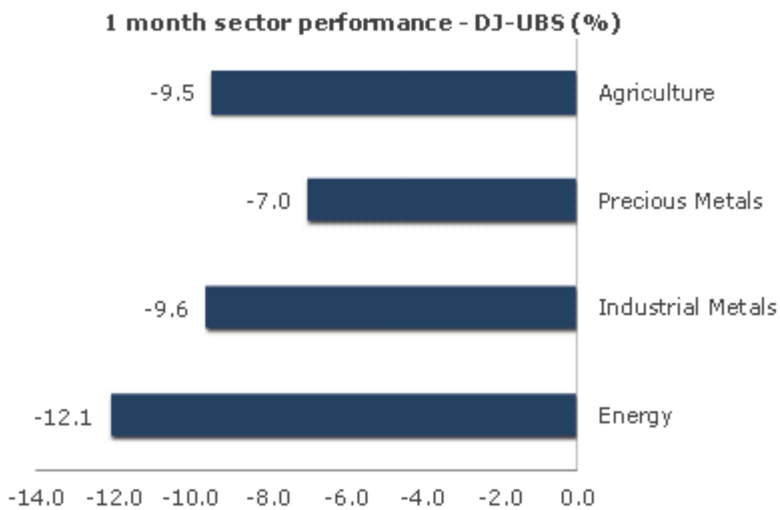
# Oil prices tumble as speculative bubble burst

The financial and sovereign debt crisis continues to set the agenda for almost every investment decision being taken at the moment. During May the crisis in Europe escalated (again) and turned a dangerous corner with the focus switching to Spain, where a bank funding crisis is putting the government under severe pressure. Meanwhile in Greece, the new election is still weeks away with the outcome potentially putting Greece's future within the Eurozone at risk. China, the main global growth engine since 2008 is slowing, and the US economy is in a mid-cycle slowdown.

These events helped drive investors towards secure government bonds, with two-year German yields going negative, and safe currencies such as the Japanese Yen and especially the US dollar, which rose to a 23-month high versus the euro. Commodities, meanwhile, saw one of the biggest monthly drops since 2008, with the broad based Dow Jones-UBS Commodity Index falling by more than nine percent, as all individual sectors, as seen below, came under heavy selling pressure. The energy heavy S&P GSCI recorded its worst month since 2008, slumping by almost thirteen percent as both WTI crude and Brent crude fell more than 20 percent from their highs and technically entered into a bear market.

