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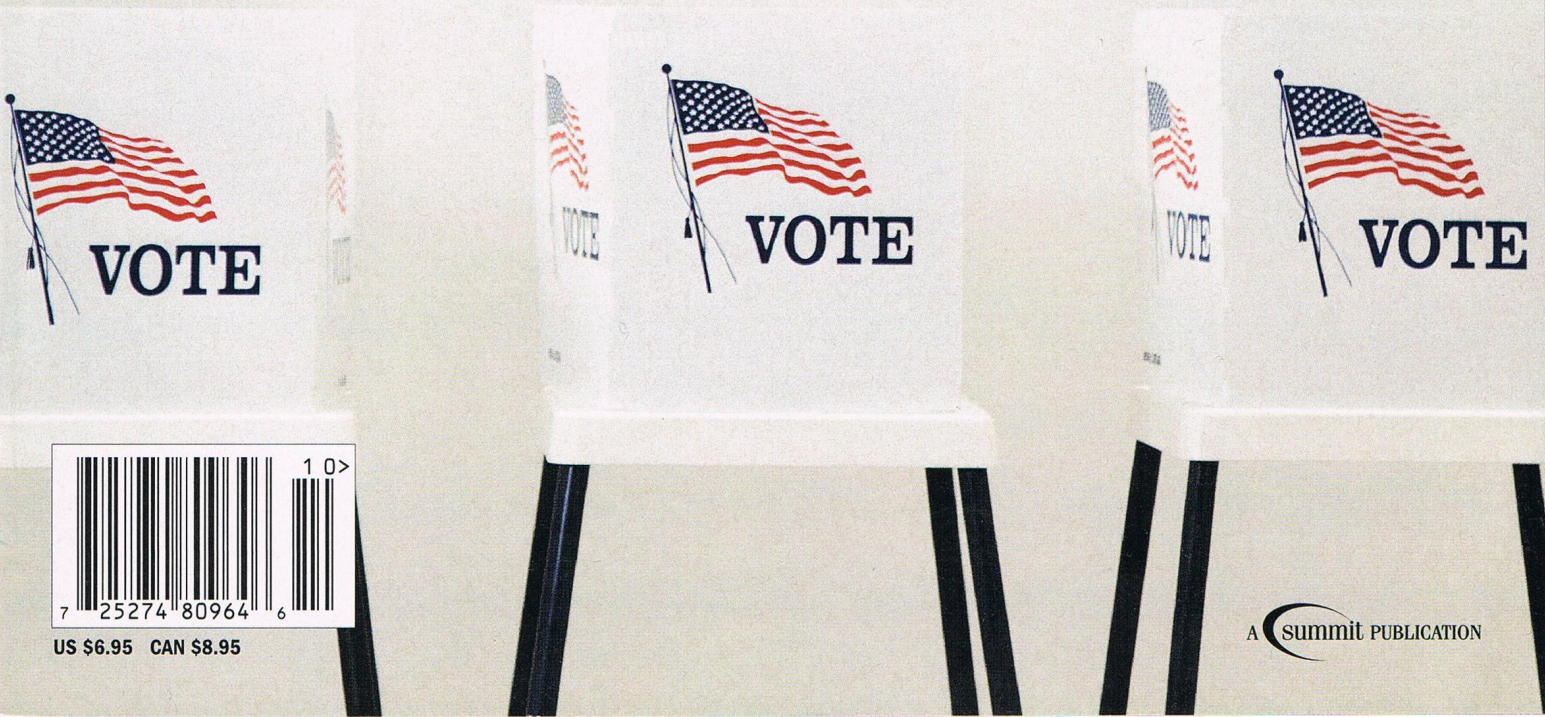
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HOW WILL THE ELECTION AFFECT ENERGY MARKETS?



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MARKETS

Energy's countdown to the election

BY PHIL BURGERT



Traders and analysts look ahead to the November election to discuss how its outcome may affect the currently oversupplied markets and the geopolitical risks that have been a major factor driving prices in recent years.

