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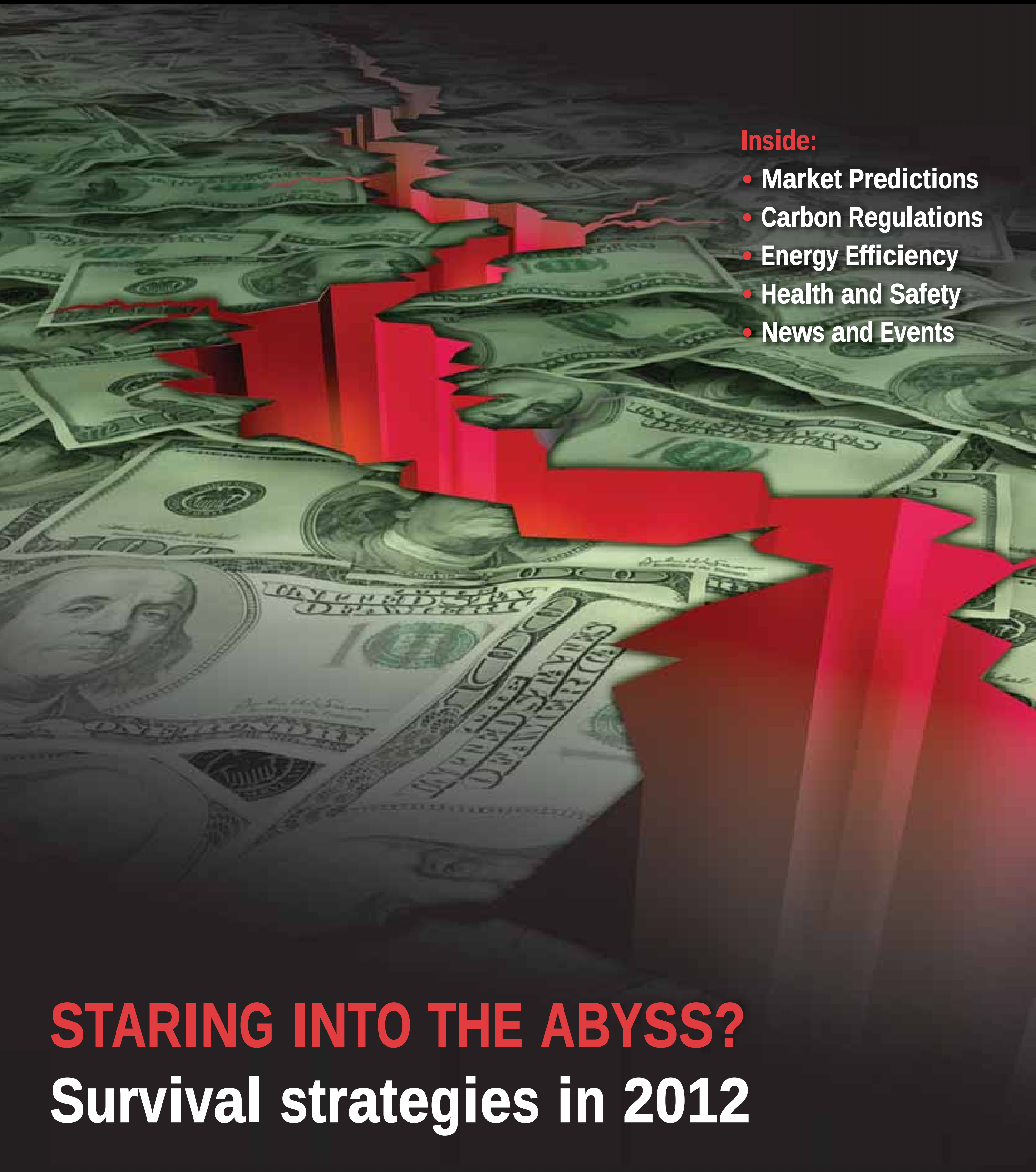

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STARING INTO THE ABYSS?

Survival strategies in 2012

Sting in the tail?

Chris Thorpe takes stock of the world energy market

Not a day will pass without talk of volatility in the markets. It could be the 'new norm', or just the result of after-shocks following a tumultuous financial crisis. Whatever the reason, market gyrations made for difficult hedging and trading in 2011.

Currently, the oil price ranges tend to be large and without a clear trend. Not that trading within wide price ranges is unusual. But typically these ranges are smaller and expectations of significant price changes are less common. Traders label this kind of market 'range bound', which often indicates that directionally biased trading decisions are even more difficult and risky. But the current market is a little different since price ranges appear to be very wide by historical standards. The market now expects extremely large price changes in all the commodity markets, and especially oil. And there is a more consistent fear of a 'Black Swan' event or extreme move higher or lower similar to that experienced in 2008.

