The Upward Convergence Of Natural Gas Will Remain Difficult To Play

Stay Away From Long-Only Products

I concluded January 2011's [Divergence Of Crude Oil and Natural Gas Widens]:

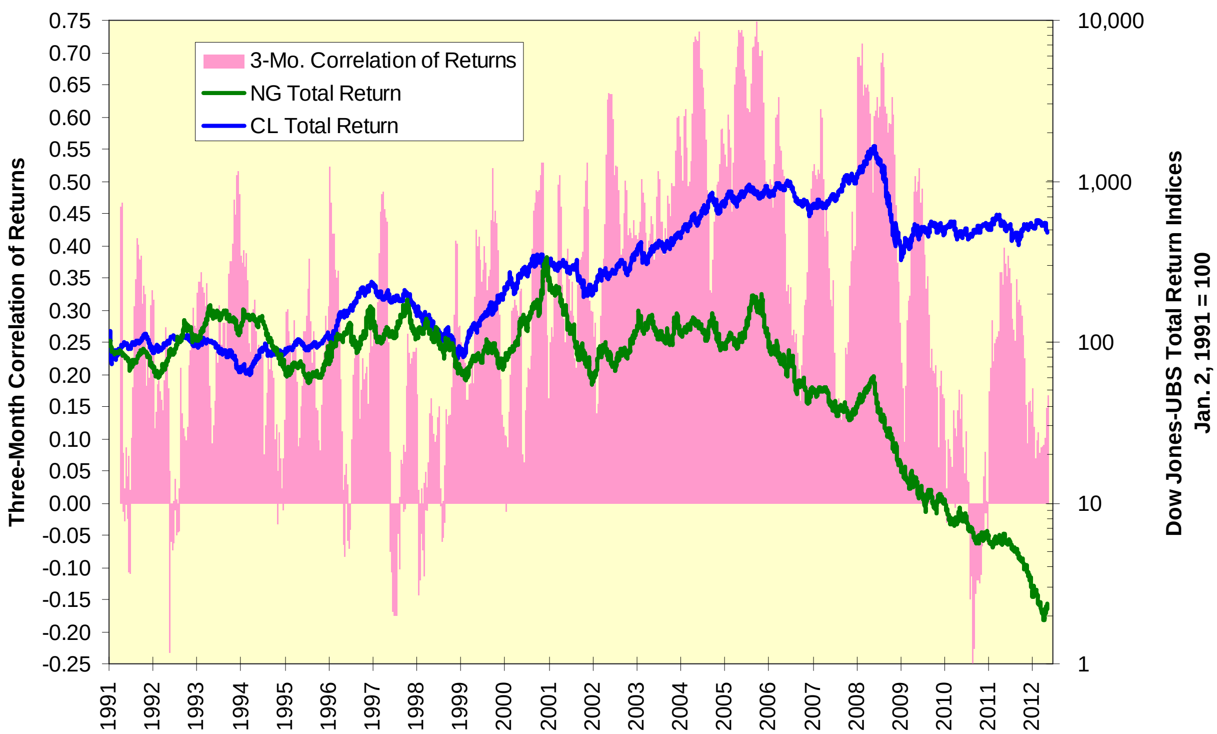
> *If crude oil remains strong in early 2011, as appears likely, the gap between petroleum products and natural gas will expand and certainly lead to confusion by those who believe these two energy sources should be correlated closely. If you are tempted to buy natural gas and sell crude oil as an arbitrage,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

That, I am proud to say, came under the category of good advice; the total returns for two of the worst investment products ever created by the mind of man or beast, the U.S. Oil Fund and U.S. Natural Gas Fund (USO and UNG, respectively) since that time have been -7.03% and -62.61% at the time of this writing.

However, just as the cure for high prices is high prices, the cure for low prices is low prices. The massive delivery-market discounts for natural gas not only for commercial & industrial users in competition with petroleum products but increasingly in utility markets in competition with coal will have their effects. I shudder when I utilities abandoning coal for natural gas if for no other reason I have seen many a natural gas price spike and have yet to see one for coal. The buy-high / sell-low crowd will lose on this switch because that is always the end result of this strategy. And as for the supply side, just wait until all of the must-drill wells from the likes of Chesapeake Energy (CHK) disappear.

Please be advised, though, that playing rising natural gas prices is not to be confused with shooting fish in a barrel, as if anyone ever has shot a fish in a barrel; this sounds like very unbalanced behavior to me. Let's take a look at the long-term return paths of the Dow Jones-UBS crude oil and natural gas indices going back to 1991. These indices are part of the broader index of long-only commodity products sold originally with the promise they would capture a positive monthly roll yield from futures in backwardation (inversion). Right; a $100 position in the natural gas subindex in January 1991 would have been worth $1.85 on April 19, 2012. This is equivalent to throwing your money into the caldera of an active volcano and far less entertaining.

Crude Oil And Natural Gas As Index Investments



What is critical to remember, though, is natural gas was in a secular uptrend until 2008 or so. If we use the peak of the crude oil market in July 2008 as a benchmark date, that same $100 in January 1991 was worth $1,656 in crude oil but only $54 in natural gas. The spot return in natural gas over the same period was 12.0%. Restated, you lost money with a long position in a bull market by virtue of negative roll yield.

As the seasonality of natural gas in unlikely to be repealed anytime soon, the fondest wishes of the global warming crowd notwithstanding, any long position in natural gas will face the same hurdle going forward as it did between 1991 and 2008. Stay away and do not look back.