Increasing Crude Oil Prices – Bubble or Real Boom…

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Recently, crude oil prices have skyrocketed to an all-time high of $ 139.12 per barrel on 6th June, 2008. On the other hand, mounting losses of oil companies forced the Indian government to raise prices of petrol, diesel and gas.

It was in August, 2007 when crude Oil price started its almost unstoppable up move and consolidated during December'07 and January'08 only to fuel the rally at faster rate in subsequent months. From a low of $ 90 per barrel in Feb'08, crude oil touched @ 139.12 per barrel in 1st week of June'08 week showing rocket hike of 54.58% in last 5 months.

The jump in crude oil prices was partially driven by trading & speculative reasons, while partially it was driven also by fundamental reasons. Fundamental reasons include decline in US oil inventories declared in June'08 and a decline in Russian oil production in May'08. In addition to this, projected decline in Mexico's oil production over rest of the year 2008 that too at considerable level (Mexico contributed 4.4% of world oil production in 2007) added to the fire. To make the situation of rising crude oil prices even worse, OPEC has continuously denied increasing crude oil production in order to curb zooming crude oil prices. All these factors have led to the sudden jump in crude oil prices during last two months, pushing up the inflation rate.

Major reasons behind high oil prices

- Rising consumption in developing countries including China and India
- Trading in commodities futures have led to speculative spurt
- The reluctance of OPEC members not to increase crude oil production

Table – 1.0 Major Consumers of Crude Oil in the world: (for the year end 2007)

CONSUMPTION SHARE		
Country	**Consumption Share**	**Consumption Change (%)***
USA	23.9%	-0.10%
China	9.3%	4.10%
Japan	5.8%	-3.50%
India	**3.3%**	**6.70%**
Russian Federation	3.2%	-0.90%
* Consumption Change from 2006 to 2007		

Source: Dhaval P Vyas Investment Research

Doing the proper analysis of the Table 1.0, we can observe that declining consumption by major developed countries, while developing countries including China and India witnessed a positive change in their consumption in the year 2007 compared to the year 2006. Moreover, traders and hedging companies through-out the world is projecting a considerable rise in consumption by China and India. This has provided a solid background to support rising prices.

However, reader note that the hike witnessed during last three months is over-priced as there is no surprising jump in crude oil consumption in last couple of years. Hence, oil prices inching $ 140 isn't be justified.

What is in store for Indian Companies and Public?

At least for short-term, crude oil prices are expected to be higher. This will put huge burden on the Indian economy. Consequently, high oil prices will ruin the economic growth as it results into high production cost – which subsequently, results into low profit margins and fewer opportunities for companies to give a more salary hike.

On the other hand, high oil prices put upward pressure on inflation numbers, which makes the life of general public tougher especially for middle-class and below that class remains the major portion of India's population. So, this makes their life hard as prices of essential commodities will rise dramatically as a result of high oil prices. Moreover, the possible low economic growth over next few months may put additional pressure of the decline in job opportunities – again causing economic problems for public.

Where the solution lies?

Recently, the Government of India has increased petrol, diesel & gas prices, RBI too increased Repo rate by 0.25% last week. But, according to us, these steps won't be enough to fight against rising crude prices and ultimately, high inflation. We strongly believe that the Indian public has solution in their hand rather than seeking government support and intervention of RBI's monetary policy. The solution lies in the efficient use of electricity, petrol, diesel, gas, water and food. Public should be given more encouragement/incentives to use of solar-energy in cooking, use of hybrid cars and electronic bikes/vehicle. Notably, as per our research, in 20 years down the line, any country to make her see as 'Super-power' will have to have full access to essential commodities especially water and oil in the sufficient manner.

Will crude-oil price increase further?

Of course, there are also some basic fundamentals reasons behind rising oil prices as mentioned earlier, but overall the spurt is more of a technical bullishness. It is the fear in minds of crude-oil traders regarding the uncertainty over crude oil production, rising consumption of developing countries and lack of dependable & sufficient alternative energy sources. All these have resulted in the skyrocketing oil prices, which is fuelled by the ongoing credit crisis in recent times. Ultimately, the imbalance in the global economic cycle has considerably pushed up oil prices and central bankers all over the world may have to fight very hard against rising inflation especially due to high oil prices.

Should Corporate India build hedging at present level?

Some of the estimates from few of the reputed firms report estimation of $ 200 for crude oil price, but we see these estimates biased rather than emphasizing the current consumption pattern and expected growth over years. Therefore, we advise companies not to take long positions in crude oil at current levels for hedging purpose, instead they can wait for lower levels to be hit and can buy futures contract later in order to avoid risk of high oil prices. The strategy is not to build aggressive long positions in crude oil at current levels as a minor-to-moderate correction to the tune of 10% to 20% may be on the cards.

At current price of $ 138- $ 140, traders can use the present level to short crude oil with downside targets of $ 110 – $ 125. On the other side, chances of crude oil crossing $ 155 seem slim at least in the short-run. However, in medium to long-run, unless, the price of crude oil doesn't break $ 110 on downside, we expect the present bullishness in price to continue. On the other hand, if crude oil prices go below $ 110, then oil prices would consolidate for some time to stabilize around $ 70 to $ 80.

It is to be noted if oil prices remain at such higher levels in the coming months, then definitely, this will put considerable downward pressure on the economic growth of developing countries including China and India. This in turn can result in decreasing consumption by developing countries as economic slowdown will occur there due to high inflation as high interest rates policy will get implemented. This in turn will put downward pressure on oil prices as those countries facing slow economic growth will reduce their oil demand. So, the possibility of cooling down oil prices can't be denied after the slow global economic growth results into low demand.

Bubble building "Crude Oil" price

Our research on international commodities market says that the current rise in crude oil prices is more of a speculation-driven rather than supply-driven. This crude oil price should be rather seen as a bubble building and not a genuine rise as we see speculative interests taking over the price discovery of oil prices. In the year 2004, we had warned similar kind of Real Estate bubble building in the USA – which has already started bursting from 2007 onwards severely affecting many of the giant companies there. Thus, we view the current high oil prices as a "Bubble Building" and not driven by fundamental reasons.