Summer 2008 **VOLUME 14:2**

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

When Will the Oil Bubble Pop?

By Che H. Lee
President

We are deluged with stories about oil, oil and more oil, "twenty-four, seven." Unbelievably, a new reality TV show "Black Gold" recently debuted, following the lives of West Texas oil rig workers. When an economic development gets seared into our collective psyche and pop culture to this extent, can the bursting of the oil bubble be far behind?

Eerie parallels exist between the sharp trajectory of oil prices and energy stocks in recent years and that of tech stocks during the tech bubble years from 1999 to 2000. Each parabolic move was similarly supported by just enough fundamental factors to give the illusion of being *entirely* rational. As is human nature, however, market participants "overdid" things, pushing prices beyond levels justified by fundamentals alone into the stratosphere that incorporates huge speculative elements.

The impact of high oil prices on the market and economy has been profound in the past couple of years, hurting Main Street and Wall Street alike. The vast majority of stocks on a typical day seem to trade inversely to the price of oil, except of course oil stocks. When the price of oil is up (which has been on most days), the vast majority of stocks head down, and vice versa.

Finding a solution to ever-escalating oil prices necessitates identifying their cause. To say that fierce debate rages on this point is an extreme understatement. When you strip away all the noise, the issue boils down to how much of the rise is justified by fundamentals, and how much, if any, is based on speculation and other factors. George Soros, the legendary hedge fund manager who knows a thing or two about macroeconomics, recently testified in Congress that the oil and commodities markets have reached bubble status. It has been reported that the percentage increase in the price of crude oil from 2001 has now incredibly surpassed the rise in speculative Internet stocks during the tech bubble.

The issue of speculators' role in the rise of oil prices is much too complex to tackle in a short article. Nevertheless, I offer some observations below why I think there is a huge speculative element built into current oil prices. Unlike fundamental factors that help sustain prices, elevated prices based on speculation will ultimately be corrected. I expect the price of oil to follow the same sorry fate as other bubbles, most recently overleveraged private equity in 2007, residential housing during 2005-2007, and tech stocks from 1999-2000.

Fundamentals of Supply and Demand

Whenever the sanity of current oil prices is questioned, those who have a vested interest in keeping prices high always trot out the same justifications. These explanations are intellectually appealing, because they offer just enough truth to be dangerous. The media typically obliges by regurgitating these reasons without challenge.

Inside This Issue:

The economic justification for high oil prices can be boiled down to the huge imbalance between supply and demand – basically economics 101. The idea is simply that when demand outstrips supply, prices will rise until demand and supply are once again brought into equilibrium.

The supply of oil is dropping because 1) we are consuming the oil in the ground faster than we are finding new oil fields, and 2) existing oil fields are becoming more unproductive, as easily accessible layers have already been harvested.

Contrasted against reduced oil supply is the increased demand for oil from the fastest growing countries around the world, most notably China and India, which currently use a fraction of what developed countries consume on a per capita basis. As these emerging countries continue to grow and raise their standard of living, oil demand inevitably will continue strengthening.

I agree with the above statements, but they alone do not tell us whether current oil prices are justified; they simply suggest that oil prices should be higher than before the economies of these fast-growing countries took off. Oil prices have more than doubled in the past year -- has the imbalance between supply and demand from a year ago likewise worsened by a factor of 2? No.

The predictable retort is that demand for oil is at least somewhat price-inelastic (i.e. a 10% rise in price does not lead to a 10% drop in demand, at least not in the short term) and, more importantly, current prices do not simply reflect supply and demand in the past year, but incorporate expectations regarding future supply, demand and prices. While present market prices surely do discount future expectations (whether we are talking about a stock or commodity), this type of reasoning sounds suspiciously like the justifications for buying tech stocks with absurdly high valuations during the tech bubble. The idea back then was that the demand for tech products and services would be so huge that the resulting high growth rates could support the high valuations.

