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

Mr. Sean O. Cota

President, Cota & Cota, Inc.

Bellows Falls, Vermont

U.S. Energy Information Administration & Johns Hopkins University
2010 Energy Conference: Short-Term Stresses, Long-Term Change
"Regulating Energy Commodities Panel"

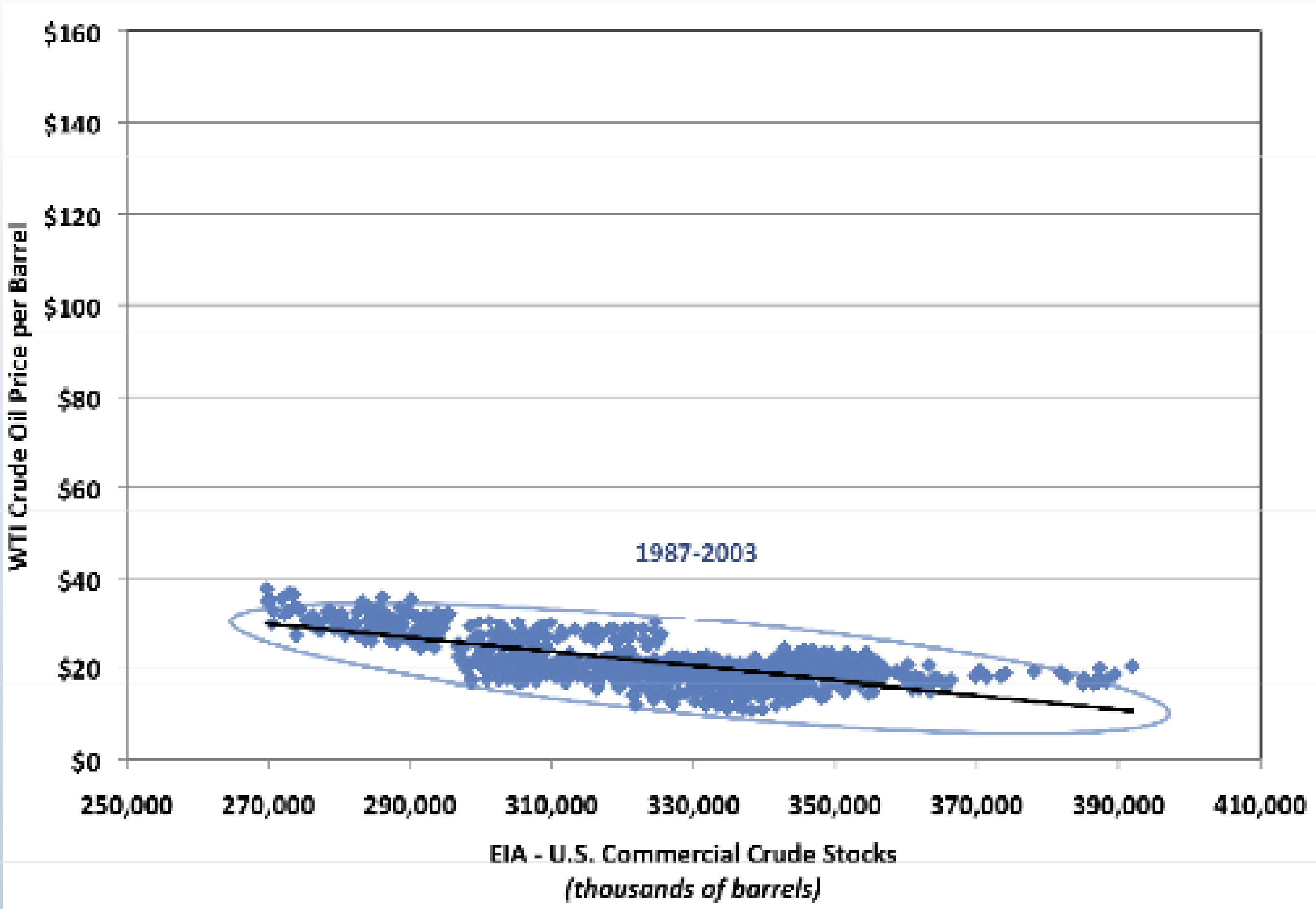
April 6th, 2010

Supply and Demand Fundamentals:

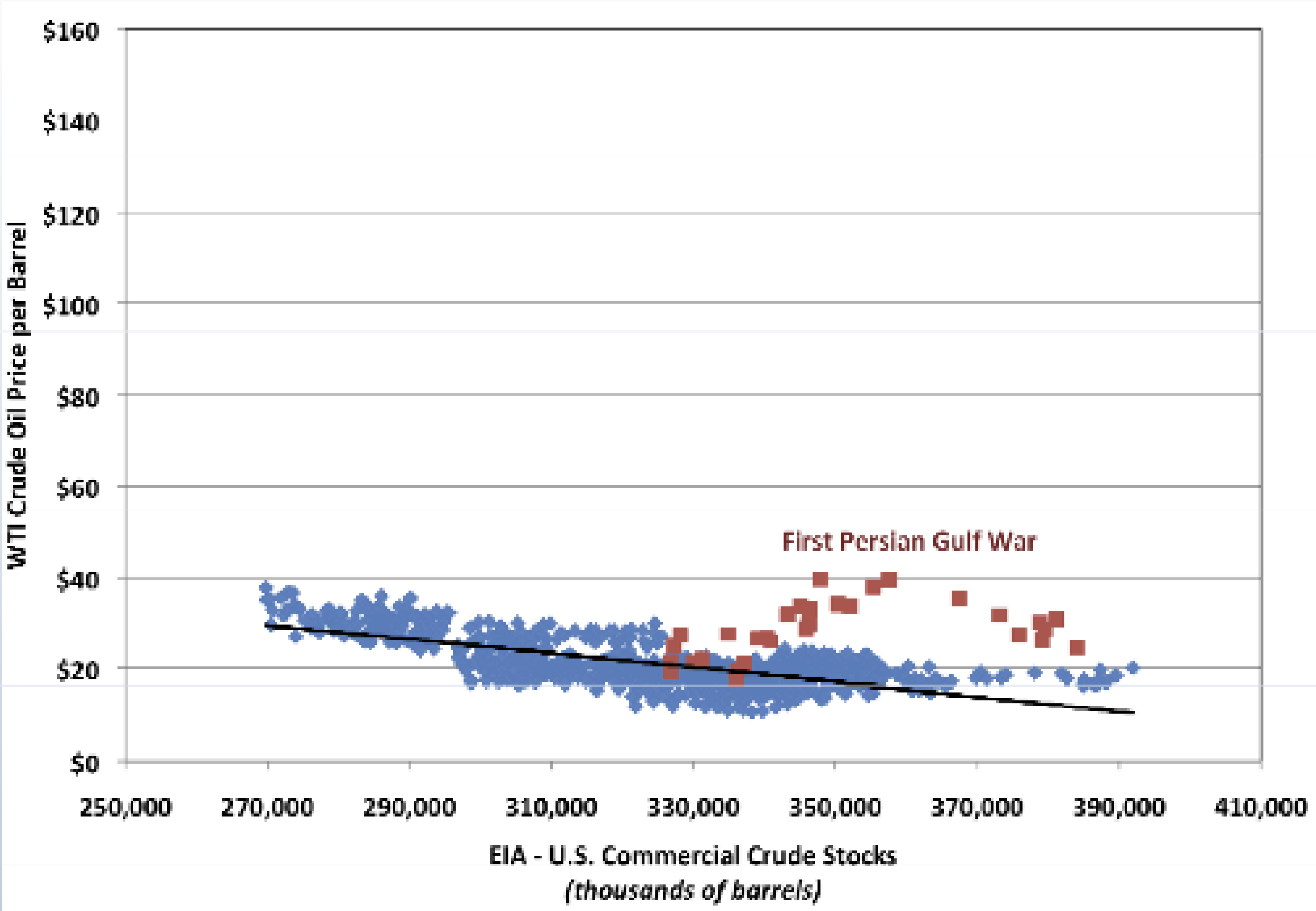
No Longer Telling The “Price” Story

- 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 “Technicals” component of oil pricing*

