



WILLIAM STERLING

STERLING'S WORLD REPORT



Oil Check: Are High Prices Here to Stay?

When oil prices approached \$40 US a barrel earlier this year, we ventured the opinion that while high oil prices were likely to put a crimp in global growth, they would *not* be the cause of a major recession and new bear market. We also looked at various ways to measure when an oil price increase was truly serious business for stock

markets – and suggested that an 80% year-on-year rise was one threshold worth watching.

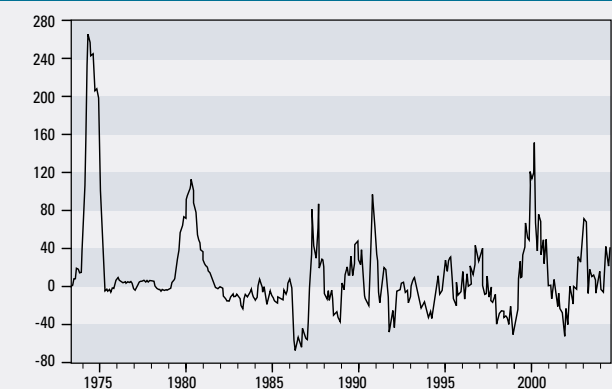
We also looked at inventories and supply trends and concluded that oil prices were well above what would be warranted by the inventory situation. Oil supply was more than matching oil demand and inventories had risen. Our conclusion was that speculative demand – from hedge funds and the like – was behind much of the rise in oil prices. That suggested that the next big move in prices was more likely to be down rather than up.

We obviously got that one wrong. Oil prices have continued to move up and topped \$50 a barrel in late September. As shown in Chart 1, the price of oil is now about 70% higher than a year ago, which is beginning to approach the “crisis” zone of an 80% annual increase that we talked about earlier this year. It is clearly time to reassess the situation.

Four Hurricanes and Nigerian Unrest

We stand by our work on oil inventories. To be sure, world demand for oil has been strong this year. According to the International Energy Agency, demand rose by 3.8% in the first half of the year, or more than double its historical

Crude Fact: Annual Oil Price Rise Reaches 70%



Source: Global Financial Data Trilogy Advisors

Chart 1: The recent rise in crude oil prices to around \$50 a barrel implies a year-on-year increase of about 70%. That is nowhere close to a record increase but is still a major event.

growth rate. However, supply growth has been even stronger, resulting in higher inventory levels. For example, crude oil inventories in the U.S. increased by 50 million barrels in the first eight months of the year. That is the second-largest inventory build in history. Overall oil inventories in the OECD nations rose by an impressive 83 million barrels in the first seven months of this year.

As shown in Chart 2, our barometer of speculative demand for oil shows the oil price about \$15 a barrel higher than



Watch Out Below: Oil Price Speculative Demand Barometer

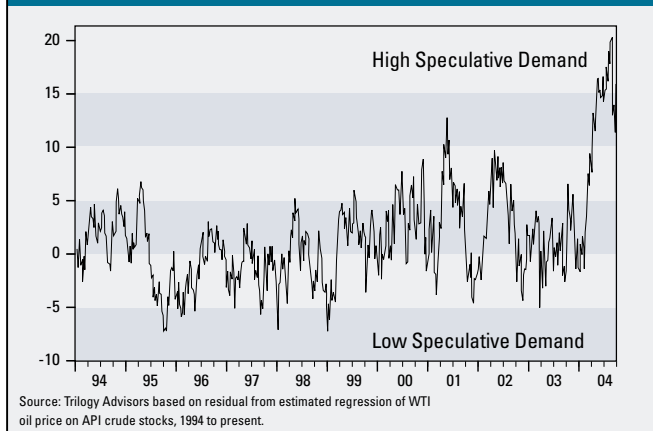


Chart 2: Our barometer of speculative demand for oil is still near record levels, with oil prices trading at nearly \$15 above the level that would typically be associated with current inventories.

would be normally justified by current inventory levels. In other words, based on historical relationships, one would expect oil prices of around \$35 a barrel given current levels of oil inventories. Instead, the price is close to \$50 a barrel. We believe the difference largely reflects speculation that has been fuelled by fears of supply disruptions stemming from terrorism and other negative shocks.

