Crude Oil And Natural Gas' Divergence Widens

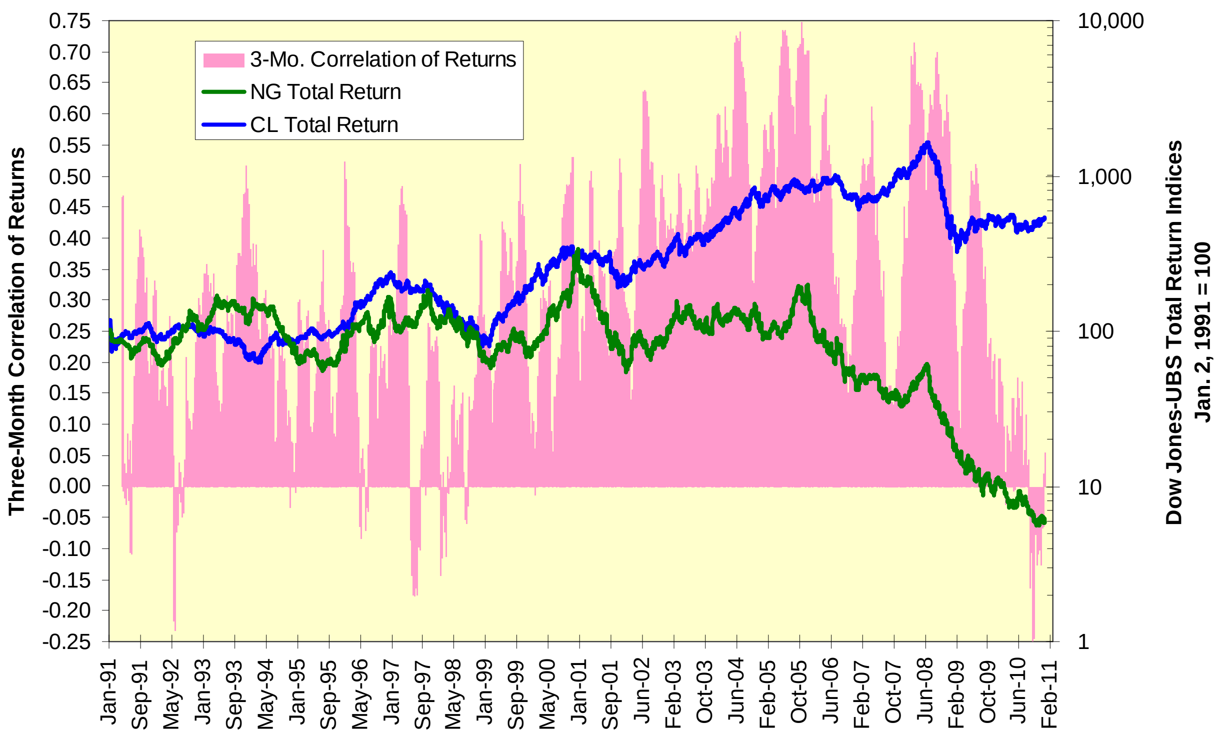
Of all the fears expressed for 2011, has anyone, anywhere, fretted about the lack of bad ideas? No; we economists know the supply thereof is infinitely elastic: Regardless of the price, they will keep coming out of the woodwork. Take the notion of burner-tip parity between fuels, an issue that has been following me around since the 1970s. It holds, in the absolute and complete absence of any evidence, competing fuels will be priced at BTU-equivalence in the final marketplace. At least a broken clock is right twice a day.

With short-lived exceptions usually associated with cold snaps, both No. 6 residual fuel oil and No. 2 heating oil, the same cut of the barrel from which diesel fuel is made, have tended to trade at a higher BTU-equivalent price than natural gas in recent years. The reasons, briefly, include the difficulty most customers have storing natural gas on-site, the premium liquid fuels will command for transportation uses and the interruptibility of natural gas for commercial and industrial users. The much higher price volatility of natural gas and its long history of disappointing its advocates depress its price in the final market as well.

Making A Bad Idea Worse

The relatively and mercifully short performance histories of commodity ETFs such as the U.S. Oil and Natural Gas Funds are linked to the total return on buy-and-hold commodity indices such as the Dow Jones-UBS crude oil and natural gas indices. The long-term history of these two indices should confirm just how different the two commodities are. The rolling three-month correlation of returns had been strongly negative in recent months, but recently resumed being slightly positive.

