THE ACCIDENTAL HUNT BROTHERS – ACT 2

Index Speculators Have Been a Major Cause of the Recent Drop in Oil Prices

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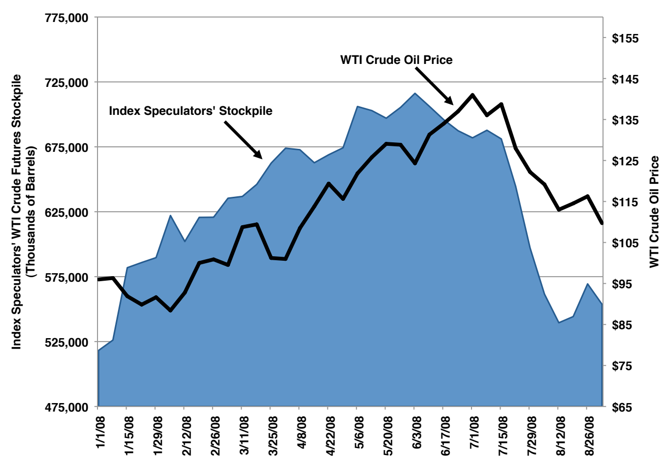
- Starting on July 15th, Institutional Investors began a mass stampede for the exits of the S&P Goldman Sachs Commodity Index. Investors pulled out about $39 billion, which has resulted in the selling of about 127 million barrels of WTI crude oil futures. WTI crude prices have dropped by about $29 per barrel as a result of this selling pressure.

- This is a 180° turn from the January through May period, when Institutional Investors poured more than $60 billion into the major commodity indices, resulting in the purchase of approximately 187 million barrels of WTI crude oil futures. WTI crude prices soared by nearly $33 per barrel as a result of this buying pressure.

- From May 20th onward, Congress held multiple hearings on excessive speculation in the oil markets and multiple bills were introduced to crack down on speculators. It is likely that Congressional scrutiny caused many Index Speculators to exit their positions.

Chart 1. Index Speculators' Stockpile vs. WTI crude oil price - 2008



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon Commodities Futures Trading Commission's COT/CIT report

- When Index Speculators pour large amounts of money into the commodities markets and buy large amounts of futures contracts, prices go up. When they pull large amounts of money out and sell large amounts of futures contracts, prices go down. These large financial players have become the primary source of the recent dramatic and damaging volatility seen in oil prices.

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Introduction

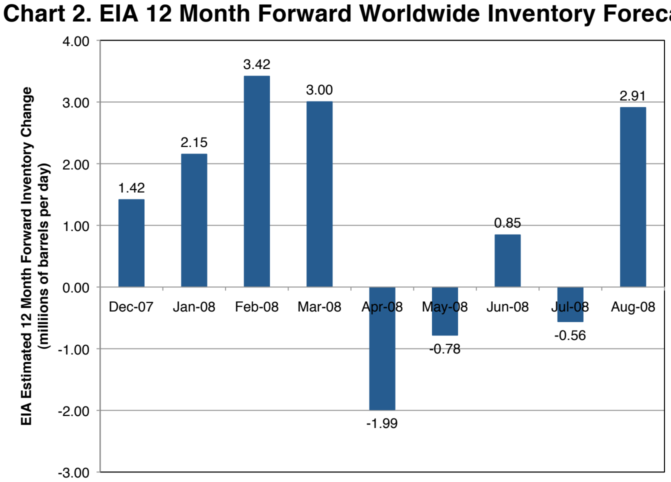
WTI crude oil prices rose dramatically in 2008 from $95 per barrel in January to $145 per barrel in July. Since then, oil prices have fallen just as dramatically to their current levels around $110 per barrel. Economists are now struggling to explain this massive volatility in terms of supply and demand fundamentals.

How can one explain a $50 spike in prices within a few months time followed by a $35 drop in prices just a few months later? Does supply and demand or a weak dollar really explain the roller coaster ride that oil prices have been on?

