



Crude awakenings

Don't get caught out by rising oil prices

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Pressure at the pump may turn positive

The price of oil is closely linked to the performance of the US dollar, explains

DAVID POTTS.

This is the world's third oil shock, and the worst after allowing for inflation, but don't let that put you off. Yet present company excepted, the world is coping much better with higher petrol prices than last time.

While the economies of the US, Europe and Japan have slowed down, nobody is suggesting a global recession is on the cards. Um, yet.

Thank the shadowy hedge funds and speculators who have uncharacteristically helped the US to sputter along by making its currency more competitive. But the dumped US dollar has been a direct pipeline to oil prices through futures speculation.

Just as the worst appears to be over for the credit crunch, so oil prices may have seen their best. For all the talk about peak oil – that supply is running out – perhaps it's peak price we've reached.

■ HERE'S THE DRILL

Lots of compelling reasons, ranging from supply disruptions in Nigeria to underinvestment in refineries and

rocketing demand from China, have been offered for the doubling in oil prices in a year and, since there's general agreement that demand and supply are finely balanced, perhaps it's been all of them.

Yet get this. Oil isn't hard to come by at all. Iran has stockpiles on tankers in the Persian Gulf going nowhere, and most of the big producers are lifting production. The Organisation of Petroleum Exporting Countries, for one, insists inventories are rising.

The bigger problem seems to have been not enough refining capacity – a hangover from years of underinvestment when oil prices were, as it turned out, ludicrously low.

Whenever a refinery is out of action for maintenance, it has a disproportionate impact on the oil price, a sure sign speculators are getting in on the act. Incidentally, odd as it sounds, high oil prices don't suit the refineries. Oil is a cost for them, and because margins are in US dollars, a

falling US dollar is a double whammy.

That's probably why the share price of our only listed refinery, Caltex Australia has moved almost inversely with the oil price during the past year.

Mind you, brokers think this has been overdone and the stock has buy recommendations from nine analysts, plus one hold.

Luckily new refineries are springing up throughout Asia. Since some countries which fix petrol prices, such as Indonesia, are cutting back their subsidies, this should also take some of the fizz out of their demand for oil.

Barring a supply shock of either the natural or political kind – always a threat – the oil price should level out if not drop from the recent speculative spike. Its price has already weakened noticeably since the head of the US Federal Reserve, Ben Bernanke, said he wanted a stronger US dollar to stop inflation.

He wouldn't be alone there. Other central banks are bound to have made the connection between a sinking US dollar and soaring oil prices. Most telling is that many Gulf producers are facing double-digit inflation themselves.

One thing's for sure. Predictions of oil hitting \$200 a barrel in the next six months already look preposterous. Even one of Australia's earliest and most consistent bulls about oil and commodity prices generally, Angus Geddes of Fat Prophets, says the oil price will correct to somewhere between \$100 and \$120 a barrel in the short term.

"I can't see \$200 this year. In the next five years it could reach that, though," he said.

Ah, but what if the US dollar dropped? After all it's been on a downward spiral against the euro for four years.

But don't forget, while the collapsed US dollar has indirectly caused great grief to financial markets and motorists, it's also providing a much needed stimulus to the US, still the world's biggest economy.

Frankly, the US dollar can only drop so far without rekindling inflation.

If the US Fed isn't on the job – which would mean Bernanke doesn't mean

what he's saying, a position that speculators would take at their peril – the other central banks will be.

■ NEXT STRIKE

Because it'll take time for new refineries to come on-stream, and there's the prospect of global demand slowing or at least not rising as it has been, what the US dollar does will have a more than proportionate bearing on the oil price.

A recovery of the US dollar would put the wind up the speculators. Because oil is priced in US dollars, hedge funds are taking a position as much against the US dollar (probably the primary motivation because low interest rates in the US are so unattractive to them) as they are backing oil. That makes them short the US dollar and long oil.

The reverse – a strengthening dollar and falling oil price – would be catastrophic for them. By holding a claim on oil rather than US dollars, in this case they would lose on both scores. They'd then be short-selling like mad.

The effects would ricochet around the financial system, not unlike the credit crunch, now that you mention it, only this time the banks would be safe.

One reason Fat Prophets is so bullish about oil is that it's also very bearish about the US dollar. It has no doubt the two go together. But is it possible to be bullish about the US dollar?

It's in nobody's long-term interest for the US dollar to decline any more and precipitate a sudden run-up in the oil price to \$200.

Central banks will buy US dollars if it comes to that. Besides, the US is no basket case. Exports are booming, inflation is surprisingly low (and

certainly less than ours) and profits are booming. And don't forget, this month, most taxpayers will be getting a special farewell cheque from George Bush of \$600 (\$628). You don't want to be standing between an American shopper and a free gift from the Government, that's for sure.

Although sentiment about the US dollar could change abruptly, with or without some help from the central banks, it seems we're stuck with prices hovering above \$100 for a long

while yet.

The reason is the costs of finding and opening new oilfields have risen

exponentially, ruling out a big rise in output in the foreseeable future.

In fact we could face the opposite problem – Russian production is erratic at the best of times while the Middle East needs to keep more of its own oil to fuel its economic boom.

It's also the case that the very things that might lead to the US dollar recovering and hurting the oil price now are just as likely to underpin it over time.

A US recovery has to be good for the oil price down the track.

■ WELL OILED

Unlike the hedge fund-manipulated futures market, the sharemarket has taken a more sanguine view of oil prices.

