

Sterling's

World Report

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High Oil Prices: How Worried Should Investors Be?

Just when it seemed safe to be back in the equity markets, unexpectedly high oil prices have raised fears of that old bogeyman from the 1970s, namely stagflation. Coupled with worries about recent terrorist attacks, such concerns delivered the first meaningful pullback in global equity markets since last spring, with the S&P 500

falling nearly 6% in March from its high early in the month. The market retraced some of that decline to finish with a modest gain for the quarter, but the point has been made – oil prices still matter.

With crude oil prices recently trading at \$38 US per barrel, the price of oil has approached levels seen during oil shocks of the past, including the early 1970s, the early 1980s and the early 1990s (See Chart 1). So, at first blush, investors' concerns about yet another oil shock are understandable.

Conspiracy theorists have had a field day, claiming that OPEC, led by the Saudis, has cut back on oil production to punish George W. Bush for meddling in the Middle East. Other analysts point to the boom in China and other emerging markets as the force behind rising demand for resources across the board. Still others are pointing to the rise in oil prices as evidence that a long-awaited peak in global oil production has arrived, with shocking increases in oil prices lurking around the corner.

Hitting the Peak

Those latter fears have been around for quite a long time. As we wrote in *Boomernomics* in 1998, oil geologists Colin Campbell and Jean Haherrere were predicting that “the world could see radical increases in oil prices” during the

first two decades of the 21st century unless alternatives to crude oil quickly prove themselves. After many years of false alarms, such warnings have tended to fall on deaf ears. However, with the surprising rise in oil prices this year, fears that the world is truly beginning to run out of oil are being taken seriously again.

Proponents of the “peak oil” theory have multiplied in the last few years and have published a number of books with ominous titles. Here is a sample of some recent books: *Hubbert's Peak: The Impending World Oil Shortage*, by Kenneth Deffeyes; *Out of Gas, The End of the Age of Oil*, by David Goodstein; *The Party's Over: Oil, War and the Fate of Industrial Societies*, by Richard Heinberg; and *Resource Wars: The New Landscape of Global Conflict*, by Michael Klare.

The credentials of some of the authors are impressive. A Princeton University geophysicist wrote the first book, while a professor of physics at Caltech wrote the second. It is safe to say that such authors know a lot more about energy than most of us mere mortals. That said, even esteemed academic researchers sometimes make very bad forecasts, especially about the future. The 1970s scare classic, *The Limits to Growth*, predicted widespread resources shortages by the end of the 20th century. The book, by researchers at the Massachusetts Institute of Technology, was thankfully very wide of the mark.



Proponents of the “peak oil” theory warn of a permanent oil shortage, essentially beginning right now. In the next few years, they believe, the world’s productive capacity of oil will reach its geological limit and fall woefully behind growing demand. This group’s arguments owe much to the work of M. King Hubbert, an American geophysicist who correctly predicted in the 1950s that America’s oil production would peak by about 1970. Using similar models, a number of researchers now predict that global production will probably peak this decade and thereafter will decline forever.

These predictions lead to the unsettling scenarios of gasoline prices in the United States of \$6 to \$7 a gallon or higher later this decade, making today’s average price of \$1.76 seem like a real bargain. Not surprisingly, the consequences of such scenarios could be grim news for financial markets, as detailed in a recent book by investment strategist Stephen Leeb called *The Oil Factor: How to Protect Yourself and Profit from the Coming Energy Crisis*. The book is well written and contains a great deal of useful information about how energy prices affect financial markets.

We are not as confident as Mr. Leeb that higher oil prices would lead to higher inflation across the board, since much will depend on the response of monetary policy. But his more general points are hard to dispute: (1) Major energy price spikes have been associated with severe bear markets for stocks, and (2) Severe oil price shocks are bad news for oil importing economies because they have the economic impact of massive tax hikes without any of the compensating benefits. Leeb has developed an interesting rule of thumb about when investors need to take action to protect their portfolios against oil price spikes. We will discuss that later.

Crying Wolf?

The key issue, of course, is whether the “peak oil” theory is right.

