

Does Oil “Glitter”?

by Ghene Faulcon

A couple of years ago, we wrote about an oft-reported connection between the Australian Dollar and the price of gold.¹ Our conclusion at the end was that, while there did appear to be a connection between the Australian Dollar exchange rate vs. US Dollar and the price of gold from nine months ago in US Dollar terms, it was not particularly useful when trying to run an active management process.

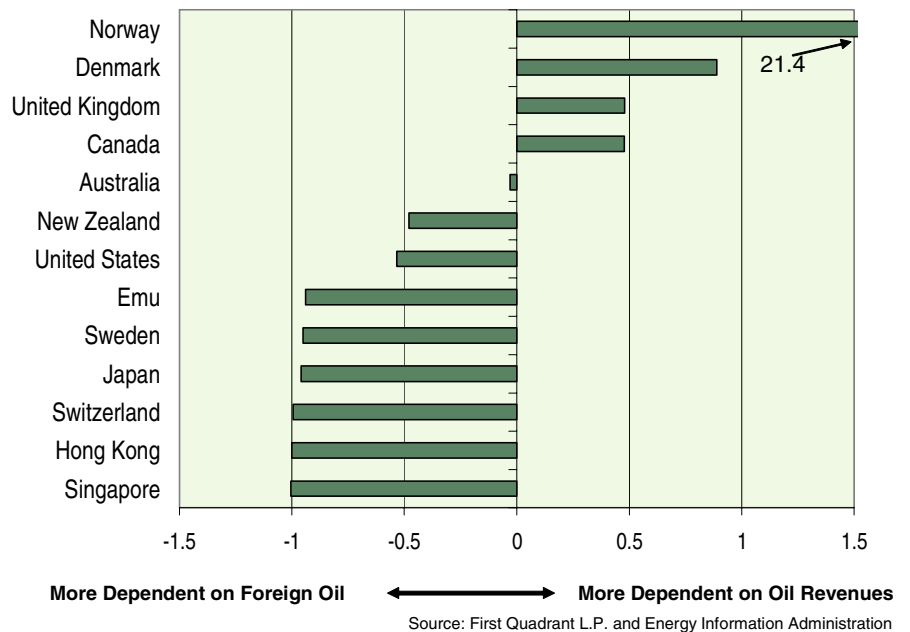
Today, we would like to look at another commodity that has often been in the news: oil. With oil price topping US\$70 per barrel in the last couple of months², discussions about the flow of “petrodollars” have increased, and the effect of the flow of those “dollars” on the various currencies may have increased as well.

There are several currencies associated with commodities and particularly oil. Of the developed markets that we follow, Canada, Australia and Norway have abundant resources and the US, Singapore, Hong Kong, and Japan are all heavily dependent on foreign sources of oil.

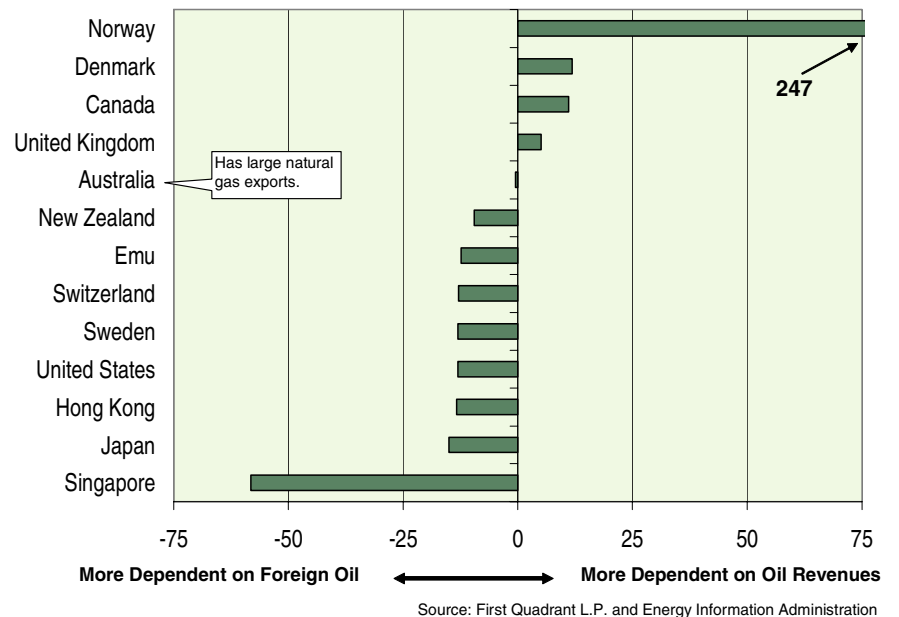
Our chosen time period includes a very strong movement in oil price and also considerable political uncertainty, war and recession. So to say the least, this will not be a work of exact science, but simply an investigation into general trends.

