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Economic Research

Speculation in the Oil Market and the U.S. Midterm Elections

Companies Mentioned

Not Rated Companies

Exxon Mobil (XOM, $69.41)

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Summary:

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 market 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. It is too early to speculate on the exact level of the increase, but our recommendation at this time is to become progressively long oil at these prices as the election approaches, with the expectation that a topping test pattern will become clear shortly after the election. We believe that the last three major declines in the price of oil coincided with various U.S. Senatorial hearings and expectations surrounding the upcoming U.S. midterm elections. We further believe that these events may have caused speculators within the oil markets to become cautious, resulting in a drop of more than 20% in the price of oil. With regard to the two prior declines, once the Senate hearings were over and the Senate did not take any significant action, the price of oil began to increase. We expect that following the current U.S. elections the price of oil will again rise testing the tolerance of the new Congress.

Key Points:

- We are recommending the accumulation of oil stocks and oil futures because we believe that following the U.S. midterm elections the price of oil is likely to test the tolerance of the market and the new members of Congress.
- We believe tat the last three drops in the price of oil coincided with two major senate hearings and the uncertainly of the upcoming U.S. election.
- On November 9, 2005, the Senate Commerce and Energy Committee held a hearing on the high price of oil. Beginning two months prior to that hearing, the price of oil began a decline from a high of $70 per barrel to a low of $56 two weeks after the hearings, after which the Senate proposed no new legislation.
- On March 14, 2006, the Judiciary Committee of the Senate held a similar hearing with virtually the same effect on the price of oil. Two month prior to the hearing the price of oil stood at $69 a barrel prior to the hearings and fell to below $60 around the time of the hearings. Once it became obvious that the Senate Committee was not going to propose significant legislation, the price of oil again rose but this time to a high of over $77 per barrel.
- With the the outcome of the U.S. midterm elections uncertain, the price of oil has again fallen 25% and we believe that after the election the price of oil will rise to a point that tests the will of the new Congress.
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See important disclosures and analyst certification on pages 6 - 7 of this report.

I. Introduction

On August 14, 2006, we called for a "short of all major international oil companies and oil futures" when the price of oil was $74.35 per barrel (*Saudi Market, China, Central Banks, and Construction Indicate a Top for Oil*). On September 26, 2006, we recommended covering all oil shorts and moving to a net neutral position on oil, when oil was trading at $61.45 (*Recommending Covering All Oil Shorts and Taking a Net Neutral Position on Oil*). On Tuesday, October 17, 2006, oil closed at $60.66, well within the recommended range. Today we are modifying our neutral rating to an accumulate in anticipation of the United States midterm elections on November 7, 2006. We believe 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; that is, we believe that after the elections oil will appreciate until there is fear in the market that Congress will take action. To this extent we are recommending the purchase of oil stocks as well as oil futures.

In our August 14th report we included in our risk analysis the following statement: "We used indicators that do not track the demand and supply for oil, or that have any bearing on speculation within the oil market." Today we continue to believe that the demand and supply for oil has not been the best indicator for the determination of the price of oil, but extend our analysis to consider a potential factor that can affect speculative activity within the oil market.

