

Goldman's \$200 Oil Call and the Hurricane Premium Theory

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I read a new report recently from Goldman Sachs and watched another bullish report from CNBC's Fast Money. They both had me thinking about oil prices and possible future potential prices. Right now market sentiment is just horrible and remember that when analyzing fundamentals, technicals and sentiment, sentiment is the only one of the three that can override the other two.

Remember the Goldman analysts who predicted and theorized The "Super-Spike" in oil? Well they are back again and what they have to say this time should definitely perk ears. Goldman analysts Arjun Murti, Kevin Koh and Michele della Vigna raised the notion that a major disruption could spike oil to \$200 a barrel. As the dollar continues to fall and commodities are seen as an instrument to hedge inflation, oil prices have been essentially melting up. The Goldman analysts said that prices have advanced more quickly than they had forecast back in 2005, when they predicted a range of \$50 to \$105 a barrel as part of its "super spike" oil theory.

Some comments :

We characterized the upper end of the band as more likely to be driven by geopolitical turmoil and that recession was a key risk to our view," the analysts said. "In fact, oil prices have reached \$100 a barrel without extraordinary turmoil, and the U.S. currently appears to be in recession.

Tacking on \$15 a barrel to all of its oil estimates, Goldman now sees average selling prices of \$95 a barrel for 2008, \$105 a barrel for 2009 and \$110 a barrel for 2010. The high end of its range is now \$135 a barrel although Goldman set the table for how prices could go higher.

As the lack of supply growth and price-insulated non-OECD demand suggest a future rebound in U.S. gross domestic product growth or a major oil supply disruption could lead to \$150-\$200 a barrel oil prices.

While saying it has a bullish long-term outlook, Goldman acknowledged that oil prices could correct from recent highs. Goldman also reiterated its view that oil prices could fall as normal market conditions return over the next four years. (Ok, nice they covered all the bases here! lol)

The core of our 'super-spike' view is that oil prices will keep rising until demand declines globally on a multiyear basis, resulting in the return of excess capacity and a lower cost

structure," Goldman's analysts said. "Given this view, once excess capacity returns, we think prices can move sharply lower.

GS recently upgraded UPL, APC and CEO.

On Fast Money, one of my favorite shows, [I watched an interview](#) with John Roque, Senior Technical Analyst and Managing Director of Natixis Bleichroeder. It was fascinating to see his chart of the Commodities Index vs. S&P 500, 1956-2008 with a 3 year moving average.

Conventional wisdom suggests that commodities are in a "bubble" right now, says Roque, but I don't think that's the case. It looks to me as if the commodities surge is in its infancy. The commodities-outperforming-stocks relationship is far below its long-term average. In fact, it hasn't been at the average for more than 20 years.

He says to buy commodities on any pullback. He also thinks that the S&P could break down to 1236.

It seems to me that high oil prices are here to stay and as a result you want to keep an eye on the oil plays that are showing strength with the price of oil. Energy exposure should also be a focal point among the institutions and individual investor portfolios going forward. Although not immune to market sentiment, energy companies could be the first to regain strength and weather the storm better than most of the market. Remember that most of these energy names have a lower oil price assumed into their earnings estimates.

I'm thinking that if oil prices hover here for awhile and stabilize, analysts have no choice but to play catch up and raise estimates for next quarter and for the year (remember that Aug-Nov is hurricane season thus there will be a an added hurricane premium). Energy companies could have some spectacular beats in the coming quarters as expectations are too low. In this last quarter, I have already started to see that come to fruition as most companies have beat expectations on the top and bottom line.

