

News Flash – Fat Tail Risks

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13 DECEMBER 2011: Today, despite continued Euro weakness and disappointing economic news out of China, oil prices moved up forcefully. It seems rationale behind this counter-intuitive move were rumors that Iran had closed the Strait of Hormuz to undertake military exercises. These unconfirmed reports were quickly denied by Iran's foreign ministry but oil prices nonetheless remained elevated as a result of growing regional tensions.

Over the recent months we have thoroughly explained our view that current energy market fundamentals do not support today's elevated energy prices. In short, we simply do not believe that near-term global demand will increase anything close to market (read IEA) forecasts. However, we have been quick to point out that rising tensions in the Middle East have been providing support to today's elevated prices (in the form of increased risk premia) and any provocative activity in the region would most likely launch prices quickly upward. The ultimate sustainability of any such increase would depend upon the type of provocation and the durability of its impact on energy supply.

It seems that this bi-polar view of the market has become widely accepted by investors as evidenced by a jump in options contracts purchased both above \$120 and below \$60 per barrel. Simply put, investors appear eager to purchase protection against fat tail risks – *i.e.*, plummeting oil prices as a result of a global recession triggered by further deterioration in Europe and China, or skyrocketing oil prices caused by a conflict in the Middle East which materially disrupts supply to the markets.

The current environment is highly unstable and investors seem to know it. As each day passes, the likelihood of one of these scenarios occurring seems to increase. The most recent meeting of EU leaders has once again failed to deliver a durable solution to the European Debt Crisis. Moreover, the leveeing of further sanctions against Iran (the world's fourth largest producer and third largest exporter of oil) as well as Iran's recent capture of a US intelligence drone has clearly increased tensions in the region. Finally, the threat of Iran blocking the Strait of Hormuz – the narrow sea passage from the Persian Gulf into international waters which transits approximately 15.6 million barrels per day, provides Iran an even larger impact on the markets than simply its own productive capacity.

These factors (along with worrying political developments in Russia - the world's 2nd largest oil producer and exporter) explain why the market is suffering from a form of bipolar personality disorder. As we have most recently stated, this type of environment creates extreme volatility and today is a perfect example. We continue however to trade within the bands we recently set out with regard to WTI and Brent – WTI between \$90/100 per barrel and Brent between \$106/115 per barrel. We continue to watch the market for a potential breakout to the upside or downside.

As always, we will be following these and other developments affecting the energy markets and will be providing further commentary. You can also follow our updates on Twitter at @nusconsulting.

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