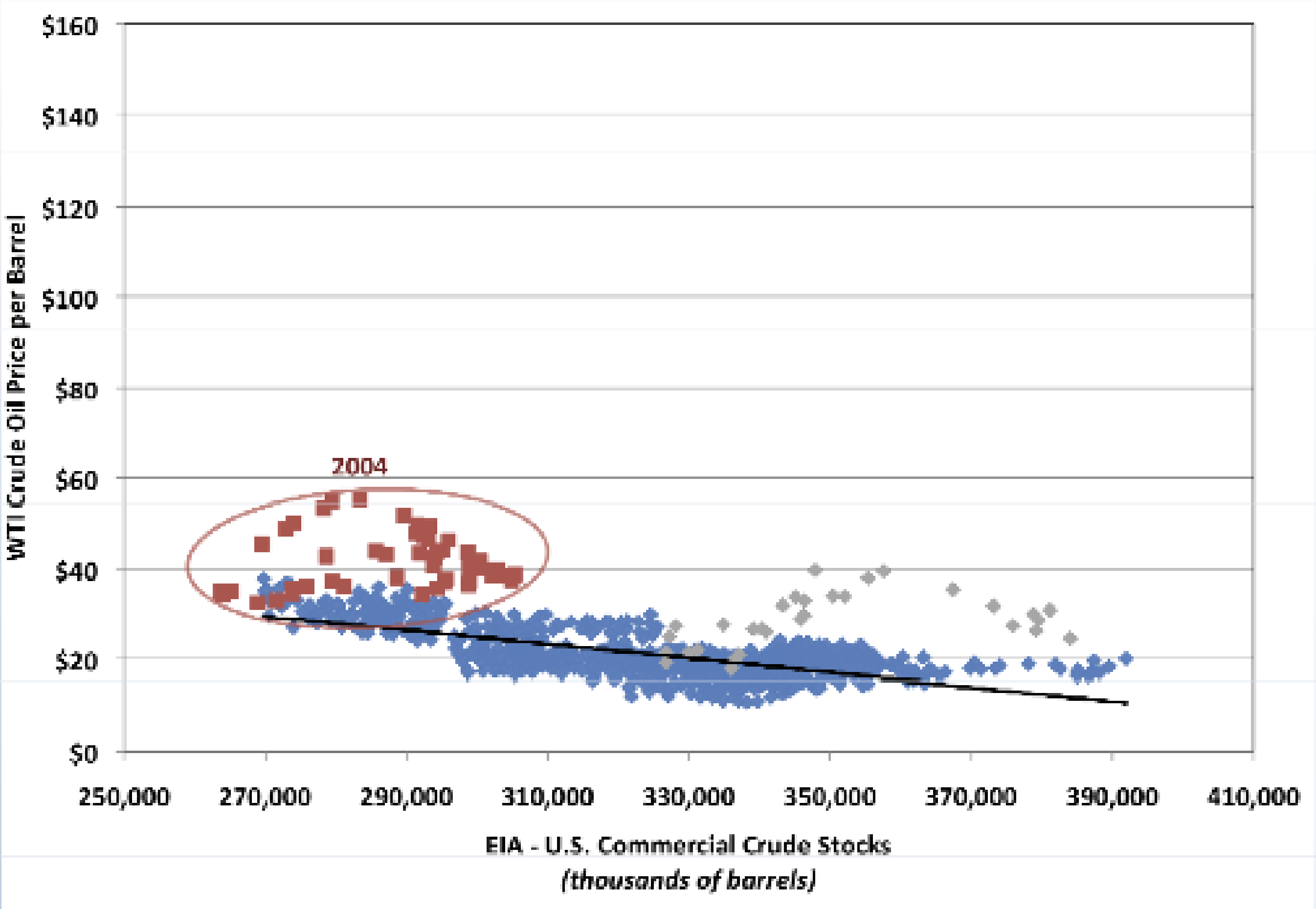
Inventories 1987-2003



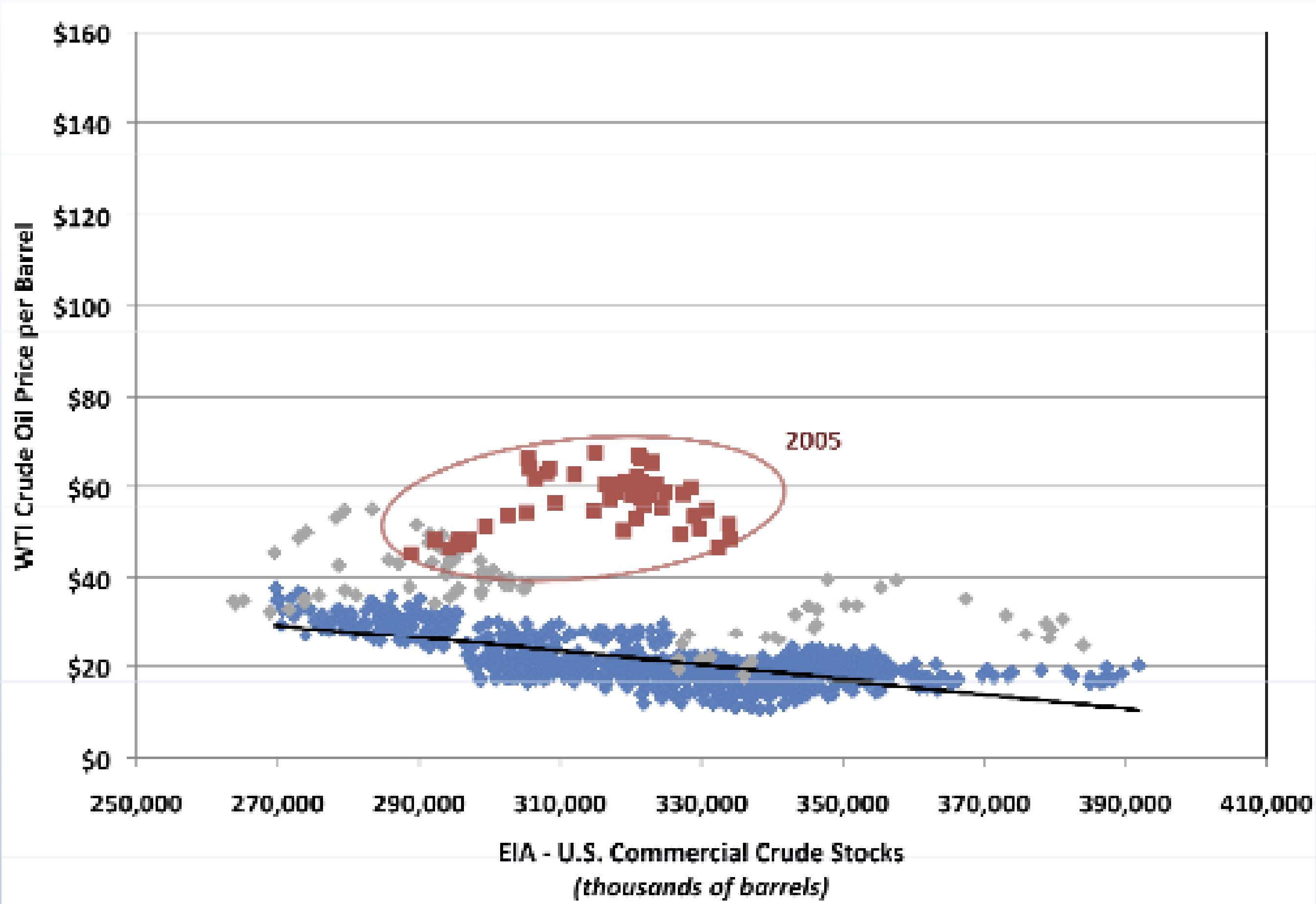
Inventories 1987-2003
(including Persian Gulf War)