Daniel Yergin, a well-known energy economist and Chairman of Cambridge Energy Research Associates, argues that the “peakists” have overstated the case for imminent oil shortages. He notes that the fear of running out of oil has always haunted the petroleum industry. Way back in the 1880s, for example, the head of the Standard Oil Trust began to sell his shares in

OIL SHOCK? - CRUDE PRICES APPROACH RECORD LEVEL

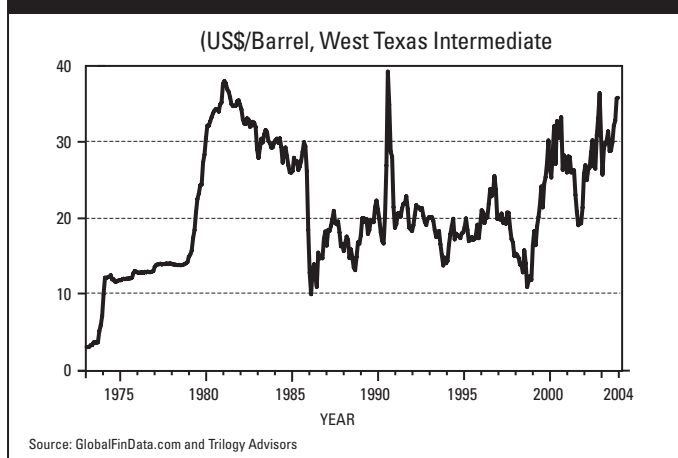


Chart 1: Oil prices in recent months have soared to near record levels, raising fears of inflation or even 1970s-style “stagflation” (stagnation plus inflation).

the company because oil engineers told him that America’s days as an oil producer were numbered. Oops.

Yergin notes that projections of imminent shortages have often failed because of two main factors. One is the opening (or reopening) of territories to exploration by companies faced with ongoing demand to replace existing reserves. The second is the impressive impact of new technologies for finding oil or getting it out of the ground more efficiently. An example of both factors working together was the development of deep offshore oil fields in the 1990s, which was inconceivable during the crisis years of the 1970s.

Pessimists point out that current reserves in the Middle East may have been overstated for political purposes by Persian Gulf countries. Optimists argue that market participants may still be underestimating reserves in Russia, the Caspian Sea and the deepwater Gulf of Mexico. Optimists also argue that the petroleum industry will continue to increase the percentage of oil that can be recovered from existing fields.

Few energy experts doubt that a peak in oil output will eventually be reached and that the world will need to develop new sources of energy. The debate is whether the shortage is imminent or whether it is more likely to be delayed much further into the future. Yergin argues that even if global oil demand increases by 20% over the next decade, led by demand from nations like China and India, that supplies will rise to meet that demand.



That said, even an optimist like Yergin assumes that there will be considerable investment needed in unconventional fuel sources, such as Canada's oil sands or the conversion of remote deposits of natural gas into usable liquids. Accordingly, even if the energy pessimists turn out to be crying wolf once again, it seems likely that energy will remain an extremely significant investment issue for many years to come.

When to Worry?

This lack of agreement among energy experts leaves the rest of us pretty much dependent on following the price of crude oil itself to decide whether there is a problem or not. And despite the near-hysterical bombast about oil and gasoline prices among some financial journalists and politicians, a bit of perspective is clearly in order.

Yes, the price of crude oil has recently traded close to record levels. However, if we look at the price of oil after adjusting for inflation, we are nowhere close to the peak prices recorded during other energy price spikes. For example, in the early 1980s, the price of oil rose to over \$80 per barrel when measured in today's dollars. Likewise, the price of oil rose to nearly \$55 per barrel in today's dollars ahead of the first Gulf War in 1990 (See Chart 2). Those were genuine oil price shocks.

Another important perspective on how oil prices affect the economy is to consider not just the level of prices, but also the rate of change. When prices rise gradually, consumers and businesses have time to adjust. By definition, there is no shock. But when prices rise abruptly, as they did during the 1973 oil embargo or before the first Gulf War, the huge and sudden drain on purchasing power in the oil consuming nations can indeed quickly trigger pronounced economic weakness.

Investment strategist Stephen Leeb put the rate of change concept to work by developing what he calls his "amazing oil indicator" for considering how oil prices affect the stock market. After looking at the historical data for the last 30 years, he developed a simple rule of thumb for using oil prices to trade the U.S. stock market. His indicator simply says to get out of stocks when the year-over-year rise in oil prices is 80% or higher. Get back into stocks whenever the year-over-year change falls to 20% or less.

Using that simple rule – and with the benefit of hindsight, of course – Leeb found that you would have avoided the bear market of 1973-1974, much of the turbulence of the early 1990s, the market crash of 1987, and even the first down leg of the recent bear market. While no indicator is perfect, as he is quick to emphasize, that is not a bad showing. He also shows that even though it meant that your time on the sidelines was less than four years out of 30, you would have multiplied your original capital by 70-fold since 1973 using the oil indicator, about twice as good as a buy-and-hold strategy.