My view is that current sky-high oil prices incorporate unsustainable speculation based on excessive and unrealistic assumptions and extrapolation about future levels of worldwide demand and supply. I next discuss why the problems with the imbalance between future demand and supply will likely be more benign than that discounted by current oil prices.

Excessive Extrapolation

If you see a car without brakes traveling at a constant 60 miles per hour towards a concrete wall that is 60 miles away and without obstacles inbetween, do you expect the car inevitably to crash into the wall within an hour? Only if you extrapolate the car's current condition and position in a straight line for the next 60 minutes would you conclude a crash is forthcoming. This conclusion is highly speculative and presumptuous, as many factors may come into play in the interim, altering the car's fate. The course of events from now to an hour from now is determined by a dynamic set of interrelated factors, each of which affects the others, and by extension the ultimate outcome.

Similarly, it would be imprudent to extrapolate current demand and supply dynamics in a straight line far into the future. Given current sky-high oil prices and the dire future supply/demand imbalance they discount, it would not take much good news on the supply and demand front to expose the speculative component of oil prices. Such good news might come from one or more of the following developments.

Ways Supply Could Grow

- High oil prices make investments in innovative drilling and recovery technologies increasingly attractive, resulting in technological improvements that allow more productive drilling of existing sites; for example, the rarely mentioned Bakken Formation spanning North Dakota and Montana has the potential to generate 200-

300 billion barrels of oil according to a highly respected 2006 study. The US Geological Survey recently estimated that the region has the potential to supply up to 4.3 billion barrels of recoverable oil, an estimate that has been heading up strongly as new, economically justifiable technologies have been implemented.

- Technological advances could lead to more discoveries of new sites.
- As oil prices and the related crisis escalate, the public may increasingly accept more drilling and exploration in currently restricted areas that are known to hold vast oil reserves.

Ways Demand Could Slow

- Consumers will cut back demand and conserve in response to ever-rising prices; indeed there is ample evidence that oil demand is already dropping because we have reached a critically high point in oil prices.
- High oil prices have made it economically feasible to start developing alternative energy sources, which will reduce reliance on and demand for oil going forward.
- China's economy is vulnerable to slowdown from time to time. The Wall Street Journal recently reported that manufacturing in certain regions of China has been decimated, as the strong Yuan has made it uneconomical for international companies to outsource their manufacturing there. This growing cost of manufacturing in China has been widely chronicled by the media in the past year; such production activity up until recently has been a huge contributor to China's economic growth and energy consumption.
- Global economies are increasingly interconnected. It is wholly unrealistic to expect that drastically slowing US and Europe economies won't have a negative impact on countries like China and India.
- Many countries in South East Asia have already partially or entirely removed oil price subsidies, causing oil prices to rise closer to free-market levels. At the very least, this will have some dampening effect on demand from those countries.
- Rarely mentioned by the media, demand for oil by developed countries has actually been *declining* in the past few years, a trend that is predicted to continue.

Like all past bubbles, the oil bubble will end badly. While we are living through a bubble, it is always difficult to recognize its true character until after the fact. It was not long ago when many people thought houses only go up in value. It is difficult to identify the trigger for any eventual resolution of the oil crisis, but in time the odds strongly favor a sharp decline in the price of oil. Even oil stocks are trading at levels that suggest sustainable oil prices are substantially below their current level.

Some Good News

By Che H. Lee
President

Even an optimist would acknowledge that the economy is going through an exceedingly tough period — increasing unemployment, record energy and food costs, housing implosion, credit crunch and massive write-offs of financial assets. Still, the media has been having a one-sided field day spreading doom and gloom, without covering "the other side." You won't find the media eager to trump the following news, but it would be useful for you to keep these positive developments in mind, as you continue navigating through this period to better times.

Here's some good news:

- April home sales rose 22% from March in a 6-county region in Southern California, encompassing areas in the country that have been hardest hit by foreclosures; this sequential monthly increase continued for May and the trend was consistent with the 29% increase during April for the San Francisco Bay area. While pessimists lament the decline in median prices, the housing market needs prices to drop before it can reach supply/demand equilibrium and subsequent recovery.

