Philequity Corner (September 1, 2008)
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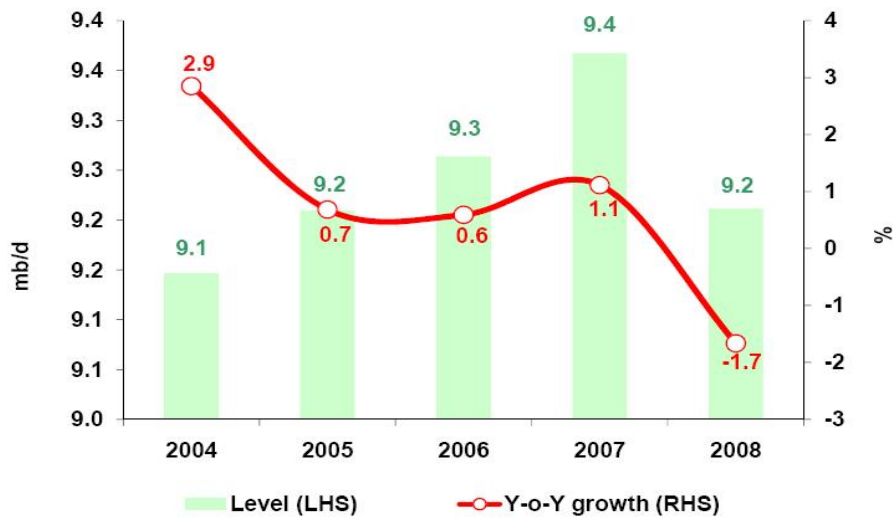
Diverging views on oil

Since reaching record highs of US$147 per barrel in mid-July, the price of crude oil is now hovering in the US$115 per barrel level. The question now is: Will oil continue to go down or revert to historic highs moving forward? US brokers are reporting diverging forecasts. Goldman Sachs recently reiterated its year-end US$149 per barrel target. Merrill Lynch also has a less bullish target of US$135 per barrel.

Conversely, some houses have estimated a level ranging between US$80-90 per barrel noting that peak prices have caused demand destruction. An example was the decline in US oil demand. Gasoline consumption had been badly hurt. Demand steadily rose since 2004 until the first seven months of the year as can be seen in the chart below. The slowdown may likely persist until 2009.

US Gasoline Demand, January - July



US Dollar Strength

The oil price reversal was largely attributed to speculators unloading considerable net long positions on the Nymex as more evidence of a global slowdown emerged. According to OPEC, non-commercial positions (e.g., the ones held for funds, investments, and banks) dropped from 22,600 to 9,400 contracts, the lowest level since early 2007. This implies that the magnitude of speculation was significantly higher than true demand. Clearly, speculation was not sustainable.

The resurgence of the US dollar relative to other major currencies has tarnished the outlook on oil including other commodities. The optimism on the US currency came as the rippling effects of the slowdown induced other markets to reassess their respective growth outlook and accordingly align monetary policies. (Refer to *Revival of the US Dollar* article in the Philippine Star dated August 18, 2008.)

What will bring oil back up?

Production outages due to hurricanes and geopolitical tensions could send oil prices to spike again. In recent weeks, the price of oil has climbed back up to US$116 per barrel, after reaching a low of US$112 last August 18. Fears that Tropical Storm Gustav will enter the Gulf of Mexico may put oil production at risk since the area pumps close to 20 percent of US oil supply.

