Energy Market Bubbles

I'm forever blowing bubbles.
Pretty bubbles in the air.
They fly so high, nearly reach the sky,
then like my dreams they fade and die.

Generals fight the last war, investors chase the hot stocks, and as anyone who had the misfortune of enduring an airport line over the recent holiday season can attest, the overwrought Transportation Security Agency is going to spend billions of dollars making sure September 11th will not be duplicated. Memo to TSA: When you build a ten-foot wall, someone will build an eleven-foot ladder.

Such is human nature. After Watergate, every two-bit political misstep got a "-gate" appended to it, and now every bullish move is described as a bubble. Haven't we already endured a real estate bubble and a bond bubble in the last six months? I don't know about you, but I don't feel worse for the wear.

Bubbles do not sneak up on anyone. They arrive with fanfare, replete with warning signs for the unwitting, and often provide statistical clues as to their degree of overvaluation. These thoughts crossed my mind on January 2, when the strong rally in stocks was accompanied by an even more breathtaking leap in natural gas prices; the February contract jumped by 9.65%. The catalyst for this move, as long as you are asking, was a forecast for cold weather in January, as unthinkable as that may be.

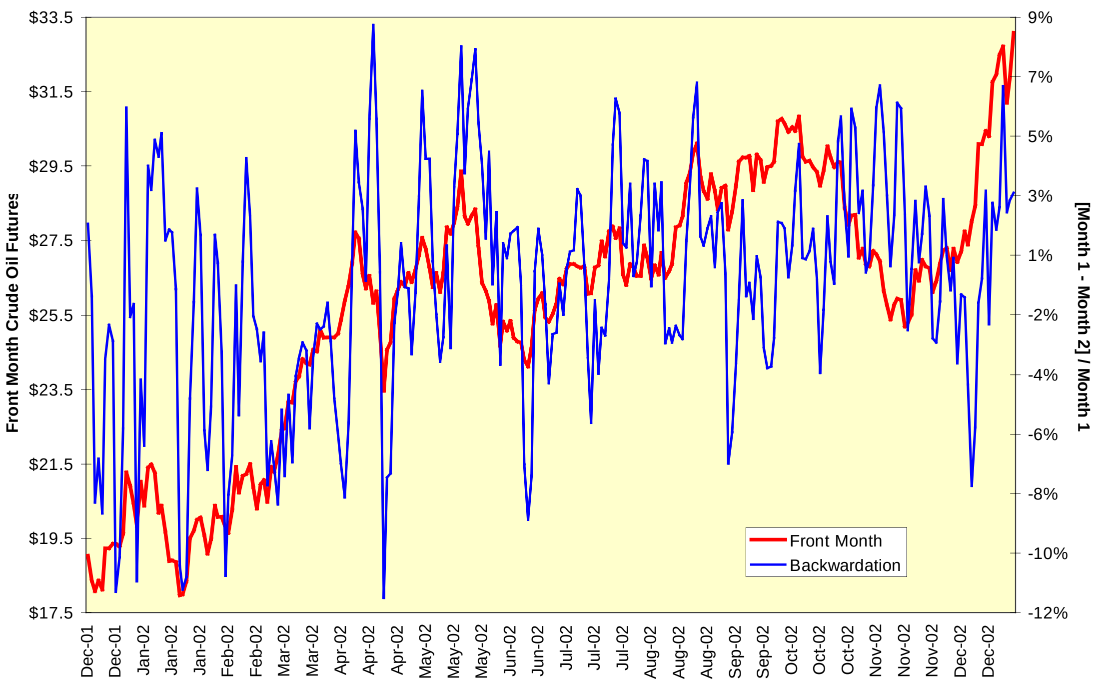
No Bubbles Here, Sir!

The crude oil market has been putting on some mileage in both directions of late. The risk of war in Iraq has not taken any barrels off the world market yet, but the oil workers' strike in Venezuela has taken nearly 2.5 million barrels per day out of the supply stream. The Venezuelan problem will be solved in due course, quite possibly with an unhappy ending for President Hugo Chavez, while the Iraqi situation will continue to drag on like some dermatological condition. Let's measure what these two in combination have done to the oil market's anxiety levels.

