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Market Memo: We're bullish on oil long-term, but in the short-term, expect a pullback

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Sometimes you're right for the wrong reason. Back in January, we set an internal target price of $120 for oil by year-end, only to see the commodity spike surprisingly near that level last week as the Mideast seemed to implode before our eyes. We remain long-term oil bulls, for reasons to be described below, but we also believe that the current Mideast "crisis" is overblown and that the near-term direction of oil prices is lower, not higher.

Our long-term case for oil is fundamental: oil is a commodity, with prices set largely by supply and demand. Based on our work, we see the next 12 to 18 months as ones in which supply is likely to undershoot consensus expectations and demand to overshoot. Together, we expect this to cause prices to grind higher—but in a way that should not pose an immediate threat to economic growth or to Fed Chairman Ben Bernanke's commitment to keeping the monetary spigots open.

Behind our fundamental long-term case for higher oil

The way to think about supply in the oil markets is that what you do today is more likely to impact what happens in two to four *years* than two to four *weeks*. Lead times on new capital projects are long, and increasingly difficult. Unfortunately, following the collapse in oil prices back in September 2008, then the near-death experience of the global economy in the ensuing year, managers in the oil business drastically cut back expenditures focused on production growth, preparing for the worst.

Now that the worst hasn't happened, new supply is coming onstream globally at a slower-than-desirable pace. Most of the world's excess capacity at the moment is concentrated in Saudi Arabia, while almost all other producers (OPEC and non-OPEC) are producing full-out. Although most oil analysts believe that the Saudis will use their spare capacity to manage prices within a $90 to $100 level, we're frankly more doubtful on this point. There are reasons to believe that he Saudi fields, themselves, may not be up to all the spare capacity listed on paper; in addition, given their social spending needs to keep their largely transient worker population happy, letting oil drift gradually higher is probably desirable.

From a demand perspective, nearly all the Street oil analysts are using their economists' global economic growth projections, which remain significantly below Federated's own. As our more optimistic growth outlook plays out over the next six to 18 months, we expect oil demand to pressure supply, driving prices higher. So net net, we think the underlying fundamental forces of supply and demand are pretty supportive for higher oil prices in the months ahead. If you overlay on this scenario the Fed's QE2 program, which Bernanke made clear that he's committed to fulfilling during his testimony before Congress this week, the probability of higher oil rises further as excess liquidity finds its way into commodity markets where supply-and-demand conditions already point to higher prices.

Why the current Mideast crisis is likely overblown

This said, we think the near-term direction of oil is lower. The supply-and-demand dynamics we outlined above have yet to really

Happy Saint Patrick's Day ...

As the Mideast is grabbing all the headlines, the Irish people held an election last weekend and the outcome was a not unexpected change of government. Quickly, the new prime minister, Enda Kenny, announced he intended to renegotiate an EU bailout package that he campaigned against because of the severity of its accompanying austerity measures—the steepest budget cuts and largest tax increases in Ireland's history—and will head off to Germany soon to do. We're watching this carefully.

As much as we believe the Irish got a tough deal, we think the consequences of acceding to the new government's demands at this stage might be very negative for risk markets—or at least the euro. Indeed, the if markets have to begin discounting in Euroland the prospect that promises to pay by a sovereign government are only good until the next election, look out below!

Our guess is that all this is largely more of the same political posturing we've seen in the messy euro consolidation process that we've written about before. But in the

play out and are not at work in the current market. What's causing the spike lately in oil is concern that the series of upheavals in the Mideast will threaten supply lines from Libya and elsewhere, and worse, that the crisis could spread to the big enchilada, Saudi Arabia. We think the probability of either event is rather low.

meantime, we're monitoring developments there closely.

Regarding Libya or elsewhere, our experience with political turmoil in other countries where oil or another commodity is a ready source of hard currency, is this: whatever government or fragment of government that takes charge, one of the first acts they take is to turn the wells back on and begin shipments in exchange for the hard currency they need to fund their new government and new programs. Witness Nigeria. This poorly managed country has been a hotbed of civil war for a decade. Civilian casualties have been appalling, and living conditions there poor. Some very bad people have been in and out of the leadership of both sides. Yet, through thick and thin, the wells keep pumping. In fact, though oil production there has been declining modestly each year since it peaked in 2005, and while there also have been the occasional short and sporadic stoppages, the overall trend has been stable and gradual enough that it has had virtually no impact on intermediate term production levels globally over this entire turbulent period. So without commenting on the plight of the Mideast's citizenry or the geopolitical impact of the changes at work there now, it is relatively not much of a leap of faith to foresee that sooner rather than later, Libya's new leaders will get the oil flowing.

Saudi Arabia is not Libya

Of course, if Saudi Arabia becomes unstable, given just how much oil there is there and how big its oil fields are, markets might have legitimate concerns that rogue rebel groups could penetrate security around the fields and blow an important one up. That wouldn't be good. However, rather than simply make a knee-jerk reaction that the Arab dominoes are pointing straight for the Saudi Kingdom, we'd like to point out a few important facts: While the population of Saudi Arabia is 25 million souls, unlike Egypt or Libya, 80% of the workforce are foreign workers who presumably would be deported and replaced if they became unruly, and who in any case have neither the rights nor expectations of a natural citizen. And despite this large population of foreign workers, conditions in Saudi are far better for the average person than in Egypt or Libya; in fact, the GDP per capita in Saudi is $24,000, compared to $6,200 in Egypt and $13,800 in Libya. At 10.8%, unemployment in Saudi Arabia is also more like that in the U.S. than Libya, where it is running at 30%. Finally, as much as one might argue about whether monarchies in the modern age are legitimate governments or not in the eyes of their people, it is certainly the case that a government based on a long accepted monarchial structure with lines extending back over a 100 years is probably viewed as a more legitimate one than that of dictatorial tyrant backed by the military and a ruthless secret police force governing solely through terror.

Bottom line, we think market fears that the Saudis are next are probably way overdone, and to the extent the price of oil reflects these fears, we expect it to decline, not rise, in the near term.

Views are as of March 2, 2011, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

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