A Review of Crude Oil Price Trend in 1st Half of 2010

Ken Koyama, PhD
Director
Strategy and Industry Research Unit
Institute of Energy Economics, Japan

The WTI crude oil futures price (the daily closing price of the front-month contract) averaged $78.5/barrel between the beginning of 2010 and the end of June. During those six months, the WTI price peaked at $86.8/barrel on April 6 and bottomed at $68.0/barrel on May 20. On June 30 at the end of the period, it closed at $75.6/barrel, down $0.3 from the previous day.

The crude oil price trend features various key points, which can be narrowed down to two. First, the price remained range-bound in the period after the wild fluctuations over the previous two to three years. Second, the price fluctuation within the range reflected macroeconomic and financial situations.

The first point becomes clearer when the trend during the six months is compared with that in the same periods of the previous two years. In the first half of 2009, the WTI futures price averaged $51.8/barrel, peaked at $72.7/barrel and bottomed at $34.0/barrel. In the first half of 2008, it averaged $111.1/barrel, peaked at $140.2/barrel and bottomed at $87.0/barrel. The average in the first half of 2010 stood in the middle between the averages for the same periods of the previous two years. The fluctuation range (the gap between the peak and bottom) narrowed relatively.

What are factors behind the narrowed fluctuation? One factor is that market participants after the past excessive fluctuations perceive excessively high and low prices as unsustainable. Another factor is that market participants’ perception now plays a key role in forming futures market prices.

As indicated by the famed “beauty contest” theory as discussed by John Maynard Keynes in his “General Theory”, market participants’ perception, or “average option of average option”can
impact actual trading behaviors and plays a key role in forming prices. This is a key point of the crude oil price formation in the present futures market. In this sense, successive remarks by many leaders of oil consuming and producing countries on problems with excessively high and low prices and desirable price levels (albeit the absence of any complete agreement on a specific level) after crude oil price plunges following the Lehman Shock might have helped form the present market perception. Among these leaders, King Abdullah of Saudi Arabia’s statement that $75/barrel would be a fair price attracted market participants’ attention.

The second point is that crude oil prices, while remaining in a $65-85/barrel range, have repeated hikes and drops linked closely to developments in the global economic and financial situations. This means that these developments are the key to future prospect for crude oil prices.

Of course, it may be needless to say that supply/demand fundamentals in the international oil market are important as the basic factor for price formation. In the price formation process where perception plays a key role as discussed in respect to the first point, speculations and predictions about future supply/demand conditions, rather than current actual conditions, have great influences. Then, world economic and financial situations attract attention as the largest factor for influencing future supply/demand conditions (particularly demand). In fact, stock prices, which mirror a world economic recovery and its expectations, have indicated a strong correlation with crude oil prices since the first half of 2009.

The trend continued in the first half of 2010. When the WTI futures price was rising to the peak of $86/barrel, IMF and other world economic growth forecasts were being revised upward, with stock prices continuing a strong upsurge. In and after April, however, stock and crude oil prices turned down on the unfolding Greek budget crisis and the fears of spreading sovereign risks in a run-up to the May bottom for the WTI futures. The crude oil price drop at the end of June also kept step with stock price falls as market tones were affected by worries about the future course of European and U.S. economies, or more directly by reports on a downgrade of the Spanish sovereign rating. In looking at crude oil prices and the international oil situation, we may thus have to fully understand oil supply/demand fundamentals as the basic pricing factor and widely and comprehensively analyze or consider complicated and diversified problems regarding world economic and international finance situations, international politics and geopolitical situations.

What are the questions to be asked after discussions on the two key points? They may include whether the perception characterizing the present market could change, what the conditions for such change would be, and what would happen to the international oil market and crude oil
prices as a result of such change. In considering these questions, we may have to analyze not only European and U.S. economic and financial situations but also the future course and potential downside risks for the Chinese economy that now drives world economic growth. We may also have to take full consideration on how the Gulf of Mexico oil spill accident attracting global attention would affect the entire oil market. The task is not easy at a time when future developments of various factors are very uncertain. Nevertheless, I would like to analyze the entire international oil situation including the above discussed points at the IEEJ’s 404th forum on research works planned for July 14.

Contact: report@tky.ieej.or.jp