The Quarterly Report

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INSIDE STORY

Texas Tea

"Come and listen to a story 'bout a man named Jed, poor mountaineer barely kept his family fed. Then one day he was shootin' at some food, and up from the ground come a bubbling crude. Oil that is. Black gold, Texas tea."

The Ballad of Jed Clampett

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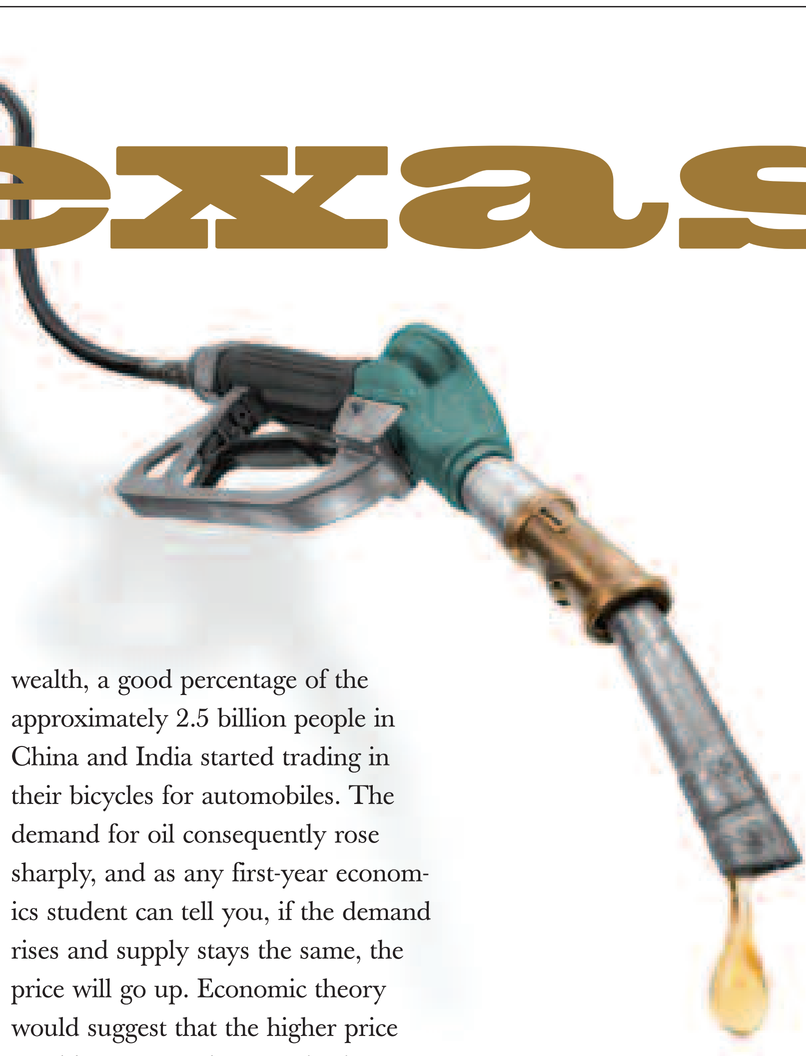
Texas



If they were ever going to bring back "The Beverly Hillbillies," now would be the time. Not only is that Texas tea in Jed's backyard worth approximately five times what it was worth in 2002, but that mansion in Beverly (Hills, that is) can be purchased for a good 20% discount off the housing boom highs. Jethro could have the biggest cement pond you have ever seen, and Granny could have a proper distillery added to the house. Mr. Drysdale would be ecstatic, as Jed's business alone might be enough to save his bank from the woes of sub-prime. Can you imagine a more timely show?

Unfortunately, this is not a television situation comedy. The housing slide continues and the credit crisis just seems to linger. However, the big star of this past quarter has been oil, so that will be our focus for this article.

Americans love nothing more than to play the blame game. Whose fault is it that oil is selling at over $140 per barrel? We want a simple solution, like the oil companies are just gouging us, or speculators are manipulating the market. The truth is not that simple, and unfortunately for those who would like to see "justice" done, there really aren't any bad people pumping up the price of oil just to make our lives miserable, and no matter what your favorite politician promises, there are no quick fixes.

