

## What's Behind the Energy Price Rise?

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**Slowing Global Demand-** We believe geopolitical concerns about supply disruptions (not soaring demand) is behind the recent rise in oil prices. Over the 12 months ended February 28th, global oil usage was 83.4 million barrels per day, up only 1% from a year ago and down from the March 2005 peak of 4.6%. While oil demand in China and India continue to grow, elsewhere in the emerging world oil demand is falling. Total emerging nations' demand (41.6 million bpd) plunged from 7.8% annualized growth last fall to 1.7%.

**Higher Supply and Inventories-** On the supply side, non-OPEC oil production is running 1.5 million barrels per day higher than in September while OPEC output has slipped 0.8 million bbl/day. Output in Russia, Canada and China are trending higher, while U.S. production continues to rebound from post-hurricane lows. With demand falling and supply up slightly, oil inventories continue to rise. In addition, a number of refiners remain down for seasonal maintenance and about 7% of gulf refining capacity has yet to be restored from the hurricanes. This has created a backing up in oil waiting to be processed. Last week, the Department of Energy reported that crude oil inventories rose to a seven-year high and were well above the upper range of normal for this time of year.

Why are oil prices rising? If demand is slowing, supply is rising and inventories

are high, why aren't oil prices falling? The fear of future supply disruption has increased hoarding by end users. Emerging countries and speculators in particular have bid up futures prices betting that panic buying will drive prices higher. Large speculators are currently positioned 8% net long, which is relatively high. NDR's Crowd Sentiment Poll for Energy Futures has also spiked to an extreme reading of 75. Sentiment is getting to an area that is ripe for reversal and forced covering of speculative long positions. Markets that become one sided are prone to violent shifts in the opposite direction.

We've had numerous crises before without oil prices spiking like this. Why is this time different? Perhaps it's because supply and demand are more tightly balanced and prone to disturbances. More likely, it is that we are seeing a lot more simultaneous geopolitical concerns that could impact the supply of oil: Iraq, Iran, Venezuela, Nigeria, reduced Gulf production. Without these market fears, oil prices would be much lower. There is probably \$20/bbl of risk premium embedded in oil prices.

**Rising Gasoline Prices-** The increase in gasoline prices is easier to explain. First, the price of oil is higher and crude accounts for 55% of the price of gasoline. Second, refining capacity has not yet fully recovered from last year's hurricanes with utilization rates still relative-

ly low at 88%. Normal utilization rates run closer to 95%, with 5% of capacity down for repair at any one time. Although utilization is up from the low of 70% immediately after Katrina, it is still low. Smaller refinery runs are keeping gasoline inventories lean and putting upward pressure on prices. With the summer driving season and the start of hurricane season immediately ahead of us, the potential for further speculative excess can't be ignored.

The Marketplace is doing what it does best- While speculators and hoarders are pushing prices higher, the underlying supply/demand fundamentals suggest that the price should be going down from here. Higher prices are doing what they always do; reduce demand, increase supply and encourage alternative choices. The biggest dangers come from emotional overreaction and government "solutions" which interfere with market signals.

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