

Crude calculation

IEA's oil dump inflames jittery market

June 24, 2011 – The decision by the International Energy Agency (IEA) to release 60 million barrels of crude oil from its reserve took markets by surprise this past week. The big indexes, especially Toronto's resource-rich benchmark, plunged Thursday after the announcement. Most seemed on the road to recovery by Friday's close. So why the oil gambit?

The IEA, a 27-member consortium of Western oil-consuming nations, said in the press release that the move comes as a response to the disruption in supplies of light sweet crude – the most desirable kind – from Libya. And expected seasonal increases in demand this summer could make things even worse, according to the IEA. Going a step further, it says, "Greater tightness in the oil market threatens to undermine the fragile global economic recovery."

We suppose it's possible, but a release of a *total* of a mere 60 million barrels (2 million barrels per day) over the next 30 days would seem to be a drop in the bucket compared with first-quarter global consumption of a total 87.81 million barrels *per day* of crude oil and liquid fuel supplies, and supply of 87.57 million barrels *per day*.

In other words, the total extra supply released from the IEA's strategic reserves wouldn't cover even a single day's worth of global consumption. And it's far less than the 3.75 million barrels of crude per day that Canada supplies to the US alone.

In the US, officials of the Obama administration said the IEA release of oil, about half of which will come from US reserves, is intended to "complement" Saudi Arabia's pledge to pump an additional 1.5 million barrels per day.

The price of crude oil for August delivery, already in decline over the past few weeks, finished the week at US\$91 per barrel. That makes the IEA's decision to add inventory to a bearish market doubly mystifying. And probably, we'll never know really why.

For the reasons behind crude oil's decline, we have to look to the picture being painted on the broader macro-economic canvas. Unfortunately, it's not a particularly pretty picture. That comes through loud and clear in recent statements from US and Canadian central banks. Perhaps it's most telling in the rising prices (and falling yields) of Treasury securities.

In its biannual *Financial System Review*, the Bank of Canada last week painted a picture of elevated global risk to Canada's financial system, even though the Canadian financial system remains healthy. The report said "*principal* risk for Canadian financial stability is associated with the acute financial strains in peripheral Europe." [Emphasis added.] It added, "The risk associated with global sovereign debt thus remains high and has edged even higher since December." The fiscal problems in eurozone peripheral nations Greece, Portugal, Ireland, and Spain thus eclipse all other threats to the global financial system according to the BoC. And, to emphasize the risks still facing Canada's economy, in an interview with *The Wall Street Journal* BoC Governor Mark Carney said, "Monetary policy may still need to be stimulative in order to close the output gap and in order to get inflation back to target." Read that to mean low interest rates for quite some time yet.

In the US, the Federal Reserve Board predicted that the US economy would grow only sluggishly, at an annual 2.9% for all of 2011, following a tepid annual 1.9% expansion of the US economy in the first quarter. Fed Chairman Ben Bernanke was at a loss: "We don't have a precise read on why this slower pace of growth is persisting," he said at a press conference. The Fed announced that its benchmark federal funds rate would remain at near zero for "an extended period," and that it would complete its US\$600 billion program of Treasury bond purchases by the end of July as scheduled.

Meanwhile, China's slowdown continues to unfold, as industrial activity hit stall speed in June. The HSBC purchasing managers index slipped to 50.1. A reading of 50 is the threshold between expansion and contraction. The government's significant monetary tightening and tougher lending restrictions to control rising inflation have clearly been kicking in. But when demand begins to weaken in the world's second largest economy, then that's bound to have knock-on effects for raw materials around the world. And that has been a big factor in the commodity price slide in recent weeks, as speculative money abandons commodities in favor of safer harbours.

That money is joining the flood of fixed-income money already underway into the relative safety of US Treasuries. With central bankers in Europe, Canada, and the US raising the alarm over the growing risk of Greek debt contagion, strong demand for US Treasuries pushed yields towards their recent lows again last week. Prices for Canada's 10-year note have also climbed, pushing yield to about 2.9%. (The sliding yields have to be disconcerting for both the Fed and for Treasury bears like giant bond-fund manager Pacific Investment Management Inc., which recently and very publicly declared it had heavily reduced its US Treasury holdings. They may well be vindicated...but just not yet.)

Meanwhile, the US Securities and Exchange Commission (SEC) and the Fed have reportedly been monitoring the exposure of large money market funds to European debt. According to rating agency Fitch Ratings in a report last week, half of assets in the major money market funds were invested in paper issued by 15 of the largest European banks. The Fitch report said, "Of the top 15, ten are European institutions that in aggregate account for 30 per cent of total money market fund assets." Despite assurances that there's virtually no exposure to the debt of at-risk countries, investors pulled about

US\$51 billion from US money market funds with non-US government debt over the past two weeks. The ghost of Lehman Bros. is apparently still clanking its chains and howling, “Save yourself!”

What with flagging growth rates, ever-increasing European sovereign debt risk, sliding commodity prices, and an oil dump by the IEA, investors were understandably jittery last week. So in a week that saw a heart-stopping “drop-zone” followed by a rally of sorts, the big stock indexes were disinclined to move much in either direction on the week.

Toronto’s S&P/TSX Composite Index ended the week ahead just 0.9%. The Dow Jones Industrial Average lost 0.5% on the week, while the S&P 500 Composite broke even.

The “soft patch,” in both global growth and stock market performance, continues. ■

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