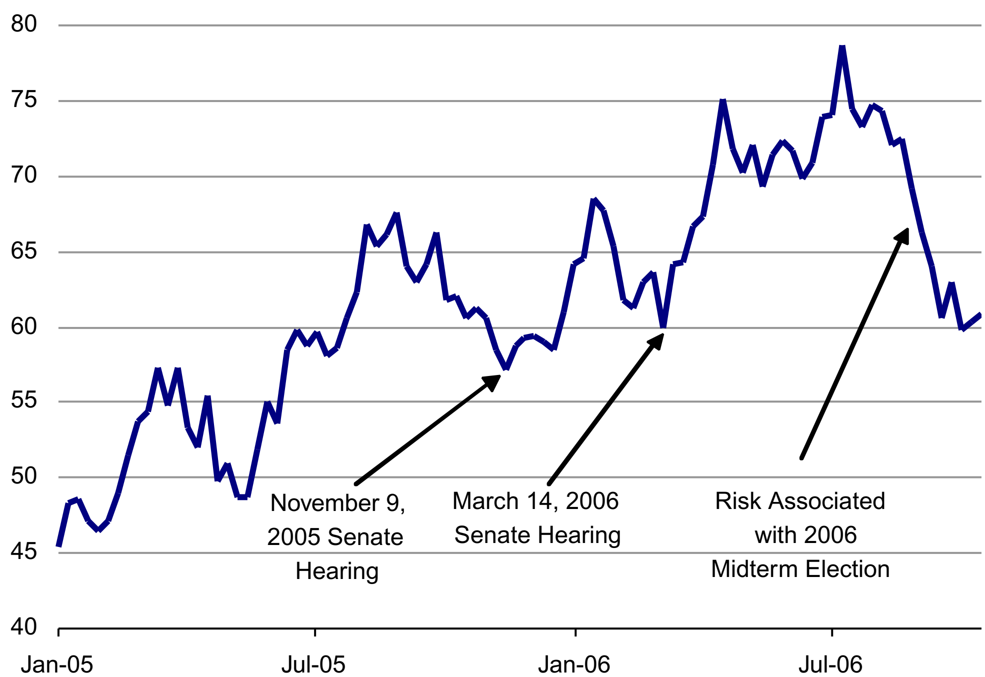
Holding a joint session between two Senate committees is an uncommon event, but on November 9, 2005 the Committee on Commerce, Science, and Transportation and the Committee on Energy and Natural Resources held such a joint session. The hearing was an investigatory hearing attempting to determine what was the cause for the high price of oil. Two months prior to the session, the price of oil stood at nearly $70 per barrel, and two weeks after the hearing the price had dropped more than 20% from that high. Preceding. We observe the same pattern with regard to the March 14, 2006 hearings of the Judiciary Committee, with the price of oil dropping prior to the hearing and increasing after the hearing when it became apparent the Committee was not going to propose new legislation.

We believe that the speculation within the oil market can be affected by the uncertainty of U.S. political activity by Congress, as well as the uncertainty concerning the upcoming midterm elections. We believe that following the midterm election the price of oil will test the tolerance of the public and Congress, and as a consequence we are recommending an accumulation of oil stocks and oil futures.

II. Senate Hearing and the Price of Oil

From Chart 1 we observe that there were three major dips in the price of oil since the middle of 2005. The first coincided with the senate hearings of November 9, 2005, the second with the March 16, 2006 hearings and we are currently experiencing the third decline, which we believe is due to the uncertainty surrounding the midterm elections.

Chart 1: Weekly Price of Oil and Senate Hearings on the Price of Oil, January 2005 to October 2006



Source: Reuters Ecowin.

III. The November 9, 2005 Joint Senate Committee Hearings

On November 9, 2005, the United States Senate held a joint hearing before the Committee on Commerce, Science, and Transportation and the Committee on Energy and Natural Resources. The essence of the hearing as stated by the Pete Domenici (R-NM), the Chairman of the Energy Committee, comes out clearly in his opening statement: "Americans have been experiencing painfully high prices at the pump...Most Americans in most of the polls show that our people have a growing suspicion that the oil companies are taking unfair advantage of the current market conditions to line their coffers with excess profits" (Opening Statement, p. 3). Senator Gordon Smith (R-OR) said something similar: "We are here today to discuss the oil industry, recent profits, and the effect of continued high gasoline prices on U.S. consumers. In this era when major oil companies control oil production from the ground to the gas pump, we need to ensure the American people that their isn't profiteering along the way" (Ibid., p. 67). Senator Maria Cantwell (D-WA) also said something similar but in a different way: "Gentlemen, this committee was billed as an investigative hearing and I think you can imagine as the public looks at what some are saying will be $100 billion in profits this year for the oil industry, while my constituents are losing their jobs or losing their pensions, that Americans want answers" (Ibid., p. 68).

Our concern here is not with the hearing, or the suggestions that came out of these hearings, but with the impact of these hearings on the price of oil, from the perception of what impact, if any, these hearings had on the uncertainty in the speculative markets.

Traditional Demand and Supply Considerations Not the Best Indicator for Evaluating the Price of Oil

In our prior work, we have noted that we believe that traditional demand and supply conditions are not the driving force in the current oil market, and that as a consequence we have attempted to look elsewhere for answers, as we did in August when we used the Saudi Arabian market as our leading indicator. Interestingly Lee Raymond, the Chairman and CEO of Exxon Mobil **(XOM)** made a similar point at the hearings. He stated that: "The facts are and I have said this publicly for a long time—the oil prices have been moving steadily up for the last two years, and I think I have been very clear in saying that I do not think that the fundamentals of supply/demand, at least as we have traditionally looked at it, have supported the price structure that is there" (Ibid., p. 53).

