

Integrated Oils Not Crude Oil Price Predictors

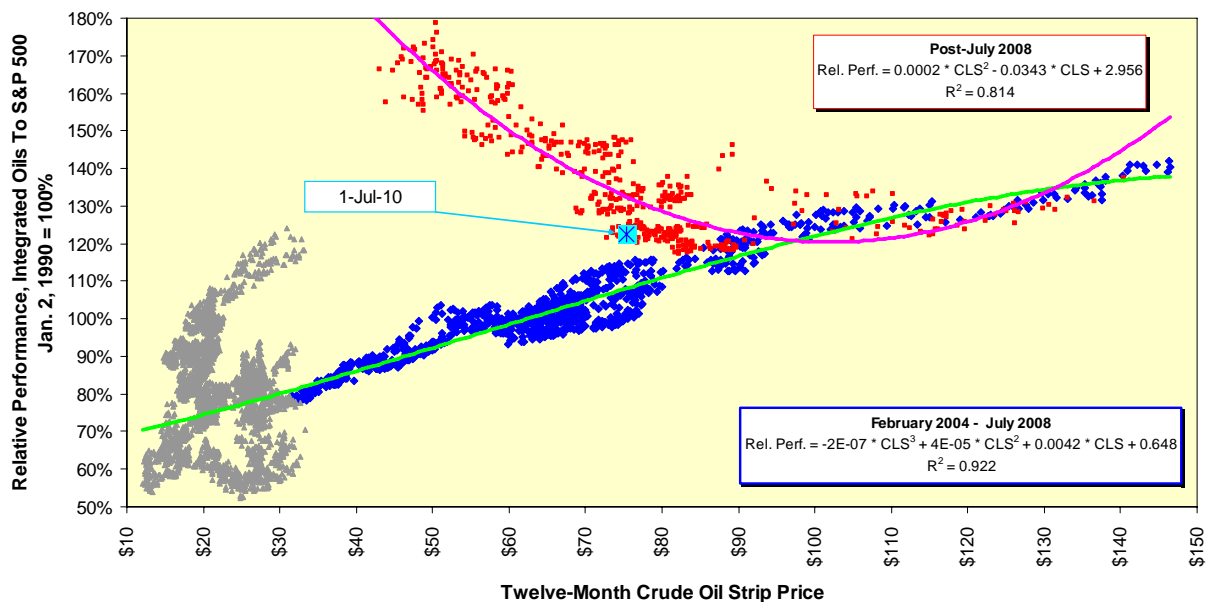
One of my favorite sayings is, “We cannot pool our collective ignorance and distill greater wisdom therefrom.” That would be like taking the highest-quality cash flows from a collection of mortgages that never should have seen the light of day and slapping a AAA-rating on them. If you start out with garbage, you end up with refined garbage, no matter how hard you and your fellow financial alchemists try.

However, not only does the belief in financial engineering remain as strong as ever, so does the belief markets are endowed with mystical forecasting powers. Markets measure; they do not forecast. All a future price represents is the reservation price at which the most desperate seller will accept to provide a price floor intersecting with a similar act of despair from a buyer seeking a price ceiling. Both parties may believe they received the wrong end of a deal neither one of them really wanted to make. Where is the forecasting omniscience there?

Integrated Crude Oil Case

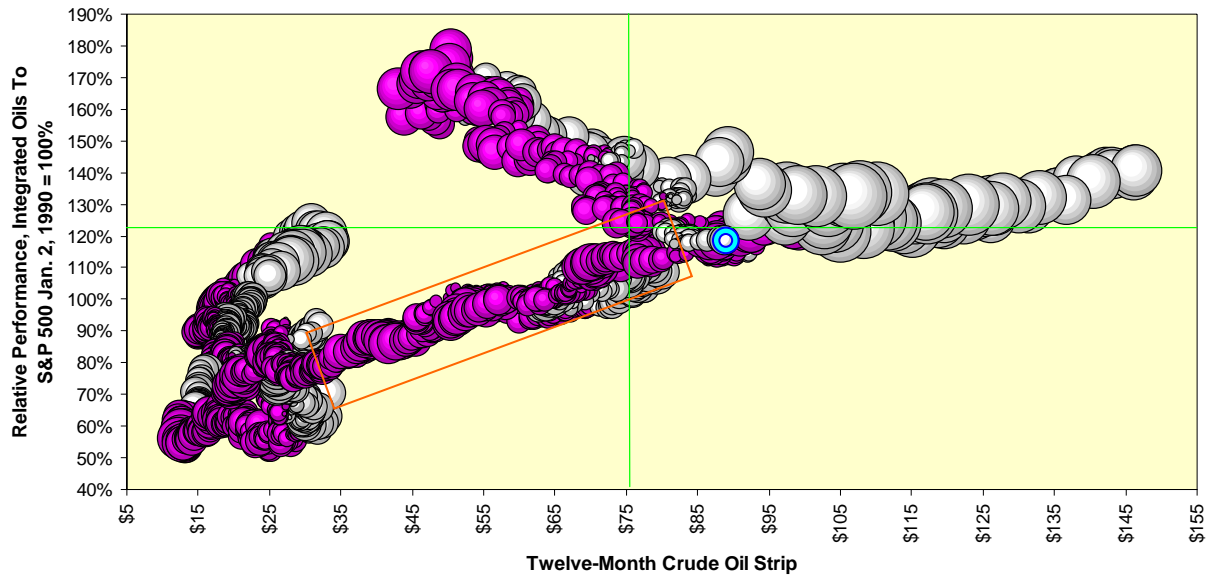
Let’s use the S&P 1500 Integrated Oil & Gas industry group and its relative total return vis-à-vis the S&P 1500 Supercomposite itself as a starting point and map it against twelve-month strip prices for West Texas Intermediate crude oil over three different time periods. The first, highlighted in grey, extends from January 1990 to February 2004, and is essentially random. The second, highlighted in blue with a green trendline running through it, and extending from February 2004 to the July 2008 peak in prices, is linear. The third, highlighted in red with a magenta quadratic trend curve running through it, depicts a decidedly different relationship. If the relative performance of the Integrated Oils is a strong function of strip prices, it certainly is not obvious with more than two decades’ of data.

Regime Changes In Integrated Oil Stocks



Now let’s reverse the issue and add a forward-looking time dimension. Here we can map the three month-ahead change in those same strip prices as a function of the Integrated Oils’ relative performance and current strip prices. Positive forward price changes are depicted in magenta; negative forward price changes are depicted in white. The last datum used, from April 6, 2010, is highlighted in turquoise, and the current environment is noted with a green bombsight.

**Relative Integrated Oils' Performance Not A Good Predictor Of
Three Month-Ahead Crude Oil Strip Prices**



Relative performance has only one small zone, highlighted with the orange rectangle, where it bears any sort of defined relationship to current and prospective strip prices. Restated, anyone looking at the relative performance of ExxonMobil, Chevron and those of their ilk to infer where crude oil prices are headed is looking in the wrong place.

A second comment needs to be made. That turquoise point is exactly two weeks prior to the BP *Deepwater Horizon* disaster; BP is not part of the Integrated Oils group as it is a British firm. Please note, however, the relative performance index for the Integrated Oils has increased from 118.65% to 122.39%. In addition, the 12-month strip price of crude oil has declined from \$86.659 to \$75.348, a drop of 15%. For all of the verbiage spilled on the disaster, including musings on whether forward prices would have to rise, the simple fact is the Integrated Oils have outperformed the broad market and twelve-month crude oil strip prices have taken it on the chin.