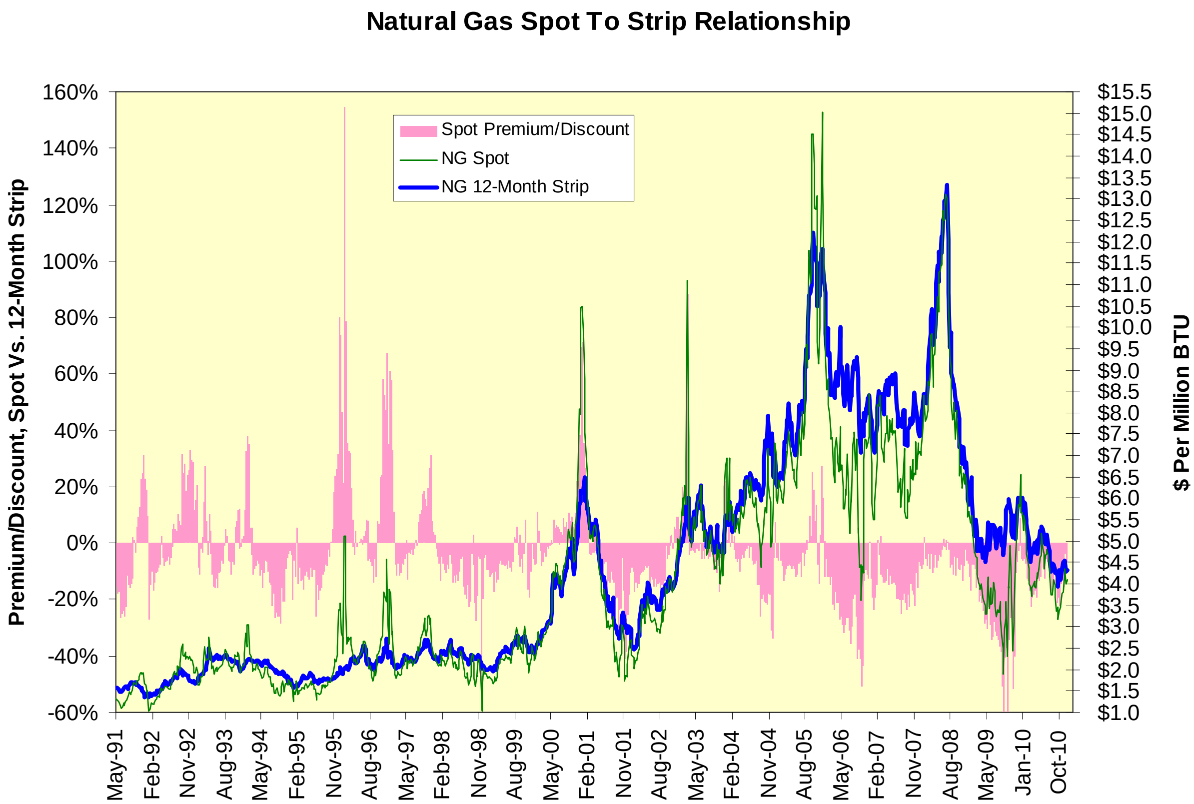
Crude Oil And Natural Gas As Index Investments



Over the past twenty years, the average annual return for the crude oil index has been 8.365%; for natural gas it has been a rather dreadful -13.912%. There are not too many instruments out there capable of losing you 13.9% per annum, are there?

Drill Baby, Drill

Natural gas drillers seem to have taken their lead from the late Charlton Heston: You would have to pry their rigs from the cold, head hands. Even in the face of plunging prices for both spot natural gas and the more important 12-month strip price, the drillers continue to punch holes in easy-to-drill and low-risk onshore shale formations and bring natural gas to the market. The irony of natural gas even during its price spikes is the world is quite literally chock full of methane; the issue never was the resource base but rather the economics of bring the gas to market economically.



The S&P 1500 Oil & Gas Drillers index, which includes firms such as Nabors, Diamond Offshore, Rowan, Pride, Patterson-UTI and Helmerich & Payne, has returned 5.3% this year, well below the 15.35% of the S&P 1500 Supercomposite itself.

If crude oil remains strong in early 2011, as appears likely, the gap between petroleum products and natural gas will expand and certainly lead to confusion by those who believe these two energy sources should be correlated closely. If you are tempted to buy natural gas and sell crude oil as an arbitrage, donate the money to charity instead.