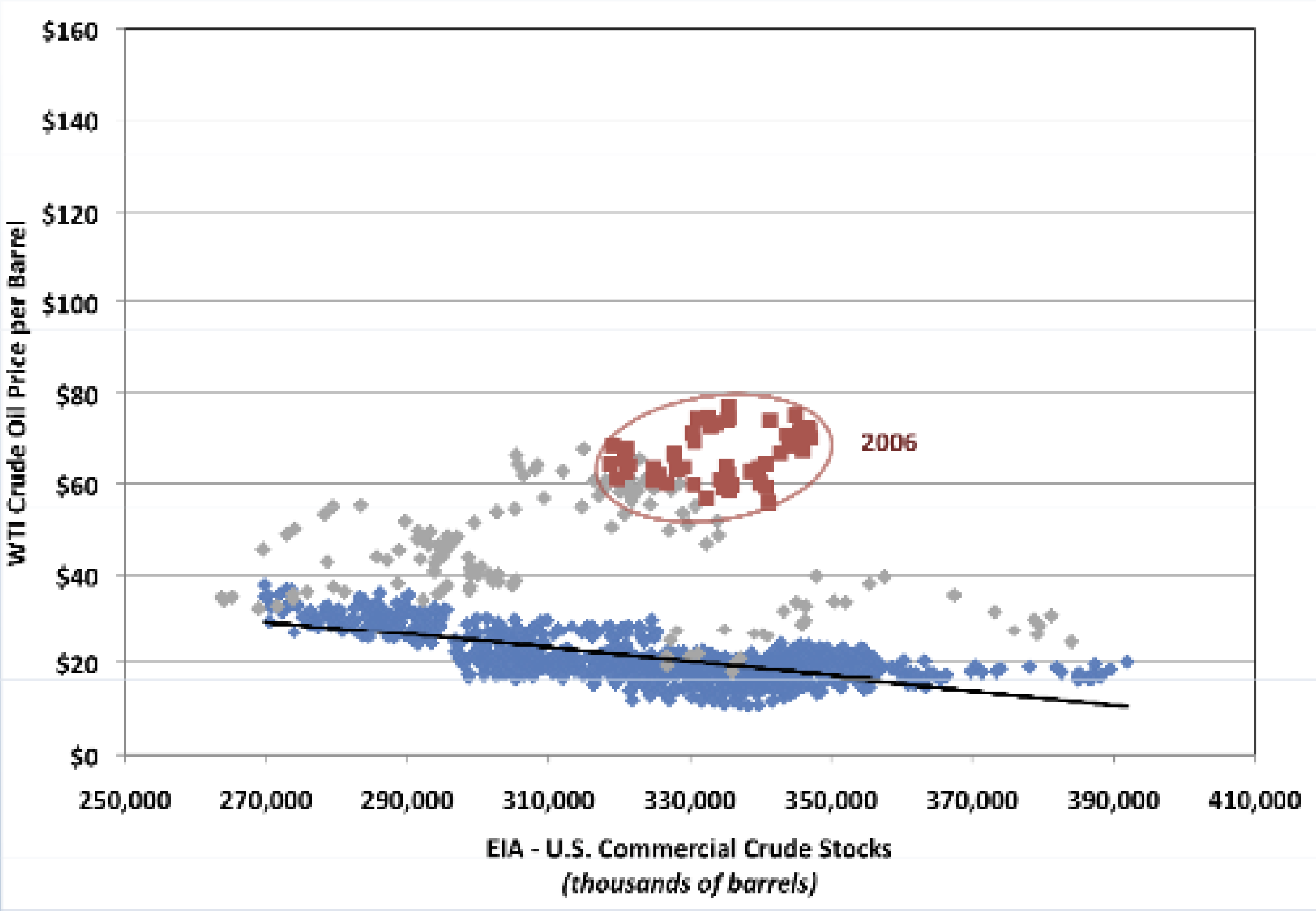
Inventories 1987-2004



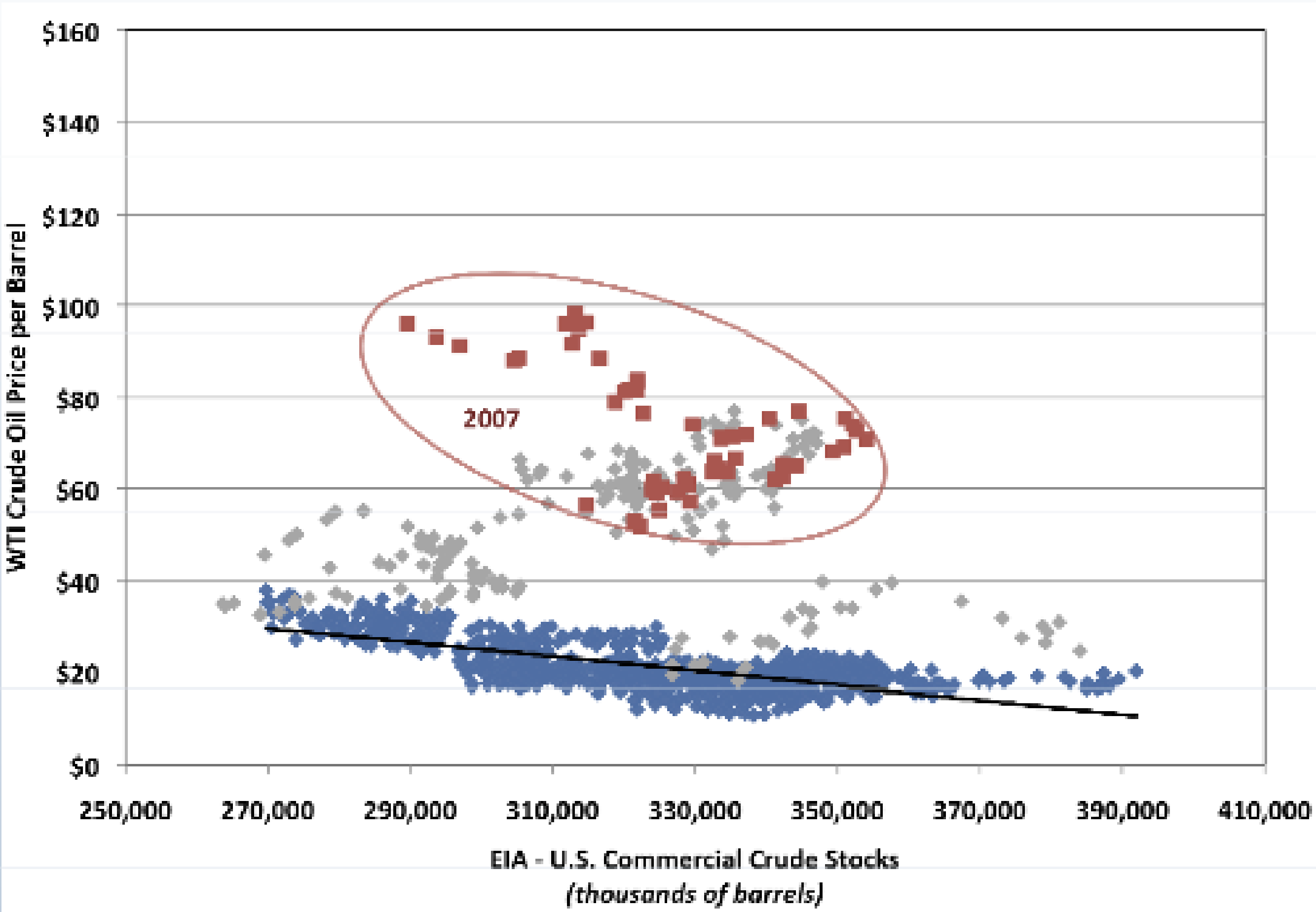
Inventories 1987-2005



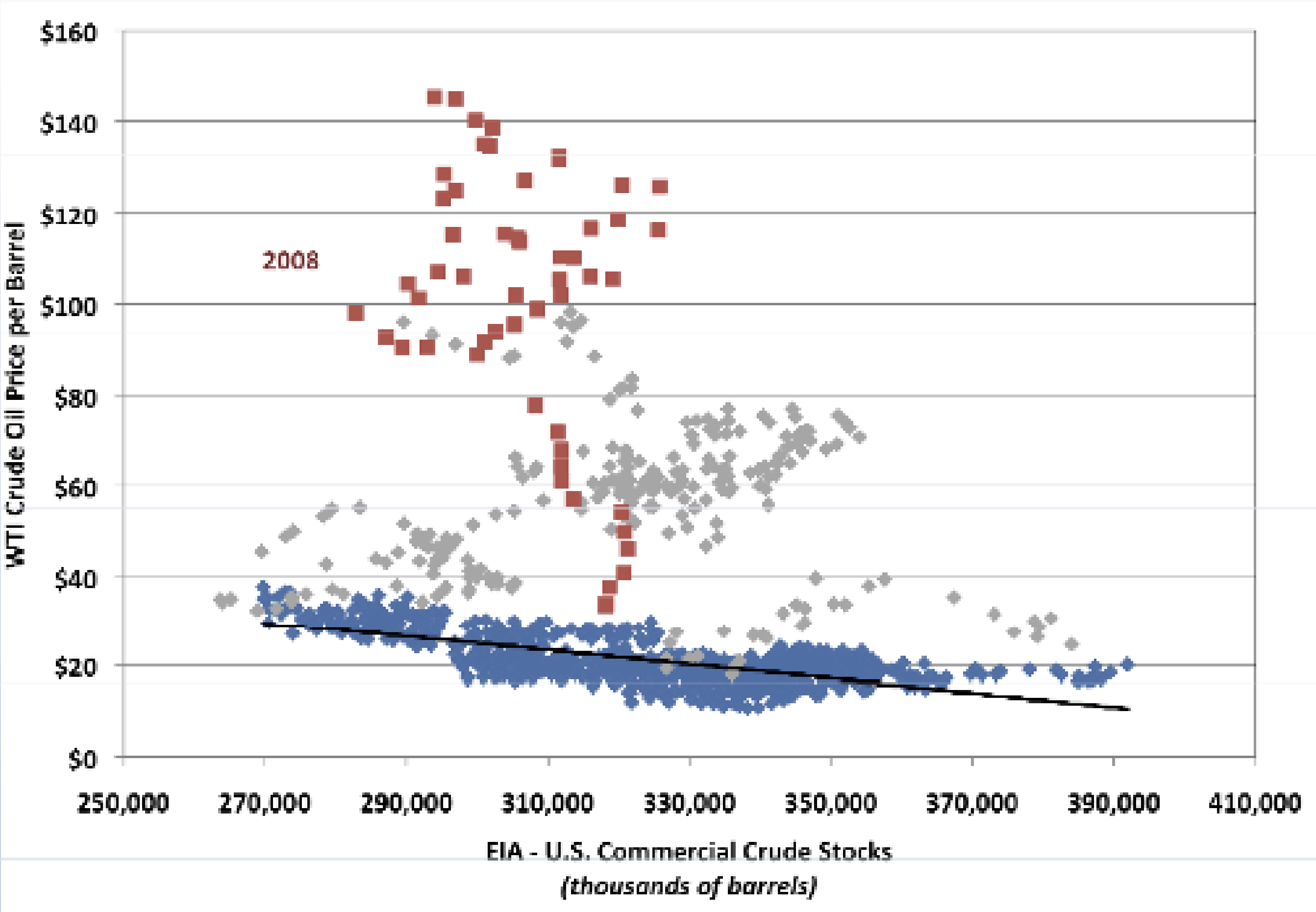
Inventories 1987-2006



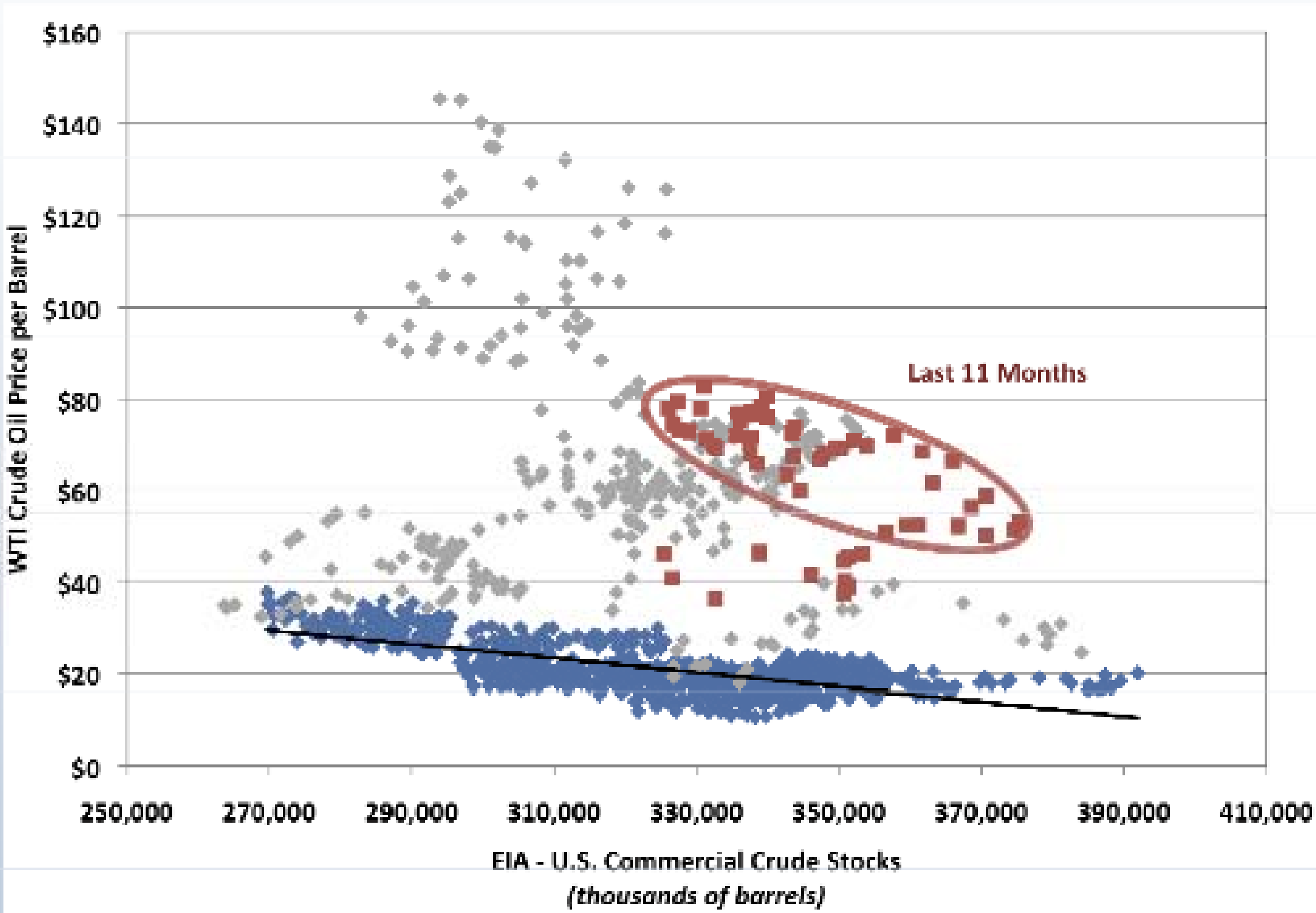
Inventories 1987-2007



Inventories 1987-2008



Inventories 1987-2010

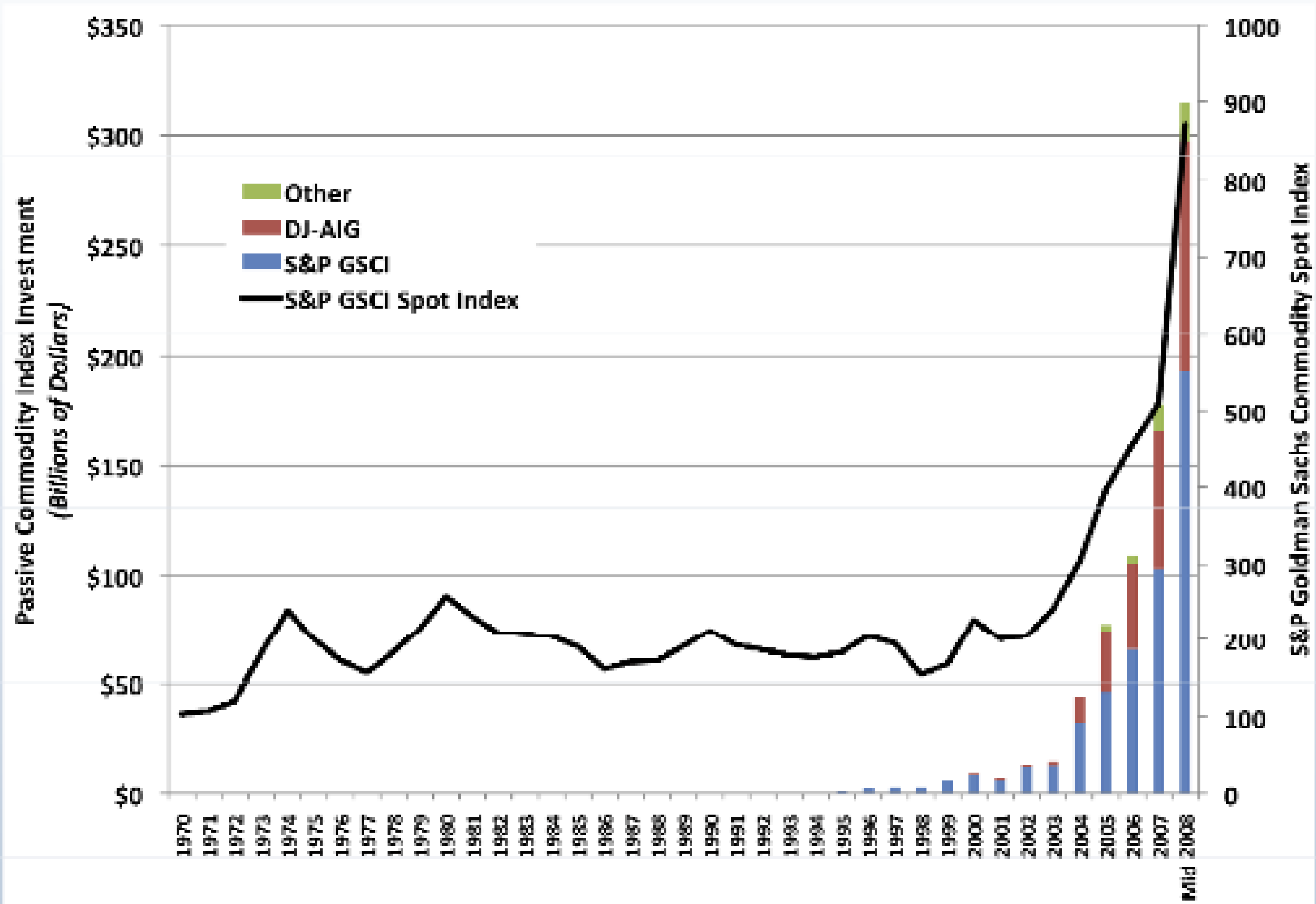


Capital In-Flows II:

Effects Of Financial Investors on Commodities

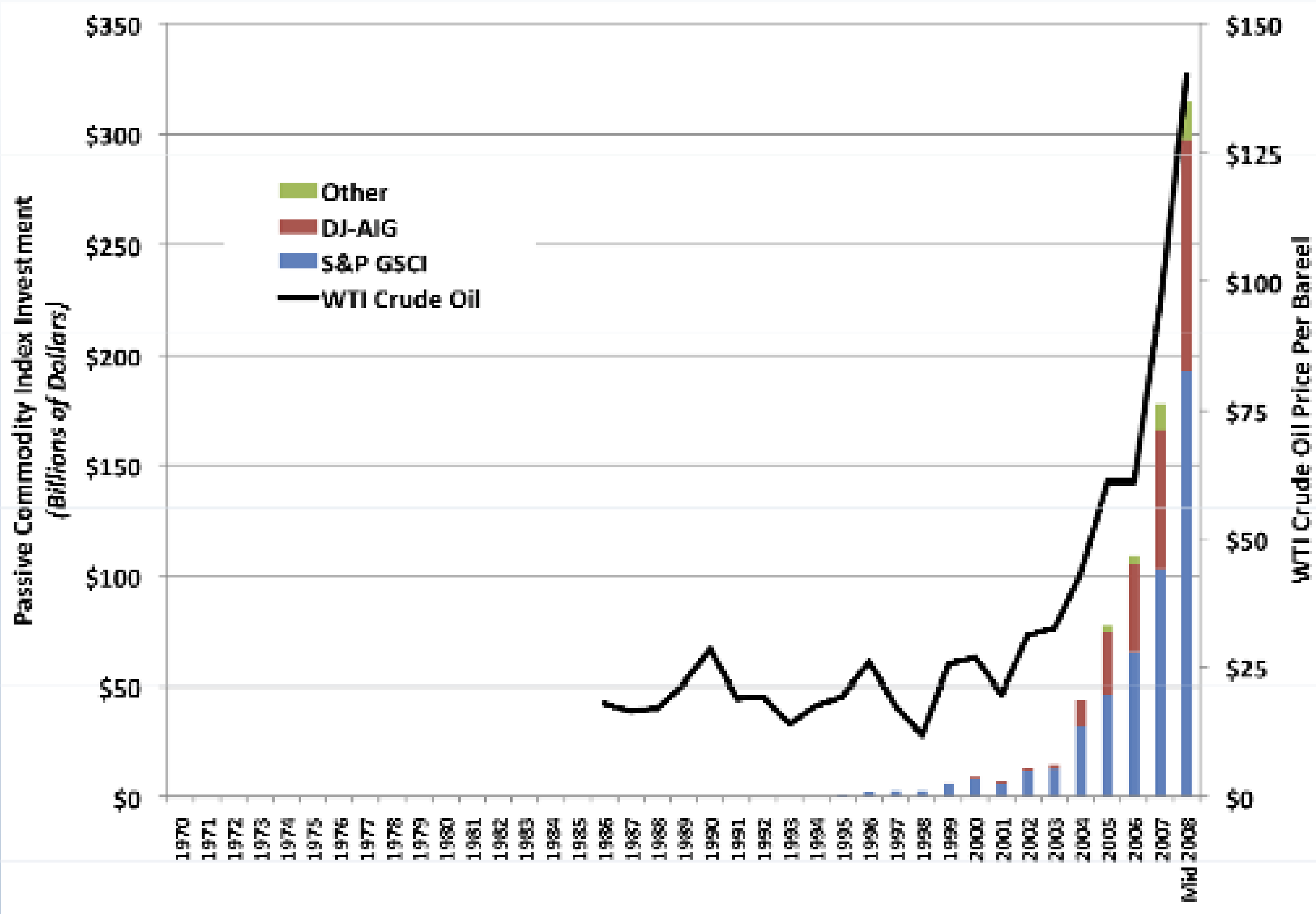
- "Everybody in the markets is chasing their own tail":
