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Uranium and Oil Don't Mix

Over the years we have written covers that compare the situation in uranium to that of oil. In most cases, this has been because developments in oil have been enlightening for uranium, as oil and uranium are both energy commodities, and both have been afflicted by the same problems. For instance, in 2000, we noted that there was a similarity between uranium and oil in that both markets were characterized by an illusion of a glut in supply. At the time, oil prices were rising rapidly when it was beginning to be realized that the glut was not real, and we raised the question "Will Uranium Follow Oil?" (The Ux Weekly, May 1, 2000, p. 1)

At the time, we pointed out an important difference between oil and uranium, in that uranium cycles were longer than those in oil and consequently the same problems that affected both uranium and oil would take longer to show up in uranium. This was indeed the case, as uranium prices continued to languish for some time (see chart below). This changed when the uranium market recovered in 2004. At this time, we wrote an editorial commenting how the uranium market had indeed followed the oil market, as market participants were beginning to realize that the apparent uranium glut was not real, and uranium prices began to make a strong recovery ("Lessons from the Oil Market Come Home to Roost," The Ux Weekly, August 9, 2004, p. 1)

Here again, we noted important differences between uranium and oil relating to the length of their respective price cycles and concluded with the following statement:

"Not only is the price cycle in uranium likely to last longer than the one in oil, but it has the potential to be much more severe. Uranium is the antithesis of a just-in-time industry, as long leadtimes are necessary to discover deposits and place them into production. Also, in the case of oil, rising prices eventually result in an economic slowdown that, in turn, reduces the demand for oil and causes price to cool off. In uranium, demand is much more inelastic, although consumers will cut back on consumption by reducing tails assays in enrichment contracts, however there are limits to this type of activity."

The point here was that both supply and demand are more inelastic in uranium than oil, a fact that has become more evident over the past year, as oil and uranium prices have followed different courses, with oil prices retreating, but uranium prices continuing to head steadily upward.

This declining trend in oil was highlighted in a recent article in The Wall Street Journal entitled "High Prices Prod Developed World to Curb Oil Use" (January 19, 2007, p. 1). In this article, the WSJ cites some of the reasons that oil prices fell from over \$70 to \$50, including mild winter weather, heavy selling by financial funds, and reduced consumption by the developed world. (At the time of the WSJ article, the price of oil fell to \$50.48, and futures prices fell below \$50.)

It is important to note that none of these factors has affected the uranium market. The warm weather is not a consideration, financial funds have not engaged in heavy selling, and consumption has not fallen. On the supply side, the WSJ points out bio-fuel substitutes for oil have increased in response to the oil price rise, another difference with uranium. The last time we looked, nobody was growing any uranium.

It is interesting to examine the situation in oil because it highlights the factors that cause prices to fall in normal markets. As prices rise, demand falls as consumption behavior is modified - buyers seek substitutes for the good or service whose price is rising. At the same time, demand increases for the substitute products or services, and higher prices for the good or service in question causes a positive response in supply.

Factors such as these will some day cause the price of uranium to fall; the questions are when and by how much. One problem in uranium is that higher prices have little to no effect on consumption, since there are no real substitutes for uranium except for enrichment (which is also in short supply), and this means that market equilibrium (the point where price stabilizes) depends on increases in uranium as well as enrichment supply. The other problem is that uranium supply is not responding very quickly, as indicated by the fact that production declined last year. Consequently, uranium prices are still under upward pressure, pressure that will only be alleviated when supplies expand sufficiently.

From this perspective, oil and uranium prices have been heading in different directions, upsetting the perception held by some that oil and uranium prices are somehow linked. While oil and uranium may be substitutes over the long term (an effect that would be heavily discounted when considering to substitute one for the other), there is no ready near- to-medium-term substitute for

uranium (except enrichment), and thus the fall in the price of oil will have little to no effect on uranium consumption or prices. (In economic terms, there is essentially no cross-price elasticity between oil and uranium.)

In this regard, the positive correlation between the prices of uranium equities and oil prices has always been somewhat puzzling to us, except with respect to the fact that they are both commodities and are affected by the same macro forces that affect all commodities, such as a weak dollar. In contrast, an argument can be made that there should be an inverse relationship between oil and uranium prices, as low oil prices would cause economies to grow more quickly, and require more base-load electricity generation such as nuclear power, which would increase the demand for uranium.

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