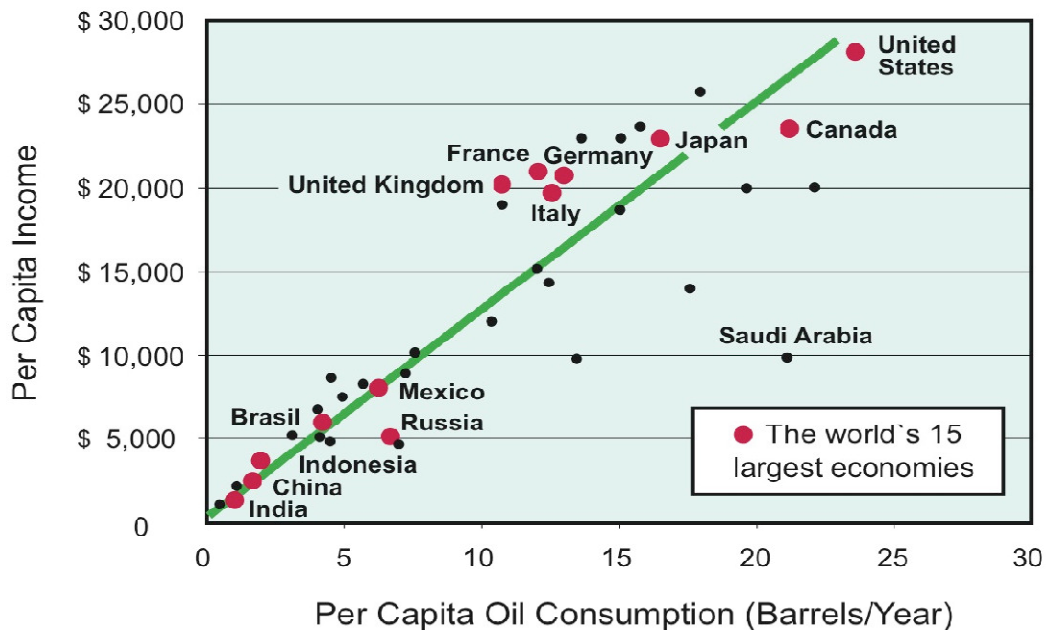


March 2011: A Crude Dilemma
By John Goltermann, CFA CPA

Civil unrest and political turmoil in the Mideast may expose the vulnerable relationship between the global economy (and certain asset prices) and the price of crude oil. The potential impact of higher crude oil prices is not fully appreciated by many market participants, but it may be soon. This month’s commentary provides background and food for thought on the current situation.

Obermeyer Asset Management’s Investment Committee has long been of the view that crude oil prices will consistently be pressured to the upside. Yes, prices will move up and down with perceptions of future global economic growth, and some of these moves will be dramatic, but crude oil prices are likely to increase going forward. This is because of two critical factors: 1) oil consumption is highly correlated to standards of living – which are increasing dramatically in the emerging markets, and 2) every major oil-producing field around the world is in decline.