  - Derivatives markets are the 'dog' and the spot markets are the 'tail'
- In crude oil markets today, derivatives determine and drive spot prices
- Oil has become its own asset class
  - Oil has become 'financialized'
  - Financial investors have 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



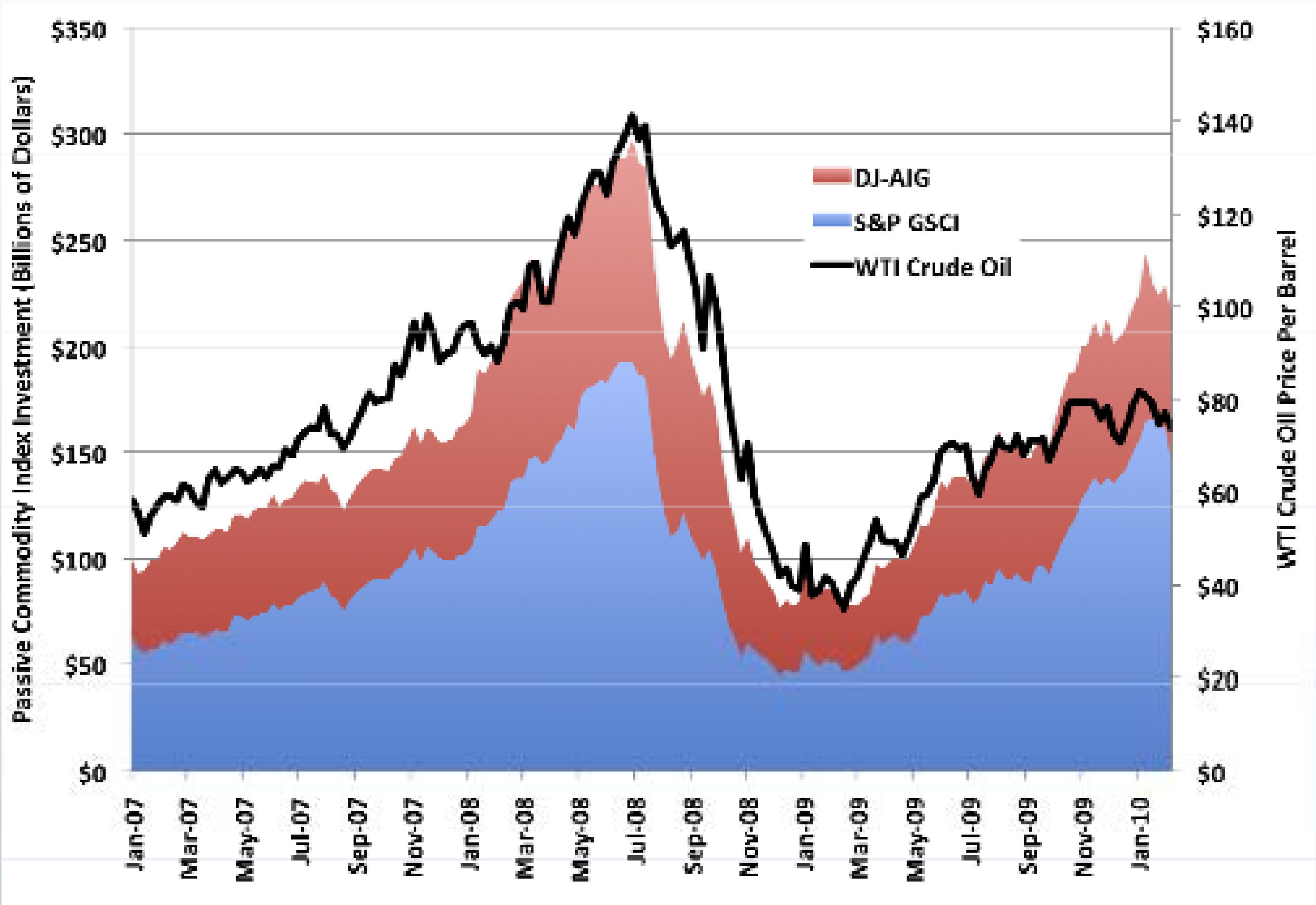
Source: Goldman Sachs, Standard & Poor's, Dow Jones, calculations based upon Commodities Futures Trading Commission (CFTC) Commodity Index Trader (CIT) Supplement. Mid 2008 figure is as of July 1.