Recent headlines have been dominated by events that have triggered concern about oil supplies. A series of four nasty hurricanes walloped Florida and the Gulf of Mexico, reducing oil production in that area. Then, militants in Nigeria threatened to attack oil facilities in the world's seventh-largest producer. Murphy's Law – "What can go wrong, will go wrong" – seems to be alive and well in the oil business at the moment.

Interestingly, as Bear Stearns oil analyst Fred Lueffer recently pointed out, *virtually every major fear about oil supply outages has so far gone unrealized*. The direct impact of terrorism on the oil supply has been relatively muted. Saudi Arabia's oil output has increased by more than one million barrels per day

this year. Overall, OPEC has surprised analysts by boosting production by 1.7 million barrels per day this year. Russia's troubled oil giant Yukos has boosted production by 6% this year, despite the arrest of its former CEO. And even beleaguered Iraq has managed to produce an average of two million barrels per day this year, which is 78% higher than last year. Current production in Iraq has reportedly climbed to more than 2.5 million barrels per day.

Evidence is also mounting that high oil prices and softer economic growth are beginning to reduce the growth in demand for oil. According to U.S. data, oil demand through August was up only 1.7%, compared with growth of 2.9% in the second quarter. China is also seeing a marked slowdown in demand growth, with demand in August up 10%, or less than half the rate estimated for the first half.

Why Would Oil Prices Fall?

Mr. Leuffer's conclusion, which we find instructive, is that current supply and demand economics and current inventory levels (adjusted for the temporary effects of the recent hurricanes) justify oil prices in the range of \$25 to \$30 a barrel. As inventories rise, he expects the price of oil to decline to under \$25 a barrel. Three factors, in his view, are likely to put downward pressure on oil prices:

1. Rising inventories. In coming months, it appears that OPEC production will outstrip demand by more than 2.5 million barrels per day, which should reduce the fear premium that is currently in oil prices.
2. Reduced speculation. The absence of a supply shock itself would reduce the speculative demand for oil. In that sense, no news is bad news for oil prices, which have depended on a series of unusual events to fuel speculative demand.



3. Liquidation of speculative contracts. The current high degree of speculation in oil markets suggests that any price weakness will feed on itself. Speculative traders tend to be driven by price momentum. Thus any break in the oil price should trigger liquidation of large speculative contracts. That, in turn, should lead to even lower prices.

To a surprisingly large degree, the effective owners of a large amount of current oil supply are apparently hedge funds based in pleasant places like Greenwich, Connecticut. Collectively, they are almost certainly not planning to open gas stations or refineries and must be hoping to sell their oil contracts at higher prices. If prices begin to weaken for reasons Mr. Leuffer outlines, we doubt they will want to accept delivery of millions of barrels of oil at their leafy suburban locations.

How Have Equity Markets Coped?

If Mr. Leuffer is even partly right about the potential for a significant drop in oil prices, we think it would be very positive news for global equity markets over the next six to

12 months. Most economists estimate that every \$10 a barrel move in oil prices, if sustained, would add or subtract roughly 0.5% to world GDP growth over the following year. Accordingly, estimates for world GDP growth for 2005 have recently come down from about 4% to 3.5% as a result of higher oil prices. If prices drop significantly, look for upward revisions to both GDP growth forecasts and corporate profit forecasts everywhere in the world, except among the major oil producers.

It is also useful to look at other historical episodes when the price of oil moved up by 70% or more. As shown in Chart 3, equity prices on average have actually posted modest gains over the following six to 12 months. Importantly, the gains have been in the solid double digits if Federal Reserve policy was in a pro-growth mode – as indicated by a positively sloped yield curve – at the time the 70% increase in oil prices occurred.

Recall that the yield curve is the difference between long-term government bond yields and short-term interest rates. Historically, the yield curve has been a good leading indicator of economic activity over the following six to 12 months, and not a bad leading indicator for stocks as well. Currently, with short-term rates under 2% and long-term rates over 4%, the yield curve is pointing to further growth ahead. The positive slope of the yield curve also indicates that the Fed is not too worried about the prospects for inflation.