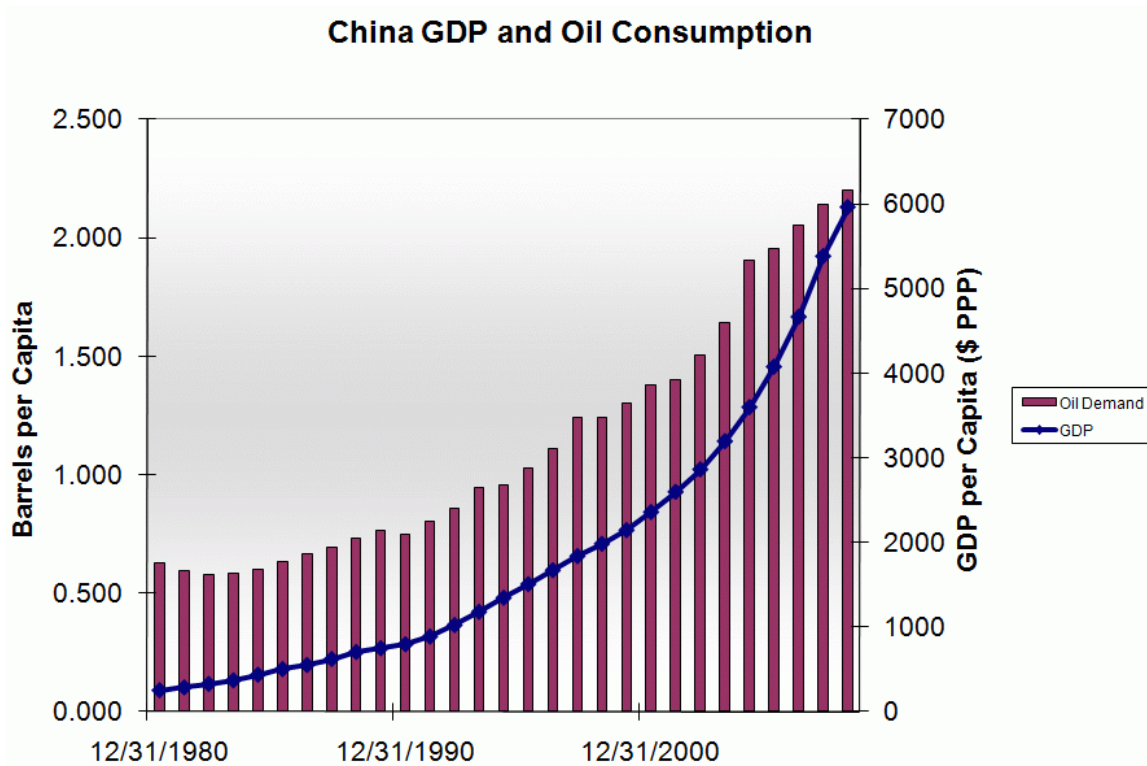
The chart below highlights the relationship between living standards and oil consumption – with the OECD countries currently consuming the most oil per capita and the emerging economies at the other end of the spectrum. We expect many emerging market countries to move up and to the right.¹



Source: Economides and Oligney, 2000

¹ Also of note, the points to the right of the green line represent producing countries (or countries where there are fuel subsidies), and the points to the left represent countries with a greater-than-average fuel consumption tax.

This chart shows the correlation between GDP and oil consumption in China specifically:

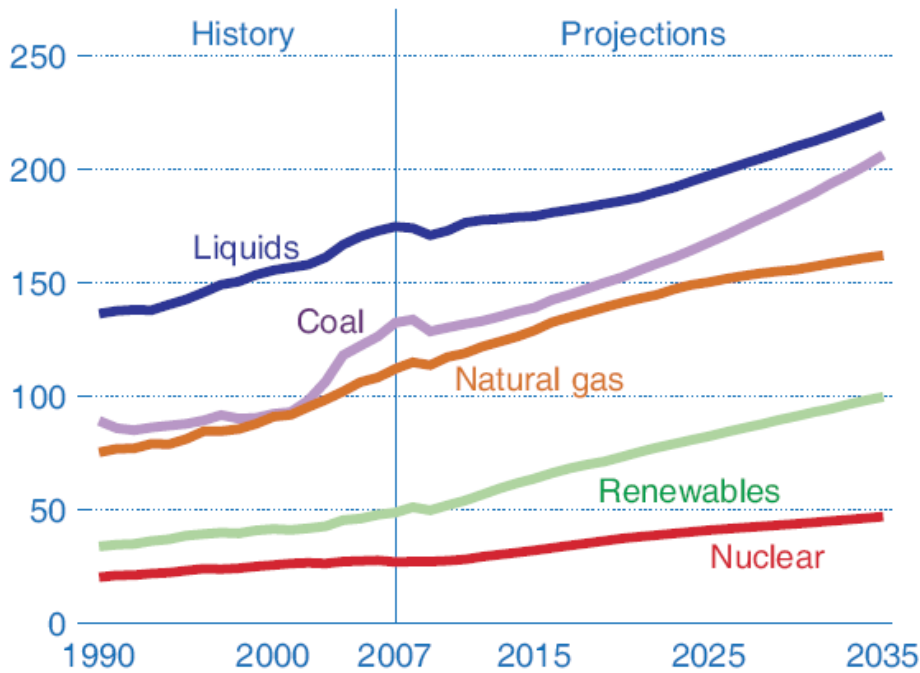


Source: BP Statistical Review of World Energy 2009, Bloomberg Finance LP, World Bank