Passive Commodity Index Investment



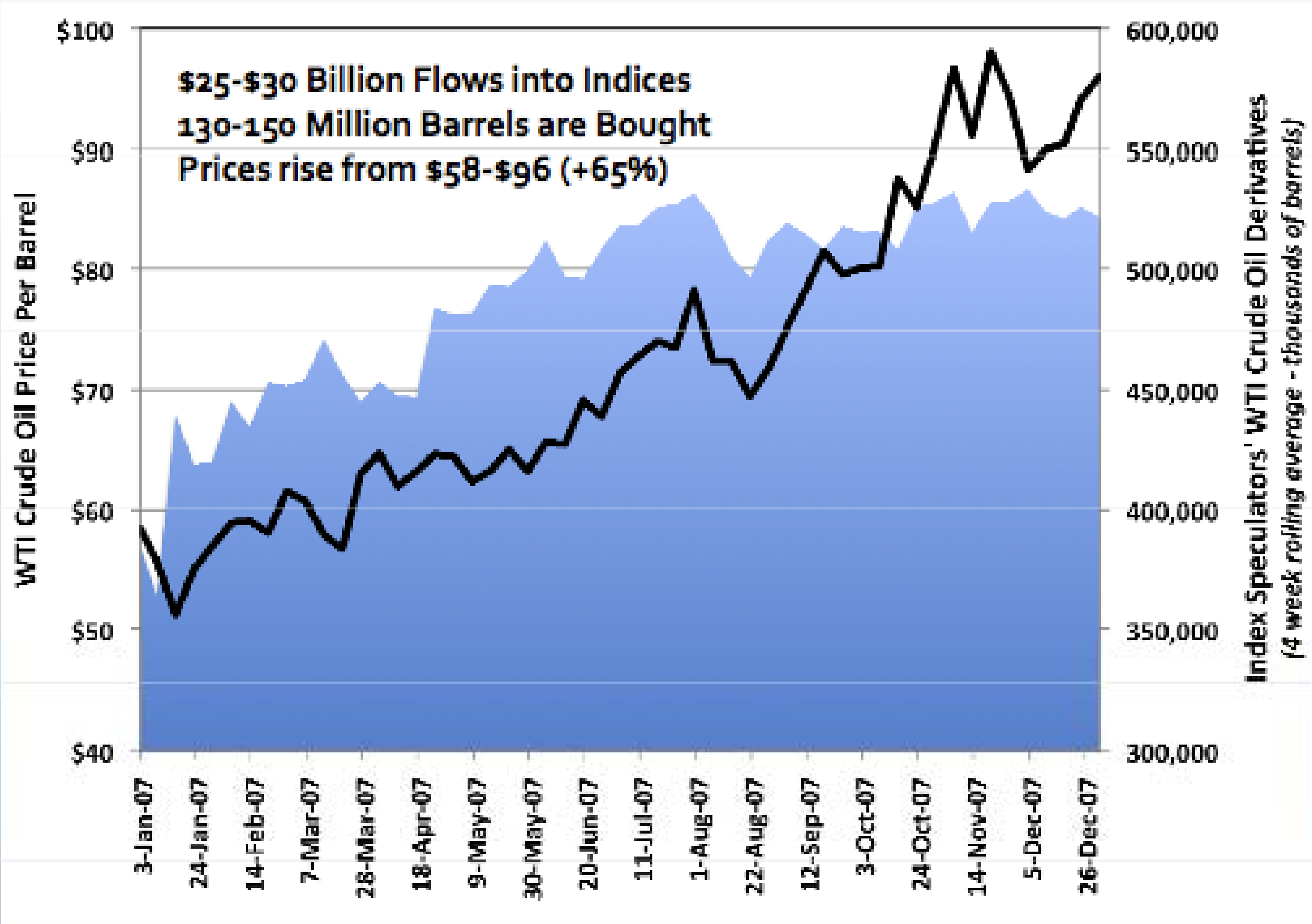
Source: Goldman Sachs, Standard & Poor's, Dow Jones, calculations based upon CFTC CIT report. Mid 2008 figure is as of July 1.

Passive Commodity Index Investment



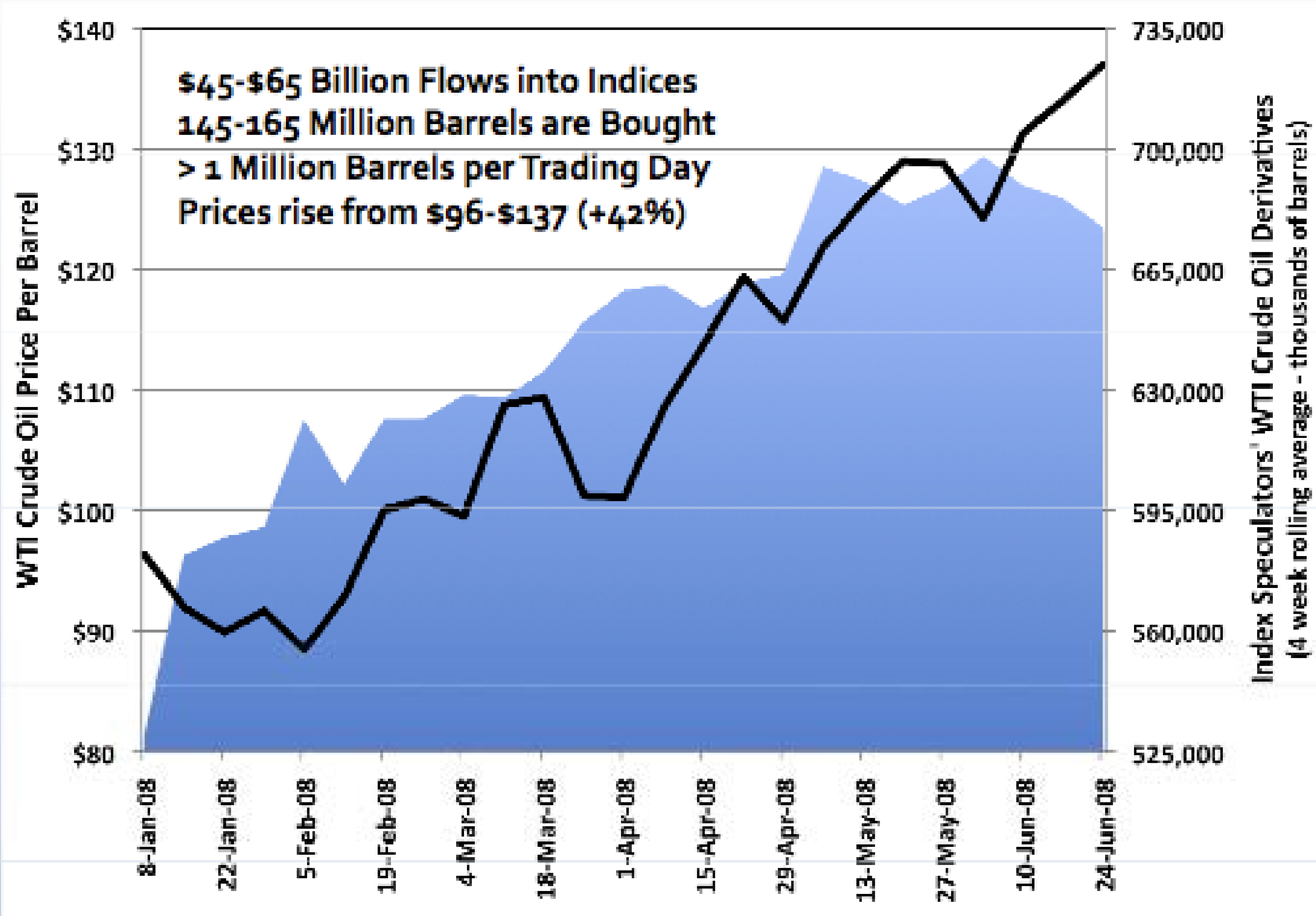
Source: Author calculations based on CFTC CIT report

2007



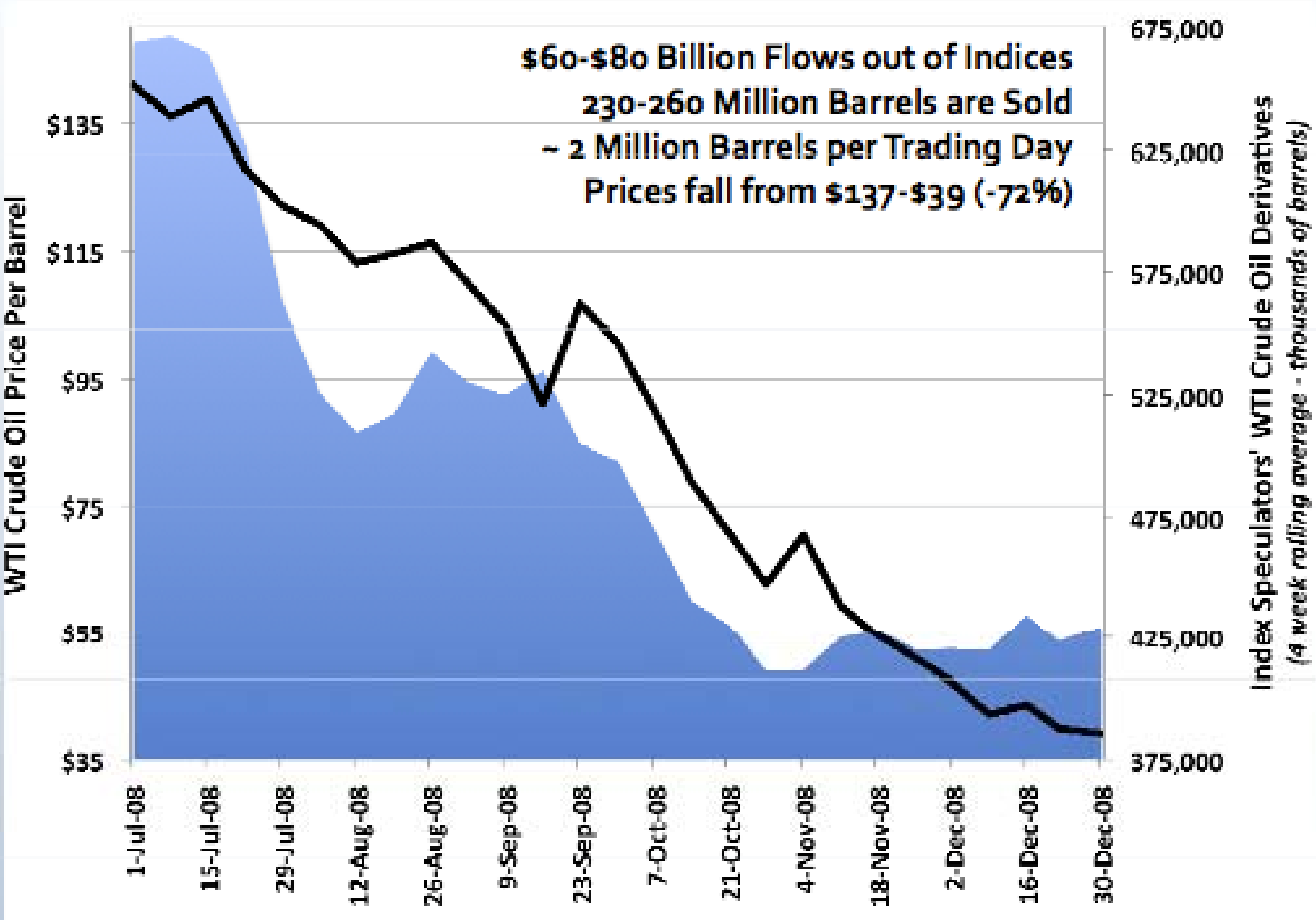
Source: Author calculations based on CFTC CIT report

