Market reaction to the IEA stock release:
Perception management

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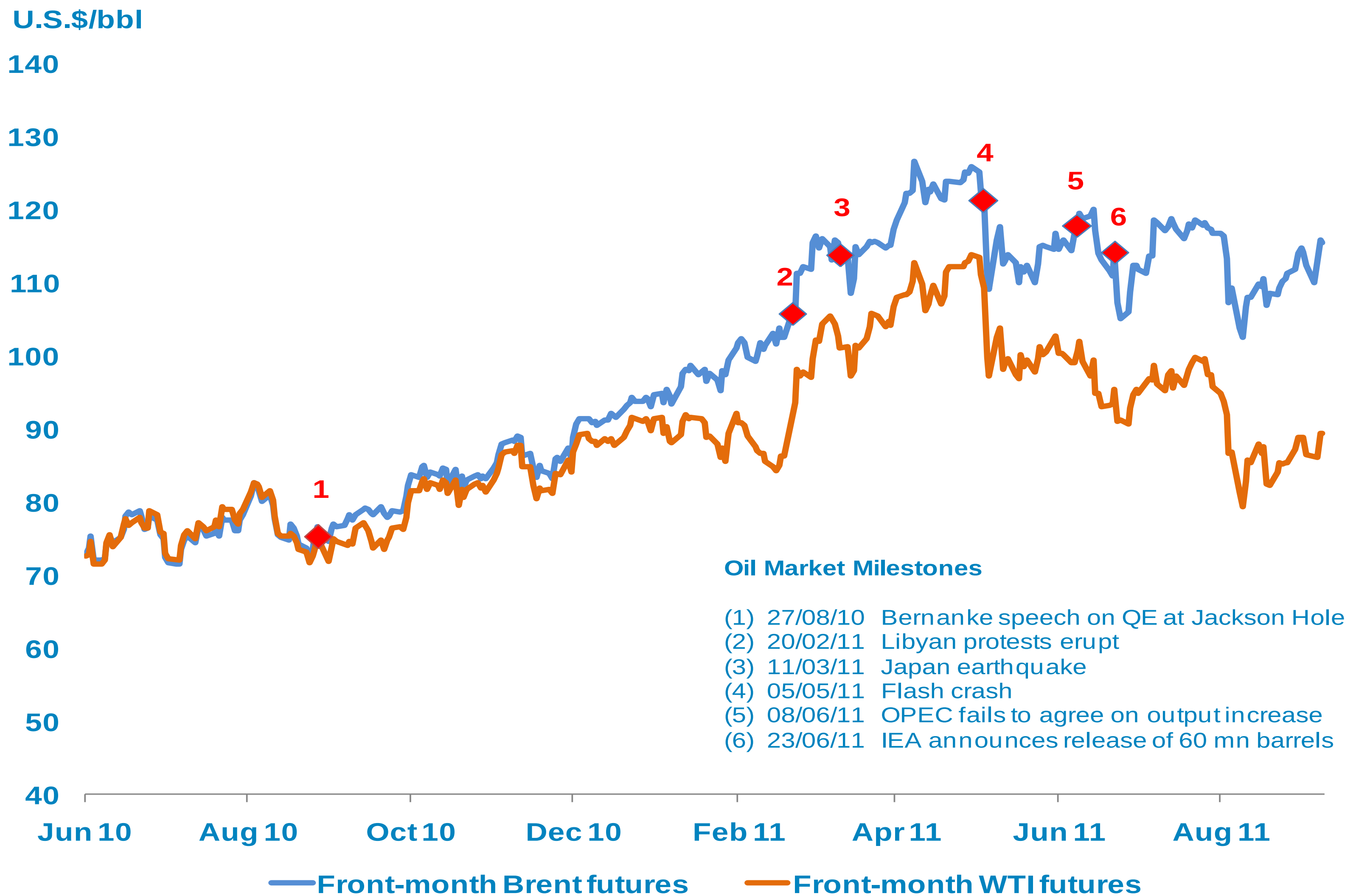
IEA stock release one of several big shocks to hit market in 2010-11