In contrast, as shown in Table 1, the yield curve was inverted during the two major energy price spikes that occurred in the 1970s. That meant that the Fed had its foot on the brakes and was seriously concerned about accelerating inflation. In current circumstances, with global bond markets having rallied significantly in recent months, the Fed and other central banks remain relatively relaxed

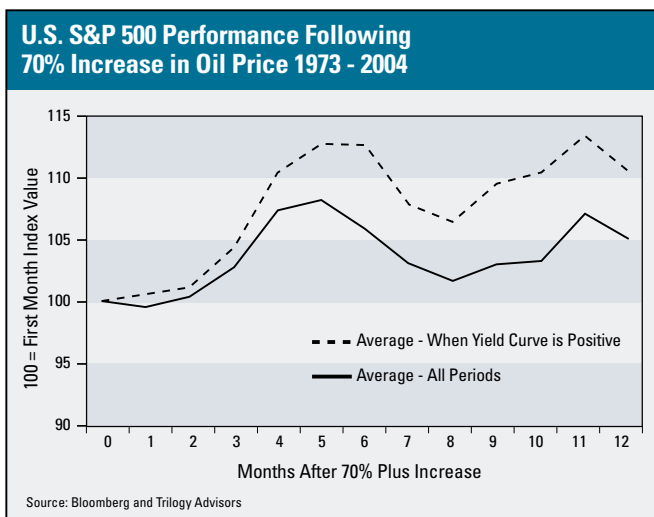


Chart 3: On average, the stock market has posted positive returns in the 12 months following a 70% plus increase in oil prices.



History Lesson: Financial Market Performance Following a 70% or Greater Rise in the Price of Oil

Episode	Yield Curve	Subsequent Change in S&P 500 (%)		Subsequent Change in 10-Yr US Bond (basis points)	
		6 months	12 months	6 months	12 months
Nov-73	Inverted	-9.0	-27.1	83	95
Sep-79	Inverted	-6.6	14.8	320	242
Mar-87	Positive	10.3	-11.2	212	106
Sep-90	Positive	22.6	26.7	-77	-135
Nov-99	Positive	2.3	-5.3	11	-70
Mar-03	Positive	15.7	32.2	49	16
Average		5.9	5.0	100	42
Average When Yield Curve is Positive		12.7	10.6	49	-21

Source: Global Financial Data and Trilogy Advisors

Table 1: Not surprisingly, the stock market has fared better following sharp rises in oil prices when the Fed pursued a pro-growth monetary policy – i.e., when the yield curve was positively sloped.

about the global inflation outlook and are likely to maintain pro-growth monetary policies for some time to come.

What is different between now and the 1970s? In addition to oil being only about half as important to the economy now as it was then, we would point to the huge increase in global competitive forces that are keeping inflation in check. Growth in jobs and capital spending has been surprisingly subdued in the United States during the current expansion, presumably because of ongoing competition and new capacity coming on stream in places like China and India. Labour productivity growth also remains impressive, suggesting little pressure on overall unit labour costs. During the inflation-prone 1970s, the fear of “wage-price spirals” was ever present.

During the current episode of higher oil prices, there is little evidence so far that higher oil prices will trigger a wage-price spiral. Companies have had relatively little success making price hikes stick, as shown by tame consumer price data. Workers have had little leverage to

boost wages due to a lacklustre job market and ongoing competition from overseas.

Although stock prices have delivered minimal returns so far this year, other risky assets like high-yield bonds and emerging market bonds have posted decent returns. These results, together with the positive yield curve, suggest that financial markets are positioned for growth ahead.

If history is any guide, stocks should be able to post healthy double-digit gains over the next six to 12 months with this

backdrop. As always, we may need to reassess this view if oil prices continue to climb. However, if our observations on oil inventories are on target, it's likely that we will be revising upward our expectations for global growth and corporate earnings performance.

One final point: As Table 1 indicates, bond yields more often than not tend to rise following a year-on-year increase in oil prices of 70% or more. With 10-year U.S. government bonds yielding little more than 4% currently, it is hard to get excited about the potential returns from bonds. This is especially true if bond yields rise and deliver some capital losses that offset part of the 4% yield income. With global equities trading at under 15 times next year's estimated earnings and with many equity markets offering dividend yields of more than 3%, equities continue to look more attractive than fixed income despite current jitters about oil prices.

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