1st Half 2008



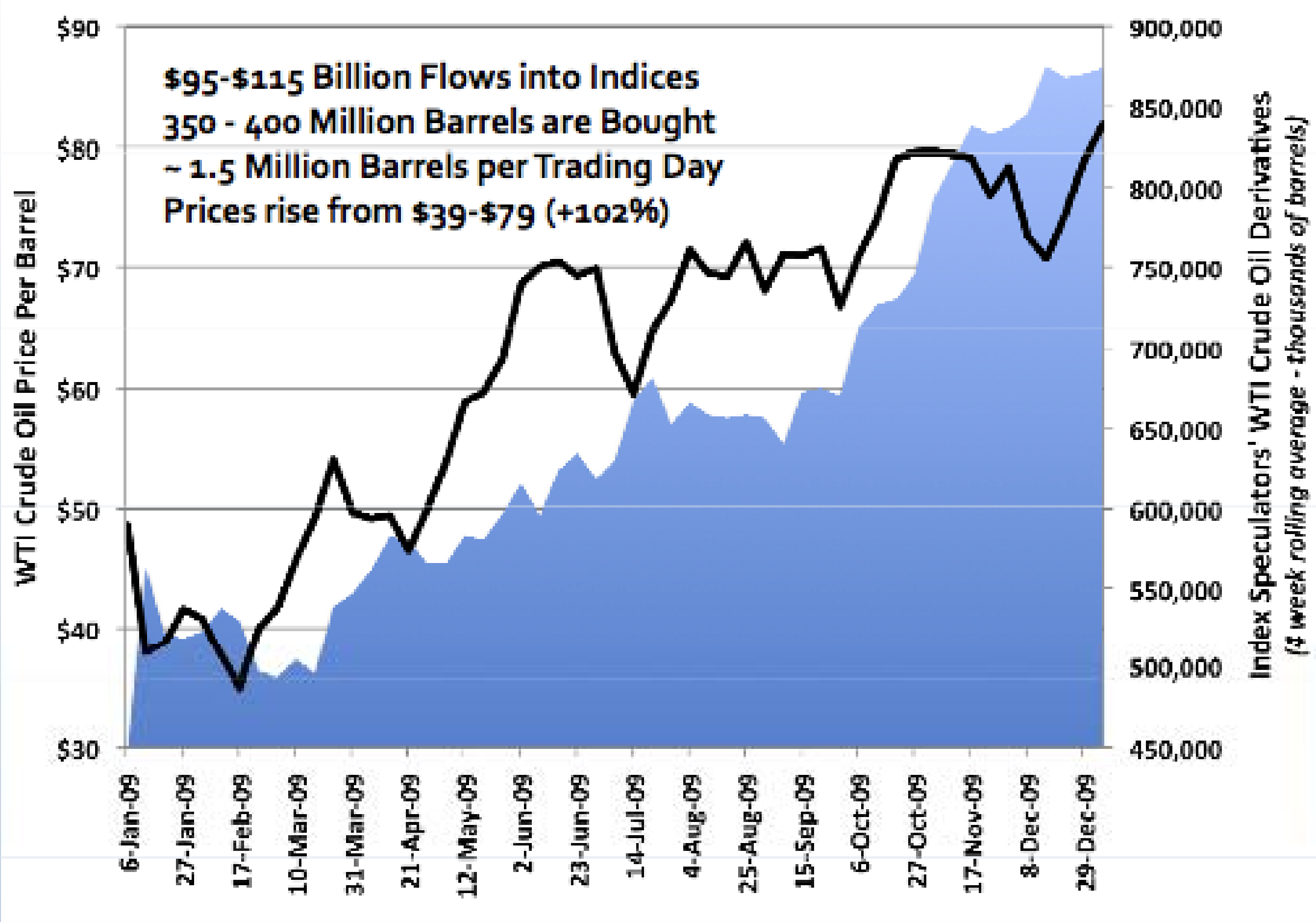
Source: Author calculations based on CFTC CIT report

2nd Half 2008



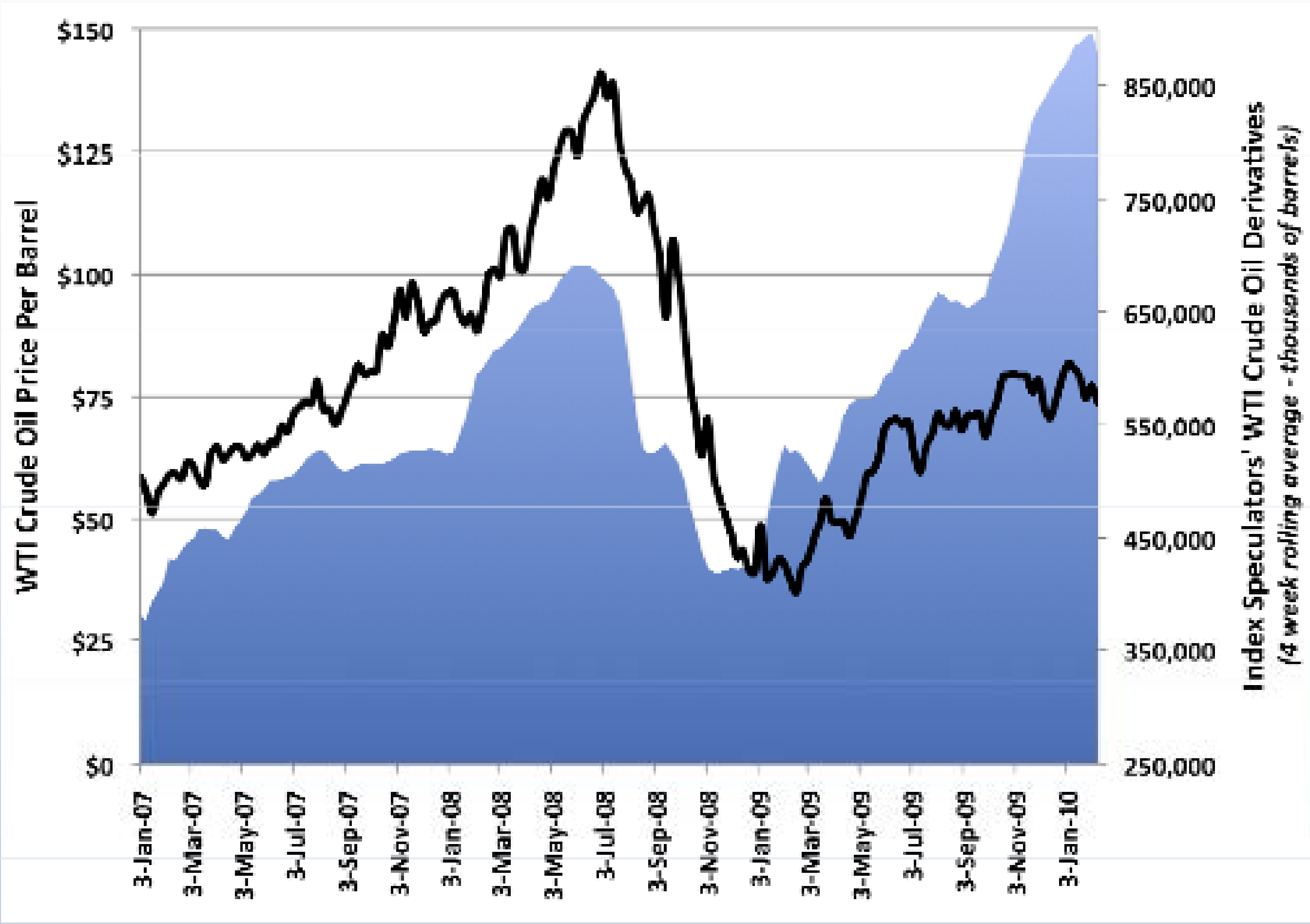
Source: Author calculations based on CFTC CIT report

2009



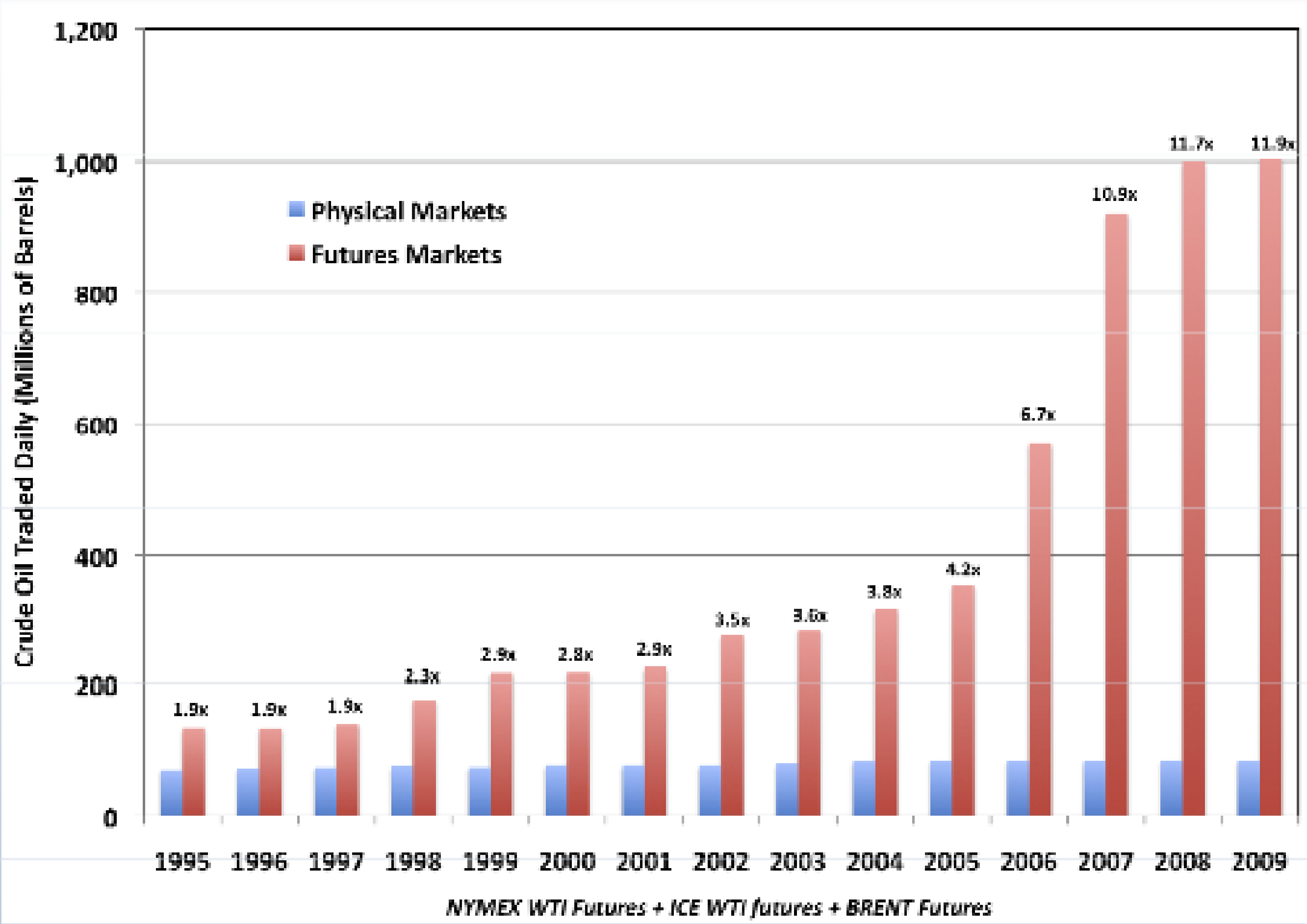
Source: Author calculations based on CFTC CIT report