Six specific milestones, plus a lot of general macro and financial turbulence

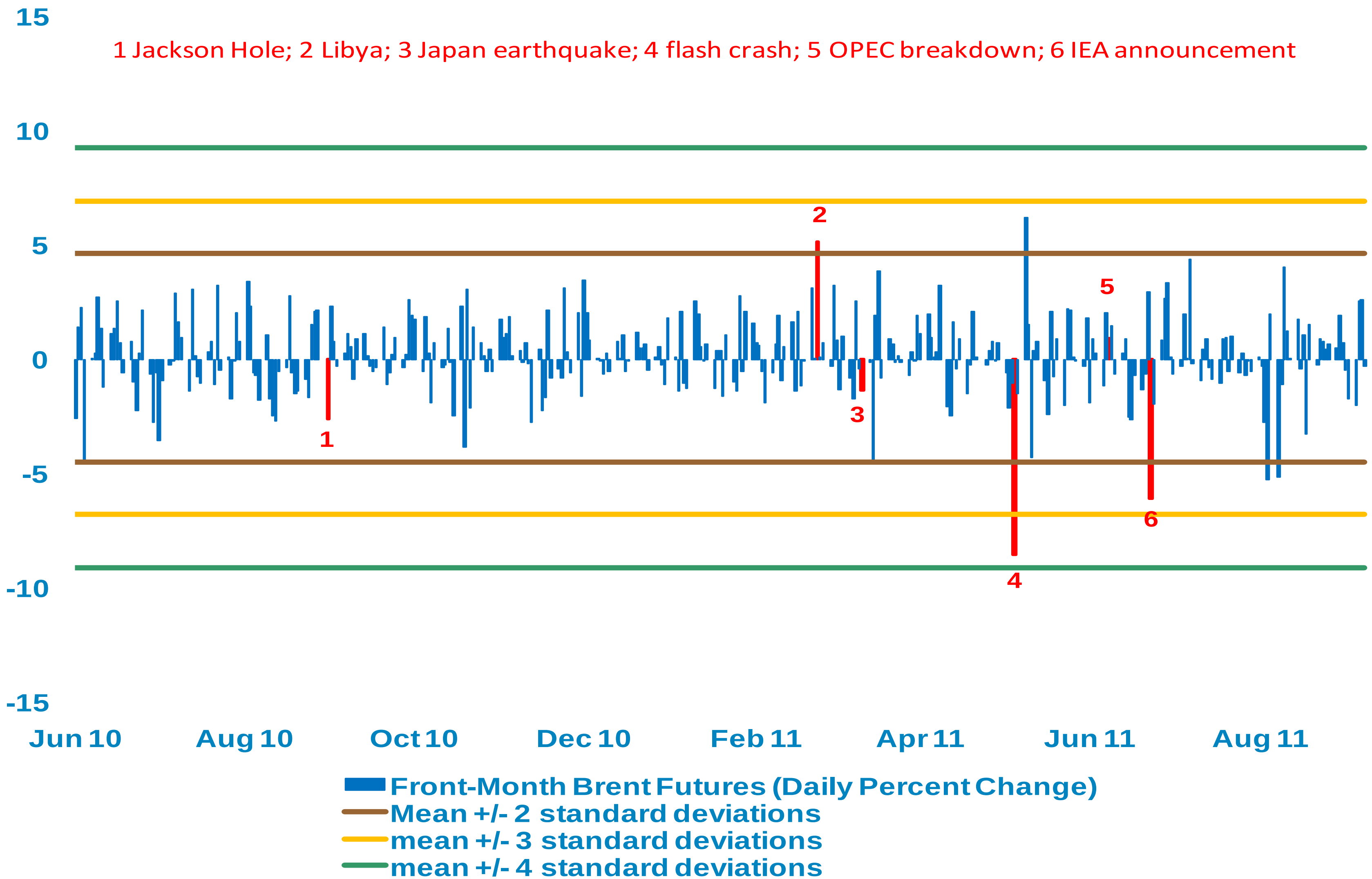
28 Aug 2010	Fed Chairman Bernanke trails QE2 in speech at Jackson Hole
20 Feb 2011	Libya unrest erupts, news reports highlight risk to supply
11 Mar 2011	Japan earthquake causes massive disruption, disables nukes
05 May 2011	Flash crash hits oil and spreads to other commodities
08 Jun 2011	OPEC meet breaks up without agreement on oil production
23 Jun 2011	IEA announces release of 60 m bbl from reserves

