FUTURES $ OPTIONS

Fear or logic?... …(Fear always wins)

*by Philip J. Baratz, C.T.A.**

Thanks to Charley, Frances and Ivan (the 2004 Hurricane Trifecta), I was able to plead my case to our fearless editor, Mike SanGiovanni, and he granted me an extra two days to get my article in….. As I sit to write this on September 13th, we have just had three out of the past seven trading session witness moves of more than seven cents per gallon (actually four of the past eight moved by closer to five cents). Early September is supposed to be the time to get the jet skis into the shed, to close up the boat, to try to get a few more rounds of golf out of the summer, and to schedule the seasons' last barbeques. It is NOT supposed to be the time of year that sees panic-stricken buying by oil dealers who have spent the whole summer wondering when the 25-cent drop was going to show up.

We have had refinery issues (early "turnarounds"), weather issues (hurricanes in the South, and flooding in the Northeast), lack-of-weather issues (and entire July and August without 90-degree temperatures in many locations), supply disruptions, threats of supply disruptions, etc., etc. Oddly, and almost eerily, over the past month, we have heard very little about terror-related supply disruptions, and planned terror attacks. So, what we are facing (as this is being written) is ALMOST what we had hoped for—a lessening of terror fears. That's the good news. The news that is not as good is that inventories (distillates and crude oil) are not as plentiful as they had been—the last reporting period showed the lowest crude oil inventories in six months. In addition, and perhaps related, the demand for distillate products, as of the month of August, was about 7% higher than during the year-ago period.

What "the markets" tell us

What is of greater concern than the market's meteoric rise to over $45.00 per barrel is the fact that this "spike" might not be a one-time occurrence. As many have been warning for the past year, the lack of sufficient refining capacity is already hampering a tight supply/demand market. Even in the event that oil producing countries decide to pump more oil out of the ground, the question will remain as to how to convert that into a sufficient amount of gasoline and distillates for consumption. When you look at the price of oil, you can easily see the jump in "spot" prices over the past year; but what is more noticeable is that the "back" months are moving more up faster than the spot months. The move to $45.50 per barrel from May to August was an increase of about $3.70 per barrel for the "spot" month. During that same time period, the "longer dated" futures contracts (for delivery of crude oil at a later time period) rose by almost $6.00 per barrel. The concern there is that even when/if prices of oil do fall back to more "normal" levels, the drop might not take crude oil below $30.00 per barrel any time in the foreseeable future.

Back to the initial premise: what moves prices? Fear or logic? Everything that we can point to says that the answer is fear, not logic. Supply, demand, terror, the U.S. Dollar, NYMEX speculators, etc., all seem to be viewed through bullish-colored glasses. The hope by oil consumers (and in many cases by resellers) is that prices will eventually move back down to reality—or to "logical" levels. While it is noble to believe that the supply-demand equilibrium will win out, the reality is that the ongoing fear in the marketplace is preventing that from happening. However—and this is a *big* "however"—if consumers were unwilling to pay the inflated prices, the selling price would have to drop. But as long as the consumers are willing to pay those prices, and the worlds' economies continue to demand increasing volumes of oil, the sellers will be able to demand these high prices. When does the price reach an unacceptable high?

Was $49 per barrel this high? Logic (an ugly, unreliable word) dictates that it should be, but last I checked, this was a publication for heating oil distributors, not speculators. The difference between the two has never been more apparent than this year.

We can all agree that we don't like prices where they are. Almost all of us can agree that they should be lower, and that during the winter they might fall. Many of us point to "external forces" keeping prices up, and believe that those factors are inherently unfair. But, as my grandmother used to say, opinions are like noses—everyone has one. Just because we think, hope, believe, pray, etc. that prices are too high, it doesn't mean that they will come back down to terra firma just because we think they should. THAT is the difference between hedging and speculating. The earlier the acceptance that the difference between hopes and reality (fear and logic) are what separates true hedgers—defined as someone who doesn't want outside forces to determine their profitability—from those who just keep hoping that they are right.

Human nature causes people to react more than it allows people to anticipate. Very few oil companies that I am familiar with can actually dispute that reality with regards to their own businesses. As tough as it is on your business to ONLY act as a reaction, it is that much tougher—as many are seeing this summer and fall—to freeze, and to fail to act. Just because you ignore something doesn't mean it will go away.

**President of Angus Energy, Inc., 1-800-440-0472; fax: 1-954-564-7045; e-mail: pbaratz@angusenergy.com.*