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Politics and the Price of Oil

Summary:

We believe that the price of oil will continue to rise based on the passage of the Senate version of the Energy Bill, by a 65 to 37 margin, last Thursday June 21, 2007. On October 18th 2006 two weeks prior to the general election in the United States we wrote that: "We believe that following the U.S. midterm elections on November 7, 2006, the price of oil is likely to test the tolerance of the markets and the new members of Congress; that is, we believe that after the elections oil will appreciate until there is fear in the market that Congress will take action" (New York Global Securities, *Speculation in the oil Market and the U.S. Midterm Elections)*. Late Thursday night the Senate revealed their preferences, and indicated to the market that there need not be "fear in the market that Congress will take action" (ibid) against the oil companies.

Thursday's action by the senate was best summarized in ***The New York Times*** which wrote that the auto industry is the only industry that the Senate "took on…essentially sparing oil and gas companies and major utilities" (New York Times June 23, 2007 p. A11). On October 18th when we wrote our prior article on oil, oil closed at $57.66 a barrel. On Friday June 19, 2007 the price of oil closed at an annual high of 69.15 a barrel.

On August 11, 2006 when oil closed at $74.38 just off its all time high of $77.05 we called for a "short of all major international oil companies and oil futures" based on the strong belief that: "traditional demand and supply conditions are not the driving force in the current oil market, looking elsewhere for answers" (New York Global Securities, *Saudi Market, China, Central Banks, and Construction Indicate a Top for Oil)*. In our October 18th report we began to look at the impact of politics, as an indicator for the intermediate price of oil. We continue to believe that politics and not supply and demand conditions are the best predictor for the future price of oil. Based on the Senate vote last Thursday we expect that the price of oil has not yet reached it intermediate peak, and will not, until there is fear in the market that Congress will take action against the oil companies.

Introduction

We believe that the price of oil will continue to go higher and possibly even test it's all time high of $77.05, despite that fact that on Friday June 23, 2007 the price of oil closed at a year to date high of $69.15. We base this analysis on our continued belief that current political indicators outweigh the traditional demand and supply forecasting measures for the price of oil. Last Thursday June 21, 2007, near midnight, the United States Senate voted on a new energy bill that raised the Corporate Average Fuel Economy (CAFÉ) standards on automobiles, but spared the oil companies from any restrictive measures. This leads us to believe that Congress is not ready or currently able to tackle the major oil companies.

Beginning with our August 14th report on oil, when we called for a "short of all major international oil companies and oil futures," we began looking for alternative measures for understanding the drivers of the price of oil. We argued that traditional supply and demand conditions for oil no longer provide the best indicators for understanding the oil futures markets (New York Global Securities, *Saudi Market, China, Central Banks, and Construction Indicate a Top for Oil).* In that report we concluded that the Saudi Arabian stock market may have been a precursor indicator for an upcoming decline in the price of oil.

Two months later we followed the same logic looking for alternative measures for understanding the oil market and in that report we concluded that politics may be the most acute driver. On October 18, 2006 we wrote that: "the speculation surrounding the election will continue to keep the price of oil at current levels, but we expect that once the election is over the price of oil will again rise and test the tolerance of the market and the new members of Congress… and will continue to appreciate until there is fear in the market that Congress will take action" on the oil companies (New York Global Securities, *Speculation in the Oil market and the U.S. Midterm Election).* In that report we looked to U.S. politics for our indicator, with two Senate hearing affecting major intermediate increases and declines in the price of oil. We used that evidence to predict that following the midterm election the price of oil would again rise, until the market feared that Congress would act against the major oil companies.

