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Fear returns to drive the global oil market

Egypt crisis shows risks for world's fuel supply

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If any further evidence was required that we are back in a bull oil market, then Egypt has done the trick. Benchmark prices this week passed US$100 a barrel for the first time in more than two years on the back of political turmoil in Cairo. Egypt is a crucial transit route for Middle Eastern oil to global markets via the Suez Canal, and home to the Sumed pipeline linking the Red Sea to the Mediterranean

If either of these routes were to close, oil tankers would need to divert 10,000 kilometres around Africa. If both close, more than 2 million barrels of oil a day - about 2.5 per cent of global supplies - would be offline.

It is well known that speculation plays a hand in oil prices, and that most commodity prices have been driven up of late, but the critical point is that geopolitical factors will be back with a vengeance in a US$100-per-barrel world. So buckle up, we're in for a bumpy ride.

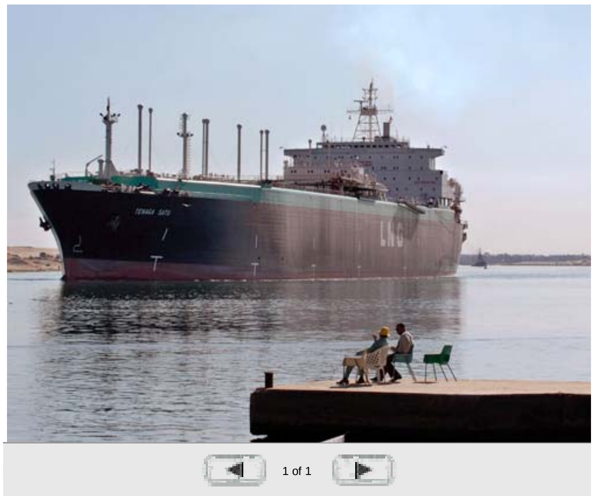
In 2008, such factors ranged from the assassination of Benazir Bhutto in Pakistan in late 2007 to a warning from failed US presidential candidate Hillary Clinton to Iran over its nuclear programme. Investors paid more heed to these than to fundamentals.

That was until the financial crisis hit. After the collapse of Lehman Brothers in 2008, when nobody wanted to be the next "nightmare on Wall Street", positions were rapidly unwound to realise capital gains and release liquidity. And although prices slumped to as low as US$33 a barrel in early 2009, the market still had enough geopolitical ammunition to lift them back up if it wished.

The fact that the market is starting to resemble the geopolitical situation before July 2008 will be of interest - and concern - for those in the oil game. Markets are inherently fickle about pricing geopolitical risk, and never more so than when fundamentals are tightening.

How fickle are we talking? Surely if geopolitical risk has returned, then the market has priced it in - after all, isn't that what markets do? Well, no actually. They are extraordinarily bad at assessing political risk, and the Egypt crisis is no exception.

No sooner had the barricades been broken in Cairo than talk of "political contagion" in the Middle East broke out across the trading floors of London and New York. Ben Ali had just fallen, when suddenly Mubarak was on borrowed time. Iran is still simmering from post-election protests in 2009, and any one of the decrepit monarchical regimes in the Gulf could be next. Saudi Arabia, Kuwait, the United Arab Emirates and even Qatar are all on the list, as are Algeria and Morocco.



A tanker sails through the Suez Canal. Oil prices will become more volatile if unrest spreads beyond Egypt.

Photo: Bloomberg

While these states no doubt share similar structural flaws and deep political fault lines, it's even truer they all have solid track records of containing social unrest through political repression rather than addressing the underlying sources.

But if the market is already nervous about small players like Tunisia and Egypt, then where will it head if Iraq takes another turn for the worse, or if Venezuela, Bolivia or Ecuador expropriate their oil? Further unrest in Central Asia, or reduced production in Russia, could be a problem.

Iran is an even bigger challenge. Tehran can be expected to keep nudging towards nuclear capabilities for political gain; it's far less certain that it will actually acquire nuclear weapons. Yet the dangers of conflating this with apocalyptic scenarios for the Middle East are all too real, either for regional players or trigger-happy Republicans in Washington.

Closing the Strait of Hormuz would cut off about 20 per cent of global supplies. And that's before we even get onto discussion about the inherent risks associated with China's so-called string-of-pearls policy to contain its Asian rivals.

In the global oil market, the perception of political risk can be just as potent, if not more so, than the real risks it faces. If the Egypt crisis is anything to go by, then geopolitical factors have not been properly priced in.

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