Supply and Demand Do Not Fully Explain Oil's Price Moves

The Energy Information Administration (part of the U.S. Department of Energy) is charged with developing forecasts of supply and demand for the United States and the rest of the world. When supply exceeds demand then world inventories grow and vice versa. Chart 2 shows the EIA's monthly forecasts for oil inventories on a 12-month forward-looking basis. This is their professional estimate of what supply and demand will do on a worldwide basis over the next 12 months.

Chart 2. EIA 12 Month Forward Worldwide Inventory Forecasts



Source: Energy Information Administration, U.S. Department of Energy "Short Term Energy Outlook"

In the first quarter of 2008 the EIA was forecasting that supply would exceed demand over the next 12 months. Despite this fact, WTI crude oil prices rose dramatically. Oil prices continued to rise into July, at which point the EIA was forecasting that demand would outstrip supply (a bullish sign). A week later WTI crude oil began its precipitous drop.

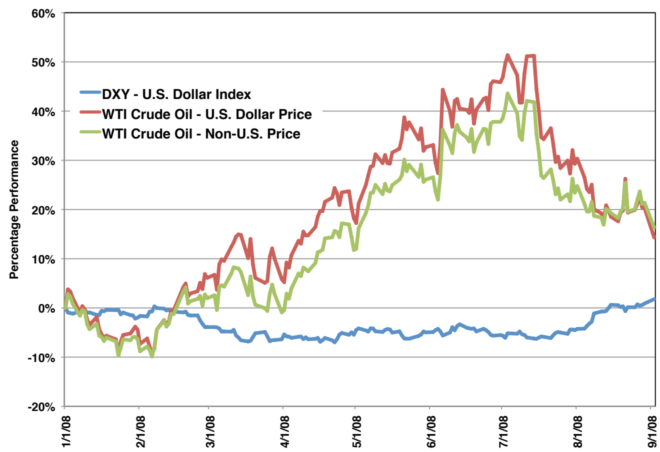
It is important to note that during the first six months of 2008, actual worldwide inventories for crude oil were essentially flat – they did not change. Therefore, supply and demand were in balance during this time period. Clearly, supply and demand cannot fully explain crude oil's dramatic rise and fall during 2008.

U.S. Dollar Weakness Does Not Fully Explain Oil's Price Moves

Many people believe that the U.S. dollar has had a significant impact on oil prices. The most common explanation given is that countries whose currencies are strengthening vis-à-vis the dollar will demand more oil because the price they pay for oil falls when the U.S. dollar falls.[1]

Chart 3 shows how the U.S. Dollar Index performed (on a percentage basis) compared with the U.S. dollar price of WTI crude oil. Chart 3 also adjusts the WTI crude oil price, taking into account the weakness in the U.S. dollar, in order to show what non-U.S. consumers would have to pay for crude oil.

Chart 3. Percentage Performance of U.S. Dollar Index and WTI Crude Oil Prices (in U.S. dollar and Non-U.S. dollar Terms)



Source: Bloomberg

In 2008 the U.S. dollar never weakened more than 7%, yet the price of WTI crude oil climbed by as much as 50%. For a non-U.S. consumer prices peaked at 43% above their January 1st level.

It is very difficult to believe that non-U.S. consumers were increasing their demand for oil in 2008. It is much more reasonable to believe that (just like U.S. consumers) they were doing everything in their power to consume less oil. Clearly a 7% weakening in the U.S. dollar cannot come close to explaining a 50% increase in WTI crude oil prices.

Note that oil traders' fixation with the U.S. dollar is prima facie evidence of the "financialization" of commodities.[2] Most likely, the U.S. dollar's impact on commodity futures prices comes not through changes in real world supply and demand (which would be seen in the actual supply and demand data), but instead through the inflow and outflow of investment funds from foreign speculators.