IEA stock release one of several shocks to hit the market in 2010-11

Announcement depresses spot Brent, but only temporarily

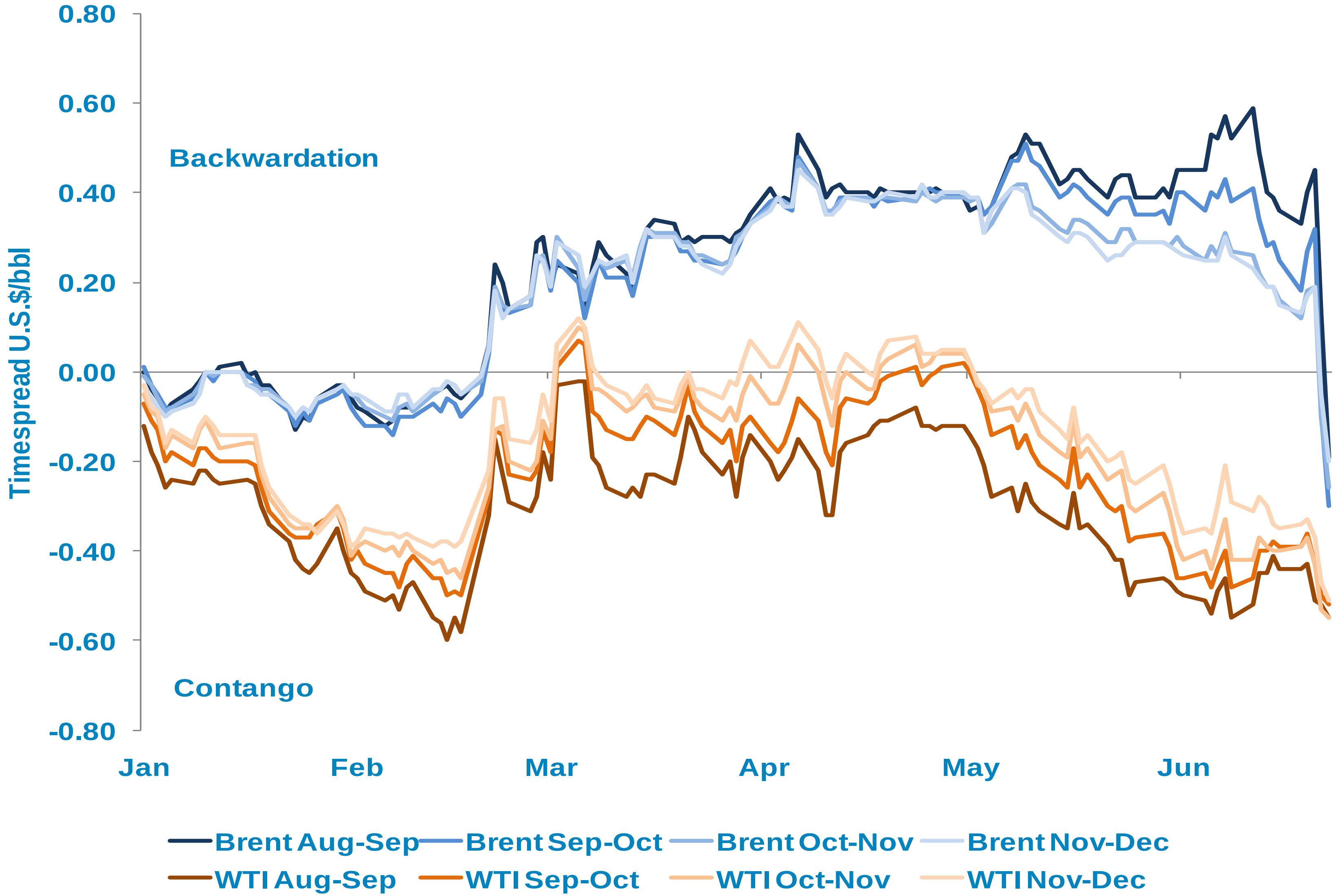


Spot Brent prices fall almost $7 a barrel on day of the announcement
Fall was significant, 6% or 2.65 standard deviations, but hardly an earthquake