First we need to define what we mean by countries that are dependent on foreign oil or dependent upon oil as a source of revenue. We have two possible definitions. The first measures the Net Oil Exports as a fraction of Oil consumption and the second does so as a per capita measure. Both versions tell

Net Oil Exports/Total Consumption



Per Capita Total Net Exports (bbl/year/person)



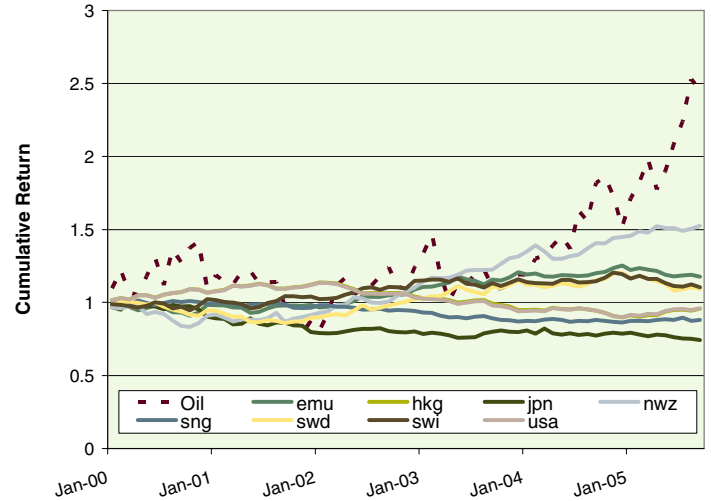
the same story – Norway, Denmark, Canada and the United Kingdom are producers, Australia is basically neutral and the rest are dependent upon foreign sources. One note: though Australia is neutral in terms of crude oil, it is a significant exporter of Natural Gas. As Natural Gas has seen a very similar run up in prices as that experienced by crude, we will put Australia in the same category as Norway and the other producer countries.

Individual Producer performance

For the producers, the results are exactly as we might have assumed if oil was a driver of those currencies. The petroleum producing countries have a flat to slightly down performance until the end of 2001. From this point forward, all of these currencies experience a significant return. Over the course of the same time, the oil price has behaved in exactly the same way, though significantly more volatile and with larger gains. The largest exporter, Norway, has had the greatest return among the exporters.

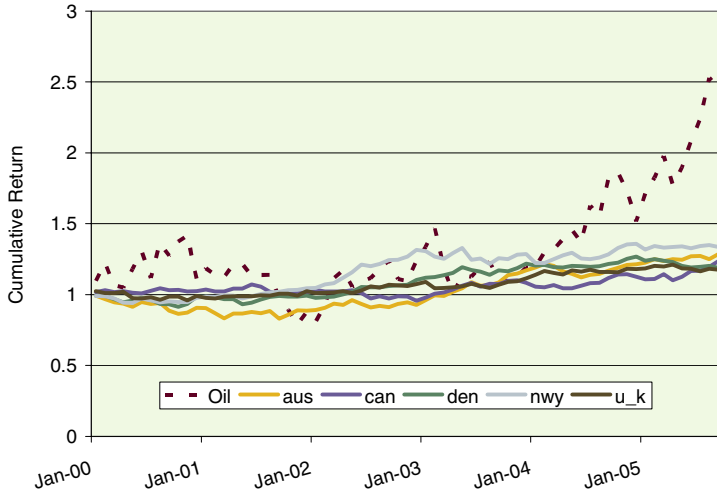
our experiment does not isolate oil price effects as well as we would like. Since there are other forces at work we cannot make strong conclusions on the individual countries.

Foreign Exchange Performance of Importers



Source: First Quadrant L.P. and WM/Reuters

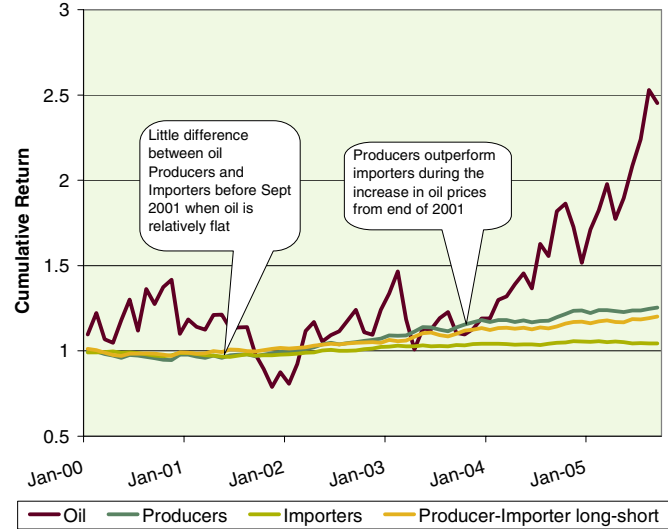
Foreign Exchange Performance of Producers



Source: First Quadrant L.P. and WM/Reuters

How have importers as a group done compared with exporters?

