

Rising Oil Prices: Just a Windfall or More?

by
Thomas Dunbar
Registered Investment Advisor

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Oil-rich nations including Saudi Arabia, Russia, Norway, Kuwait, Nigeria, and Venezuela are awash in cash due to recent oil price increases. Their respective benchmark stock-market indexes rose 116%, 75%, 78%, 155%, 89%, and 70% from the start of 2003 through September 2004, according to the September 30, 2004 edition of the *Wall Street Journal*.

Investors that own oil companies based in the United States have also benefited from rising stock prices, stock buy-backs, and dividends. However, rising oil prices cut into profits of U.S. businesses because of the increases in manufacturing and transportation expense that result from rising oil prices.

Everyone has read that China is urbanizing, industrializing, and intends to increase its political power. In 2004, the consumption of oil in China was 1.3 barrels of oil per person per year. In contrast, Mexico's citizens on average consumed 7 barrels of oil per year. When China's consumption per person rises towards that of Mexico it will be significant because China has 1.2 billion people and the world only produces 80 million barrels of oil per day. A similar forecast of increased oil demand applies to India, another highly populated country that is also industrializing.

The Oil Factor is a book written by Stephen Leeb published in 2004. He studied the relationship of oil price moves and the effect on stock prices. He looked at oil prices from the start of 1973 through 2003 comparing the oil price to the S&P500 index. He found that the results were staggering. When oil prices rose by 100% or more over a 12-month period, stocks during the next 18 months experienced an average decline of 27% (sometime during the following 18 months). The average maximum gain of stocks during the 18 months was only 4%. In other words, when oil prices doubled in a 12-month period, if you had stayed out of the market, you risked missing, on average, a mere 4% gain at some point during the next 1 ½ years. But if you had bought stocks instead, you were more than likely to see them shed 27% at some point during the next 18 months. These results are particularly compelling, according to Leeb, because they occurred in the context of a 30-year period in which stocks were sharply undervalued in terms of prices-earning ratio as compared to today. He found the evidence overwhelming that no investor should buy stocks without first looking at the direction of recent oil prices.

By way of background in May of 2004, oil prices were approximately \$36 a barrel. In March of 2005, oil prices were approximately \$51 per barrel. If prices rise to \$72 per barrel by May of 2005, then the oil price would have doubled from May of 2004. Then, the "Oil Indicator" as defined by Steven Leeb would present itself and one could expect a drop in equity prices of 27% at some point over the following 18 months. (Some commentators present compelling, rational arguments that oil may soon be priced at \$80 to \$100/barrel based on decrease supply/increased demand.)

One might state to oneself, “I don’t invest in stocks so why does it matter to me if oil prices rise? I might just get a Hybrid car and not worry about it.” First, it takes 25-50 barrels of oil to make the hybrid car. Additionally, commentators such as Mat Savinar point out that geologists’ have studied the amount of energy required to produce our necessities. One calorie of food eaten in the United States requires 10 calories of fossil fuels to produce according to geologist Dale Allen Pfeiffer who wrote an article entitled, “Eating Fossil Fuels”. The size of this ratio stems from the fact that every step of modern food production is fossil- fuel and petro-chemically powered. Pesticides are made from oil, commercial fertilizers are made from ammonia which is made from natural gas which also is about to peak in terms of its supply. Farm implements such as tractors and trailers are constructed and powered using oil. Food distribution networks are entirely dependant on oil. In the United States, the average piece of food is transported 1500 miles before it gets to your plate. Savinar points out that modern medicine, water distribution, and national defense are entirely powered by oil and petroleum-derived chemicals. Most of the consumer goods you buy are made with plastic which is derived from oil.

Much has been written about Canadian tar sands and the fact that those deposits may contain a 30-year supply of oil. However, the oil sands in Canada require a lot of energy to extract the oil from the sand and the oil sands in Canada are projected to produce only 2.2 million barrels per day by the year 2015 which is not much oil considering that we currently utilize over 80 million barrels of oil per day and are projected to need 120 million barrels per day by the year 2020. A similar scenario faces the development of the huge oil reserves of oil shale in the American West.

One of George W. Bush’ energy advisors, investment banker Matthew Simmons of Simmons and Company International is considered to be one of the most reputable and reliable energy investment bankers in the world. In an August 2003 interview, Mr. Simmons stated that he believed that it was possible that energy production had peaked and it was particularly disturbing because 5 of the world’s 6.5 billion people at that time were not using oil and gas. Simmons stated that under the best of circumstances there would be no energy crisis for perhaps two years and after that he stated that it was a “certainty”. In May of 2004, Simmons explained that in order for demand to be appropriately controlled, the price of oil would have to reach \$182 per barrel. With oil prices at \$182 per barrel, gas prices would rise close to \$7 per gallon.

Solar and/or wind energy only produces less than one half of 1% of the world’s energy.

Numerous commentators have stated that more than half of the oil producing nations are now past their peak of production capacity and are now in decline. The U.S. peaked in 1970, Russia in 1987, U.K. in 1999. Many commentators also suggest that the Middle Eastern Countries do not have the reserves they claim to possess.

“Oil, Oil, Everywhere” was an Opinion article written by Peter Huber and Mark Mills published in the *Wall Street Journal* on January 27, 2005. These authors stated that the price of oil remains high only because the cost of producing oil remains so low. They argued that oil production across the globe is not increasing because the cost of extracting oil from the Persian Gulf is so cheap that it discourages developers from investing billions of dollars in new projects because “the second cousin of Osama bin Laden can

knock \$20 off the price of oil with an idle wave of his hand on any given day in Riyadh” (by producing wide open). They also argue that when investors do build large refineries for tar-sand that the technology will continue to improve and costs will drop. However, few companies will invest billions to do so since the price of oil might drop significantly and bankrupt the investment. They also argue that bacteria has been bio-engineered to crack heavy oil molecules to help clean up oil spills and also to mine low grade copper and they also would be used to extract Albertan oil from sand and shell. Huber and Mills argue that if the price is right there is plenty of oil but at much higher prices.

Rising oil prices have also caused governments to activate plans for more nuclear reactors. The price of uranium has more than tripled since 2001. Due to the rising oil prices, the public perception has changed as to the attractiveness of nuclear energy across the world. China has plans to build in excess of 20 additional nuclear reactors. Plans are similar in Russia.

To sum up the scenario and add a local flair, may I quote William Faulkner. If Faulkner were alive today, he might revise his famous quote to read, “I believe that man will not merely endure. He will prevail (but at a much higher cost!)...”

Tom Dunbar is a money manager and attorney in Jackson, MS. Questions or comments may be sent to Dunbar Financial Strategies, LLC via e-mail at tomdunbar1@jam.rr.com or 601-366-3170.