Oil Prices Cannot Be Wished Lower

The first oil shock of the 1970s produced fear and anger, both of which derived from the sudden awareness of our vulnerability. Then the price fell for a few years until the second oil shock, associated with the Iranian Revolution and the Iran-Iraq War, which produced a surge to the highest inflation-adjusted petroleum prices ever. By 1986, the price collapsed, and after a brief rally in 1987, collapsed again to low levels.

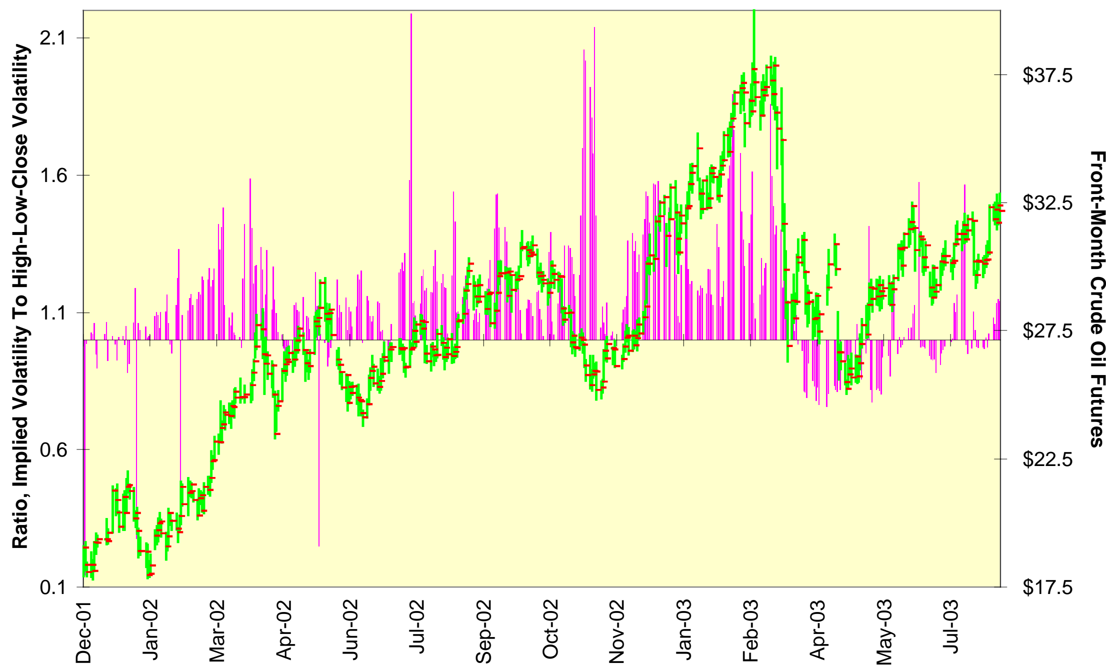
The third oil shock was not a supply shock at all but rather a self-inflicted buying panic produced by uncertainty over Iraq's invasion of Kuwait and the impending war. Prices fell and remained low all the way into 1996, at which point a mild rally appeared and disappeared. The downturn in demand associated with the Asian and Russian crises of 1997-1998 put prices down to their lowest inflation-adjusted prices ever by February 1999.

The fourth shock, also associated with Iraq, took place this winter during the buildup to the second Iraq war. Given the history noted above and the prospect that a quick and convincing victory would assure the U.S. of a secure supply of oil, many assumed we would see a repeat collapse of oil prices.

That collapse did not happen and, given the various indicators on display below, is not likely to happen for the foreseeable future. The high tax on the global economy represented by high oil prices will remain. Whether this is sufficient to either keep the global economy on a slow growth path or push it back into a global recession is indeterminable, but higher oil prices are never a positive for global growth.