The quick answer is "not much." In a prior life as a commercial hedger, I developed three different measures of a commodity market's buying or selling pressure; these were linked together to form the proprietary Market Tension Index discussed in Chapter 5 of the book referenced in this article's footnote.

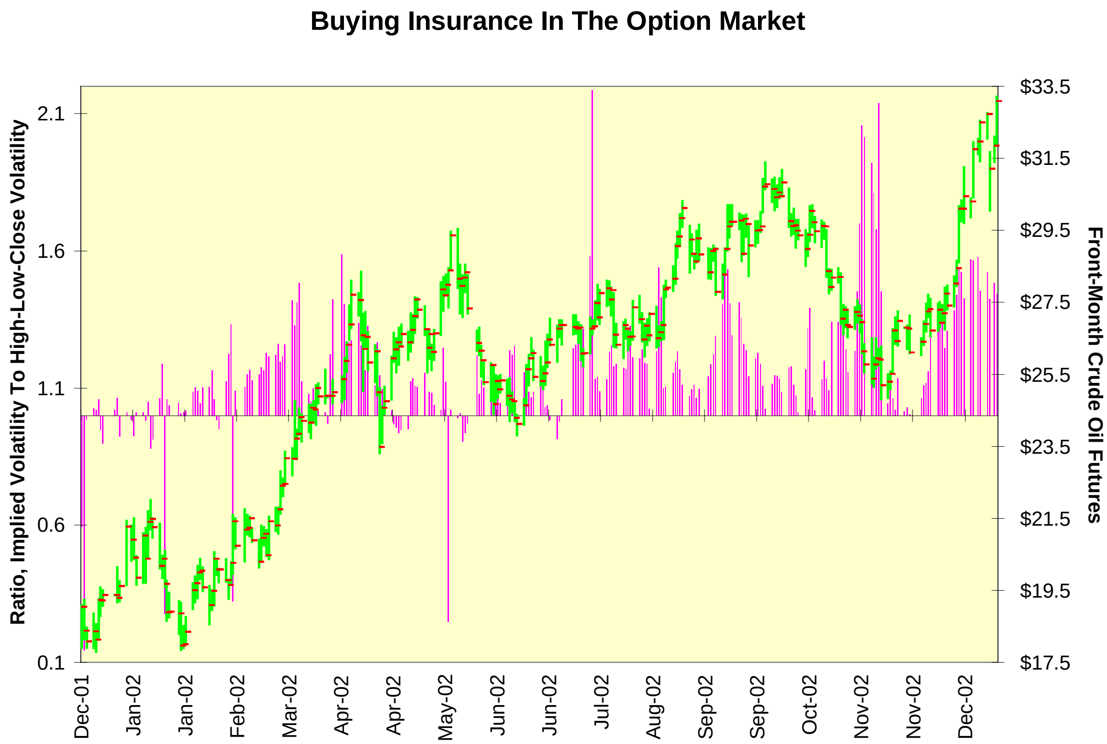
The most important two of these measures, the shape of the forward curve and the option market's excess volatility premium, are not flashing any sort of buying panic signals at the moment. The shape of the forward curve is described most properly with a measure called "convenience yield" or the implied yield on storing excess inventory. However, we will use the simpler "backwardation," or premium of the first delivery month of crude oil futures relative to the second month, expressed as a percentage of the first month's price.

No Buying Panic



Backwardation can reach some very high levels; it was not at all unusual during the Persian Gulf War period to see backwardation levels of $2.00 per barrel. Everyone was waiting for the price to come down and was then forced to scramble at the last minute to secure supplies at a premium. A surge in backwardation as prices rise signifies a high level of anxiety about the ability of prices to maintain their current levels; that situation simply does not apply to the crude oil market at present.