From 1980 to 1999, the price of a barrel of crude declined from near \$40 to \$10. This was a period 1) where there was relative peace and prosperity around the world; 2) where the U.S. was unquestionably the single world superpower; 3) that came after massive investment in new production after the supply shocks of the 1970s; 4) during which a cozy alliance with Saudi Arabia developed; and 5) where the GDP growth curve in China was much flatter than it is now. U.S. living standards also increased dramatically during this time (aided by an explosion in private sector credit and plentiful supplies) and consumption grew to 24 barrels/person/year. Complacency set in: while oil supplies might be a problem sometime in the future, why worry? There were wondrous new technologies to invest in and bigger and better houses to buy. The future is now here.

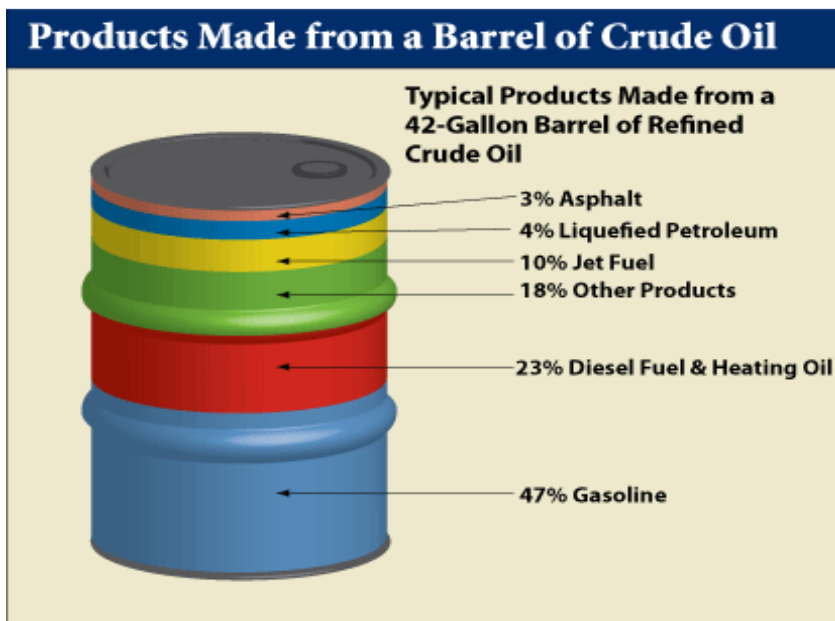
Because of globalization – and despite the U.S. governments’ best efforts to force the use of alternatives to oil through massive subsidies and regulation – global oil consumption has increased and will likely continue to do so. Oil is an integral part of global transportation and industrial and military systems, upon which a significant amount of economic activity is based. The next chart shows EIA projections for future global consumption by energy source. Assuming there is population growth and that living standards improve, oil demand will be greater than ever.

World marketed energy use by fuel type, 1990-2035 (quadrillion Btu)



Source: U.S. Energy Information Administration

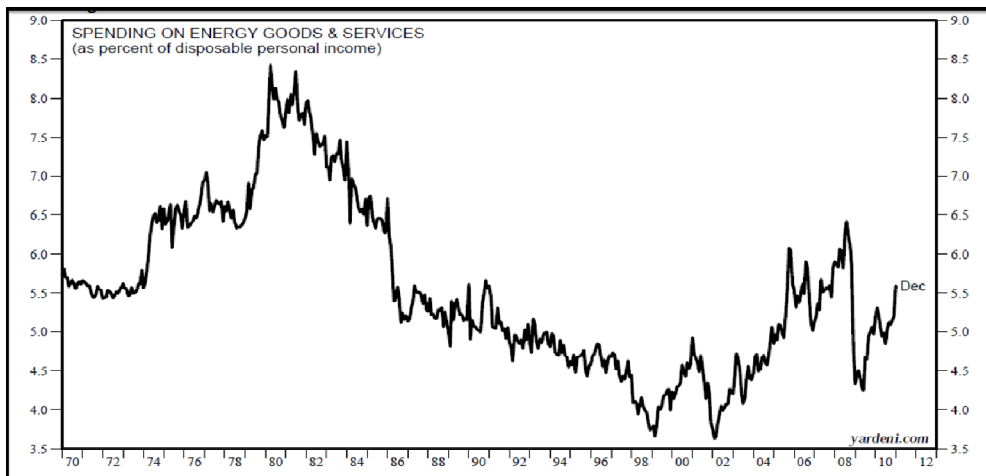
As illustrated below, the vast majority of crude oil goes into making transportation fuels. In the United States, it's about 70%. The rest goes into commercial and industrial applications and only about 1% goes into electricity generation. This is why the economy is highly sensitive to changes in the crude price.