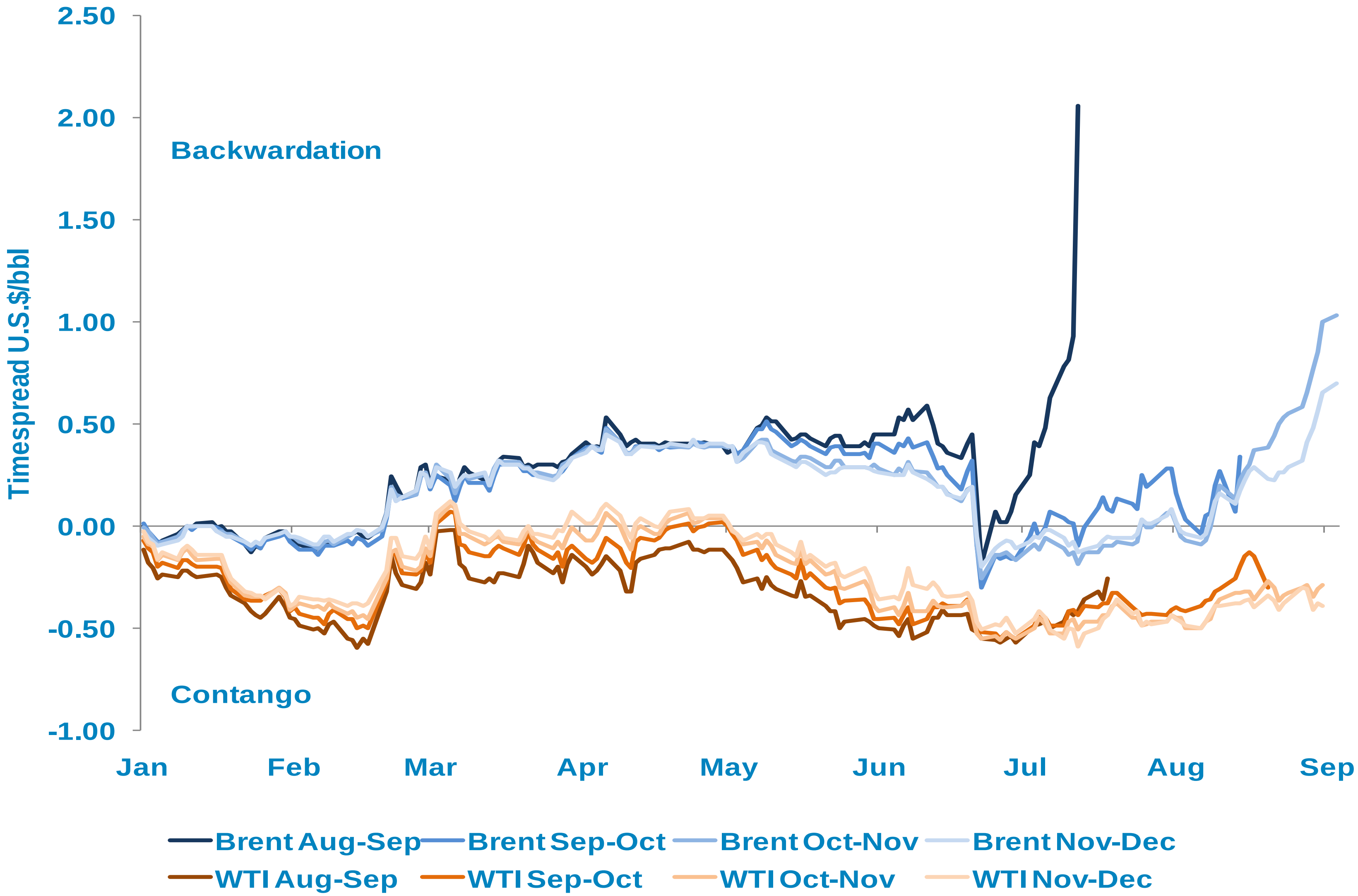
Announcement immediately relieves prospective Q3-Q4 tightness

Crushes timespreads in Brent and brings them nearer alignment with WTI



But the relief offered by the stock release is short-lived

Brent timespreads show renewed tightness from August onwards



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Putting the 60m bbl into context
What is the relevant comparison?