- Re-sales of existing US houses rose 2% in May from April, with particular strength in some of the hardest hit areas. Further, the inventory of unsold homes dropped 1.4% (though it is still much higher than normal at a 10.8-month supply).
- An index of pending home sales around the country rose 6.3% from March to April (though pending sales are subject to cancellation).
- Housing starts in March were down a whopping 58% from their January 2006 peak, approaching the roughly 60% average decline for each of the four major housing downturns since the 1960s. Further, housing starts in May are at the lowest level since March 1991. These cutbacks help reduce housing inventory.
- Standard Pacific (a homebuilder) recently reported that its sales in Florida for the April-May period increased 42% from last year. The CEO of Toll Brothers, another homebuilder, echoed this improvement in the company's sales in parts of Florida. Together, this might evidence some relief in one of the worst housing markets in the nation, and one of the first to go into the tank.
- Over 520,000 borrowers received loan relief in the second quarter of 2008, according to Hope Now Alliance, reducing the amount of foreclosed homes being added to the housing supply.
- Lenders are slashing prices on foreclosed properties, resulting in bidding wars in parts of California, Florida, Nevada and Arizona.
- Wage inflation is nowhere evident.
- The credit crisis is thawing -- $132.8 billion was raised via bond issuance in May, the most ever raised in a single month. This follows over $80 billion capital that was obtained to replenish the balance sheets of financial institutions, not to mention the billions of dollars raised by private equity funds to inject liquidity and buy distressed debt. Billions of dollars of leveraged loans that originated from the private equity craze as well as mortgage-related investments found ready buyers in the past few months, helping financial institutions improve their liquidity positions. For example, CIT Group recently was able to sell its entire portfolio of mortgage assets in a single transaction to a private equity fund, evidencing a more liquid market for these impaired assets.
- Investment banks are not tapping the liquidity provided by the Fed to the maximum amounts possible, indicating the liquidity crisis is abating; recently, only about half of the $200 billion that the Fed has made available to dealers via the Primary Dealer Credit Facility has been tapped.
- Evidence is building that the supply/demand imbalance for oil is improving:
    - Saudi Arabia is set to increase oil production; contrary to conventional wisdom, it is not in that country's interest to maintain high oil prices that spur development of alternative energy sources.
    - Both OPEC and The International Energy Agency revised down their estimate of 2009 global oil demand. Worldwide demand for oil for the first five months of 2008 has in fact ***dropped***.
    - The world economy is intricately linked and it is very difficult to see how over $390 billion of write-downs and credit losses that have already severely wounded the US economy would not have a noticeable, adverse effect on the growth prospects of countries like China and India, which are primary sources of elevated demand for oil and commodities.
    - Sky-high oil prices are already materially affecting demand:
        - The MTA reported that 400,000 more people rode the trains in May 2008 compared to May 2007; further, more than 7.6 million riders used the subway and light-rail lines, a number that is 6% higher than a year ago; similarly the American Public Transportation Association shows public transit use up 3% year over year.
        - Mastercard reports demand for gas is off 5.2% from a year ago.
        - The Economist magazine reports that the growth rate in global consumption of oil last year was barely a quarter the rate in 2004; in the developed countries, consumption has in fact been falling for the past 2.5 years.
        - The Federal Highway Administration in March showed drivers traveling 11 billion fewer miles compared to March last year, the largest year-over-year decline ever. Also, the shift to smaller and more energy efficient cars continues. For instance, sale of Hummers has dropped to 2380 units from 5214 in January.
        - Foreign countries, most notably China, India, Taiwan, Indonesia and Malaysia, have begun lifting price controls or subsidies, permitting oil prices to rise to market rates. This will reduce global demand for oil.

None of this good news means the economy and markets will recover abruptly. However, bit by bit, these developments collectively contribute to the foundation that will lead to an eventual recovery for our economy and the markets.