Adviser Soapbox

Oil's Down. Time To Buy?

Drobny Global Advisors 01.29.07, 11:45 AM ET

2007 is still very new, yet already we are witnessing significant macroeconomic developments, perhaps the most striking of which is the continuing breakdown in commodity prices. (The Reuters/CRB commodity index has already added another -5.9% loss to its 2006 decline of -7.4%.) The transition into an environment of weaker commodity indexes began last summer, when the well-defined three-year uptrend in the CRB failed in spectacular fashion, and the renewed selling during the first three weeks of 2007 has put considerable strain on the view that commodities are simply "consolidating" within a longer-term upward trend. Indeed, the decline in the CRB index over the last eight months has now erased almost all of its gains from the past two years--a period in which global stocks (as measured by the MSCI World Index) have climbed more than 25%.

A closer look at the various components that make up the CRB index reveals that the commodity price breakdown has been almost entirely a function of falling energy prices; among the six components of the index (softs, energy, grains/oilseeds, precious metals, livestock and industrials), energy is the only category that has lost significant ground during the past 12 months. Natural gas has been the worst performer, down a whopping 44% since the start of 2006, but crude oil has been playing catch-up to the downside during the past few weeks and is now down more than 14% year-to-date.

Get inside the trading strategies of global hedge fund managers like George Soros and Jim Rogers. Click here for institutional quality research in Inside Global Markets.

Among the various actively traded commodities, crude oil commands the most attention, and for good reason--see the U.S. Oil Fund ETF. The size of the oil market dwarfs all of the other commodity markets, and changes in the price of oil affect businesses and consumers around the world in a way that no other single commodity can. What happens in the oil market can have myriad implications for stock market investors, from the performance of energy stocks and emerging-market equity indexes to the direction of inflation and global monetary policy.

Special Offer: Read advice from the same experts that the world's top billion-dollar global hedge fund managers subscribe to. Click here for timely trades from Drobny Global Advisor's new publication, Inside Global Markets, and get a complimentary copy of Steve Drobny's "Inside The House of Money" when you subscribe.

Why Did Oil Fall?

There are several possible explanations for why oil has broken down after rising for five years--with very different implications for the investment environment going forward.

Many have cited unusually mild winter in the Northern Hemisphere (which, *The Economist* tells us, "saw New Yorkers sunbathe in early January"). But while this may indeed be a contributor to the latest bout of weakness in the price of oil, it does not explain the bulk of the slide, which occurred back in August and September--and in any event, less than 10% of oil is used for heating.

Others believe that falling oil prices are a precursor to a weakening global economy. The fact that industrial commodities such as copper have also experienced significant price declines in recent weeks makes this interpretation more credible than the warm-weather argument. The fear is that copper may be signaling more trouble ahead for the U.S. housing market--the average American home contains 400 pounds of the metal.

However, recent economic reports from the United States and around the world have been better than expected (including strong retail spending numbers and employment gains in the U.S. and robust manufacturing data in Germany), causing several economists who had previously slashed growth forecasts for 2007 to revise their numbers higher. Additionally, global equity markets are at or near record highs. Take a look at the MSCI EAFE Index. Even energy stocks have significantly outperformed the underlying energy commodities, with indexes of integrated energy companies such as the Energy Select ETF and Oil

Services Holders ETF both managing to maintain their multiyear technical uptrends. All of this suggests that economic growth concerns are not the culprit.

What's more, global liquidity remains plentiful, despite the recent efforts of the world's leading central banks to reign it in, meaning that there is still plenty of money in the system to fuel higher asset prices. Indeed, the Bank of England surprised markets with a rate hike in the last two weeks.

If the explanation for the continuing slide in oil prices isn't to be found in demand-dampening factors such as warmer weather or slower economic growth, perhaps the answer lies on the supply side of the equation. The longer-term trend in oil inventories has been steadily higher. But despite the healthy amount of oil being stored by the world's users, these inventories can only provide protection against short-term supply disruptions. With OPEC attempting to establish a $60 floor under the price of oil, and with very little spare capacity among the members of the cartel (with the exception of Saudi Arabia), it is hard to argue that enough has changed on the supply side to account for the huge drop in oil prices. And oil futures would seem to confirm this view, as December 2008 contracts have fallen almost as sharply as December 2007 contracts since the end of June.

Special Offer: Drobny Global Advisor's has been providing research to the most exclusive and smartest hedge funds for years. Now Forbes is offering an inside look at global macro hedge fund strategies in a new publication Inside Global Markets. Click here to become a Charter Subscriber.

While warm weather, growth fears and rising inventories may have provided a catalyst for the oil price decline, financial flows are probably the best explanation for the speed and magnitude of the drop. In the wake of the 2000-2002 equity bear market, the popularity of "alternative investments" exploded, and investors of all stripes, including individuals, hedge funds and pensions, eagerly participated in the growing enthusiasm for the relatively small commodities markets.

Prior to the beginning of last year's downturn, first-quarter inflows into the 200 retail funds followed by J.P. Morgan were $7 billion, twice the level of 2004 and 2005, and according to a recent survey conducted for PNC Wealth Management, alternative investments accounted for 9% of the average high-net-worth portfolio in 2006, almost the twice the level seen in 2005. With such large amounts of capital going into commodity index funds, and with oil representing the largest component in most commodity indexes, the trend toward greater diversification into alternative assets inevitably had a big affect on oil prices--adding as much as $35 per barrel, according to estimates made by Citigroup.

For an object lesson in what happens when extreme fund flows suddenly reverse, one needs only look back to what happened after March of 2000, when more than 94% of the assets in Fidelity's 41 Select Fund were concentrated in 14 growth funds--with so many investors already having loaded up on growth stocks, who was left to buy at higher prices? As the subsequent 78% decline in the Nasdaq would soon demonstrate, no one. Might oil now be facing a similar outcome, with those stepping in as buyers today making the same mistake that so many investors did in the summer of 2000, when they thought that the Nasdaq's 30% slide represented a great buying opportunity?

Or does this correction represent a tremendous buying opportunity?

All is explained in the latest issue of Inside Global Markets …

Excerpted from the Jan. 18 issue of Inside Global Markets, which includes expanded analysis and a recommended trading opportunity. Click here for more information about Inside Global Markets and subscription details.

More Adviser Soapbox Columns

Send comments and questions to newsletters@forbes.com.

If you have questions and comments about the trading ideas presented in Inside Global Markets, please address them to igm@drobny.com.