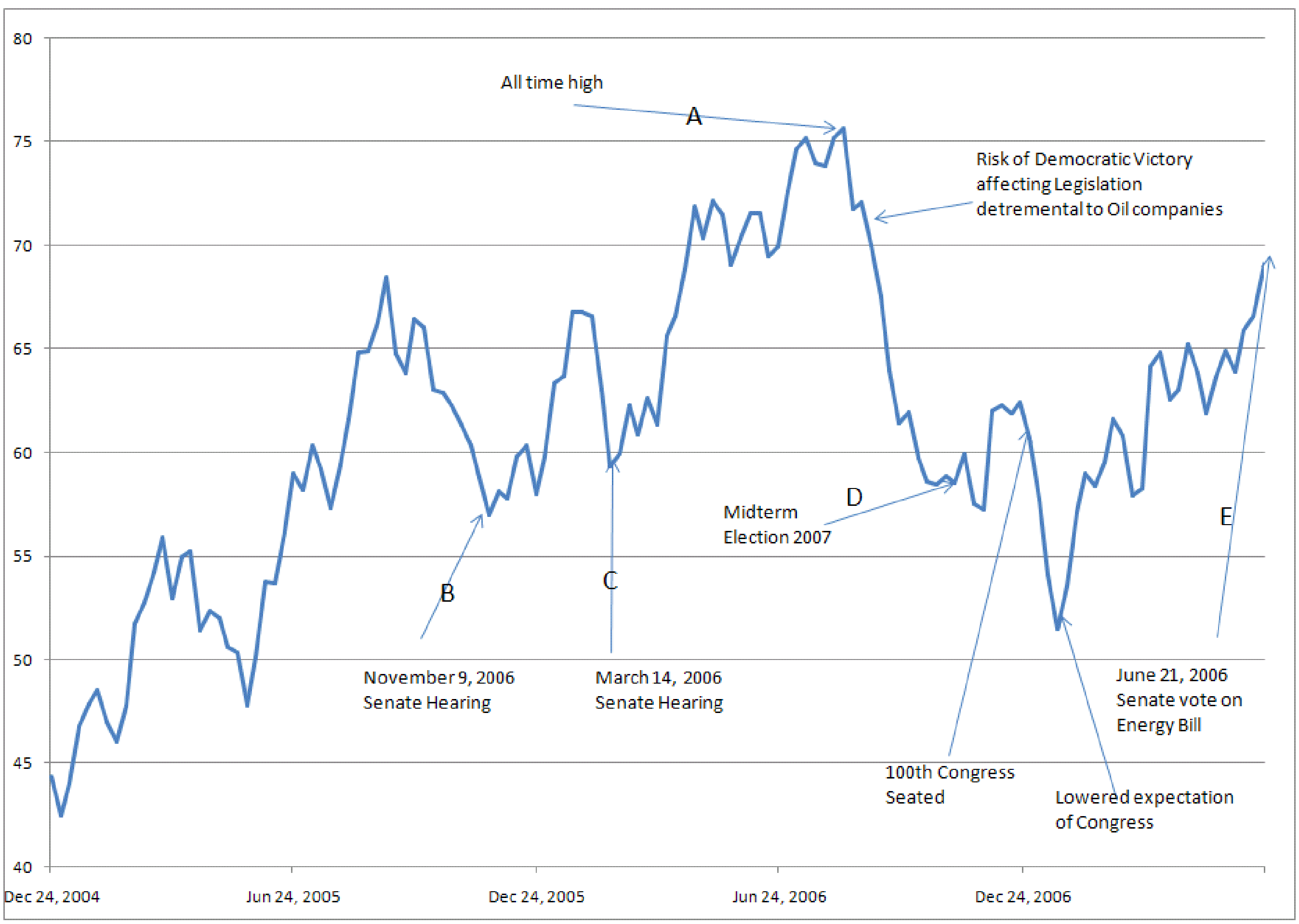
Last Thursday June 21, 2007 the United States Senate voted on their version of the Energy Bill by raising the Corporate Average Fuel Economy, or CAFÉ standards for automobiles. This measure will reduce the use of oil, in the long run, but will have no intermediate effect. The New York Times correctly observed that: "the measure essentially spared oil and gas companies and major utilities" (*New York Times,* June 23, 2007, p. A 11). The Senate we believe clearly indicated their inability to directly take on the oil companies but moving to the weaker target, the auto industry. The Senate on Thursday we believe clearly indicated to the futures market their unwillingness or inability to take on the oil industry directly. As a consequence we expect that the price of oil will move higher and test the all time high of $77.05, in the near future.

Politics and Speculation within the Oil Futures Markets

In Figure I we plot the weekly price of oil for the past two and one half years, highlighting significant U.S. political events. We draw attention to two Senatorial hearings related to oil, and the last midterm election. Point A in the figure coincides with our August 14th report which called for a short of oil futures, arguing that the rapid decline in the Saudi Arabian stock market lead us to believe that oil may have seen an intermediate peak. This report laid out our thesis that simple supply and demand conditions may no longer be the best measure for forecasting the future price of oil.

In our October report we again looked for alternative measures to understand the price of oil and argued that the Senate hearings had a remarkable impact on the intermediate term price of oil. The Senate hearings on oil, we argued, created potential risk factors for speculators and it was only when it appears obvious that congress was not going to act, did the price of oil go back up. This is highlighted by points B and C in figure I. We concluded that political factors were instrumental and perhaps more significant in the intermediate term, than supply and demand conditions. Based on this belief we argued that we expected the price of oil to rise again testing various levels based on the tolerance of Congress. Point D on our chart indicates the time of the midterm election. Following the election with the unexpected victory by the Democratic Party of both the House and the Senate oil stabilized and then declined slightly following a period of enhanced anti oil rhetoric by the newly installed Democratic Leadership.

Figure I: Weekly Price of Oil and Various Political Events, December 2004 to June 2007



Source: U.S. Department of Energy, Energy Information Administration, CSPAN, SIS.

Today we find that our political thesis appears to have had some lasting explanatory power, with the price of oil being 20% higher than just prior to the election. We also find that based on the recent vote in the Senate, and despite that oil is back to nearly 70 dollars a barrel, Congress has clearly revealed that it has shied away from challenging the oil companies directly at this time. This event is shown by point E in figure I.

Based on the fact that congress is not currently ready or able to take on the oil industry directly we believe that the price of oil will test the highs of August 2006. We expect this to occur in the near term particularly if both houses feel that they are unable to challenge the oil industry in this round of Energy legislation.

Risk Factors

We have made various forward looking statements about the price of oil that are not based on any demand and supply considerations and or any other economic factors. We based the entire analysis on one market the United States, and on one indicator, politics. We have not factored in any kind of national or international considerations that may affect the price of oil, such as a breakdown in a pipe line, political unrest in a country or region, or any other factors that might affect the price of oil.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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