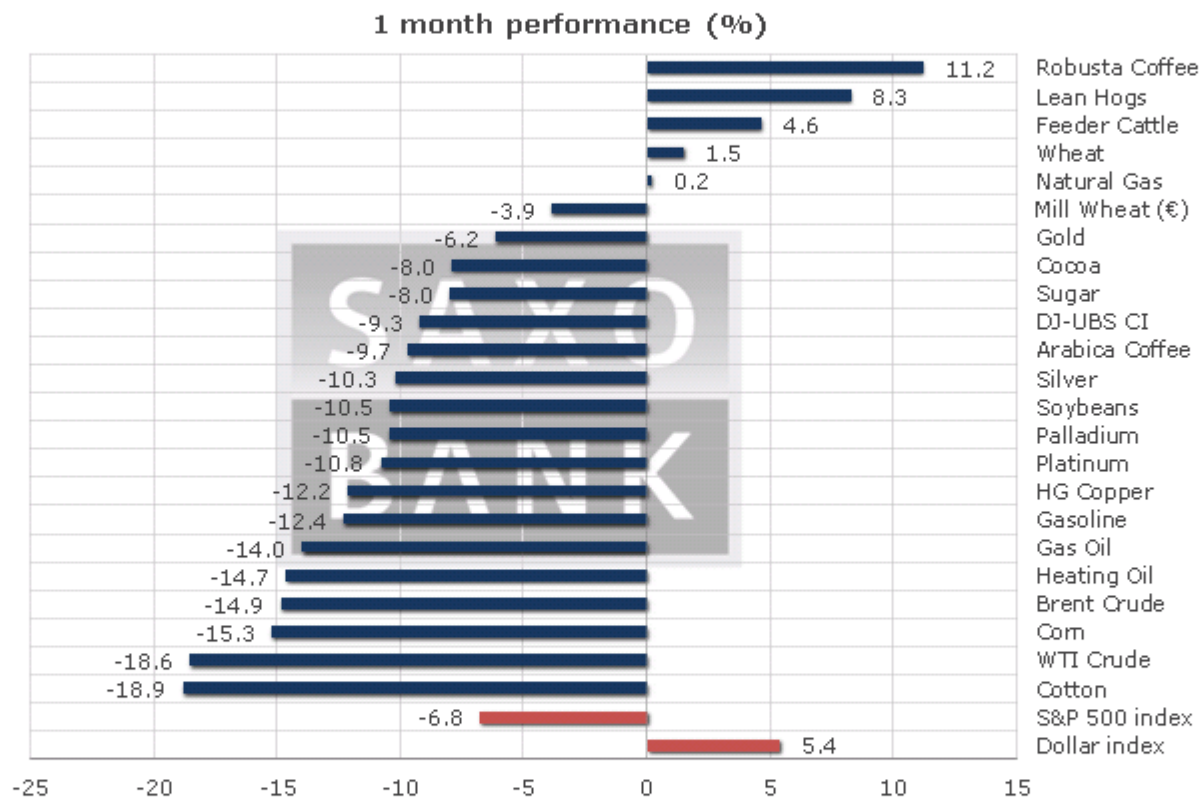


Source: Bloomberg and Saxo Bank

Precious metals put in the best relative performance, somewhat indicating that the safe-haven attraction of gold is not completely gone. Considering the strong move in the dollar, gold's losses were limited and it even recorded a small gain measured in Euros. It never the less continues to struggle to rekindle its attraction among leveraged investors such as hedge funds.

The energy sector, led by WTI crude, was the hardest hit, as focus increasingly switched from geo-political risks to a slowdown in demand. The bursting of the speculative bubble in both Brent and WTI crude also played an important role in explaining the dramatic move lower. The agriculture sector was also exposed to elevated levels of volatility with gains in livestock and wheat more than offset by major losses in cotton, corn and soybeans, mostly due to good weather prospects and speculative investors reducing their long exposure.

Industrial metals also took a tumble, as the slowdown in China has triggered some speculation about where the future demand is going to come from. Tin was the hardest hit while copper, falling by 11.5 percent, recorded its second worst month since the 2008 recession.



Source: Bloomberg and Saxo Bank Stategy and Research

**Gold outshines the other metals**

Following the initial move lower in early May, gold has spent the last few weeks trading in a relatively small but choppy range. Investors have been finding it difficult to work out whether it's a risky or a safe haven asset and have chosen to play the range instead. As mentioned earlier, precious metals and especially gold has performed relatively well despite the rising dollar which have put many commodities under pressure. Hedge funds and other leveraged investors currently hold the smallest net long positions since the 2008 recession, and have so far failed to engage as the momentum for now has been lost.

Investors in gold ETP's pulled 17 tonnes or less than one percent of total investments during May, which signals a deeper correction, are required before they change their long term bullish views on gold. One concern has been the lack of physical buyers who stepped in and helped stabilize the market during previous sell-offs. This softness in demand is led by China and especially India, the world's largest consumer, with the rupee trading at record low levels with the economy experiencing the worst performance in almost a decade.

A break below the previous low at 1,520 carries the risk of another 100 dollars to the downside leaving potential longer term buyers more content to wait to engage until after we see a move back above 1,610.

Source: Bloomberg and Saxo Bank Strategy & Research

Both silver and platinum have found it tough going, with platinum's discount to gold rising to 11.5 percent following the move back below 1,400 dollars per ounce. The fundamental outlook for platinum looks supportive with supply disruptions at a time where demand from the auto industry is holding up. Silver is marred by an increased production surplus and demand from financial investors is required in order to avoid this surplus from rising further. Fundamentals, however, do not play a major role right now while the risk-off sentiment controls most investment decisions.

Copper is now showing a negative return on the year and with China and Europe combined accounting for almost 60 percent of global copper consumption, the recent news from these two regions continues to have an adverse impact on the near-term outlook. Diminishing supplies and low stock levels outside China however should help cushion the fall despite hedge funds and other leveraged accounts having accumulated the largest net short position in almost three years.

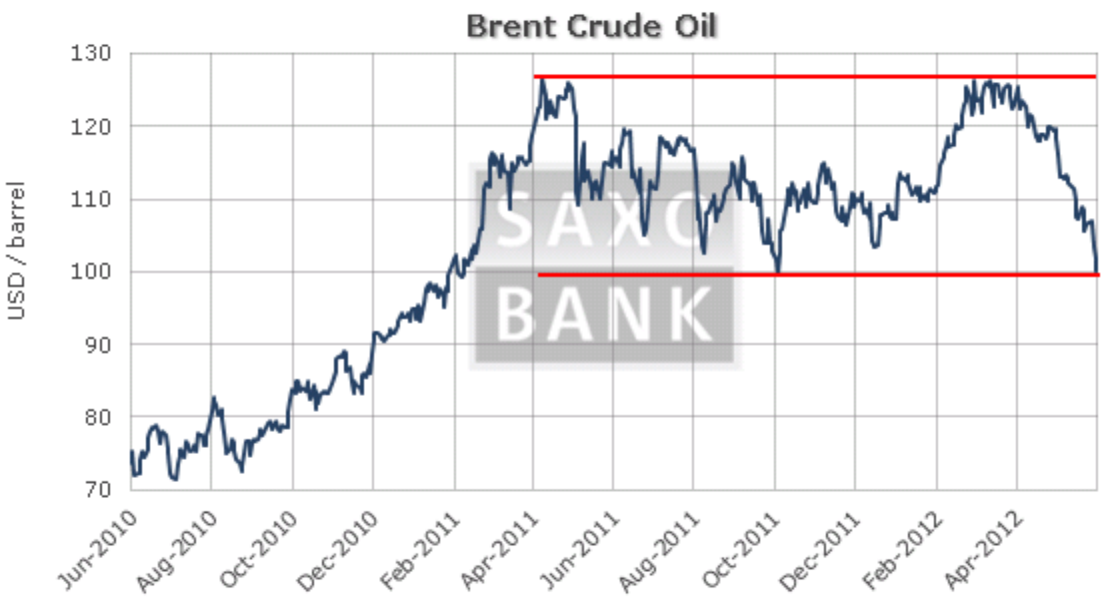
**Crude oil in a technical bear market**