How do we know that oils have been particularly affected? Of particular note is the increasing demand for protection against extreme moves in market prices. Hedgers and financial managers want to buy options to protect them against prices either drifting very low or spiking very high.

Tail risk

These extreme outcomes are often referred to as 'tail risk' which describes the low probability data points in statistical distribution curves. Like it or not, investors, fuel buyers and even producers have become accustomed to wide price dispersion. Range bound markets thus have a new meaning. Whereas 'range bound' would typically connote a narrow trading range, the term now suggests wide trading ranges. This is not to be confused with implied volatility which, at high price levels, can actually decrease in periods of wide trading ranges. In periods of high nominal prices, the percentage change is actually lower for the same range of prices. For example, a 10% move from $100 a barrel is $10, whereas a 10% move from $50 a barrel is only $5. Therefore, the same volatility at $100 has a much larger impact on the markets that it would at $50. In these wide ranging markets, implied volatility changes from high to low, but it is not persistently high in the options market as one might expect.

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No one likes a bear

Given a lacklustre global economy, it could be argued that oil prices should be much lower. Demand is lower as refineries have struggled to remain profitable. In the Atlantic Basin alone, 1.8 million barrels a day of refining capacity is scheduled for shutdown. In the United States, gasoline sales at the pump are down 3.5% versus a year ago and demand has not even recovered to pre-2008 crisis levels. European economic conditions are no better under the weight of the sovereign debt crisis and a weakening Euro. Furthermore, the market should remain well supplied (at least in the short run) as Libyan and Iraqi oil production increases and Saudi Arabia remains reluctant to scale back production brought on-line to compensate for Libya's production losses earlier in 2011. Overall, the **Organization of Petroleum Exporting Countries**' (**OPEC**) production has increased to a three-year high of 30.9 million barrels a day. Although these conditions should lead to weakening markets, the price of oil in Euros is actually higher now than it was near the peak of the commodity markets in 2008. If it weren't for Iran and the threat of an embargo on Iranian oil, we would likely see $80 a barrel oil in a matter of weeks. But it is folly to become myopically focused on fundamental supply and demand. It may even

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> **'It is folly to become myopically focused on fundamental supply and demand. It may even be a waste of time to depend on fundamental research when trading behaviour is so fickle'**

be a waste of time to depend on fundamental research when trading behaviour is so fickle.

Who likes a bear market anyway? You don't gain much by being overly pessimistic. In part, optimists know that the bears are often wrong. Nobel laureate Paul Samuelson claimed: 'The markets had predicted nine of the last five recessions.' When it comes to oil or any commodity markets, typically the bulls are the producers, including OPEC members. They are continually optimistic about future prices because they need new investors or depend on high oil prices for their income. Investors and lenders would never commit capital to bearish commodity plays. Even *The Economist*, which in 1999 suggested that a $10 a barrel oil price may be 'too optimistic' and may be 'heading for $5', was criticised by its readers for being overly bearish. With behavioural economics supporting high prices, even very bearish fundamentals can be overcome by enough optimists. In 2011, a bearish global economic picture helped pull the oil markets below $80 a barrel only for them to rebound well above $100 a barrel by the year end. Even during the depths of a recession, one only has to look to investment bank economists and sell side analysts for more positive news.

Paid to be positive

Most bank economists are paid to be positive about the future, or at least create an outlook for clients that is positive in some sense. It just does not sell to be a bear, or suggest that companies will fail. For example, most brokerage houses offer products that are based on buying assets that are undervalued, versus selling products that are overvalued. The 'long' versus 'short' strategy is typically only employed by hedge funds, which are a less common investment product for the average investor. Furthermore, many investors use commodity products as a hedge against inflation. Investors are dissuaded from selling anyway since the sale of assets often triggers capital gains taxes. Therefore, markets are often buoyed by long only investment strategies which tolerate any range of outcomes. This time, the ranges are just wider, plus or minus 10%-20% in either direction. For the oil markets, those are big ranges.

Winner's curse

Markets in any case will be subject to winner's curse. That is to say that among those bidding in any auction, the winner will likely have overvalued the asset at the high end of the potential range. The same can be said for markets that depend on a 'greater fool' where investors hold assets only in hopes of selling to the next bidder at a higher price. These economic theories can cause volatility in the market especially when liquidity or a sufficient number of buyers and sellers are unable find a fair value to transact. When the markets cannot clear, price volatility ensues and the resulting price ranges can be dramatic. Commodity markets are very dependent upon a floor price where there is a strong belief that products are 'cheap' or below the cost of producing them.