2007 - 2010



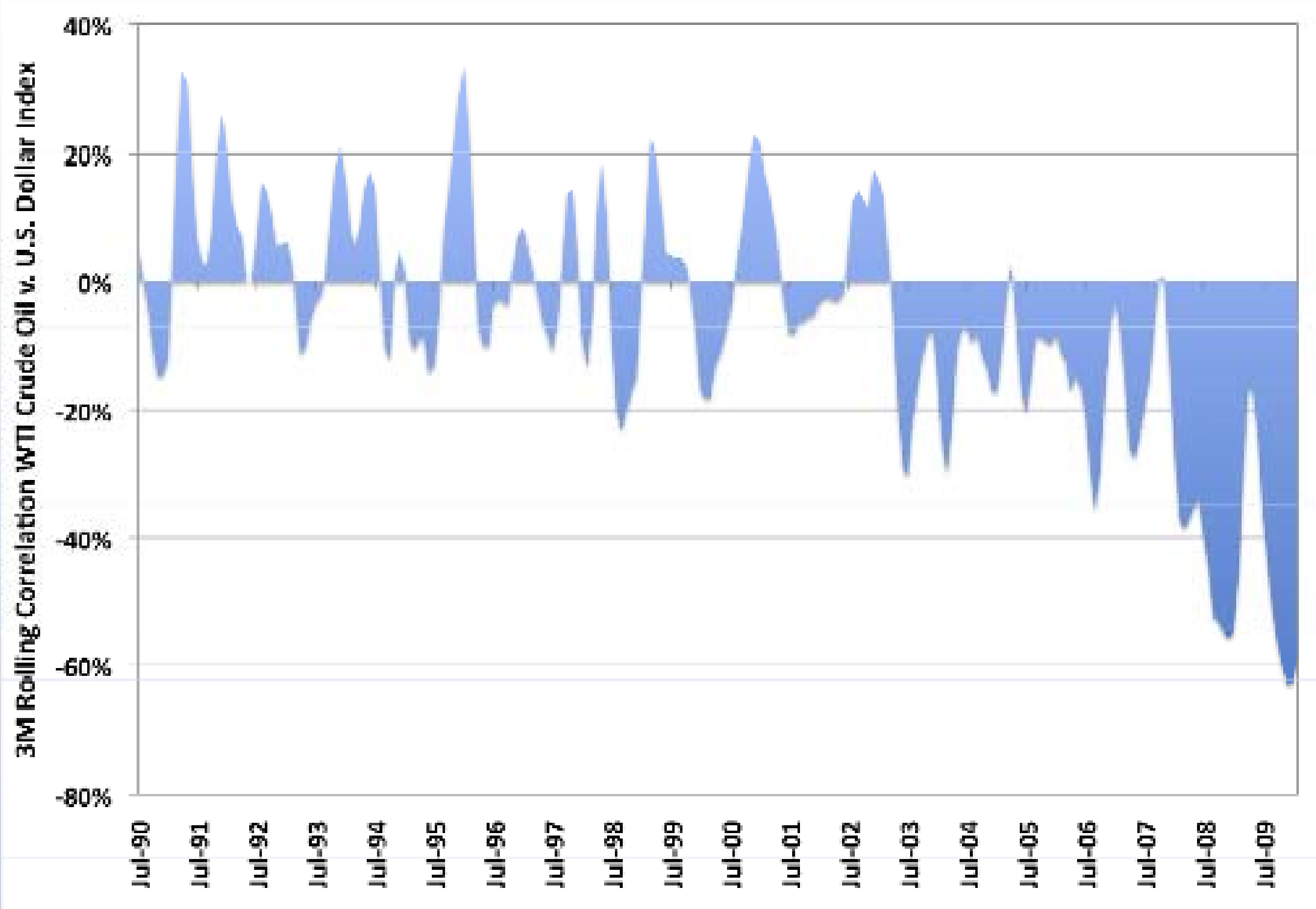
Source: Author calculations based on CFTC CIT report