[1] Crude oil is priced in U.S. dollars around the world.

[2] Testimony of Roger Diwan in front of the House Energy Committee's Subcommittee on Oversight And Investigations, June 23, 2008. http://energycommerce.house.gov/cmte_mtgs/110-oi-hrg.062308.Diwan-testimony.pdf

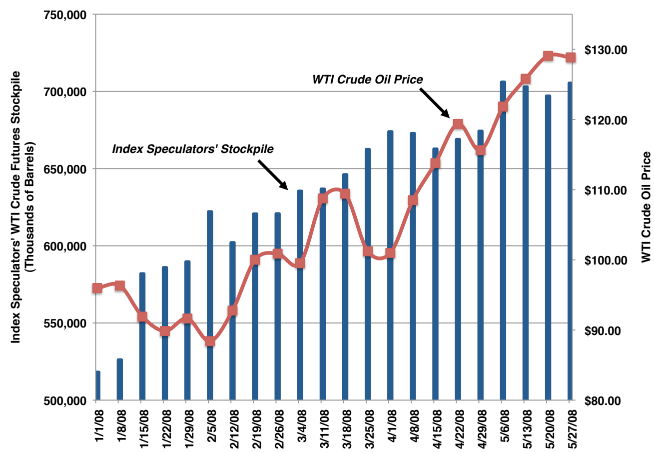
Index Speculator Investment Is a Major Cause of the Dramatic Movement in Oil Prices

Index Speculators[3] have been one of the primary factors in the exaggerated volatility of WTI crude oil prices during 2008. Their buying and selling of WTI crude oil futures has contributed greatly to the dramatic rise and fall of oil prices.

January 1, 2008 to May 27, 2008: Oil Prices Skyrocket

In the first five months of 2008, Index Speculators poured over $60 billion into commodity indices. As Chart 4 illustrates, this led to the purchase of about 187 million barrels of WTI crude oil futures. This buying pressure was a primary factor in the $33 per barrel increase in the WTI crude oil price.

Chart 4. Index Speculators' WTI Crude Futures Stockpile vs. WTI Crude Oil Price



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon the Commodities Futures Trading Commission's Commodity Index Trader report

May 27, 2008 to July 15, 2008: Congress Threatens Action

The period from the end of May to mid-July was a pivotal period for the commodities futures markets and the institutional investment community. Not much happened on the surface: Index Speculators reduced their positions slightly and oil prices increased some more. But a debate was raging in Washington DC over the role that speculators were playing in the rise of the price of oil.

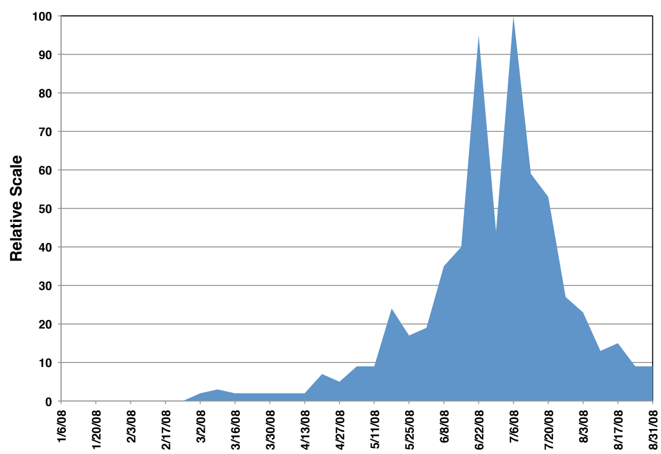
There were multiple hearings held in both houses of Congress during this time, focused on the effect that speculators were having on food and energy prices. There were multiple pieces of legislation introduced that would have cracked down on speculation. Both the Senate and the House had substantial bills proposed by the majority that made significant progress during the month of July.

[3] Index Speculators are Institutional Investors with money allocated to replicating a commodity futures index such as the S&P Goldman Sachs Commodity Index or the Dow Jones – AIG Commodity Index.