Foreign Exchange Performance of Producers and Importers



Source: First Quadrant L.P. and WM/Reuters

Individual Importer Performance

So have importers had the opposite fate? Not exactly. In fact, New Zealand has had the best performance of any country in our investment universe. Three other importing countries join it, proving to be profitable investments during the run up in oil. However, the US and Japan, the two largest countries by GDP, are down very significantly in the last 4 years. These mixed results only highlight that

The average oil importing nation has had positive performance over this time frame, but not nearly as good as the average producer. A portfolio that invests in the pro-

ducers and shorts the importers has fared well during the run-up in oil prices.

Out “Oiling” Oil...

Our strategy outperforms oil investing on a risk-adjusted basis for each of the 5 time periods that we have chosen. Just as oil, this strategy fared best in the most recent period and both fared worst over the 15-year period to today.

Performance of Different Investments (information ratio)

	Oil futures	Producers	Importers	Long-Short
19 years	0.25	0.654	0.314	0.563
15 years	0.154	0.418	0.225	0.36
10 years	0.448	0.679	0.133	0.73
5 years	0.43	1.593	0.837	1.442
Since Sept 2001	0.792	2.122	1.217	1.759

While not a perfect proxy for oil prices, that basket of currencies does seem to bear a strong resemblance, doing so with somewhat lower volatility.

From an active management viewpoint, however, we would need a forecast of changes to future oil prices to use such information to earn alpha. And while we do think we understand enough about currencies to manage them actively, we’re not sure we’d suggest we can predict oil prices with any certainty!

We will leave you with one passive thought, however: perhaps, if we want to invest in oil, we should do so via currencies?

Returns and Expectations

During September, the Bank of Canada joined the US Fed in raising rates. The Fed’s increase of 25bp came as a result of inflation worries. This was despite the economic impact of the two hurricanes that struck the Gulf Coast. Canada also increased its rate by 25bp. No other central bank activity occurred during the month.

Canada’s policy change resulted in a 16bp increase in cash yields but the US Fed’s rate increase resulted in only a 3bp increase in US cash yields. Hong Kong’s 44bp increase once again was the biggest increase in cash yield. Singapore (31bp), Norway (21bp) and New Zealand (18bp) were the other countries with large increases in their short rates. Cash yields increased in the remainder of the countries that we follow, but were all small changes.

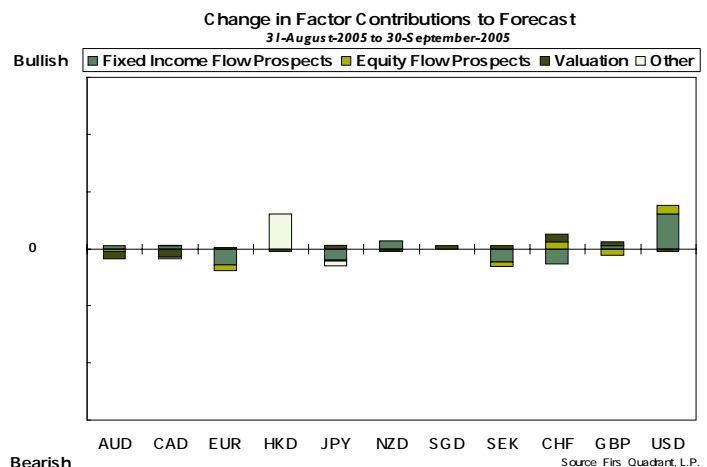
Bond yields reversed direction from last month, and

like cash yields, increased in every market that we follow. The biggest moves were in Australia (32bp), the USA (25bp), New Zealand (24bp) and Canada (19bp).

Japan continued its bull equity market up 12%. Sweden (6.2%), Switzerland (5.9%), and Australia (5.1%) all posted strong gains for the month. Continuing the theme of increases all around the world, the remainder of the countries also had stock market gains with the US lagging behind with only a 0.7% increase.