Source: U.S. Department of Energy

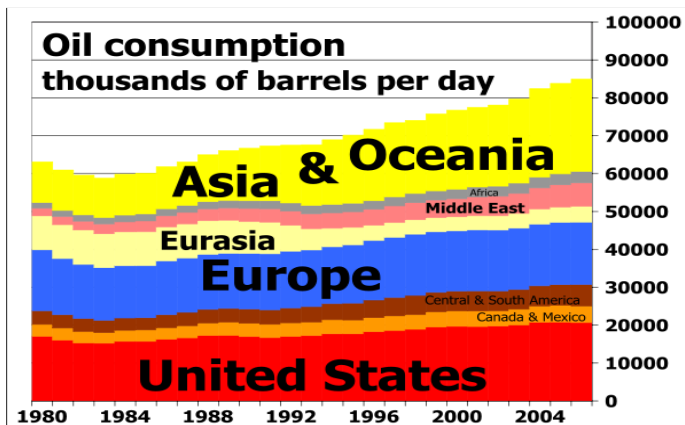
Between 2002 and 2008, the percentage of disposable income spent on energy increased from 3.5% to 6.5%. Due to a massive expansion of private sector credit during this period, higher energy prices were absorbed by increasing real estate prices and wealth. As real estate began to suffer – due to debt levels hitting critical mass in 2007 and the implosion of the unregulated shadow banking system – the cost of servicing debt became excessive when combined with higher energy expenditures.

As illustrated below, energy prices kept rising after real estate prices started to decline in early 2007, contributing to the collapse of Wall Street and the credit markets. Then, when oil prices cratered, they helped catalyze the ensuing recovery. But now the percent of income going to energy has again moved north of 5.5% – and debt levels have not declined. If debt was at manageable levels (such as in 1980), this wouldn't be a big deal. But debt levels are 3 times higher as a percent of GDP, meaning economic sensitivity to oil prices is extremely high.