Paper Dominates Physical



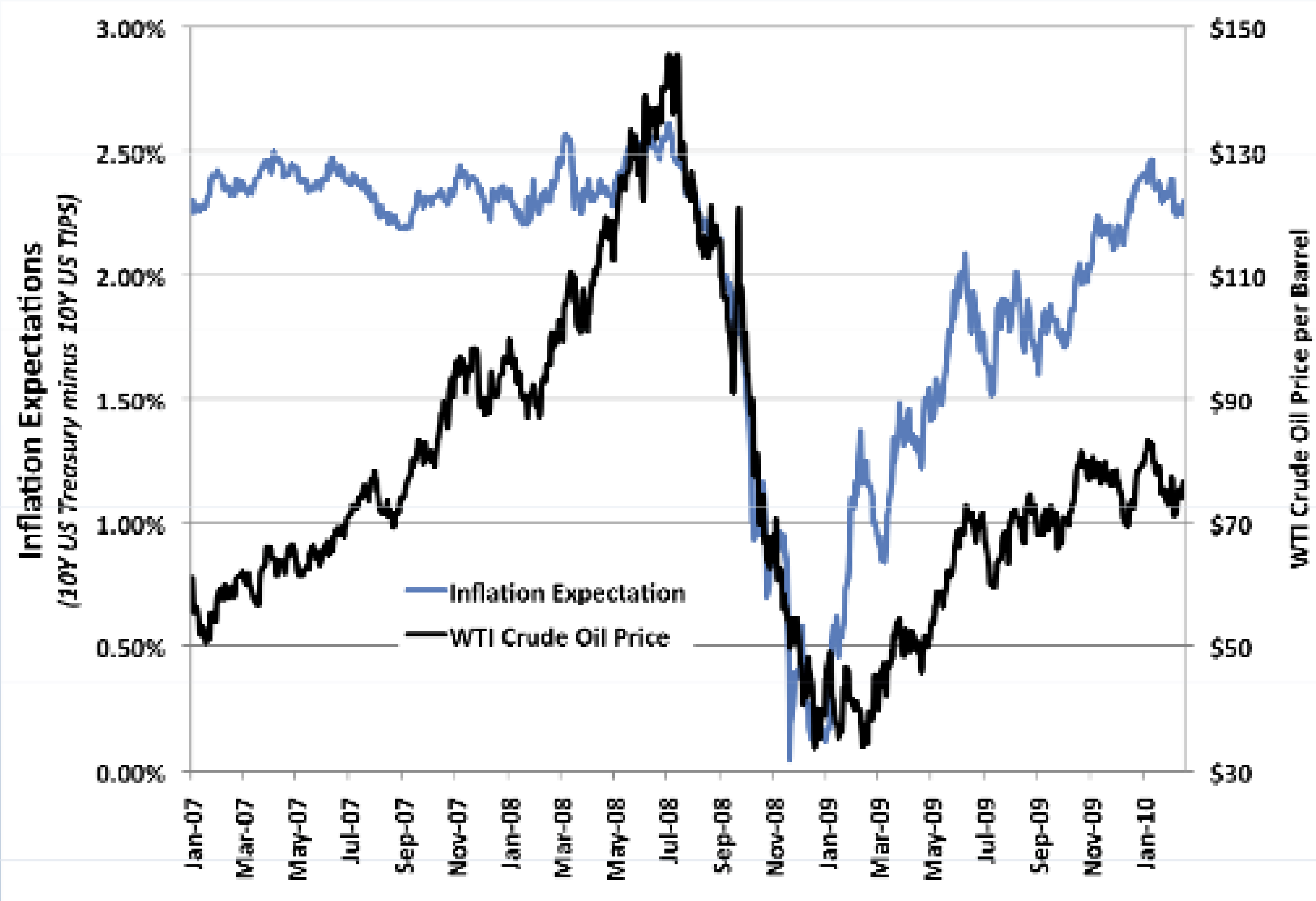
Source: Bloomberg, EIA

Dollar vs. WTI



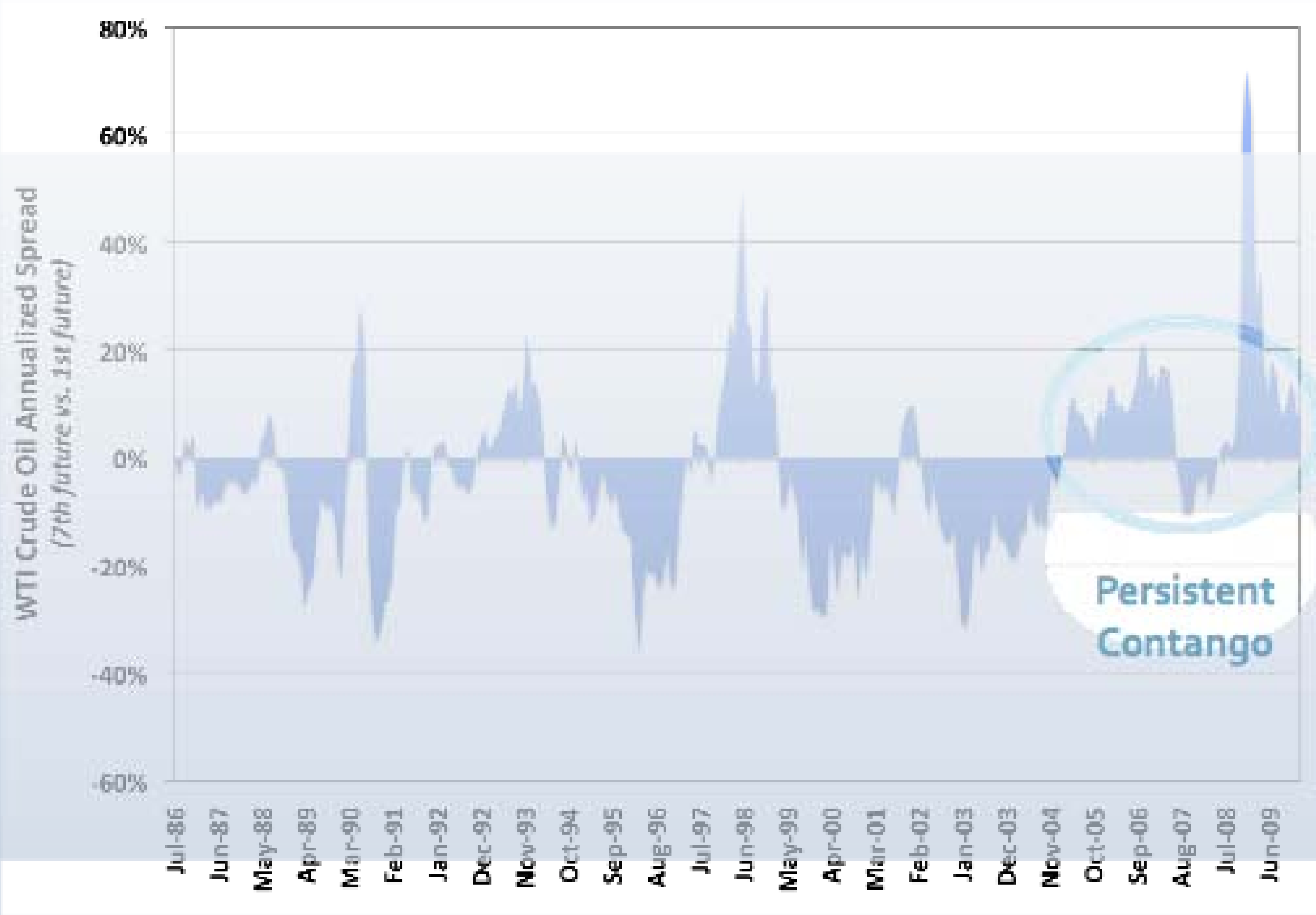
Source: Bloomberg. Rolling 3 month average of 3 month daily correlation of prices changes – U.S. Dollar Index (DXY) to WTI Crude Oil.

Inflation vs. WTI



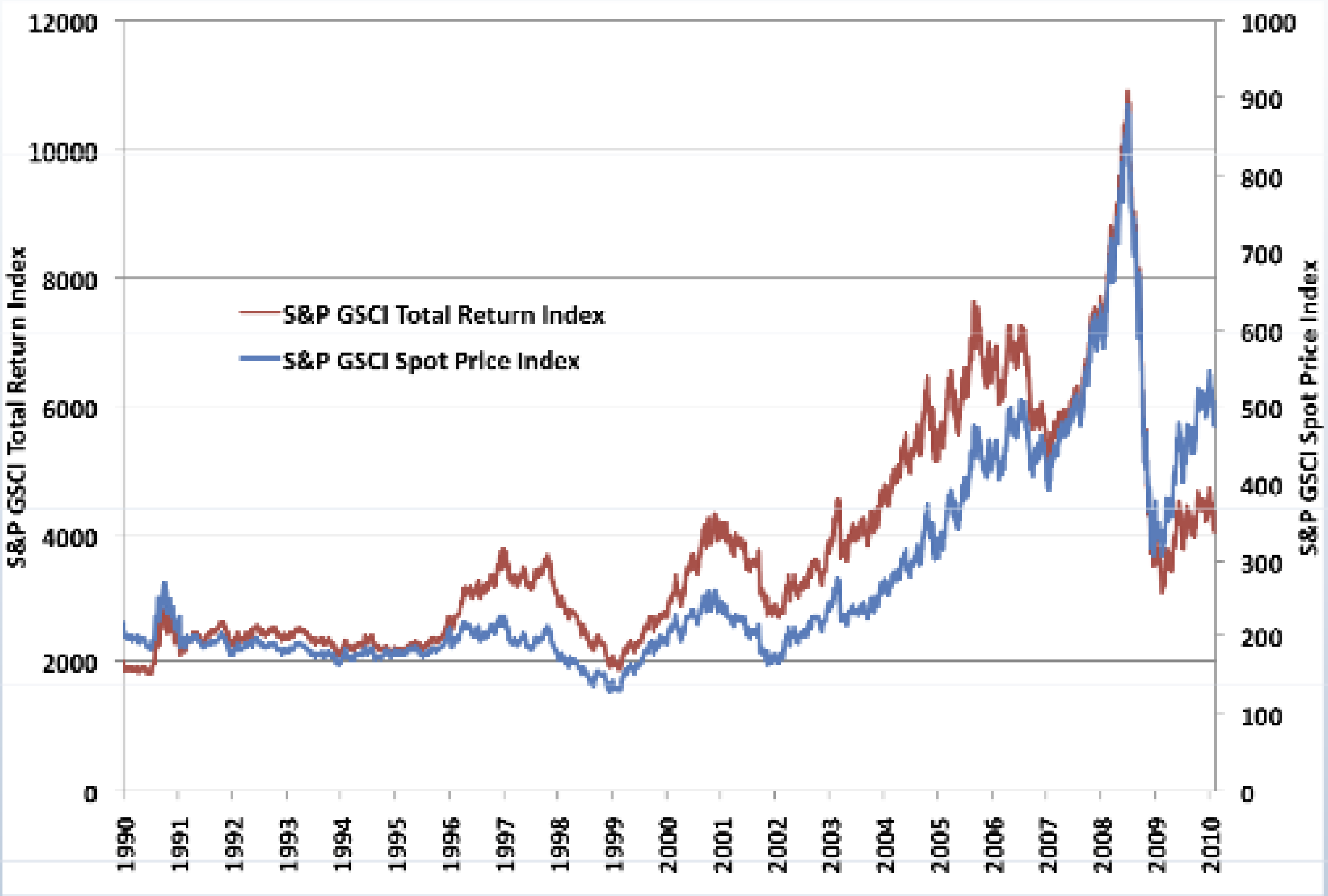
Source: Bloomberg. Inflation expectation is 10 Year U.S. Treasury minus 10 Year U.S. Treasury Inflation Protected Securities (TIPS)

Persistent Contango

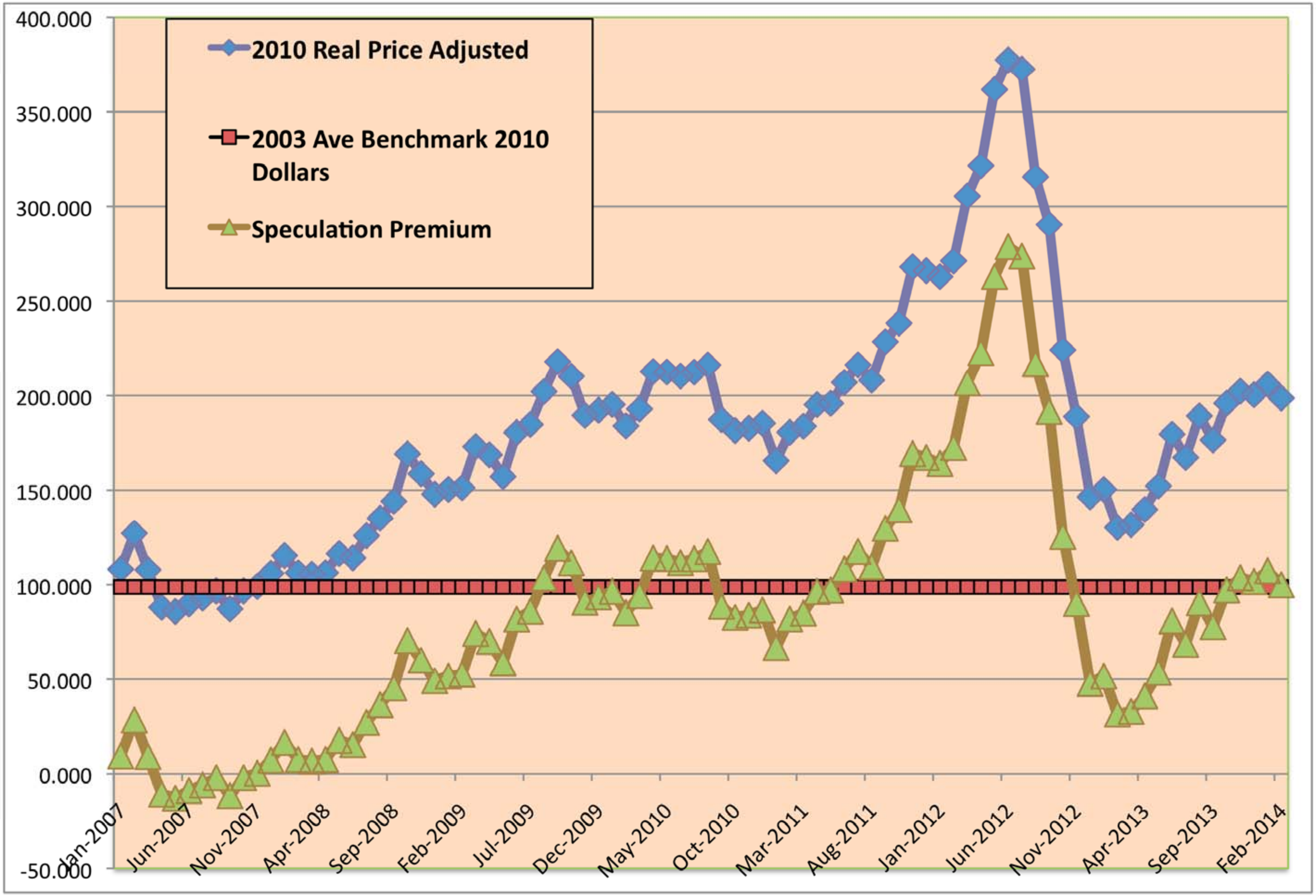


Source: Bloomberg. Monthly averages of annualized spread between 7th WTI crude oil future from expiration and 1st WTI crude oil future from expiration

Negative Roll Yield



Source: Bloomberg


2010 Real Price Adjusted
2003 Ave Benchmark 2010 Dollars
Speculation Premium
400.000
350.000
300.000
250.000
200.000
150.000
100.000
50.000
0.000
-50.000
Jan-2007
Jun-2007
Nov-2007
Apr-2008
Sep-2008
Feb-2009
Jul-2009
Dec-2009
May-2010
Oct-2010
Mar-2011
Aug-2011
Jan-2012
Jun-2012
Nov-2012
Apr-2013
Sep-2013
Feb-2014

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!**

With Thanks

- Mr. Michael Masters
  CEO, Masters Capital Management

- Mr. Peter C. Beutel
  President, Cameron Hanover

- Mr. Rob Underwood
  runderwood@pmaa.org
  Manager, Petroleum Marketers Association of America (PMAA)

- Ms. Elizabeth McCarthy
  elizabeth@nefi.com
  Policy Advisor, New England Fuel Institute (NEFI)

- Mr. Sean Cota
- sean.cota@cotaoil.com