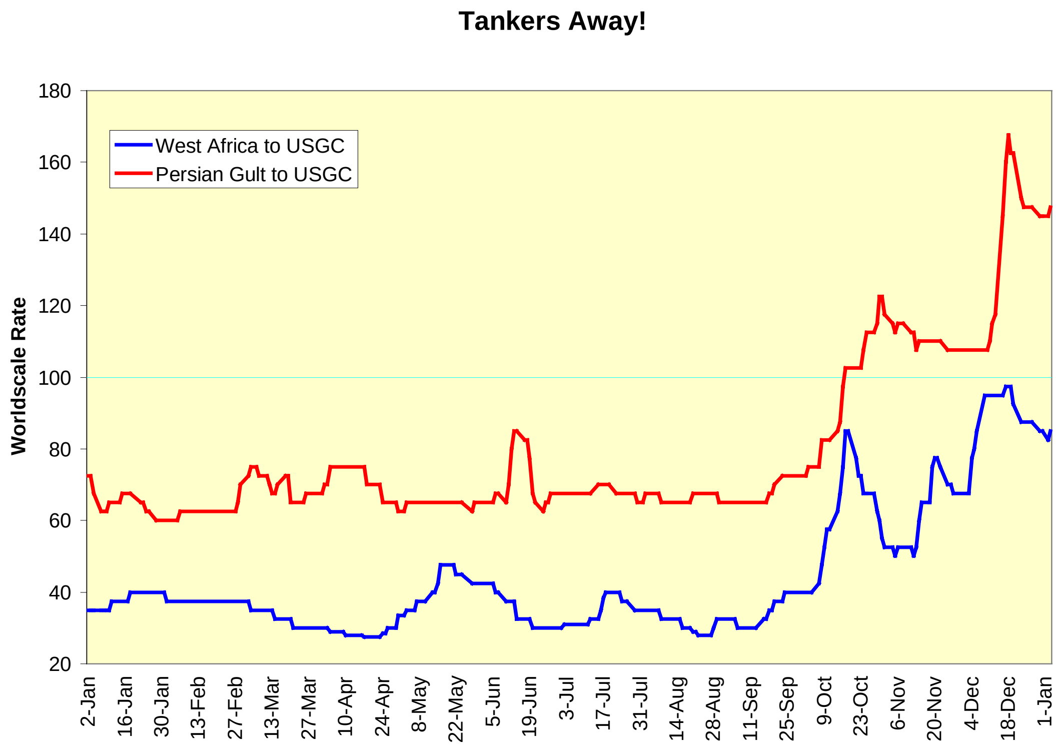
A second measure of the Market Tension Index is presented in its pure form and that is the ratio of the implied volatility in the options market to the historic high-low-close volatility. The two volatilities measure different concepts. Implied volatility is a forward-looking measure of insuring against an uncertain outcome, while the high-low-close volatility is a backward-looking measure of known price movements.



While the ratio is near the high end of its normal band, it is not signaling a great demand for price insurance, either. The complacence of the crude oil market in the face of one actual supply disruption, one threatened supply disruption, and prices at two-year highs is remarkable. Have the nation's refiners adopted Alfred E. Neuman's "What, Me Worry?" attitude as their own?

Always Prepared

While pundits talk, refiners do. An indicator used to forecast successfully in this column before, crude oil tanker rates, has been shooting higher since mid-September. Tanker rates, like dry freight rates and base metals prices, are useful as forecasting instruments simply because of their lack of speculative content. If tanker rates for delivery to the U.S. Gulf coast are going up it is because refiners are working hard to replace the supplies lost from Venezuela and possibly Iraq at some point in the future. The tanker rates are expressed as Worldscale numbers wherein 100 is defined as the expected tariff for a given route.



The role higher energy prices can play in derailing the economy cannot be ignored; four out of the past four recessions have been preceded by higher oil prices. However, the financial markets have assessed the risk correctly in the sense that the crude oil market is not acting abnormally. In the absence of concrete news on either the Iraqi or Venezuelan situations, we simply must deal with higher crude oil prices as a short-term aberration already in the process of correction.