In addition, the Commodities Futures Trading Commission (CFTC) announced multiple initiatives and investigations with the stated intent of determining what role speculators played in oil's rapid price rise. They made special calls on swaps dealers for information related to Index Speculation (among other things) and they also struck deals with foreign regulators to increase reporting for markets they did not regulate, like the Intercontinental Exchange (ICE).

Generally, most Institutional Investors do not want adverse publicity. As Chart 5 shows, according to Google, the search term "oil speculation," which did not even register at the beginning of the year, hit a peak in the late May to mid-July timeframe. Clearly, the U.S. public was waking up to the issue. And the threat of Congressional action against excessive speculation was highly elevated during this time.

Chart 5. Google Searches for Term "Oil Speculation" in 2008



Source: Google

Although Institutional Investors typically buy and hold investments for the long term, it is likely that a large number of Index Speculators were concerned enough by what was occurring in Washington to pull their money out of commodity index investments.

July 15, 2008 to September 2, 2008: Oil Prices Plummet

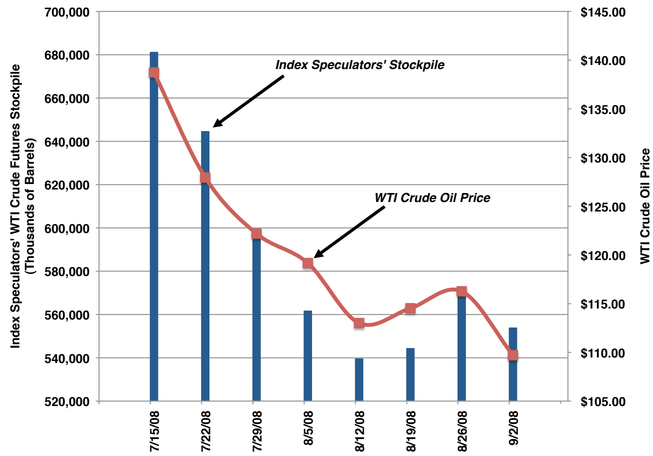
Beginning on July 15th [4], Index Speculators led a mass stampede for the exits, pulling out approximately $39 billion from the S&P Goldman Sachs Commodity Index.[5] As Chart 6 shows, this resulted in the selling of about 127 million barrels of WTI crude oil futures from July 15th to September 2nd. This dramatic selling pressure contributed greatly to the $29 oil price drop during those seven weeks.[6]

[4] July 15th was a significant date because many Institutional Investors make portfolio allocation decisions on a quarterly basis. July 15th was the first day in the 3rd quarter following the index "roll period."

[5] The Dow Jones – AIG commodity index did not experience outflows during this period, it actually experienced a nearly $7 billion inflow. But because the S&P-GSCI is 40% WTI crude and the DJ-AIG is only 16% WTI crude there still were a net 127 million barrels sold.

[6] When Index Speculators liquidate positions they sell all the commodities futures in the index. As a result 22 out of the 25 commodities in the index dropped in price right along with oil.

Chart 6. Index Speculators' WTI Crude Futures Stockpile vs. WTI Crude Oil Price



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon the Commodities Futures Trading Commission's Commodity Index Trader report

Summary

When Index Speculators pour large amounts of money into the commodities markets and buy large amounts of futures contracts, prices go up. When they pull large amounts of money out and sell large amounts of futures contracts, prices go down. These large financial players have become the primary source of the dramatic and damaging volatility seen in oil prices.

If Congress acts to restrict speculation, then price volatility will be reduced and food and energy prices will come down as excessively speculative money flows out of these markets. If nothing is done, then money can continue to flow in and prices can go right back to their previous levels.

As a matter of policy, does it make sense for the American economy, American corporations and American consumers to be held hostage to the needless price volatility caused by the investment decisions of Index Speculators?