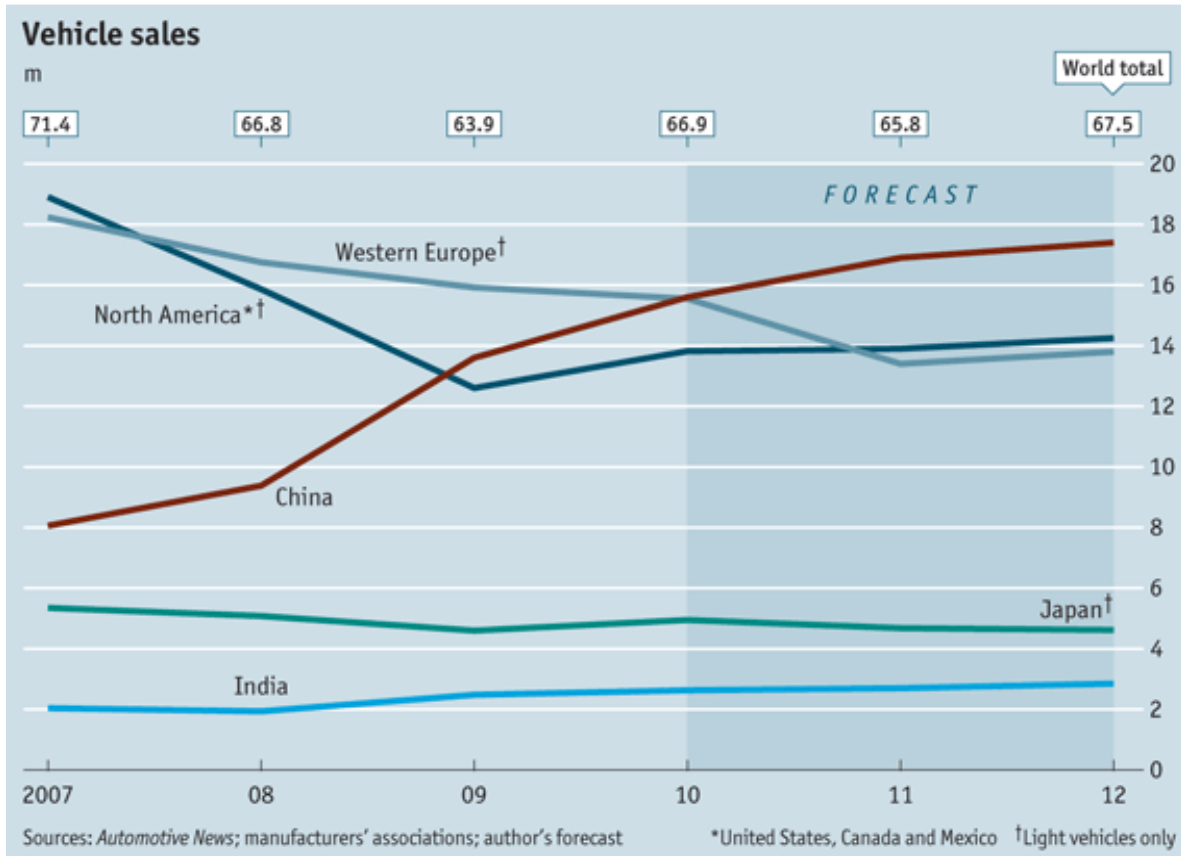
Source: Ed Yardeni

If the U.S. were the only consumer of oil, influencing its price would be more achievable. Unfortunately, as the chart below indicates, the vast majority of demand growth is coming out of Asia as its living standards improve. Therefore, U.S. energy policy will have little impact on the price of crude. If anything, U.S. monetary policy combined with energy policy may have the opposite effect.



Source: U.S. Energy Administration

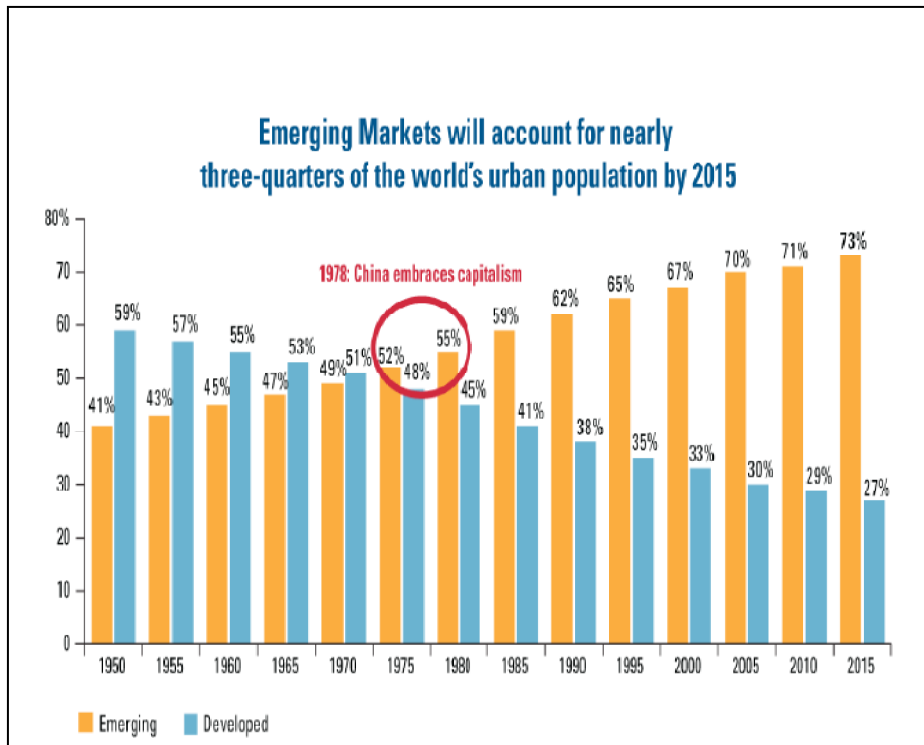
The relative growth of regional energy consumption is in large part attributable to the combination of rising incomes and rapidly improving living standards in Asia, but also to better demography overall in the emerging markets. The proportion of the population that will be seeking much higher living standards is dramatically rising, and the share of global population that already has high living standards is decreasing. This leads to accelerating oil demand increases.