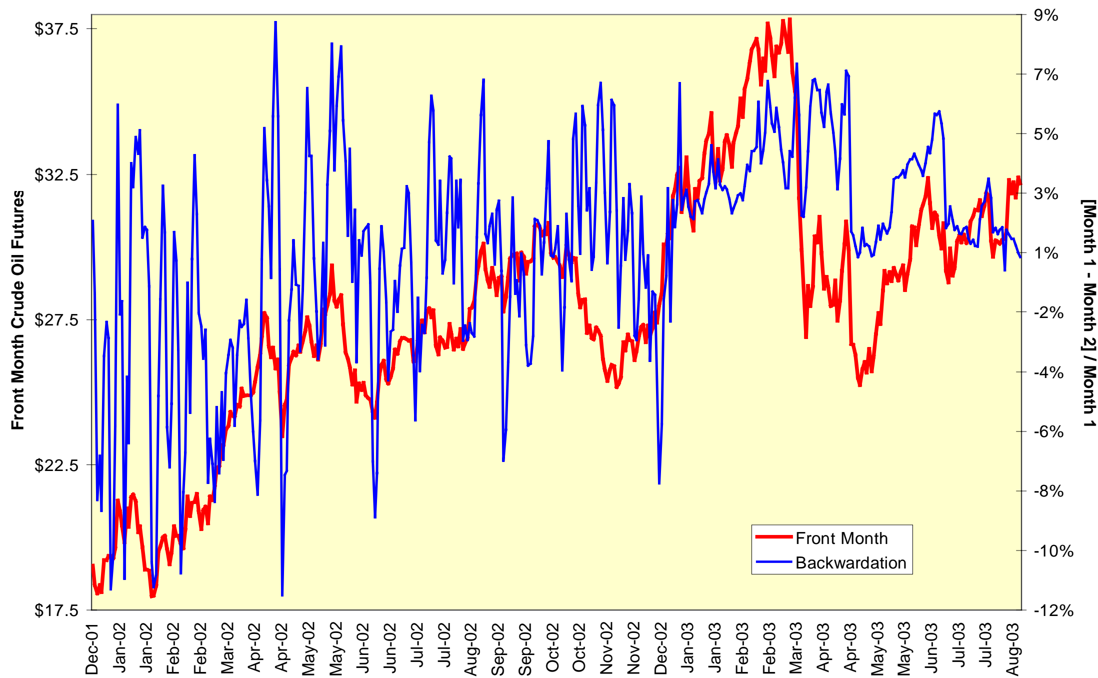
Some Quantitative Indicators

First, let's update some of the indicators presented here last January, the last time I addressed the global oil market. The ratio of implied volatility to high/low/close volatility in the crude oil market gives a good measure of the extent to which traders are willing to purchase insurance against adverse price moves. Whenever this ratio falls toward 1.00, it indicates relative comfort with the prevailing trend.



The ratio had been high during the rally leading up to the start of the Iraq war, but since has fallen back toward near 1.00 levels. The present uptrend is not one which either buyers or sellers feel uncomfortable with, and that signals a high likelihood of continuation.