The month of May, just like last year, has turned out to be a horrible month for oil investors. The price of both WTI and Brent crude has collapsed due to a dramatic shift in focus away from fear of geo-political motivated price spikes towards slowing demand. Both crude varieties have now fallen by more than 20 percent which is the technical description for when a market moves into a bear market.

A strong dollar, weaker fundamentals and the bursting of the speculative bubble have done the damage to prices and while it is bringing a lot of relief to consumers, some of the major producers, who requires high oil prices in order to balance their budgets, will soon begin to feel the pain and it could trigger a slowdown in supply in order to bring the price slump under control. Saudi Arabia have now for months been arguing that 100 dollar crude would be a reasonable price for both sides and now that it has been reached additional comments will be watched with interest as the record production from Saudi Arabia during the last few months have helped support the current softness in prices.

Speculative investors have once again felt the pain of a trade going badly wrong, as they have scrambled to reduce their net long positions in WTI and Brent crude from a record 500 million barrels back in March. As of May 22 this position was still some 326 million barrels and further dramatic reductions would have taken place up until today. In comparison a similar sell-off from March to October 2011 caused the net long positions to be halved.

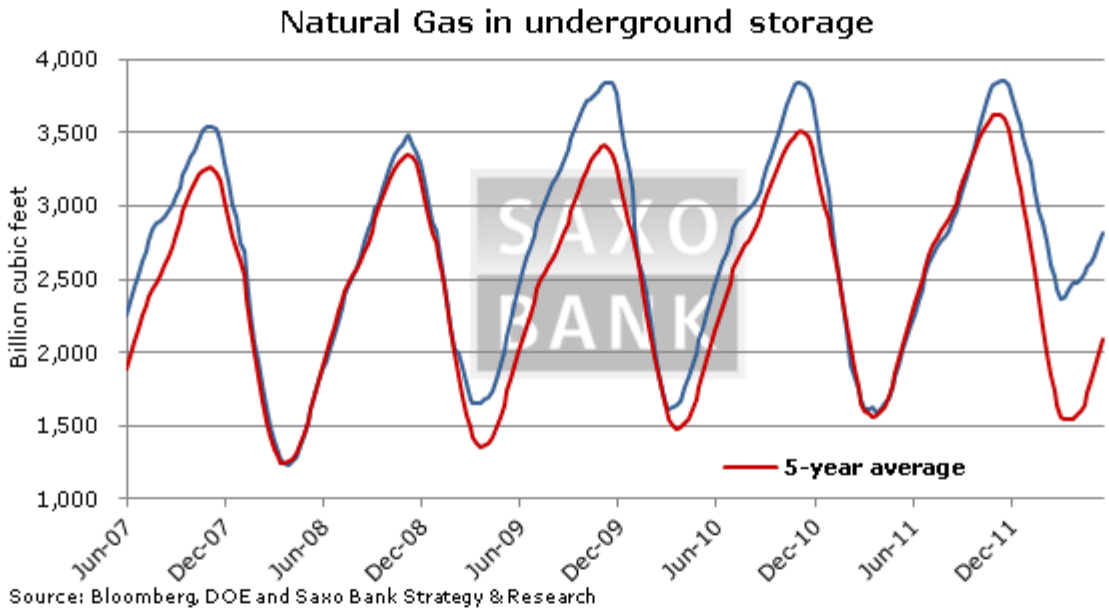
The chart below shows what an important level we have reached on Brent crude oil. Following the double top we now have to see whether a double bottom can be established. It is obviously clear to see that a sustained break below 100 dollar technically would indicate a move much lower.



Source: Bloomberg and Saxo Bank Strategy & Research

**Low natural gas prices the cure**

During the early parts of May, natural gas rallied strongly on signs that lower prices had finally begun to impact production levels and consumption was picking up due to US power generators switching from coal to gas. But as the price approached 3 dollars per MMBtu the advantage of gas over coal began to diminish, triggering a slowdown in the switching. It is believed that a price no higher than 2.5 dollars is required during the rest of the injection season up until October in order to insure the market becoming better balanced. The chart below shows how much current levels of gas inventories in underground storages across the US are above the five year average. So for now the main cure for low prices seems to be another few months with low prices.



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