Source: The Economist, Dec. 27, 2010

Rising income enables the purchase of a new car (as indicated by the chart above). One issue to consider is that of the vehicle sales in China and India, the majority are first-time purchasers, meaning that those sales represent incremental oil demand. In the U.S. and Europe, vehicle sales typically represent purchases of replacement models – often of cars with improved gas mileage. Incremental petroleum demand from these sales is flat to slightly negative.

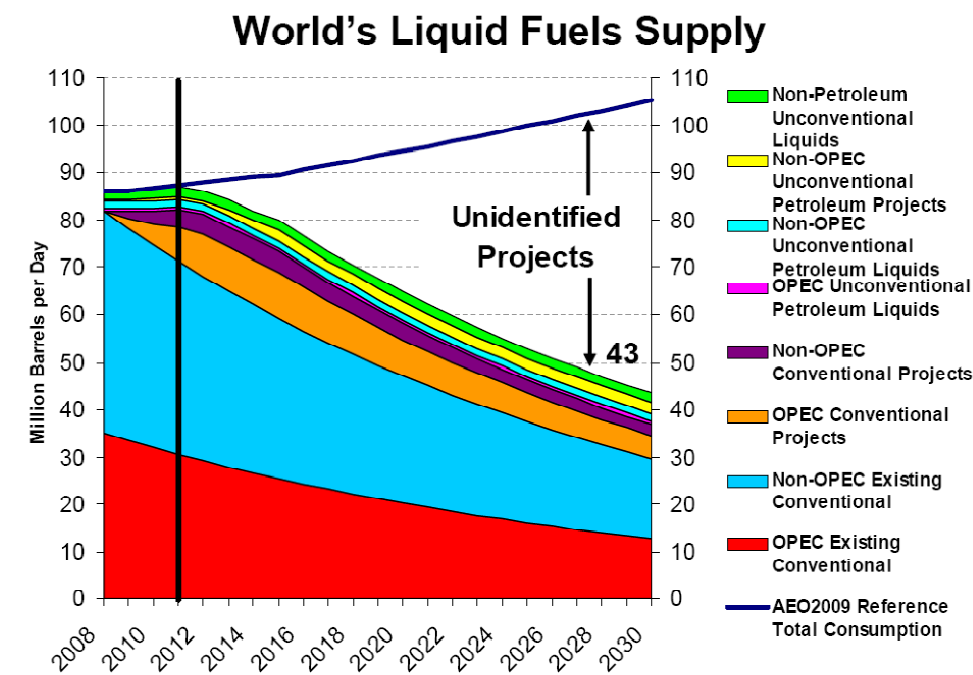
Also important is the increasing influence of the emerging markets as they become a greater portion of the world's urban population (see graph below). This means that developed markets are less and less impactful over time and, since the U.S. and Europe import the vast majority of their crude oil needs, they have become price takers as opposed to price setters.



Source: United Nations World Population Prospects 2005 Revision, Morgan Stanley Research