What make commodities special and different are their various forms of storage. Some commodities like gold can be stockpiled in warehouses for years, where others like natural gas have a finite storage capacity. Still other commodities like orange juice or milk are perishable. When storage capacity is ample and inventory levels are low, commodities tend to perform well. Conversely, if the market is over supplied and storage is full prices plummet as is evident in the US natural gas market today. However, the market has a miraculous way of finding innovative ways to store or transport commodities when it becomes economical. The liquid fuels market has entered an era with very high potential levels of inventory due to floating storage, which is the use of idle tankers for storage rather than transportation. Weak shipping markets have created low cost floating storage options. The various factors around storage make price volatility and price ranges difficult to predict.

Though oil markets may not yet be in any trend higher or lower, we should expect wide price ranges for the foreseeable future. Given that weak demand is persistent, 2012 should provide some fuel price respite from the lofty levels traded in 2011. But oil supply is always subject to dramatic interruptions so the upside range must also be respected. The Libyan conflict in 2011 took as much as 500,000 barrels per day of light sweet crude oil off the market very quickly. Nigerian production is halted from time to time due to strikes or terrorism. And, of course, Iranian supply is not only under the limits of a western embargo but could be further curtailed by a conflict in the Straits of Hormuz. These kinds of supply disruptions will create wide price swings that are impossible to predict with any certainty. Lastly, the market hates to be bearish, and the demand for commodities as an asset class continues to have strong support despite weakening short term fundamentals. Herein lays the entire reason to hedge fuel prices: unpredictability. Now more than ever, protecting against price spikes and preparing for wide price ranges is a necessity.

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Asia-Pacific Commodity Outlook Conference February 22-23, 2012

KEY NOTE SPEAKER:

Jim Rogers, a native of Demopolis, Alabama, is an author, financial commentator and successful international investor. He has been frequently featured in Time, The Washington Post, The New York Times, Barron's, Forbes, Fortune, The Wall Street Journal, The Financial Times, and most publications dealing with the economy or finance.

EVENT LOCATION:

Grand Hyatt Singapore

This important event will feature world-renowned economists and analysts as well as INTL FCStone's own traders and brokers presenting their insight into the global and Asia-Pacific economies.

Speakers will cover the supply-demand outlook for key agricultural commodities including wheat, palm oil, vegetable oil, sugar, dairy, coffee and cotton; base and precious metals, energy products including petroleum and natural gas; and raw materials. The conference also will cover new exchange traded and OTC products; investment banking opportunities; and regulatory developments in the U.S., Europe and Asia-Pacific region.

WHO SHOULD ATTEND:

General, Finance, Operations, Purchasing, and Sales Managers, and industry participants who are seeking insight that will help them make strategic decisions.

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AGENDA:

INTL FCStone Opening Remarks
Pete Nessler, President, FCStone, LLC

Welcome
Terrance Wood, Head of Commodity Risk Management, FCStone Asia Pte. Ltd

Keynote Speaker
Jim Rogers, Chairman of Rogers Holding and Beeland Interests, Inc., World Renowned Investor & Author

World Dairy
Robert Chesler, Head of Food Service Division, FCStone, LLC

World Wheat
Mike O'Dea, Senior Risk Manager, FCStone, LLC

World Weather
Professor Roger Stone, University of Southern Queensland

Precious Metals
Jeff Rhodes, CEO, INTL Commodities DMCC

FX Global Developments
Greg Vincent, Head of FX, INTL Global Currencies

Raw Materials
Tom Zabrodsky, Senior Vice President, INTL Commoditites, Inc.

Introduction to CME Group Metals Products
Lawrence Leong, Associate Director, Metals, CME Group

World Energy
Chris Thorpe, Executive Director of Global Energy, INTL Hanley, LLC

World Feed Grains & Oilseeds
Mike O'Dea, Senior Risk Manager, FCStone, LLC

World Sugar
Mario Silveira, Senior Risk Management Consultant, FCStone do Brasil Ltda

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Patrick Baker, Header Trader, INTL Hanley, LLC

World Cotton
Bill Dwyer, Senior Manager Advisory, FCStone Australia Pty Ltd

World Coffee
Oscar Schaps, Global Head of Soft Commodities, INTL Hencorp Futures, LLC

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Jim Mammone, Executive Vice President, INTL Commoditites, Inc.

Base Metals
Fred Demler, Global Head LME, FCStone, LLC

Metals & OTC
Mike Ortiz, Header Trader, INTL Hanley, LLC

Investment Banking Asia
Sagiv Shiv, Senior Deal Originator, INTL Provident Group USA

Agricultural Products & Regulatory Changes
Nelson Low, Director Agricultural Products, CME Group