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## LIQUID ASSETS

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# Precision timing

In the context of lower oil prices and rock bottom interest rates, futures markets are currently pricing hedges at a decade low. Chris Thorpe looks at the market positives – as well as the uncertainties – to be considered when contemplating a hedging strategy

**Fuel consumers dizzied with data from market prognosticators are frustrated. Hasn't the oil market bottomed yet? What happened to an improving economy and rebounding demand? Isn't the shale supply boom over yet? These are all reasonable questions posed by global fuel buyers. The answers vary but one thing is certain: the price of oil at $40 per barrel is half that of 2014, and the same or lower than the decade before. The opportunity to buy or at least modestly hedge long term fuel costs may not look this good for years if not decades to come. So why the hesitation?**

Price forecasters expect a wide oil price range. It could even go as low as $20 per barrel, according to Goldman Sachs' latest forecasts. The well-respected PIRA Energy Group has taken the opposite side of the argument, calling for $75 per barrel oil by 2017, largely based on improving Chinese demand and slowing supply growth in US shale.

Don't rely on either with great confidence. Price forecasters are paid to use available data to come up with some sort of 'guesstimate' where commodity prices will go. Curiously, increasing amounts of data and improving computing power have not produced superior forecasts.

In the oil markets, trend followers tend to be the most common type of forecasters. No matter the direction of the trend, they will gravitate toward that trend and prescribe a higher level of forecasting certainty on that trend until it is clearly reversing. Today's market appears to be trending lower with increasing bearish sentiment about how low the market could go.

Do gut feelings really matter? Similar to many other financial markets, commodity markets' future prices are dependent upon multiple variables and random events that are not predictable with any great certainty, regardless of market sentimentality. Some algorithmic trading platforms (computer driven trading strategies) will move positions with great size based on triggers that have nothing to do with overall market trend or sentiment. Some may be triggered by world events and terrorist risks, others by interest rates, currency values and inter-commodity price differences.

What does the free market say? The futures market is currently $40 per barrel for prompt West Texas Intermediate (WTI) for pick up in Cushing, Oklahoma. $40 dollars to pick up today or about $50 to pick up in two years, based on futures traded recently (a $10 spread from the present to the future date of December 2017).

The futures price tradable today is not where people think it will be priced in the future and it is not a forecast. It is easy enough to confuse 'futures' pricing with prices in the future, which no one really knows. The futures market for storable commodities takes into account the following things: the cost to store the product and insure it, the cost of money to finance the dollars employed over time (measured by interest rates). If there is a scarcity of storage or interest rates are rising, then the futures price may be very high. There are also cases where short term demand is so great that near term prices trade well above the futures market. Again, this is not a forecast only a market driven phenomenon that can reverse as fast as it appears.

Oil demand cratered in 2008 after a global economic shock literally halted orders and stalled factories. Similar to total economic output, the rebound in oil consumption was slow and has taken until now to really measure progress. While American consumers are finally driving smaller vehicles and consuming less fuel, hydrocarbons remain the dominant fuel source globally, accounting for approximately 80% of total energy consumed. As global economic growth continues to recover, oil markets follow suit.

Oil prices will increasingly reflect the strength of developing countries, including China. As Western countries reduce their consumption of oil, the market balance will increasingly depend on developing countries, which currently account for nearly half of global oil demand. China alone accounts for 12% of global oil demand, which is important because Chinese economic growth continues to slow and may drop to as low as 6.2% by 2017, according to the Organisation for Economic Co-operation and Development (OECD). For the time being, failing a hard landing in China, modest oil demand growth is expected as long as global GDP growth falls in line with 2016 Energy Information Administration (EIA) estimates of 2.7%.

A persistently low oil price environment near $40 per barrel has caused considerable pain for most global producers whose operational cost is closer to $50. If prices remain this low, shale and on shore drillers will start reducing output as current wells are depleted and new wells are delayed.

The knock on effects are widespread. Failing loans and increasing defaults have added to producer woes as capital becomes more expensive and harder to find. With less credit lines available, oil industry capital spending is increasingly dependent on dwindling operating cash flow.

At this rate new wells and exploration projects will eventually be scuttled. This year alone, 46 major oil projects totalling 20 billion barrels of potential oil reserves have been deferred by companies including Shell, Chevron, BP, Statoil and Woodside, according to consultancy Wood Mackenzie.

While supply and demand forces oscillate oil prices, one potentially greater factor is the relative strength of the US dollar. Despite record low interest rates, the US dollar remains the favoured global reserve currency. Dollar strength puts negative pressure on nominal oil prices. If the dollar was to weaken versus other global currencies, oil prices could increase sharply in US dollar terms despite bearish physical market dynamics.

With some grand economic assumptions firmly in place and a great degree of uncertainty accepted, let's examine the risk of taking the bull view on oil prices. First, the closer we get to average producers' lower price bound or limit where they lose money, the higher the chance that the market will eventually recover and go higher.

So even if we can tolerate uncertainty, when is a good time to hedge? Ask yourself the following questions: Will my business do well if I can cap or fix my fuel price at the current market? Can I pass on the cost of hedging using my current business model (for example, passing on the costs of insurance and treating it as an expense on my profit and loss statement or increasing prices to customers to cover the cost)? Can I use the current price ($40 today or $50 in December 2017) as a tool to stabilise my current budget period or upcoming budget year(s)? If the answer to any of these questions is yes, then now may indeed be a good time to hedge.

Energy consumers of all kinds are enjoying the lower cost of both oil and natural gas. Industrial companies of all types can run their plants and fuel their logistics networks at lower costs than they have for the last decade. Many are now taking advantage of lower prices and locking in or buying cap hedge plans for years to come. With interest rates near historic lows, futures markets are pricing hedges way below what we have ever seen in the past for similar strategies. Yet some still hesitate due to concerns about demand growth or new supply coming from Iran, which are both reasonable and supportable arguments.

Whichever way the market goes in three, six or twelve months, there is a safe way to hedge prices for your fuel, whether it be using crude oil or refined products. The best way is to buy insurance, using oil derivatives known as 'call options' which can be used to create a capped price protection strategy. This kind of insurance-like strategy will pay you if prices rise above a certain level and limit your cost to the insurance premium if prices are to fall. The cost of the insurance is known up front and pre-paid like any insurance policy. Cap price strategies can be tailored for short or long periods of time and can be modified over time according to business needs. Whichever strategy you pick, make sure to adopt a systematic approach and avoid episodic reactions to market events.

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The years following 2008 were bad for almost everyone but the worst seems to be behind us. The global economy is growing, albeit it at a measured pace. As you embark upon your hedging strategy be aware of bears who are most confident near the end of a down market. Taking on a bullish hedge (or protecting against prices rising) may not be a popular proposal in the boardroom even though current market conditions likely provide one of the best hedging conditions in the last decade for energy. Currently, it seems like everyone is joining in the negative sentiment which may be a sign we are approaching a bottom in the oil markets and we should be looking up. No matter our views or markets, preparing a hedge strategy assuming our forecasts are wrong will help no matter what.

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