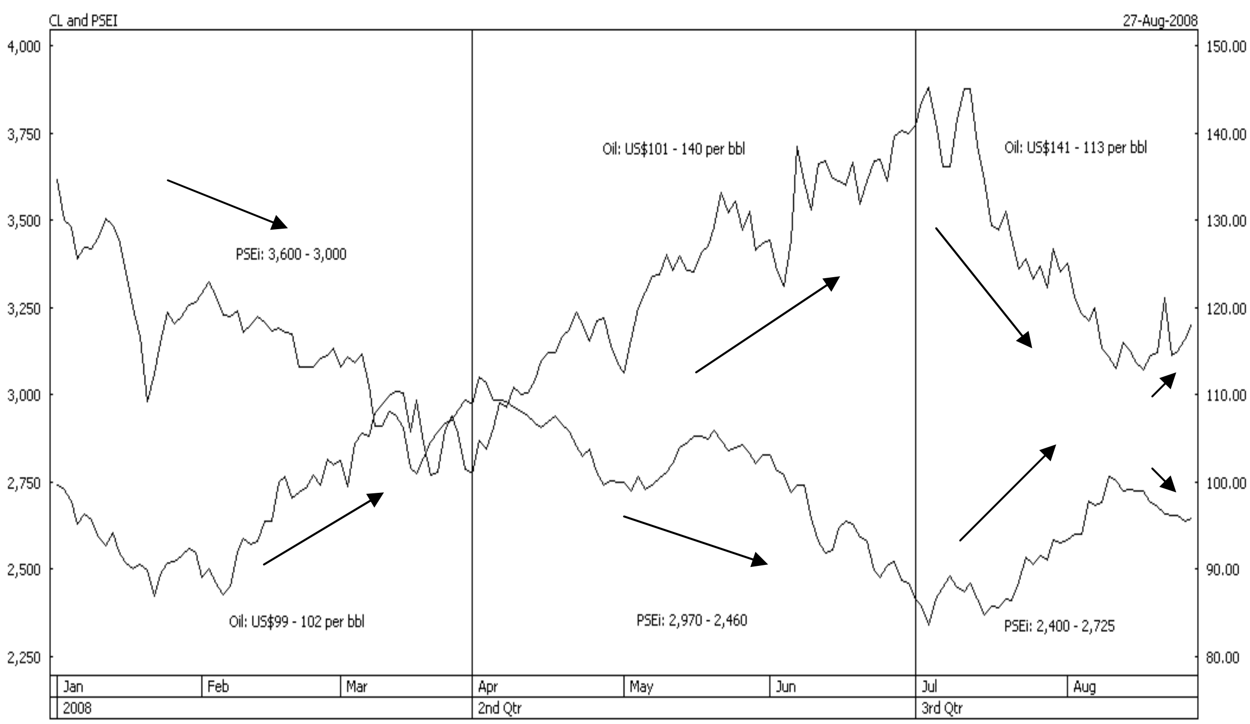
Meanwhile, Venezuela is considering a cut in production and will seek OPEC's nod in a meeting this month. Longer term, Venezuela's deepening ties with Iran (both oil-producing nations) is increasingly becoming a concern – for national security and for oil price stability reasons. Anti-American Venezuelan President Hugo Chavez is said to be supporting the operations of Hezbollah, a Lebanon-based terrorist group, which is known to be allied with Iran in fighting Israel. Whether the brewing coalition evolves into an anti-US terrorist powerhouse or not, history tells us that anything related to terrorism – especially if it involves oil-rich nations – typically results in higher oil prices.

Oil prices drop, PSEi goes up

As an oil-dependent country, any major movement in oil prices largely affects the Philippine economy. Since oil prices exceeded the US$100 per barrel mark, the stock market's performance was anchored on oil's movement as inflation worries set in. The graph below highlights the strong inverse correlation between oil and the PSEi.

Note the major triggers that occurred during the year. When oil prices breached the US$100 per barrel mark in the first quarter, the PSEi dropped below the 3,000 level. When oil prices zoomed to US$148 per barrel in the second quarter, the market plunged to 2,339.84. However, when oil price started to correct, the PSE index rose from 2,400 to 2,725. (Refer also to *Bottoming out* issue of the Philippine Star last August 4, 2008.)

Crude Oil versus the PSEi



Clearly, surging oil prices is a negative not only to the Philippine stock market, but also to the world economy and stock markets. While a drop in crude oil price is a boost to stock market, oil price stabilizing at these levels will help strengthen world economies. It is the wild price swings and high volatility that is destabilizing to the stock markets.

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