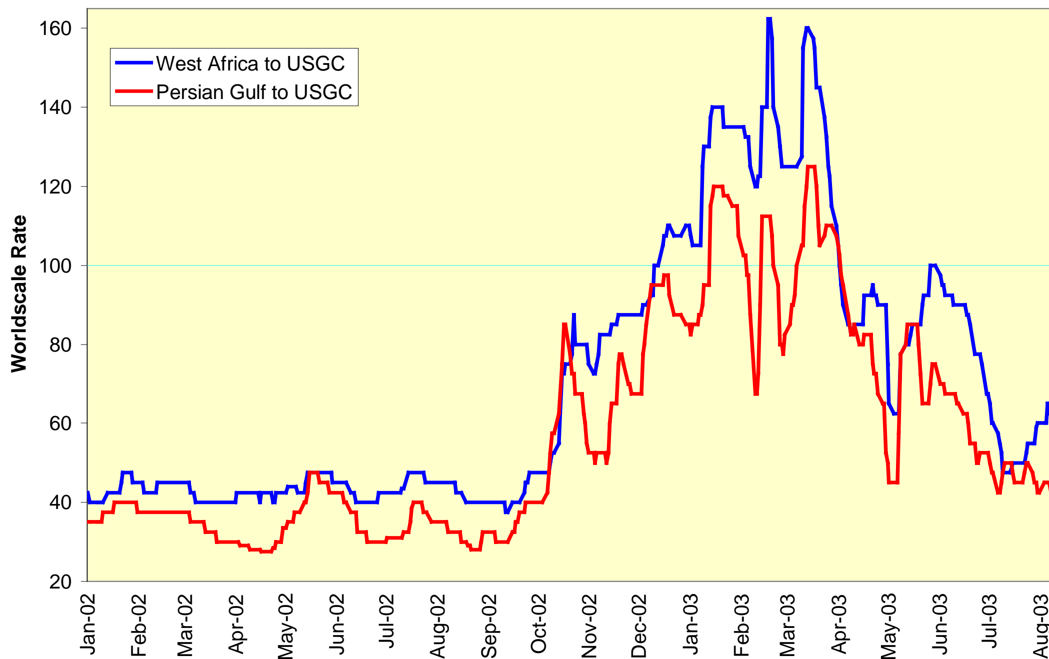
The second indicator to be updated is the intermonth spread, or backwardation, between the first and second months of crude oil futures. A high level of backwardation, or premium of the front month to the second month, indicates anxiety on the part of both buyers and sellers that the present price is unsustainable and is expected to fall.



The level of backwardation has been falling even as price has been rising. Once again, this indicates a high level of comfort with the present price trend.

The third indicator to be updated is a pair of tanker rates to the U.S. Gulf Coast, one from West Africa and one from the Persian Gulf. These rates, expressed as Worldscale, or percentage of the calculated normal shipping tariff, surged going into the Iraq war as Saudi Arabia and others made additional supplies available.