Woodside Petroleum's share price might be near a record but it hasn't kept pace with the oil price.

Even taking into account the rise in

the value of the Australian dollar, the share price has lagged oil by almost half – though, it must be said, while matching most of the volatility.

“A \$US10 rise in the oil price should see energy shares outperform the broader market by 15 per cent,” said Shane Oliver, chief economist and head of investment strategy at AMP Capital Investors.

But they haven't, suggesting “investor scepticism about the durability” of high oil prices.

One of the best-performing oil stocks has been Oil Search, but it's also failed to keep up.

“It's all hit and miss. Share prices don't budge that much despite an oil price increase. But they'll drop when the oil price drops,” said Imran Valibhoy, an analyst at the tipsheet wise-owl.com.

So maybe oil stocks aren't as expensive as their price-earnings ratios would suggest.

Then again, you could argue they're no more than fair value having already picked the longer term oil price, a view taken by Fat Prophets.

It likes Woodside, Oil Search and the smaller Australian Worldwide Exploration, which all have large reserves and long-life wells, but not at these prices.

“Don't buy today. Wait for a pullback which will open up an opportunity to buy,” Geddes said.

Among brokers, Oil Search is the standout stock with nine buy recommendations, compared with three for Woodside (nine say it's a hold or sell) and seven for Australian Worldwide Exploration.

And that's more because of its huge reserves in Papua New Guinea of gas, an alternative to oil.

Well-regarded middle-sized oil explorers include Roc Oil with seven out of nine brokers covering the stock calling it a buy and the other two a hold; and Beach Petroleum which also has extensive gas interests and has six buys

out of six broker recommendations.

Although the oil price has become a speculative bubble, the same can't be said for speculative stocks.

The prices of many of the smaller oil explorers have barely budged from a year ago.

Partly because the bigger producers are such a sure thing that there's no

need to take extra risk in a volatile sharemarket to start with, analysts tend to give the oil speculators short shrift.

There's also a bit of science and a lot of luck involved.

“You have to look at the fundamentals such as their drilling prospects and the size of their reserves,” said Valibhoy.

Still, two stocks that he says pass the test are Cue Energy and New Zealand Oil and Gas which have already started drilling.

Mind you, it seems the market has

already moved on. It's gas-from-coal-seam stocks that are grabbing the headlines now.

Three of these which have roared up are Linc Energy, Metex Resources and Sunshine Gas, though all are still speculative. Come to that, there are other oil substitutes too such as solar energy (Origin Energy) and hot-rock technology (Geodynamics).

> CRUDE FACTS

■ Oil prices have doubled in a year; real oil prices are 25 per cent higher than during the oil shocks of the '70s.

■ Russia is the biggest oil producer; the biggest exporter is Saudi Arabia.

■ OPEC pumps only 40 per cent of oil exports.

■ Demand averages 85.75 million barrels a day, compared with production of 86.8 million barrels a day.

■ The US guzzles one-quarter of the world's oil production.

■ The second-biggest guzzler is China which is projected to overtake the US by 2020.

■ Non-OPEC countries are forecast to increase production by 600,000 barrels a day this quarter (US International Energy Agency) and OPEC by 300,000.

■ Oil consumption will double by 2030 (IMF).

■ Investment bank Goldman Sachs warns oil could reach \$US200 a barrel in six to 24 months.

■ Hedge funds reportedly hold 1.1 billion barrels of oil through futures contracts.

■ The cost of developing a new oil field has more than doubled in four years; hiring a deep-water drill ship costs \$625,000 a day.

■ A 1 per cent move in the US dollar leads to a \$US4 oil price move the other way.

It seems we're stuck with prices hovering above \$US100 for a long while yet.

> HOW TO SAVE ON PETROL

WITH some savvy shopping, you can get 19c a litre off your petrol.

And that's without having to spend extra at the service station.

Fill up on Tuesdays and you could save even more compared with the higher pump prices at the weekend.

The secret is to split your shopping.

Spend at least \$30 at Coles or Woolworths/Safeway and collect the 4c-a-litre discount shopper docket. Once you've filled up the car, spend at least another \$30 at an IGA supermarket where you flash your receipt showing how much petrol you bought. It then takes the 4c a litre off at the checkout.

It's double dipping on a Coles or Woolies docket and it's perfectly legal.

There's even the possible bonus of picking up more specials since you'll have two supermarkets to, um, check out.

Better still, use a Coles Source MasterCard, for which there's no annual fee and so no downside, and you get an 8c discount from Coles. Fill up and go to

IGA and there's another 4c. Or there's the BP-Citibank MasterCard which gives you a 10 per cent credit on the first \$300 you spend a month at BP.

That's 15c a litre off.

You get the 10 per cent rebate for three months if you sign up before the end of the month (see www.citibank.com.au/cardsoffer), then it drops to 5 per cent which is still 7.5c a litre off.

Since you'd have to buy your petrol at BP, the Coles or Woolies dockets won't be any use. But you can still get the 4c a litre off at IGA.

So that's a grand total saving of some 19c a litre at current petrol prices.

Mind you the \$79 annual fee is a bummer, but because there's a 1 per cent discount if you use it anywhere but BP (such as a supermarket) this more than pays for itself soon enough.

With the average credit card's annual workout of \$20,000, there's a potential net annual saving of \$121.

The BP-Citibank annual spending limit is a whopping \$60,000.



Oil shocker ... despite the high price of oil, no one is suggesting a global recession is in the offing. Yet. Photo: AP