Philequity Corner (June 15, 2009)
By Valentino Sy

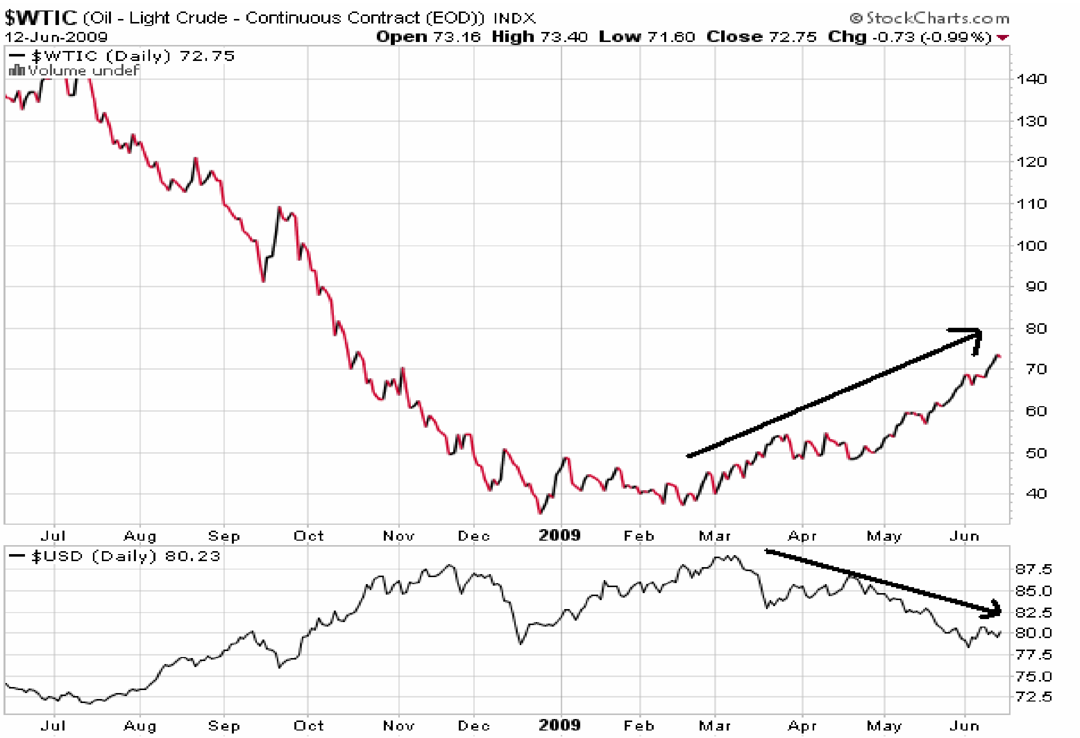
Why is crude oil rising?

Crude oil prices have nearly doubled since we made the call for a bottom in oil three months ago (see *Crude Oil: Forming a Bottom* in the March 2, 2009 issue of **The Philippine Star**). A lot of people are wondering why oil prices are rising despite the global recession, rising bankruptcies and unemployment, and sluggish global trade.

Fundamentally, there is no reason for oil to go up. Global demand for oil is still at a 10-year low. In fact, the Organization of Petroleum Exporting Countries (OPEC) lowered its forecast on world crude oil demand for 2009 to 83.8 million barrels per day in its latest monthly report released on Friday. The new forecast is 1.62 million barrels lower than the world crude oil consumption in 2008, or 1.89 percent lower.

The return of risk appetite

Sentiment, however, plays a big part in the markets and the return of risk appetite is a major driver in oil prices. In recent months, speculation that the worst of the global slump is behind us has caused a sudden return of risk appetite and a sell-off on traditional safe-haven assets like the US dollar (see figure below).



Source: Stockcharts.com

In addition, the decline in the US dollar has also caused crude oil prices to rise. Crude oil, like all commodities priced in US dollar, has gone up.

Another reason for the surge in oil prices is the fear of being left behind which caused people to scamper towards oil and other risky assets.

Finally, concerns of forthcoming inflation are starting to creep in because of the massive global pump-priming and reflationary policies. The challenge is for the policymakers to get a grip on inflation once it comes in.

Risk aversion trades

Throughout most of 2008 and up to the first two months of 2009, risk-aversion trades were in favour. Examples of these are:

- Long the US dollar
- Long the Japanese Yen
- Long the Swiss Franc
- Long US Treasuries
- Keeping cash
- Investing in money market funds
- Selling all other assets

Risk appetite trades

But after the financial markets bottomed in March of this year, risk-appetite trades returned. These investments came in the following forms:

- Long crude oil
- Long agricultural commodities, like coffee, sugar, corn, soybeans, etc.
- Long materials and mining resources, such as copper, lead, aluminium, steel, etc.
- Long gold and silver because of inflation trade
- Long equities, especially in emerging markets (including the Philippines)
- Long sovereign and corporate bonds, especially emerging market bonds
- Short US dollar, especially against commodity currencies such as the Aussie dollar, the Canadian dollar, and the Brazilian real.
- Short US Treasuries, especially long-dated notes.

From risk revulsion to risk appetite

It isn't just oil, other commodities and equities that have gone up. Bond spreads on emerging markets have improved with the JP Morgan EMBI+ Index showing that spreads over US Treasuries have fallen to 417 basis points compared to the near 700 basis points at the start of the year. Credit default swaps on emerging market debt have also come down.

Meanwhile, volatility measures such as the VIX (a.k.a. the investor's fear index) is now lower than when it was on the eve of the Lehman bankruptcy, a clear sign that risk appetite has returned to the markets.

Source: Stockcharts.com

Buy emerging market equities

Two weeks ago, we said that the PSE index would reach 2,600 to 2,800 by the end of the year (see *Peso to regain strength* in the June 1, 2009 issue of **The Philippine Star**). By Friday, however, it almost hit the low end of our target, closing at 2,598.80, despite calls for a correction by many brokerage houses.

As we have said in previous occasions, it is difficult to predict how a correction will unfold, just as it is difficult to predict a market top or a bottom. So far, the present correction phase in global equities has been sideways and shallow.

Over the long-term, we continue to be bullish on equities, especially on emerging markets, including the Philippines. While corrections and consolidations may eventually materialize, we believe that improving economic conditions coupled with the return of investor risk appetite will help sustain higher equity prices going forward.

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