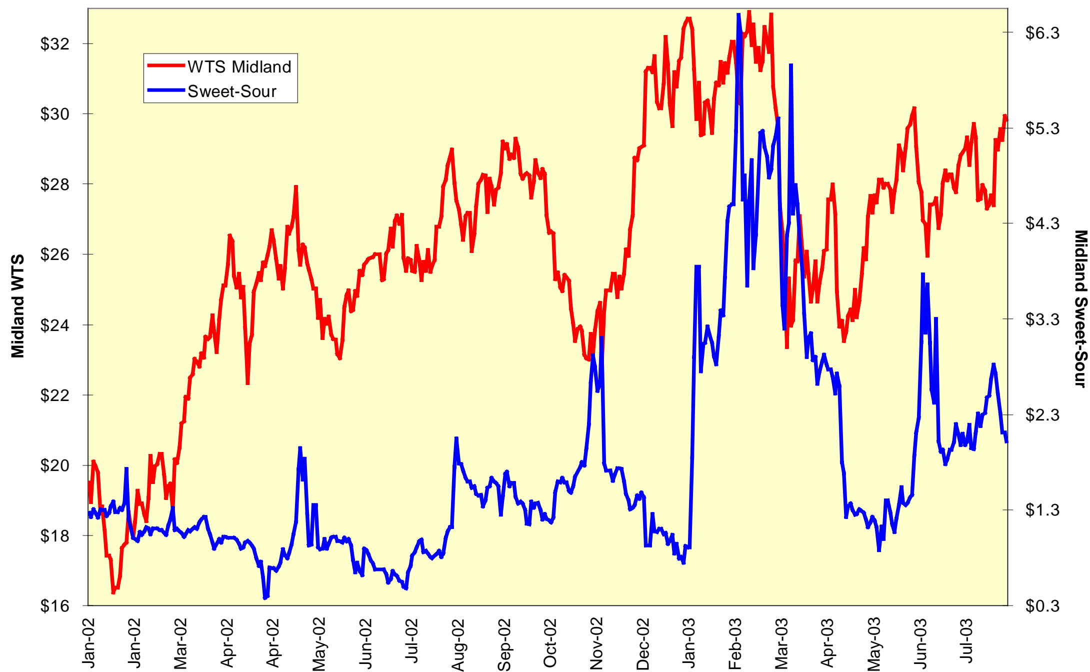
In No Rush To Get Here



Now that the war is over in a manner of speaking, tanker rates have fallen. This means that fewer vessels are being nominated for voyage to the U.S., which has negative supply implications.

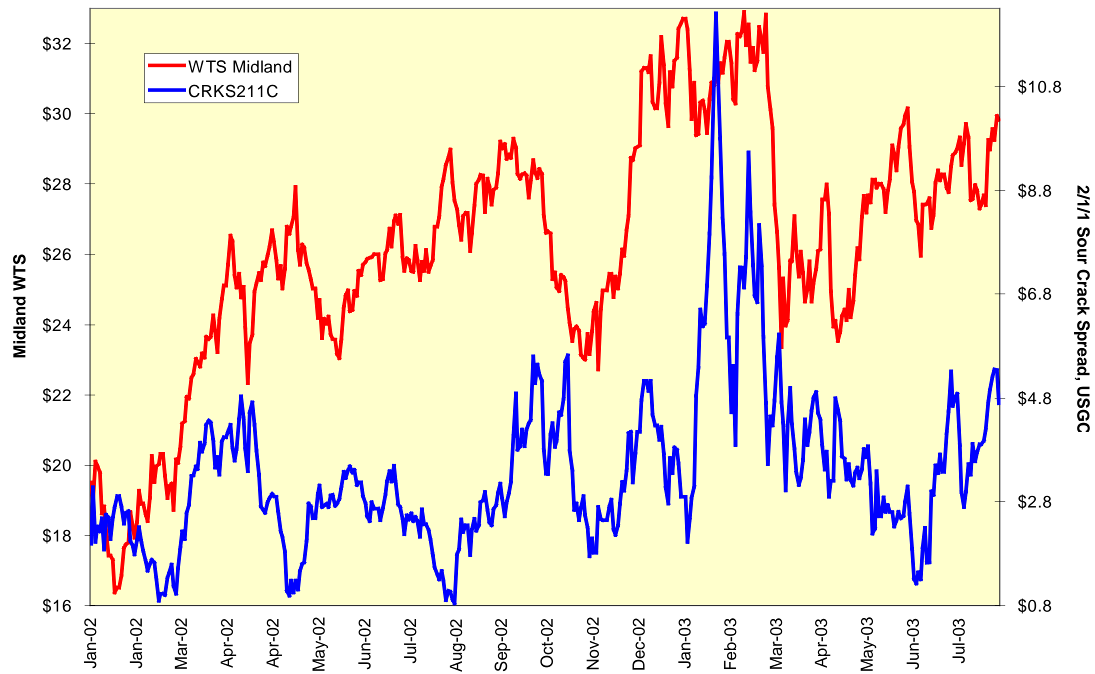
In sum, all three indicators examined in January can be construed as supportive to higher oil prices. Now let's add three different oil market spreads to extend the analysis. The first of these is the spread between sweet, or low-sulfur, and sour, or high-sulfur, crude oil. Let's look at West Texas Intermediate for the sweet and West Texas Sour for the sour crude, both prices taken at Midland, Texas (city motto: "What's a tree look like?").

