Philequity Corner (May 26, 2008)
By Valentino Sy

What should investors do as oil rockets past $130?

Crude oil for July 2008 delivery settled $132.19 a barrel on Friday after reaching a new record high of $135.09 on Thursday on concerns supplies may not be adequate. The International Energy Agency (IEA) said last week that it may cut its long-term projection for supply after studying the depletion rates of the world's 400 largest fields.

Meanwhile, the announcement of Saudi Arabia to increase its output by 300,000 barrels a day in June was not enough to calm the oil markets since this amount is just sufficient to match the decline in supplies coming from Venezuela, Nigeria and Indonesia.

Data from the IEA shows that world oil demand has equaled, if not outstripped, supply since the first quarter of 2007.

World Oil Balance (in millions of barrels/day)

	2006	1Q07	2Q07	3Q07	4Q07	2007	1Q08
DEMAND							
OECD	49.3	49.7	48.2	48.7	49.9	49.1	49.5
Non-OECD	35.5	36.4	36.9	36.9	37.3	36.9	37.8
Total Demand	84.9	86.1	85.1	85.6	87.1	86.0	87.3
SUPPLY							
Non-OPEC							
OECD	20.0	20.2	19.9	19.5	19.7	19.8	19.8
Non-OECD	28.8	28.0	27.9	27.7	27.7	27.8	27.7
Processing Gains	2.0	2.0	2.1	2.1	2.1	2.1	2.1
Other Biofuels	0.3	0.4	0.4	0.4	0.5	0.4	0.6
Total Non-OPEC	51.1	50.5	50.3	49.8	50.1	50.2	50.1
OPEC	34.3	35.1	35.0	35.4	36.4	35.5	37.2
Total Supply	85.4	85.6	85.2	85.2	86.5	85.6	87.3

Source: IEA

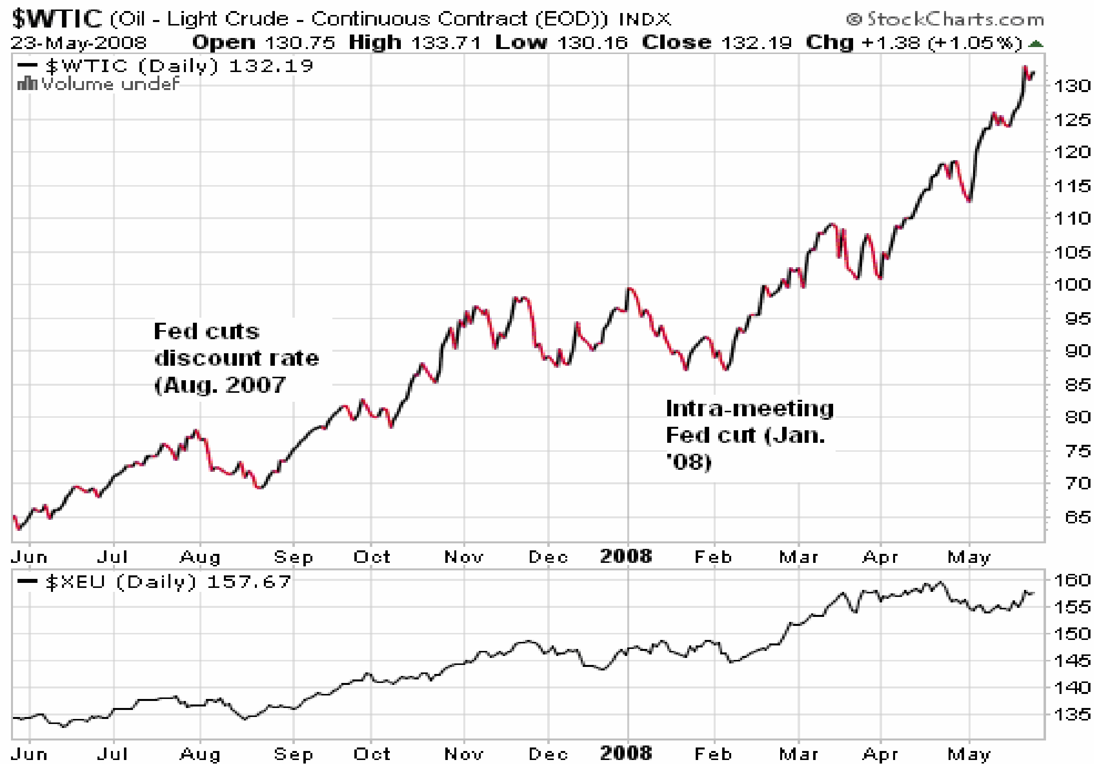
More than the traditional supply and demand

Other factors are contributing to the parabolic rise in oil prices, namely: the weakening US dollar, the Fed's monetary easing and the massive capital inflow into oil- and commodity-related funds.

The falling dollar has prompted investors to buy oil as a hedge against the currency's decline. In fact, the correlation between euro and oil prices for the past year has been 0.95 for the past year (see chart below), indicating they have moved in the same direction 0.95 of the time.

The Fed has also much to do with the escalation in oil prices due to their aggressive monetary easing. Note that oil made its important moves (making new highs) after the

crucial Fed cuts in August 2007 and January 2008. In fact the price of oil has almost doubled since August 2007, when the Fed first signaled it was easing rates.



Investments coming from institutional investors (pension funds, sovereign wealth funds, university endowments, and others) have also come in a big way. In fact, the amount invested in commodity index funds has now reached $260 billion as of March 2008 from only $13 billion in 2003 – a 20-fold increase. Meanwhile, the rise in demand for oil coming from index funds has risen by 848 barrels last year, almost as high as another China whose oil consumption has been rising 920 barrels a year for the past five years.

Is oil due for a correction?

Short-term, there are indications that the oil market is due for a correction. First, sentiment is overwhelmingly bullish and price momentum is extremely overbought. Second, the market is in a rare state of contango (with future prices above those prevailing today), which precedes, at least, a temporary top in prices. And third, there are also rumors that last week's price surge was due to a short squeeze where some hedge funds with long-dated futures found it hard to look for any counterparties in the market, forcing prices upwards.

Nonetheless, the long-term bullish case for oil remains intact. Growing demand from China and shrinking global supply means that high oil prices are here to stay. And while the probability of an impending correction in oil is high, it is often risky to go against the trend, especially during a mania.

What should investors do?

At present, it is very difficult to know how high oil prices may still go and how much longer the superspike may last (see our article *Superspike in Oil* on the May 12, 2008 issue of **The Philippine Star**). Renowned oil speculator, T. Boone Pickens, has predicted oil to hit $150 per barrel, while Goldman Sachs and recently UBS have targeted a high of $200. What is clear, however, is that the escalation of oil prices is jeopardizing the current rally in global equities.

Investors therefore should continue to practice sound asset allocation and diversification. Our advice has been that investors who run diversified accounts should add oil funds such as United States Oil Fund (if not outright oil futures) in their portfolio, both as a hedge against an oil-induced shakeout in stocks and as a direct play on policy reflation and global economic recovery.

Another strategy is to add commodity-related currencies such as the Aussie dollar and the Canadian dollar. Both currencies provide an excellent hedge against a weak US dollar and a play on high oil & commodity prices.

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