The currency markets continued to be as active this month as they were last month with the best performing currency outperforming the worst performing currency by 4.8% and the average currency moving by 1.3%

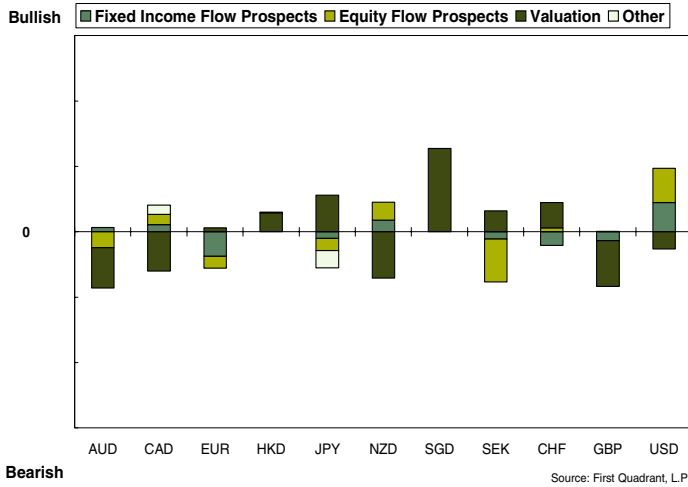
Once again, interest rate changes had the most impact on the model. This resulted restoring the US Dollar bull position from the summer and neutralizing the previous bullish position on the Yen. Rate changes also contributed significantly to the short Euro position and moderately to the short Swedish Krona position.



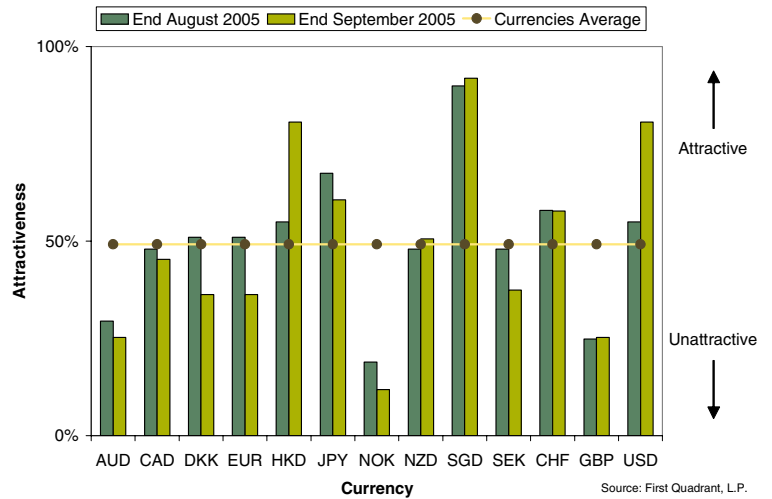
After months of leading the pack, the British Pound has been caught by the New Zealand dollar and they both share the distinction of being most overvalued currencies of our trading basket while the Australian and Canadian Dollars follow close behind. Once again, the Japanese Yen is the most undervalued currency with the Swiss Franc and the Swedish Krona and close behind.

September was a month of mixed, but overall down results as nearly every currency made a contribution to the result. Our biggest difficulty was with our Australian and Canadian short positions, but the long positions in Japan and Switzerland provided a little drag the portfolio as well. Our best returns came from the US dollar bull position and the British pound and Euro short positions.

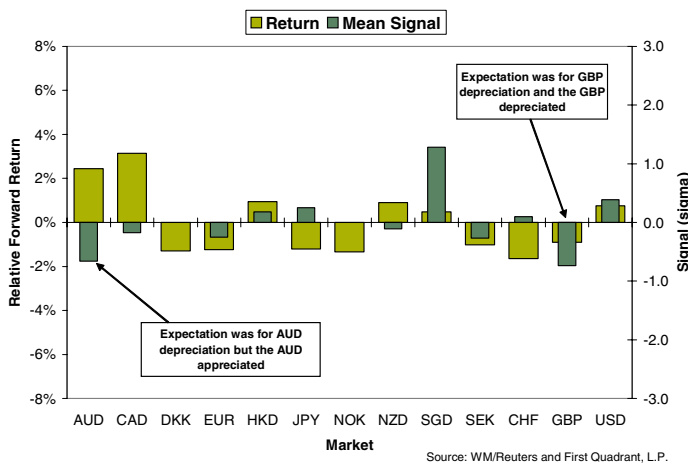
Factor Contributions to Forecast
30-September-2005



First Quadrant Currency Attractiveness



Currency Returns and Expectations
September 2005



We have broken away from our neutral position in most currencies. We are significantly more bullish for the US dollar as a result of the interest rate changes during the month. The flip side of that coin is that we are a bit more bearish in nearly all other currencies.

(Endnotes)

- ¹ "Does the AUD 'glitter'?", First Quadrant FX Monitor, May 2003.
- ² Though it has fallen recently to just under US\$60 per barrel.

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