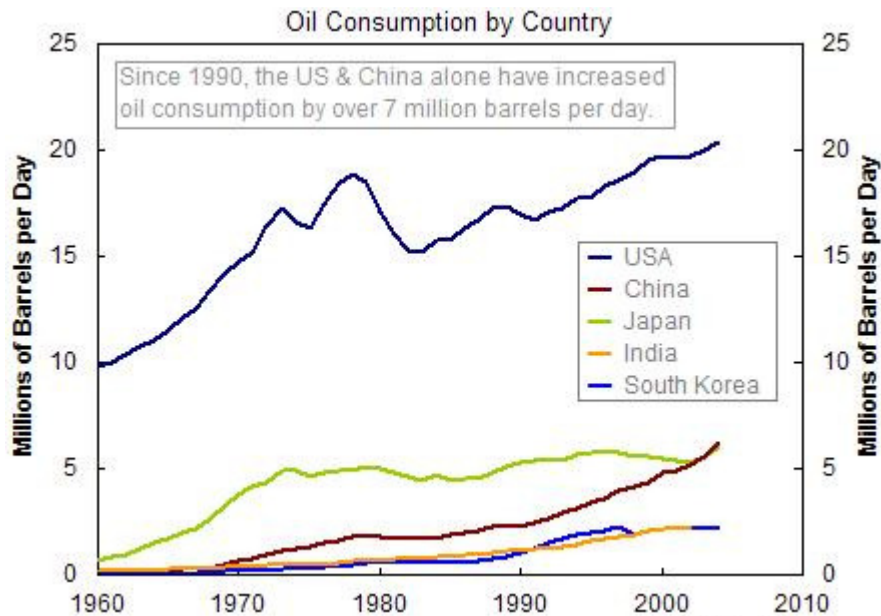
The Supply Situation

On the supply side, geological constraints are an issue. The low hanging fruit in terms of reserves are gone and new discoveries and new extractions are more difficult and more costly. The Deepwater Horizon incident serves as a cautionary tale. One chart says it all in terms of the supply situation:



Source: EIA, AEO2009

On top of this frightening global supply projection, the U.S. has moved from energy independence (as recently as 1970) to significant foreign dependence and now imports about two-thirds of what it consumes.² Why? For one, the environmental movement (catalyzed and mobilized by a 1969 spill off the Santa Barbara coast) caused the regulatory and financial cost of new exploration and production to become largely uneconomic, or rejected outright. Secondly, as the next chart shows, crude oil consumption went up dramatically in the U.S. between 1980 and 2000.

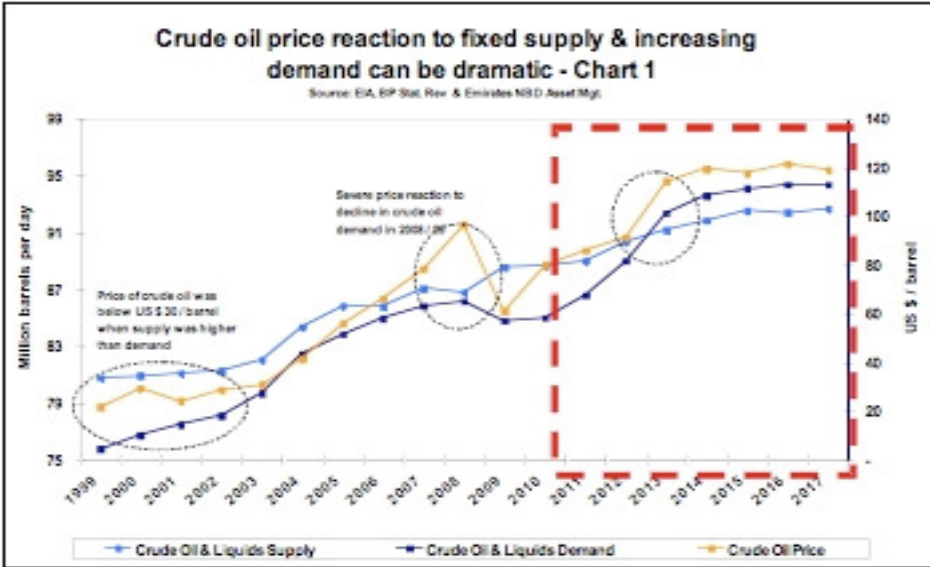


The result has been a dramatic increase in domestic crude oil imports. In the early 1980s, we imported about 30% of what we consumed. In the mid-1980s, that proportion increased; we now import almost 65% of what we consume.³ The oil we consume is going to be produced somewhere...just increasingly outside of the U.S. This is not because of a “save the planet” policy. It’s more of a NIMBY⁴ policy. With oil price’s sensitivity to perceived changes in the supply situation (see graph below), skyrocketing prices could easily cause a catharsis among the American electorate – a growing realization that not only does *not* producing our own energy supply outsource millions of jobs, but it hands over influence of our own economy to petroleum producing nations.

² Source: CIA Factbook and U.S. Energy Information Administration

³ Ibid.

⁴ NIMBY: Not In My Back Yard.