Vulnerabilities in both political parties are seen by traders and analysts when it comes to debating the Nov. 6 election and how to trade it, but a surprising number of market participants are expecting little of importance to result in the energy sector from the presidential voting.

In a rundown of energy market fundamentals, possible election outcomes could be the least important, according to Spencer Patton, chief investment officer at Steel Vine Investments, who lists potential disruptions of the current hurricane season, talk of possible releases from the Strategic Petroleum Reserve, declining Chinese economic results, potential Middle East risks and quantitative easing with higher importance.

Political impact Geopolitical risks

"There's not a huge part that really hinges around the election," Patton says. "If you saw a Republican victory, the markets would respond quite favorably to that [as] a pro-business development. So that would be [positive] for oil prices

just like it would be [positive] for other markets. You would see virtually every risk asset move higher."

As this issue of *Futures* went to press, Patton and other analysts said the markets, however, were expecting an Obama victory. "That's where the odds are right now," he says. "So if there is an Obama win, we won't see too much of a difference."

Dominick A. Chirichella, founder of the Energy Management Institute, also downplays the election's importance. He says oil is being driven by three main factors now: Whether the new European Central Bank's bond buying program will offer a solution to Europe's fiscal problems, the potential for new quantitative easing from the U.S. Federal Reserve and geopolitics in the Middle East.

"These are the dominant price drivers with the election still not in the cross hairs of market participants," Chirichella says. "When we move closer to the election I would expect market participants to react to whoever is in the lead at the time."

Others, however, are more fully engaged in looking at the elections already. "Politics and oil — it doesn't get any better than this," says Phil Flynn,



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senior energy analyst at Price Futures Group. "Politics bleed oil and there's no other issue that irritates the average voter as much as gasoline prices."

Flynn says the major factor in the oil market now is the expectation of bailouts in Europe and the euro. "But what may be good for Europe is not necessarily good for President Obama, because when the central banks start stimulating the economy it comes at a price, [that price is] rising oil and gasoline prices," he says. "If this trend continues into the election, President Obama will get the blame."

Flynn and other analysts say Obama's extended delay of the Keystone XL pipeline from Canada is one element of his record that will attract blame. "The Republican platform is in favor of more domestic oil and gas production, and as far as infrastructure, we have the hotly debated Keystone pipeline that Governor Mitt Romney is in favor of," says Mike Zarembski, manager of futures trading for optionsXpress.

Chirichella adds that a Romney victory would be expected to provide a positive

boost for accelerating the movement of oil from Canada and more U.S. drilling both inshore and offshore. The U.S. oil outlook also will be affected by the outcome of the ongoing federal “fiscal cliff” debate, he adds. If that is not resolved smoothly, the U.S. economy “could move back into a recession and thus have a negative impact on oil consumption,” he notes.

“Keystone is one issue, but that’s not the only place where the President is vulnerable,” adds Flynn, who suggests that the primary other place Obama is vulnerable is his policies on green energy. Flynn is critical of the Obama administration’s spending on alternative fuel sources (see “Energy subsidies for all,” right). He says it has “failed to deliver, while there seems to be a resistance” to growing fuel supplies from new sources such as hydraulic fracturing, natural gas production and directional drilling. The numbers on alternatives have improved as have traditional sources, but they have failed to keep the cost down (see “Tallying supplies,” right).

Flynn also acknowledges that Romney so far has provided few details of his own proposals to take advantage of such technology advancements. “I don’t think he’s framing the debate well, and he’s at a disadvantage because he is not an energy guy,” Flynn says.

Patton says that neither Obama or Romney are interested in natural gas, which he describes as the “red-headed step child of energy right now” but an option that the country should focus on more. “[Natural gas] prices are going to remain depressed for an extended period of time,” he says (see “Bear market?” page 14). “I don’t see much upside given natural gas supply massively outstrips demand. Prices between \$3 and \$4 is the future of natural gas over the next four or five years.”