The first eight years of this new century have seen explosive growth in emerging countries, primarily in China and India. Along with that growth has come new-found wealth, and with this wealth, a good percentage of the approximately 2.5 billion people in China and India started trading in their bicycles for automobiles. The demand for oil consequently rose sharply, and as any first-year economics student can tell you, if the demand rises and supply stays the same, the price will go up. Economic theory would suggest that the higher price would cause people to cut back on consumption and would provide an incentive for suppliers to increase output, thereby causing demand to shrink, supply to grow, and the prices to fall back to norms.

Who is to blame for **$140** oil?

Why hasn't that happened? Let's take supply first. There was an initial supply response, but supply seemed to peak in 2005 with total production of approximately 85 million barrels a day. There are a couple of reasons why supply has not grown faster. In our fast paced world we forget that getting oil out of the ground takes time, and six years is not a long time in the context of developing an oil field. The largest part of the price increase has been over the last nine to twelve months, and it simply isn't reasonable to expect results that quickly. Based on capital expenditures of the large oil companies, they are working hard to find and get us more oil, but it doesn't happen overnight.

In addition, oil is a non-renewable energy source. The world's existing oil fields are in different stages of their production life, but as a whole, the existing sources are experiencing declines of approximately four percent per year. This means that the first 3.4 million barrels of new daily production simply replaces the depletion from existing wells.

These factors have played a role in the lack of response in the supply of oil, but what has kept demand so high?

Tea

The reality is that cutting back on oil is not that easy. Sure there are things we can do. Couples with two cars can use the more efficient car as much as possible. We can all plan more carefully to consolidate our car trips and avoid wasted mileage. We can use public transportation and, of course, take better care of your car and check the tire pressure. All these tips can help your pocketbook and the environment, but not driving is not an option for most of us, nor is not heating your home.

The biggest reason there has not been a reduction in the demand side of the equation is because of government subsidies for oil. Fuel subsidies are widespread in emerging-market nations. Morgan Stanley estimates that half the world's population enjoys fuel subsidies, and a quarter of the gasoline consumed worldwide is bought at less than market prices. Gas is five cents per liter in Venezuela, which is the cheapest price in the world. The Chinese pay $0.79 per liter, compared to Americans at $1.04 per liter and Germans at $2.35 per liter. Consumer demand in the emerging economies will not slow down unless the consumer is impacted by the higher prices.

This combination of increased demand and tight supply started the run-up in oil prices, but does it really explain $140 per barrel? Not by a long shot, according to Chicago-based market research firm Probability Analytics Research. They say that supply and demand account for a price of oil in the $60 to $75 range. The Saudi Arabian oil minister, Ali Al-Naimi, agrees with them and has suggested that the range should be $60 to $70. These estimates are considerably higher than what oil prices were in the last decade, but half the current price. So what is causing the difference?

Some have blamed the value of the dollar. Oil, like most global commodities, is priced in dollars and the value of the dollar has been falling. If the dollar is less valuable, then it will buy less oil, or so the argument goes. This is true to a point, but the dollar has not fallen nearly far enough to account for oil at $140 a barrel. So there must be something else.

Investors make up the difference, according to Mike Masters of Masters Capital Management, who notes that trading volume in oil futures markets has gone through the roof. For example, open interest in the West Texas Intermediate crude oil contract traded on the NYMEX (just one example on just one of several exchanges) has

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REVIEW *of* ECONOMY

PESSIMISM CONTINUES to rule the economic talk, and I know I might shock and even offend some if I dare suggest that the apocalypse is not near. However, with oil prices where they are and the housing crisis only getting worse, the economy as a whole is surprisingly stronger than one would suspect.

GDP growth for the 1st quarter 2008 was 1.0%. That is hardly robust, but it is positive which means even with all the bad press the US economy managed to grow. Most of the growth can be tied to exports. Exporters have been helped by the continuing weakness of the dollar which makes US goods less expensive for foreigners.

Unemployment has risen to 5.5% in June. The employment picture is getting worse as there are few new jobs being created. However, we do need to keep this in perspective; the average unemployment rate for the decade of '90s (when all was good) was 5.76%.