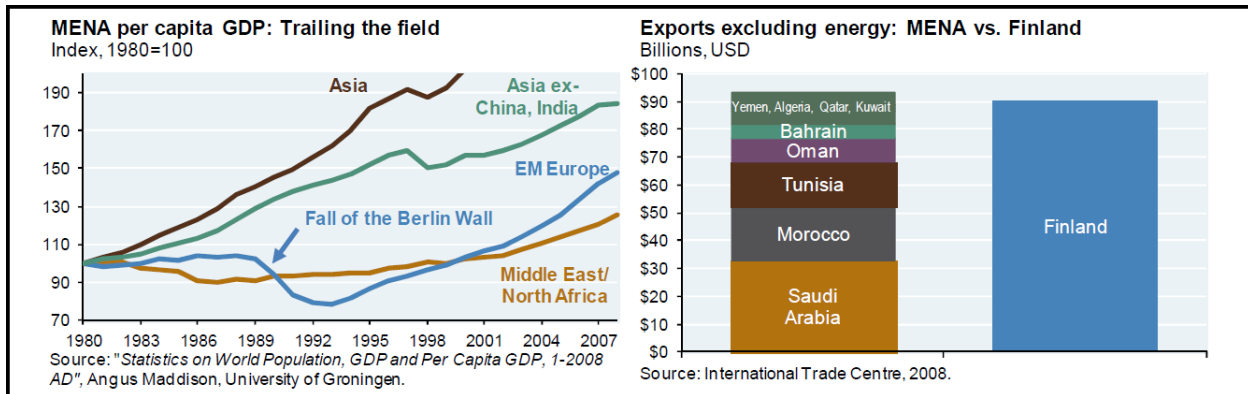
The price of oil all by itself is likely to force a policy change in time for the next election. If we care about our own standards of living, the U.S. has no choice but to increase domestic crude oil production. We don't want to find out the hard way if our economy can withstand \$300/barrel oil, but the Mideast unrest may start us down that path because it takes years to bring new projects online and any perception of disruptions of already tight supplies could cause a price shock.

The Mideast Situation

Unrest in the Middle East is occurring for two basic reasons: 1) this region's monarchies and autocracies haven't sufficiently shared the wealth and 2) demography.

Oil production and revenues have exploded in the Mideast over the last 30 years (no graph for this...take our word). But other industries never developed, not even agriculture. Nigeria and Egypt are two primary examples. Governments never used their enormous oil revenues to develop other economically competitive sectors, so most North African countries are almost pure petro-economies.

My friend Marc Faber passed along the next chart, which shows an amazing statistic. The non-energy exports of the MENA countries (Middle East/North Africa) were, in aggregate, lower than those of Finland, a country whose population is 5% that of the Middle East!



Source: Michael Cembalast, J.P. Morgan

Middle Eastern unrest could get much uglier, pushing oil prices higher and increasing the value of reserves in the Canadian oil sands dramatically. Moreover, with a declining dollar and the political incentives of the Fed and government (excessive debt and 'non-discretionary' government spending) to continue debasing it, OPEC countries are not incentivized to increase production. They actually have an incentive to *curtail* production to keep the dollar value (or the value of the local currency, which is usually pegged to the dollar) of their reserves as a hedge against U.S. monetary policy and to convert the oil revenue they *do* earn to non-fiat currencies such as gold and silver. *This dynamic applies and should be considered by investors in many oil consuming countries around the world and who operate in currency regions that have excessive leverage and high levels of government spending, i.e., yen-, euro- and dollar-based investors.*

With the Republican victory in the last election and the termination of Henry Waxman's chairmanship of the House Energy and Commerce Committee, a key roadblock to increasing U.S. imports from the Canadian oil sands has been removed and the stock prices of Canadian reserve assets have moved as we expected. Waxman consistently blocked efforts to build a 1,600 mile, 1.1 million bpd pipeline called Keystone XL that would facilitate increasing imports from Canada citing "increased carbon dioxide" as the primary reason. With his removal, we view Canadian oil reserves as primary beneficiaries of Mideast unrest.

From an investor standpoint, we believe one should hold positions 1) in energy reserves in politically secure areas; 2) in drilling, production and servicing assets for a future ramp up in domestic exploration and production; and 3) in precious metals as a way to retain real wealth. Because of the potential negative effect of high oil prices on the real economy, one should avoid positions that rely on robust economic growth in the developed world. These views are expressed in our current client portfolios – and have been for some time.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.