The long-term outlook for natural gas production, if not for price, is bright because the U.S. Energy Information Administration’s (EIA) 2012 energy outlook expects domestic production to outpace consumption. The EIA estimates the United States will become a net exporter of natural gas by around 2022.

Zarembski suggests that a “potentially huge difference” will be seen in U.S. energy planning depending on which party controls the White House and Congress

ENERGY SUBSIDIES FOR ALL

While the government has showered traditional and alternative energy sources with subsidies, EIA data from 2010 shows that traditional energy has been more efficient.

Power Source	Total U.S. subsidy (millions)	2010 U.S. power consumption (million bbl. oil equivalent)	Cost per energy equivalent barrel of oil consumed
COAL	\$1,358	3,439	\$0.39
OIL AND GAS	\$2,820	10,012	\$0.28
NUCLEAR	\$2,499	1,394	\$1.79
BIOMASS/BIOFUELS	\$7,761	381	\$20.37
GEOHERMAL	\$273	35	\$7.80
HYDRO	\$216	414	\$0.52
SOLAR	\$1,134	18	\$63.00
WIND	\$4,986	153	\$32.59

Source: EIA

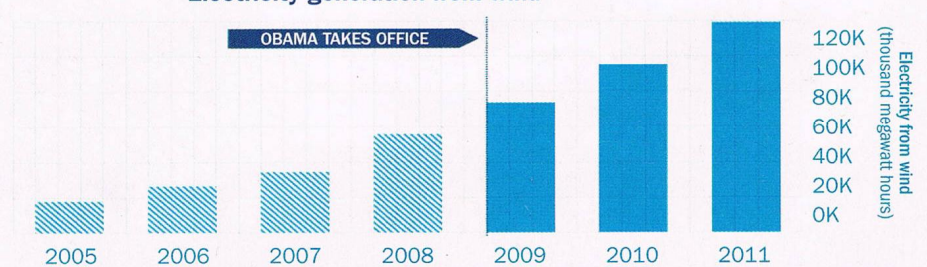
TALLYING SUPPLIES

Despite rising prices, statistics shows that U.S. production has increased in both traditional energy and alternative sources. On the alternative side, solar and biofuel production has increased as well as natural gas on the traditional side.

Boosting U.S. domestic production of oil



Electricity generation from wind



Source: Energy Information Administration and Obama for America

after the election.

Patton, on the other hand, says that the United States has not had an energy policy in the past 40 years. “It’s nauseating how poor the country is at trying to pave a path forward on energy policy. It’s all just a bunch of hot air from both sides.”

But the election also will contribute to volatility that already is coming from other geopolitical and economic factors, Patton says, suggesting that long volatility strategies are a way to trade the election (see “Options Strategy,” page 10). “You can buy both a crude oil put and call in the hopes that you’re going to get a

big upside move or a big downside move through the end of the year,” he says.

“Something is going to happen over the next three-and-a-half months, whether it be Israel attacking Iran, a Strategic Petroleum Reserve release or any number of things. There’s going to be more clarity on China, so the odds are good that you’ll have a significant move by year-end,” Patton says.

Chirichella says current oil market fundamentals still are biased to the well-supplied side as global demand is on the defensive. U.S. crude oil inventories still are hovering near the highest level since

the early 1990s, while there is a deficit of refined products in the U.S. vs. last year and the five-year average.

“However, the U.S. is exporting about 1 million [barrels per day] (bpd) of distillate and about 500,000 bpd of gasoline,” he says. “I view exports as just another form of inventory that, if needed in the U.S., would be diverted to internal use.”