What does Leeb's oil indicator say about the current situation? Relax. As we show in Chart 3, the year-over-year increase in oil prices has been only 16%, which is nowhere close to Leeb's danger zone of an 80% rate of change. Yes, oil prices are high and have been creeping up in recent months. But they were also relatively high for most of last year as well, so the shock effect – as measured by the year-over-year change – is limited. Based on the recent history of oil prices, it would take a quick move into the range of \$48 per barrel or higher in coming months for Leeb's oil indicator to produce a sell signal. Thankfully, that doesn't look likely for now.

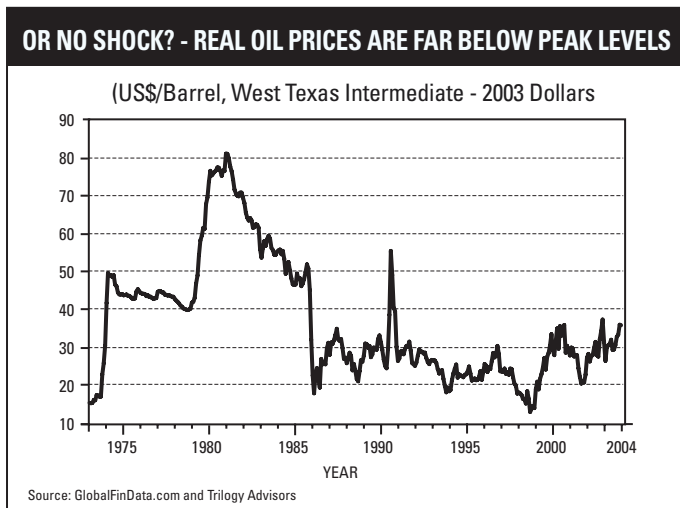


Chart 2: Recent oil price trends do not look nearly as shocking after adjusting for inflation. On a constant-dollar basis, oil prices reached more than \$80 per barrel in the early 1980s.



LEEB'S LAW

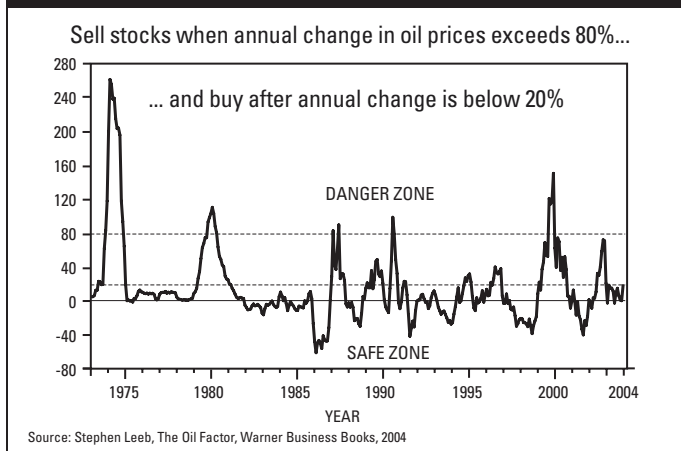


Chart 3: The annual rate of change of oil prices has historically been a very good stock market indicator. Fortunately, we are nowhere close to the “danger zone” of increases of 80% or more.

Why Oil Prices May Decline

If anything, we take some measure of comfort from the fact that OPEC is curtailing production because its members are actually worried about the potential for a price crash when the seasonal demand for oil slows this spring. Whatever the long-term outlook may be, oil inventories have been on the rise in recent months. There are also indications that the speculative demand for oil has skyrocketed among hedge funds that are unlikely to want to take delivery of large amounts of oil if prices start to soften.

Moreover, as has been widely reported, OPEC is correctly concerned about many of its members cheating by over-producing relative to their quotas. The reason is simply that prices are so high right now that the incentive to “make hay while the sun shines” may be too much for many OPEC members to resist. And that, of course, is how cartels break down.

Based on these observations, we think the next major move in oil prices this year is more likely to be down, toward \$30 a barrel, rather than up into the danger zone of \$48 or more. If we are correct, that should be seen as good news by global equity investors, who were clearly worried about the oil price trend in recent months.

Make no mistake – oil is critical to the world economy and world financial markets. For investment strategists, there are probably no more important variables to watch than the “big three,” namely the price of money (interest rates and yield curves), the price of credit (corporate bond and high yield bond rates), and the price of oil. Currently, the price of money and the price of credit are well behaved from the point of view of supporting further gains in equity markets. And trends in the price of oil have not been as alarming as some media commentary would suggest.

If, as we believe, the next major move in oil prices is down, 2004 should still be a very good year for stock market investors. As for the debate on whether we are facing an imminent global oil shortage, count us as highly interested agnostics. We are interested enough that we will add some version of Mr. Leeb’s oil indicator to our bag of tricks. And we think the issues raised by the oil pessimists are important enough that we will make sure our research team pays even more attention to energy issues in coming years.

Happy motoring!

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