Financial Energy Commodities Speculation: A Disconnective Effect on the Fundamental Price Discovery Mechanism

or

Fundamentally EIA Fundamentals Don’t Matter.

It’s About the Investment Money Flows

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Supply and Demand Fundamentals: No Longer Telling The “Price” Story

- Historically, Supply and Demand, expressed as ‘Inventories’, used to be a fairly strong indicator and predictor of oil (WTI) price
- Since 2004, Supply and Demand have become increasingly irrelevant at both indicating and predicting oil price
  - Enter the “Technical” component of oil pricing
Inventories 1987-2003
Inventories 1987-2003
(including Persian Gulf War)
Inventories
1987-2004
Inventories
1987-2005
Inventories 1987-2006
Inventories 1987-2007
Inventories
1987-2008
Inventories 1987-2010

WTI Crude Oil Price per Barrel

EIA - U.S. Commercial Crude Stocks (thousands of barrels)

Last 11 Months
Capital In-Flows II:

Effects Of Financial Investors on Commodities

• “Everybody in the markets is chasing their own tail”:
  – Derivatives markets are the ‘dog’ and the spot markets are the ‘tail’

• In crude oil markets today, derivatives determine and drive spot prices

• Oil has become its own asset class
  – Oil has become ‘financialized’
  – Financial investors have become deterministic price-makers and altered
    the natural price discovery mechanism for producers and consumers

• Oil prices are highly correlative to the following market benchmarks:
  – The U.S. Dollar, the S&P 500, and inflation expectation measures

• The return impetus and rationale which catalyzed financial investors
  into oil and energy commodities futures market has been eradicated!
Passive Commodity Index Investment

Source: Goldman Sachs, Standard & Poor's, Dow Jones, calculations based upon Commodities Futures Trading Commission (CFTC) Commodity Index Trader (CIT) Supplement. Mid-2008 figure is as of July 1.
Passive Commodity Index Investment

Source: Goldman Sachs, Standard & Poor’s, Dow Jones, calculations based upon CFTC CIT report. Mid 2008 figure is as of July 1.
Passive Commodity Index Investment

Source: Author calculations based on CFTC CIT report
2007

$25-$30 Billion Flows into Indices
130-150 Million Barrels are Bought
Prices rise from $58-$96 (+65%)

Source: Author calculations based on CFTC CIT report
1st Half 2008

$45-$65 Billion Flows into Indices
145-165 Million Barrels are Bought
> 1 Million Barrels per Trading Day
Prices rise from $96-$137 (+42%)

Source: Author calculations based on CFTC CIT report
$60-$80 Billion Flows out of Indices
230-260 Million Barrels are Sold
~ 2 Million Barrels per Trading Day
Prices fall from $137-$39 (-72%)

Source: Author calculations based on CFTC CIT report
2009

$95-$115 Billion Flows into Indices
350 - 400 Million Barrels are Bought
~ 1.5 Million Barrels per Trading Day
Prices rise from $39-$79 (+102%)

Source: Author calculations based on CFTC CIT report
2007 - 2010

Source: Author calculations based on CFTC CIT report
Paper Dominates Physical

Source: Bloomberg, EIA
Dollar vs. WTI

Source: Bloomberg. Rolling 3 month average of 3 month daily correlation of prices changes – U.S. Dollar Index (DXY) to WTI Crude Oil.
Inflation vs. WTI

Source: Bloomberg. Inflation expectation is 10 Year U.S. Treasury minus 10 Year U.S. Treasury Inflation Protected Securities (TIPS)
Persistent Contango

Source: Bloomberg. Monthly averages of annualized spread between 7th WTI crude oil future from expiration and 1st WTI crude oil future from expiration.
Negative Roll Yield

Source: Bloomberg
Summary, and In Conclusion

• Financial investors have transformed the natural price discovery mechanism function for oil because of their dominance in derivatives.
  • Oil is a financial asset and correlates with financial market benchmarks.
  • Oil is ‘financialized’ and prices are subject to speculative booms/busts.
• The unnatural price discovery mechanism function allowing these speculative asset bubbles must be addressed through Regulation!
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