Investment Watch

Oil!

"Black gold! Texas tea!" The headlines read, ***"Oil Barrels Toward $50!"*** This crude awakening, not only will have us crying at the pumps; but also, has battered the stock market and may dampen both US and world growth. Will Greenspan's "soft spot" expand to engulf our economy like the La Brea Tar Pits marked the end of the Ice Age?

Higher oil prices produce a confusing maze of financial outcomes. Before we get lost, I think we can get our bearings by stepping back to the introductory quote which comes from ***The Beverly Hillbillies***, the top rated sitcom of the '60s. Too young to remember? The theme ballad relates the story - Jed Clampett was an Ozark hillbilly who with epic fortuity and sheer ineptitude struck oil, *"he was shootin' at some food, An' up thru the ground came a bubblin' crude.* ***Oil that is! Black gold! Texas tea!***"

Jed sold his Ozark oil-rich swamp for $25 million and *"..moved to Bev-er-ly. Hills that is! Swimmin' pools, Movie stars!"* Jed solved the complications of his new city life using his calm, backwoods common sense. In 1971 even though the show was still vastly successful, the social realists viewed it as an intellectual embarrassment and the networks cancelled it along with Jackie Gleason, Red Skelton, *Mayberry RFD* and *Green Acres*. Jed deserved more respect!

The death of the '60s! Those were the easy times of cheap oil and few worries. But now surging oil prices are the front-page news punctuating our long list of worries - Iraq, terrorism, the twin deficits (budget and trade), decline of the dollar, interest rates, inflation. All complicating our lives, weighing on our minds and depressing the financial markets.

But before we ask the experts, why is it that the cynicism gets more press and pessimistic prognosticators are deemed more cerebral; while the optimistic analyst must be less discerning? Are the optimistic experts seeking advice from Jethro Bodine (**Bō´** dēn), Jed's 20 year old nephew with a 6th grade education and brain surgeon wannabe. Is this why Bill Gross referred to Alan Greenspan as Mickey Mouse? Are the highbrow social realists really turning to name calling? Will Greenspan be cancelled?

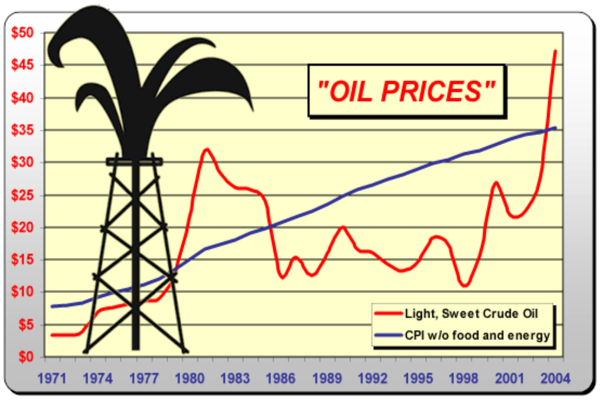
Oil! Black gold! Texas tea! Everything you've ever wanted to know about oil is on the Energy Information Administration's website, a division of the Department of Energy, **www.eia.doe.gov.** Do a search on "light, sweet crude oil" - that's the good stuff, the expensive stuff, the stuff we make unleaded, super and premium gas from and it's close to $50 a barrel today. Light refers to the specific gravity (a physics term measuring the relative density) and sweet refers to a low content of sulfur pollutants.

Light, sweet crude oil, sounds good enough to eat. In fact, with a few short clicks you'll soon discover that the USA devours 25% of the world's total oil production. You'll also learn that we import 10 million barrels/day or 60% of what we consume, while back during the oil crisis of the '70s, we only imported 33% or about 5 million barrels/day.

Not only is our reliance on foreign oil at record levels, the world's oil needs are increasing more rapidly. This is putting a strain on a system that is at the edge of capacity. As a result the meltdown of the Russian oil giant, Yukos, the ever-increasing appetite of China, and a strike in Venezuela have garnered the media's attention and been blamed for the price explosion. Finally, hurricanes in the gulf stalled deliveries and made obvious that the shock absorbers of spare crude oil and refining capacity were gone.

Just like Hollywood's ill-fated movie remake of ***The Beverly Hillbillies*** in 1992 exaggerated Jed's fortune making him a billionaire, so too have the hedge funds and brokerage firms contributed to oil hitting 14 new records in 15 days in mid-August and barreling to $50 at the end of September. Hedge funds love volatility and leverage their bets while the futures market require only small advance payments. Experts contend that this speculative fever blew oil past realistic levels to today's $50 bubble.

As you can see from the graph, since the last oil crisis in the '70s, we've been paying less for oil (red line) than for other things measured by the CPI (blue line). <u>Oil was cheap, very cheap</u>! In 1998 the price of oil was $11/barrel, then it began to spiral up to the current level of $50. ***Where does it go from here?*** $25 per barrel oil would create a good profit for a commodity that in the Middle East costs $2 per barrel to pump. Most experts expect it to settle at about $35 which ironically would almost exactly bring the price in line with the other items in the CPI.



This is where oil gets confusing. The producing countries want prices high but not *too high* that they would limit consumption, erode dependency and especially make seeking alternative energy sources financially viable. Last time oil prices soared, they triggered one of the worst downturns in our history and a world-wide recession! Recession results in less production, less spending, and therefore, less oil consumption. The oil exporting countries will pump more oil to bring the prices down. The trump card is political volatility in these countries.

Although most experts agree that $50 oil will not drive our economy into recession, they do believe that an extended period of high prices will force companies to hold back spending and especially hiring, <u>extending the joblessness</u> of this recovery. Soft labor conditions have contributed to a second straight month decline in the consumer confidence survey.

Globally, the International Monetary Fund (IMF) has stated that the global expansion may weaken slightly due to higher oil prices. However, the growth for 2004 is expected to be 5% which is the fastest rate in 30 years and the IMF only trimmed their expected growth for 2005 by 0.1% from 4.4% to 4.3%. In their projections the IMF used an average oil price of $37.50 for 2005 indicating where they think prices will settle.

Here at home the story we're told is about the same – higher prices will have a transitory effect that already slowed growth in the spring. However, according to Fed Chairman Alan Greenspan, the economy has "gained some traction… our economic activity will continue to expand at a solid pace for the remainder of the year." You know Greenspan kinda reminds me of Jed. He has that down-home, although erudite, likeable coolness and stubbornly sticks to his guns.

But, you know, he was right when he spoke of the ***transitory effects*** when inflation reared it's ugly head last quarter. The core inflation rate came in only at 0.1% for <u>each</u> of the last three months through August. <u>This is an annual rate of only 1.2%!</u> The bond market responded even in the face of the Fed's increases, with declining yields and rising prices. Exactly the opposite of what I said last quarter. Even though right now I feel as smart as Jethro, I'm sticking to my guns too! The Fed will proceed at a ***measured pace*** and trigger interest rates to rise. Stocks will benefit from our strong economy and solid corporate profits.

However, over the last quarter, when you analyze your report, you'll notice the opposite was true - your bonds did great due to a decline in interest rates but your stocks hit a **soft spot** due to higher oil prices.

Before passing judgment, stay tuned for the next edition of ***Investment Watch*** to see if my stubbornness is justified. I know you just can't wait, just as I couldn't wait for Elly Mae to invite me back for the next episode of ***The Beverly Hillbillies,***

"Y'all come back now. Ya Hear."

Keith Kowalczyk 9/30/04

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