The Fed has lowered the fed funds rate by 0.25% to 2.00%, but has signaled that this could be the end of the easing cycle as the value of the dollar and inflation are becoming greater concerns.

Housing remains a big negative on the economy but it has been overshadowed this quarter by the run up in oil. Decreasing home values combined with greater inflation driven by oil and food prices have people feeling bad, and understandably so. But, we have made it through worse economic times before, and we will make it through this as long as pessimism doesn't weigh us down, and Washington doesn't "help" us into a real economic depression. +

REVIEW *of* MARKET

THERE IS A DESTRUCTIVE PATTERN developing in the markets as pessimism is out of control. When there is no real news, pessimism takes over and the market plunges. Then the news comes out and it is better than expected. The markets surge. Then there is no news and pessimism once again takes over. We have been in this cycle for a year and a half now and I fear it will last until the election.

The S&P 500 ended down 2.73% for the quarter after surging up over 6% in April and May. Growth outperformed value dramatically, and small companies did better than large. The Russell 2000 Growth index was up 4.47%. The Lehman Brothers US Aggregate Bond index was down 1.02% as the market anticipates rate hikes from the Fed, but the High Yield index ended higher, up 1.75% as historically low default rates suggest the credit crisis is overblown.

International markets were in line with the US as the MSCI EAFE index fell 2.25%. +

MARKET *forecast*

THE IMMEDIATE FUTURE OF THE MARKET is tied to the price of oil. If oil prices break, the market will surge and our positive 5% prediction may be conservative. However, if oil remains high or even goes higher the market pessimism will continue to drive us down. The good news is that just about everyone agrees that the current price of oil is unsustainable and will go down. The bad news is that no-one can tell when this will happen. Patience, as painful as that may be, is the order of the day.

Small company stocks are looking more attractive as the market goes down. These companies typically lead the rally so history is on their side. We are slowly bringing these back to neutral weighting after being underweighted for the past year. We continue to favor growth over value.

We were right about international stocks coming back in line with domestic stocks and remain cautious on emerging market stocks.

We believe the opportunities in bonds have shifted to the corporate and high yield bond market where differential between spreads and default rates is as high as it has ever been. +

» *Continued – Texas Tea*

risen from less than 500,000 contracts in 2004 to more than 1.5 million contracts currently. Each contract represents 1,000 barrels of oil. Masters, in his testimony before a Senate sub-committee on May 20, 2008, estimated that the rise in investment interest has added an equivalent of 848 million barrels of oil to demand, roughly the same impact as increased demand from China.

To be fair, Masters' view is controversial. There are many people who have come out and tried to dispute the idea that futures trading could have this impact. They argue that investors are buying futures contracts (which give the purchaser the right, but not the obligation, to buy oil at a given price some time in the future), not actual oil. This argument does not hold water, however, because the futures price and the actual price must converge as the contracts near expiration. Otherwise there would be an arbitrage opportunity, and the markets are far too efficient for that to happen. Others argue that for every speculator that is betting on oil going up there is another speculator betting on it going down, and they counteract each other. That would be true if this was about speculation, but it isn't.

I myself got caught by that argument, but in reading the research it dawned on me that these new entrants into the oil futures market are not speculators at all – they are pension funds, who are buying and holding. This is all part of the "alternative investment" craze, which is a subject for a future newsletter. The bottom line is that pension funds in recent years have made commodities a permanent part of their portfolios. Masters may overestimate the impact, but his arguments are sound, and it defies logic to think that billions of dollars can be poured into commodity futures without having any impact on the market prices of those commodities.

So who is to blame for $140 oil? There is no one culprit, but rather a result of the confluence and culmination of several new realities of our global economy. Oil started to rise in price because of real fundamental economic principles of supply and demand, and it has kept going up because of investor interest. However, there is good news. Oil prices will fall. When? I can't tell you, but it will happen. Demand is cracking. Airlines are cutting back, people are buying smaller, more efficient cars, and those emerging countries are beginning to lift those subsidies. Finally, supply eventually will increase as new exploration begins to pay off and alternative energy sources become more competitive.

We survived the 1970's, and we will make it through these times as well. So as Jed and all his kin folk would say, "Y'all come back now, ya hear?"

CHUCK OSBORNE, CFA, *Managing Director*