1.3m barrels/day of Libyan oil exports
release replaces 46 days worth

0.9m barrels/day of BFOE deliverable against Brent contract in Aug
equivalent to 67 days production

90m barrels/day world oil demand
less than 1 day of consumption

980m barrels of commercial crude oil stocks across OECD
boosts commercial stocks 6 percent

2,677m barrels combined crude and products in OECD commercial storage
boosts combined stocks 2 percent

1,560m barrels of government-controlled stocks held by IEA members
equivalent to less than 4 percent

Whether 60m was enough is a matter of perspective

Remember many market participants are instinctively hostile to government intervention and believe it is both wrong in principle and doomed to failure

YES it was enough ("carefully targeted to meet limited objectives")

- Significant amount in terms of expected market gap over late summer and early autumn
- No risk government oil stocks would be depleted

NO it could never be sufficient ("drop in the ocean")

- Not enough to make a difference for more than a few months. Forward-looking markets react to expected balances 9-18 months ahead; stock release could not influence the market over this timeframe
- Market scepticism about using a stock (inventories) to influence a flow (supply-demand). Comparisons with the poor track record of central bank intervention in fx markets. Fear repeated intervention would threaten to exhaust the stock and eventually be abandoned
- Questions about if / when stocks would be replaced. More oil now might mean less in a few months time as inventories are rebuilt

Perceptions are often more important than fundamentals
Rational expectations (REE) versus differences of opinion (DOE)

Efficient markets / rational expectations view assumes informed market participants react in the same way to data

- Short-term volatility due to uninformed "noise" traders and limits on liquidity
- Market professionals ("insiders") have more private information and are better at interpreting public data than outsiders (including small-time speculators)
- In short time, market will settle at unique equilibrium anchored in supply-demand-stocks-capacity fundamentals as understood by insiders

Behavioural finance accepts participants reach differing conclusions about how to interpret even commonly available information; there may be no "consensus"

- Participants try to guess how others will interpret data (Keynes' beauty contest)
- Herding behaviour, volatility and bubbles

Under differences of opinion, controlling perceptions and the dominant market narrative are crucial and often matter more than the "fundamentals" themselves

IEA did not succeed in controlling how release was interpreted
Where could IEA have done better?

Confusion about the IEA's objectives

- Capping prices?
- Relieving temporary shortage?
- How to measure success? Spot prices? Backwardation?

Confusion about exactly what would be released and where

- Geographical distribution?
- Crude versus products split?

Confusion about pricing

- Public auction?
- Pricing terms?

Confusion about if and when emergency stocks would be replenished

- Would governments try to replenish stocks from the market in a few months?

Confusion about details

- Jones Act – blanket waiver / discretionary waiver / no waiver

Market participants and media are hungry for information and want it NOW

Lesson 1: Traders / journalists work in real-time, under pressure to reach quick and perhaps superficial judgments about success / failure / likely impact

IEA needed to have the *details worked out in advance* and be ready to supply them in minutes and hours in response to questions from journalists -- not days and weeks later

Lesson 2: Commodity markets are among the freest, least regulated in the world. Many participants are instinctively and viscerally hostile to “government meddling”

IEA needed to convey a clear and *convincing narrative* about why intervention was justified at this particular time to counter the inevitable criticism and be ready to pushback against its critics

Lesson 3: Given likely scepticism, IEA needed to ensure the release went exceptionally smoothly to give a convincing *appearance of being “in control”*

Lesson 4: Perceptions are everything. It is not how much stock is released, what type or where, that matters, but whether stockholders can *create a dominant narrative* that determines likely success

Release appears to have calmed market, preventing damaging spike
But it could have been handled better and been even more effective

How to measure success?

Comparison of prices and time spreads before and after the announcement is not valid

What matters is counterfactual – what would have happened without the release

Sustained tightening of Brent spreads shows market expected severe pressure in August as a result of N.Sea maintenance, that would spilled over into Sep, Oct and Nov

Market stood on brink of damaging price spike that would have had serious consequences for global economy

Stock release probably averted a far worse economic slowdown

But if the announcement had been handled more smoothly it might have been more effective shaping perceptions and had an even bigger impact

Other views about the effectiveness of the stock release

"The recent IEA release completely changed the psychology of the oil market. The move worked, as it has in the past, because speculators now have to worry that extra oil may come if prices reach a certain level" Amy Jaffe, Baker Institute at Rice University, Houston.

"It's pretty clear that things would have been worse without the releases. The supplies freed up oil that would have moved to the United States Northeast, instead sending it to Europe or Asia" according to Ed Morse, head of commodities research at Citigroup.

"The SPR releases did help since prices could have been even worse without additional supplies" according to Olivier Jakob of Petromatrix in Geneva.

All cited in "Oil releases a gamechanger, despite price bounce" 16 September 2011, by Reuters reporter Joshua Schneyer in New York

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