

## **ENERGY MARKETS: Analysts debate sustainability of oil's price surge**

01/10/2011

Nathanial Gronewold, E&E reporter

**NEW YORK — All of a sudden, it seems like 2008 all over again.**

Crude oil prices are back in the \$90-a-barrel range and seem destined to climb. Food, industrial metals and other commodities are also reaching highs. And institutional investors are once again pouring cash into commodities as Wall Street predicts a bullish 2011 market.

**Is the giddiness over commodities out of touch with reality? Some experts insist recent commodities price spikes are disconnected from the supply-demand picture and instead reflect a healthier stock market and the return of institutional investors looking to diversify their portfolios.**

**"The behavior of crowds has a distinct pattern to it," said Jeffrey Kennedy, an analyst at the research firm Elliot Wave International. "From these patterns we can get a really good idea of the market, of the psychology of the market and its participants."**

Banks are near unanimous in their predictions of higher prices to come. Analysts at Barclays Capital this morning sent a note to clients predicting that high oil prices won't significantly hinder economic growth. And West Texas Intermediate crude futures for February delivery had risen by more than a dollar in just a few hours of trading today, to \$89.15 per barrel at the New York Mercantile Exchange. Brent crude futures are priced at more than \$95 a barrel at IntercontinentalExchange in Atlanta.

Wall Street energy analysts may have sound reasons for justifying expensive crude oil this year or believing a recent prediction by a former petroleum executive that U.S. pump prices will hit \$5 a gallon next year, but Kennedy and others see classic herd behavior at play.

**Kennedy said Elliot Wave's modeling suggests "an extremely volatile commodity market where you're going to see commodities basically crash, and then a few months later rally through the roof, and then crash again, and then rally through the roof."**

Though the United States has experienced recent oil-supply drawdowns, inventories are nonetheless much higher than they were just before oil prices climbed to \$148 a barrel two years ago. And a robust economic recovery globally is far from certain, while warnings of a bubble in property values and construction in China are gaining currency among the analyst community.

Most market watchers -- Goldman Sachs, JPMorgan Chase and Barclays Capital, to name a few—point to a weak U.S. dollar, rising demand in the developed world and the resilience of the Chinese market to justify their predictions that oil prices will hit \$100 again.

But many economists insist investor moods are the source of current price spikes. **"Everybody is obsessed with the demand side of this market, and they're failing to observe that supply is also growing,"** said Tim Evans, an energy economist at Citigroup.

"Clearly, there's been a buying flow," Evans added. "But as an economist, I have to come back and say, 'Is that price sustainable? **Is it supported by what we see in supply and demand? And the current answer is 'No, it's not.'**"

As Evans and other analysts point out, crude production is rising with demand both in the United States and abroad. **Though oil prices are about 25 percent higher than a year ago, U.S. crude inventories are more than 4 percent greater, while production is estimated to be 3 percent higher.**

Overseas, oil supplies seem even more sound.

A recent estimate by the Department of Energy shows **spare capacity that producers in the Organization of Petroleum Exporting Countries (OPEC) enjoy is about 4.85 million barrels a day. In the summer of 2008, that figure was just 1 million barrels a day.** The Paris-based International Energy Agency (IEA) puts the number even higher, estimating that OPEC has more than 6 million barrels per day of spare capacity at its disposal.

### **Electronic trading's role**

**Even some traders at the New York Mercantile Exchange (NYMEX) seem flummoxed by the current run-up in oil prices.**

**"We're not trading like a commodity used to. We trade more like an equity now,"** said Jeff Grossman, a energy options trader at BRG Brokerage. "Everything is much more difficult now because the lion's share of what was trading in the pit is now on the electronic screens."

**Instead of tracking inventories, production and exchange rates, commodities prices have followed the moves of the Standard & Poor's 500 much more closely, NYMEX traders say. Indeed, Citigroup research shows that on many occasions crude oil prices and the S&P index have demonstrated a correlation of greater than 90 percent.**

In recent months, West Texas Intermediate crude prices have tracked the S&P 500 more closely than some stocks included as part of the S&P itself, Evans says.

**"The market seems to have it in its head that the demand is going to outpace supply, that OPEC spare capacity will be quickly dry up, and that we're going to get back into a real bull market situation, and I don't see it,"** Evans said.

Oil traders complain that it has become much more difficult to follow the market since floor trading was overtaken by electronic systems. NYMEX's two trading floors have been consolidated into one as floor activity shrank to a quarter of what it was, they say, making it impossible to tell who is driving prices higher and for what reasons.

"There are so many different things that a trader has to factor in trying to figure out why the market is going one way or another," said Tim Jennings at Vantage Trading. "The trading community has become much bigger since the introduction of the electronic platform."

For the most part, Jennings and his peers say \$90 a barrel for West Texas Intermediate (WTI) and \$95 for Brent crude are justified given the economic recovery in the United States and China's growing demand. But they seem much less confident than they were at the start of 2008, when some banks were predicting \$200 a barrel.

Meanwhile, murmurs of a pending end to China's construction and real estate boom are growing louder among financial analysts, and the United States is facing mounting problems with municipal and state budget deficits. And **Middle East oil output is growing as Iraq supplies return to the market, while exploration and production companies continue to announce new major resource finds in Africa and Latin America.**

More bearish analysts say all these indicators suggest that reality will soon calm the market. And reality could already be setting in: WTI prices have slid from the \$90 range, while some on Wall Street are concerned that Canadian oil sands imports will significantly boost crude inventories in storage at Cushing, Okla., if a major pipeline project wins approval.

"Right now, I'm sure a lot of people expect that oil is going to go to the moon just because of the peak oil theory that it's running out," said Alan Hall, a principal at Elliot Wave. "We don't think so."