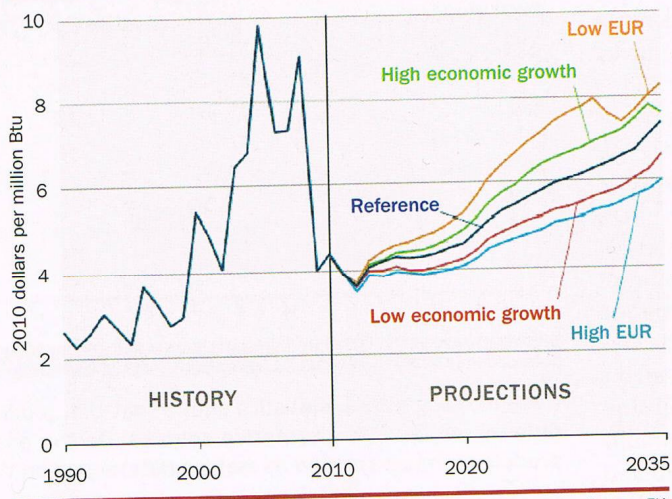
Chirichella notes that currently there is no shortage of oil anywhere in the world and there is a shortage of demand. “Global demand consistently has been declining as the global economy continues to slow. All of the projected oil demand growth is coming from the developing world with China playing a major part,” he says, adding, “The developing world, including China, also is slowing.”

Patton suggests that 10%-15% could be cut from crude oil prices if China slows more than the market expects. “Everyone is watching the data, but nobody really knows whether to trust the data because the Chinese have been known to manipulate their economic releases,” he says.

Zarembski says traders should be pre-

BEAR MARKET?

The EIA projects the spot price of natural gas to remain relatively low over the next few years. This projection shows prices based on estimated ultimate recovery (EUR) per well and economic factors.



Source: EIA

pared for trading in a choppy market going into the election and beyond because the election looks to be very close. “Given the escalating uncertainty, both political and economic, that we are seeing going into the last half of 2012, I don’t see oil price volatility declining by any meaningful level.”

He adds, “It is interesting to see reports of slowing demand for oil and energy products, but prices are holding up extremely well given a recessionary environment in Europe and slowing growth

in China and the U.S.”

However, Zarembski doesn’t expect this to last. “I don’t [expect] declining demand for energy will be a long-term trend.”

U.S. distillate inventories are at relatively low levels going into the fall and traders will need to watch how quickly refineries increase production to meet winter demand. “We were very fortunate to have had a mild winter last year and there are no guarantees that this will be the case this season,” Zarembski says.

“If we get a cold winter, expect to see a quick reduction in distillate exports with the product being diverted to the key heating oil markets along the east coast,” Chirichella says.

Zarembski adds that RBOB gasoline supplies also are beginning to tighten as refinery outages take their toll on supplies. “We would be in a much more dire situation if demand was not lackluster,” he says.

However, winter is a long way off and there will be an election before it comes. The current high price of energy may play a role in its outcome, even if it is not what is driving the market today, and the geopolitical factors may prove to be a wild card in the election.

Global trends are gold standard for metals

Only marginal changes resulting from the U.S. elections are expected to appear in base metal markets, which currently are being driven more by global trends, mainly in Europe and China, according to traders and analysts. But precious metals may move more as a result of monetary easing.

The prospects for U.S. federal fiscal restraints resulting from possible expiration of tax cuts and automated spending cuts two months after the election likely will keep clarity from appearing in the markets at least until sometime early next year, says David L. Abramson, director of research with BCA Research.

“The fiscal issues pretty much rule out any big positive,” he says. “No matter who wins the election, there is still fiscal uncertainty at least until January or February. So for the remainder of the year the U.S. is really not going to be a huge positive to offset the negative in Europe and China.”

Edward Meir, independent commodity analyst with INTL FC Stone, says that if Romney wins, the stock market is likely to rally and could pull up some of the commodity markets, although he’s reluctant to project that will happen, noting that many things could occur before November.

“We have a problem with slow growth practically around the world, so that means we’re not looking at a big bull market in any of these commodity markets any time soon,” Meier says. “Gold is going to be a bit more resilient because of the easing concerns and pump priming and all that. But the base metals are going to be on the defensive, flat to down over the next six to nine months until we get out of this slump.”

In terms of the GOP platform plank on studying the return to a gold-backed currency, none of our analysts saw it as a serious proposal.