The Speculative Spot and Futures Market May Provide Some of the Answers

If traditional demand and supply conditions are not the best determinant for the price of oil, it is imperative to consider other issues such as the speculative markets, of which the key oil companies may not even be a participant. Senator Cantwell asked the panel of executives: "I want to know whether you gentlemen will help us reform the spot market sales and lack of transparency that occurs in the off-market exchanges, the fact that we do not know what these records and trades were, there is no ability to track that. So would you disclose your sales in this off-exchange, in the spot markets" (Ibid., p. 70). The universal response of the oil executives echoed Mr. Raymond's: "We are basically not in these markets" (Ibid., p. 70).

We believe Mr. Raymond's comment that they are not in those markets, but this leaves us with an interesting situation. If demand and supply considerations are not the determinant of the price of oil, and the oil companies are not speculators, then the speculators probably have a significant impact on the price of oil. To the extent that this is correct we believe that these hearings themselves have an impact on the speculators who in turn have an impact on the price of oil.

IV. The Impact of the November 9, 2005 Hearing on the Price of Oil

As shown in Chart 1, the price of oil peaked in the week of September 2, 2005 at the price of $70 per barrel. On September 6, 2005, that same week, the Senate Energy and Natural Resource Committee held an informational meeting with the purpose: "to examine gasoline prices and factors contributing to current high prices such as global oil demand, constraints on refinery capacity, and increased speculation in the futures market" (Full Committee Hearing—Global Oil Demand/Gasoline Prices, SD-106, September 6, 2005). Two months later, the Senate Energy Committee joined with the Commerce Committee for a joint session that was not informational but investigatory for the purpose of determining a solution to the high price of oil. However, by the time the hearings actually occurred on November 9, 2005, the price of oil had already fallen $10 to a low of $59.56 dollars per barrel, hitting an intermediate low two weeks later of $56.35, a total decline of over 20% in a two month period. We believe that once it was clear that the Committees were not going to propose new legislation, the price of oil again began to gradually increase until the next major senate hearing by the Judiciary Committee on March 14, 2006.

V. The Impact of the March 14, 2006 Hearings by the Judiciary Committee on Oil

Committee Chairman Leahy (D-VT) introduced the hearings with the following questions: "The questions before us are as basic as these: When does the opportunity to repeatedly raise fuel prices, and to amass record-shattering profits on a scale never before known in our society, or in any society—when does that reach the point of becoming a corrosive kind of greed that demands some kind of corrective action? Another question: At what point does the ever-tightening circle of energy suppliers become anti-competitive? And finally, how long should the overseas oil cartel be exempt from antitrust remedies?" (Hearing on "Consolidation in the Oil and Gas Industry", March 14, 2006).

The committee was different, this time the Judiciary Committee, but the impact was the same on the price of oil, which declined going into the meeting. During the week of January 20, 2006, the price of oil hit an intermediate high of $69.15, the first time it had hit $69 since two months prior to the November 2005 hearings. The hearings were held on March 14, 2006 by which time the price of oil had again fallen below $60, to $59.70. Three weeks after the hearings, during the week of April 21, 2006, the price was back above $71. Again, the Committee had proposed no new legislation.

VI. The Midterm Elections of November 7, 2006

We believe that much of the recent decline in the price of oil in the last two months has been similar to the believed impact of the Senate hearings discussed above. During the week of August 11, 2006, the price of oil hit a local high of $77.45, after which it declined to a low of $57.70 the week of September 6, 2006. Since then, the price of oil has been stable in the high $50s to low $60s. This decline represented a 25% decline in less than a month. We believe that this drop is a speculative move caused by speculative concern that the election will produce a change from the status quo. It if for this reason that we believe that the price of oil will continue to trade in this trading range until after the midterm elections.

VII. Implications for the Oil Market Following the Midterm Elections

Following the midterm elections, we believe that the price of oil is likely to test the tolerance of the market and the new members of Congress; that is, after the elections we believe oil will appreciate until there is fear in the market that Congress will take action. It is too early to speculate on the exact level of the increase, but our recommendation at this time is to become progressively long oil at these prices as the election approaches, with the expectation that a topping test pattern will become clear shortly after the election.

VIII. Risk Factors

We have made various forward looking statements about the price of oil, that are not based on any demand and supply considerations. We based this entire analysis on one market the United States, and on one Speculative condition, politics. We have not factors any kinds of national or international situations than may affect the price of oil, like 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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HOLD [Neutral]	0	0.00	0	0.00
SELL [Sell]	0	0.00	0	0.00

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