West Texas Sour Power



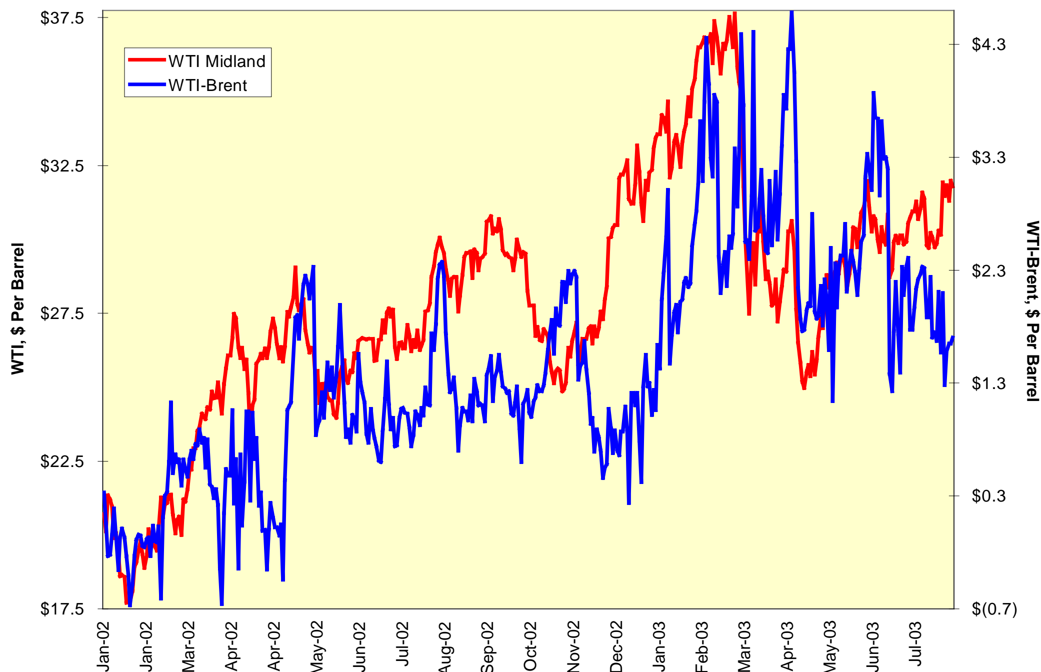
Whenever crude oil demand is high, incremental refining capacity is brought on stream capable of handling only the low-sulfur crude; the sweet-sour spread moves out as a result. The spread jumped during the war, but fell back quickly and is only now starting to move back toward bullish ranges. This indicator, once again, should be viewed as supportive of high prices.

We see a similar story for refining margins, here taken as the so-called 2/1/1 crack for sour crude at the U.S. Gulf Coast. This margin is the conversion of two barrels of sour crude oil into oil barrel each of heating oil and gasoline. A higher spread level indicates better refining economics and greater capacity to bid the price of crude oil higher.



Here again, the same story is visible: A wartime leap in refining margins, a falloff and now a move toward bullish levels capable of supporting higher crude oil prices.

The final indicator is the spread between West Texas Intermediate and Brent, the market sweet crude oil produced in the British sector of the North Sea. A high spread value indicates an unstably high U.S. crude oil market.



The Brent-WTI spread has fallen back even as the price of WTI has risen; this indicates a strong demand for sweet crude oil in the European markets and the lack of surplus capacity to meet the U.S. market. Once again, this indicator is supportive.

A Funny Thing Happened On The Way To The Empire

As noted at the start, too many of us became accustomed to a negative correlation between short-term and long-term energy prices, the condition wherein high prices today lead to low prices tomorrow. It was assumed that the successful resolution of the war would continue this cycle, and that the spoils of empire would offset the economic stress of war and occupation.

Let's review the bidding: Alan "Lone Ranger" Greenspan has pumped eight bullets out of his six-shooter, we've passed a tax cut and we're running a huge deficit. What can we do for an encore on any of these fronts? Now we have to add the fiscal drag of a war, the municipal bond mess about to erupt in California, the end of the refinancing boom and higher energy prices into the mix.

This is asking a lot from any market and any economy. That we have been able to withstand all of these current and prospective pressures is an indication either of underlying strength or a nation that simply refuses to pay attention. I'll lean toward the strength and take a deep breath.