 30. Darby has a similar prediction, placing long-term oil prices at US\$100 to US\$105 per barrel.

An important turning point for oil prices is when the oil futures market moves from backwardation – where spot oil prices are trading above futures prices – to contango, where the spot price drops below the futures price. Contango happened in London crude oil markets at the end of May.

Backwardation took place because of the squeeze in supply from above-trend growth in China and India, as well as problems in the supply process. "Ironically, when backwardation happens, this only encourages further investment as there is a carry return from selling [oil at] the spot price and buying a futures contract," says Darby.

He thinks that with prices going into contango, investors who have piled into oil will start withdrawing their funds as the income gained from rolling over spot contracts disappears.

Inflation jitters

The disappearance of backwardation aside, Darby has five other reasons why oil prices should drop. The most important of these is the effect of inflation.

"Policy-makers have started to receive inflation signals at long last," he says. "Central bankers are saying that they have made the wrong policy decision. The way I see it, they are going to tell the investment community, 'We are going to take control of the system again, we're not going to let inflation take hold.'"

Controlling inflation means raising interest rates, which slows economic growth – and hence demand for oil – while making bonds more appealing as an investment. It could mean that commodities become less attractive as an asset class than bonds, equities or property.

China is aware that it needs to take control of inflation, which increased to 8.5% in April, from 8.3% in March, on the back of soaring domestic food prices and international energy prices. On May 12, the authorities raised the reserve requirement ratio for commercial banks by half a percentage point to curb excess liquidity and to ease inflation. It was the fourth such move this year, lifting the ratio to 16.5%.

It's not the only one. On May 19, the Vietnamese central bank raised three interest rates: the base rate rose from 8.75% to 12%; the refinancing rate from 7.5% to 13%; and the discount rate from 6% to 11%.

Even the US could be forced into raising rates in the not-too-distant future. The Federal Reserve has slashed rates by 325 basis points between September and April to try and bolster economic growth. Its policies have come home to roost.

On May 20, the government announced that the core producer price index, which strips out food and energy prices, rose 0.4% in April, twice the rate forecast by analysts.

Minutes from the latest Fed meeting in April suggested that the central bank would freeze rates to stem inflation.

Plus, there's another simple reason for oil prices needing to drop: high prices really hurt.

"At the moment, the real economy cannot work with oil about US\$130 [per barrel]," says Darby. "We're getting

inflation and severe problems within the corporate sector that normally tells you we have hit a choke-point."

Nomura is so confident in the commodity bubble bursting that it has recently closed its commodity-linked inflation protection basket, made up of companies that benefitted from higher oil, metals and agriculture prices, saying that it was hamstrung by its own success. And Darby thinks stocks of regional upstream companies such as oil majors, oil explorers and oil producers have been overbought and are at risk of a sharp correction in spot prices. "Aggressive portfolios should consider shorting oil stocks," adds Darby.

In the long term, oil prices would seem set to rise. But over the coming year, there are many reasons to assume some marked corrections. Not all of the negative shocks to oil prices may have filtered through yet, and endowment managers and other investors would do well to keep a careful watch of their energy investments.

Just like coffee, too much exposure could give them the jitters.

All material subject to strictly enforced copyright laws. © 2008 Euromoney Institutional Investor PLC.