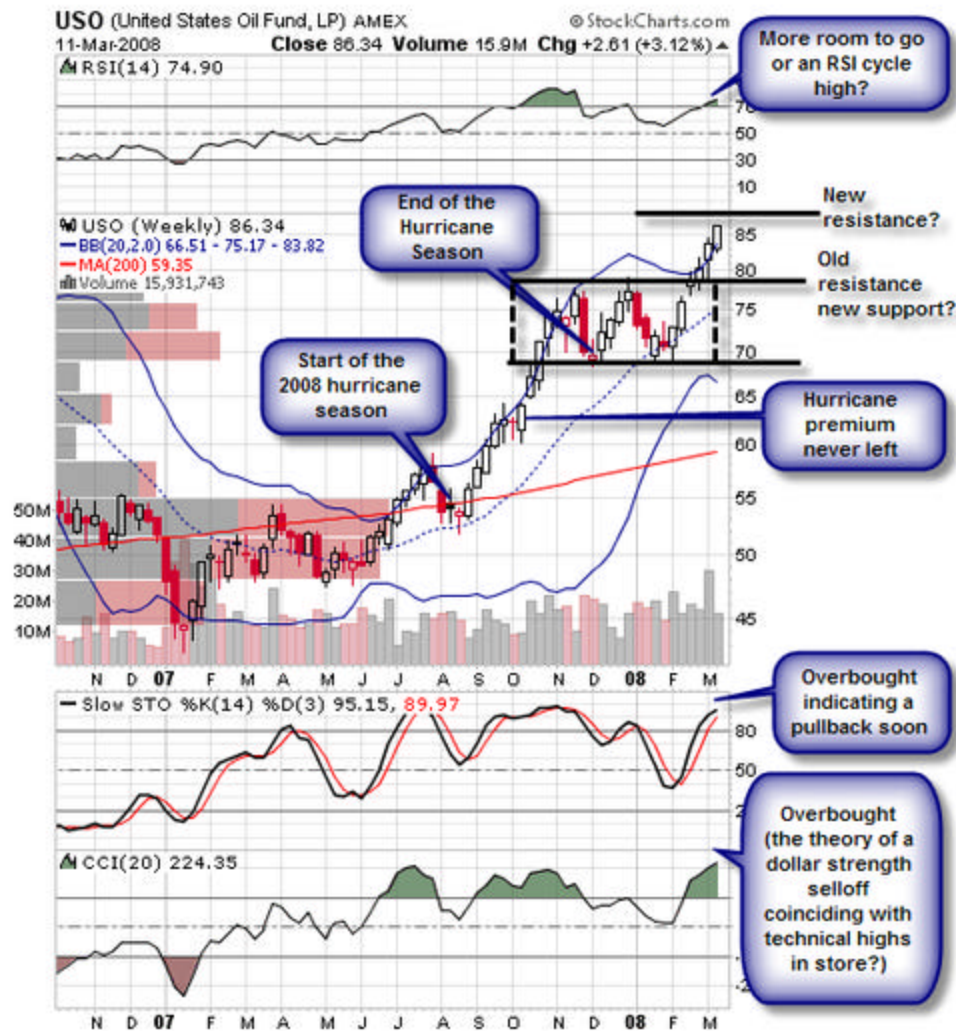
USO and the Hurricane Premium That Never Left

Take the guess work out of finding a correlated oil play and just go long oil itself without worrying about sector or market sentiment forces upon the individual stock. I started writing this article on the weekend and am amazed at how strong oil continues to be. When looking at the weekly chart of the United States Oil Fund ETF ([USO](#)), I was struck at how the hurricane premium from August to November never really left the price of oil. The USO recently broke out of its Darvas consolidation box between the zones of \$69 to \$79 and is now establishing a higher consolidation box using previous resistance as support.

With a possible resurgence of the economy (GS' theory) and also the upcoming hurricane season starting in August, one has to wonder if we will only see higher prices for the rest of the year or at the very least a hovering of high oil prices around \$100. Last hurricane

season was quite active, as soon as one left, one emerged sometimes two. With this type of hurricane anxiety, oil never sold off to lower ranges. Will this be the next impetus to push oil prices higher on a new leg like last year?

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Sometimes it is more important to ask the next question than to answer the question at hand. The question at hand is why are oil prices this high especially with a cooling economy and OPEC's notion of adequate supply (could it be from a weak dollar)? The question of the near future is after summer, how high will oil prices be going into the hurricane season? Another question to answer is will a stronger dollar cause an oil price correction? And with that, could a resurgence of the economy and the summer driving season nullify the stronger dollar? Then comes the hurricane season.

As the use of fossil fuels warm the Earth's atmosphere to create warmer waters in the Gulf. This only makes hurricanes ever more powerful, unpredictable and possibly more destructive on the US energy nerve on the South Coast. Which came first the chicken or

the egg? Its a vicious circle for oil prices. This year it is still up in the air whether we will have an El Nino or La Nina hurricane season.

[According to the World Meteorological Organization](#) (Science Daily):

Most interpretations of existing climatological data suggest the likelihood of La Niña conditions remaining heightened through the second quarter of 2008 and, at a lower level of confidence, into the first part of the third quarter.

Longer seasonal forecasts beyond the third quarter of 2008 are not considered to contain useful information at this stage on the continuation of La Niña or the rise of El Niño.

It is rare for a La Niña event to persist for two years or more, such as occurred from early 1998 to early 2000. The likelihood of the current La Niña continuing for such a period will remain unclear for some months, but will be closely monitored.

Long-term statistics suggest it is more likely that in the latter part of 2008, neutral conditions will prevail, i.e., neither La Niña nor El Niño with no significant cooling or warming of Equatorial Pacific sea surface temperatures.

Whether it is La Nina, El Nino or neither, hurricanes will arrive during Aug.-Nov. and it seems the wall of worry will be built. It will be built faster if it turns out to be an El Nino season.

I do believe that oil prices should be range bound in a higher consolidation phase even after the coming "strong dollar" pullback. That being said, here's a list of energy companies to keep an eye on for the rest of the year: