

That Fickle Pickle Known as Oil

By Reid Holloway

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People certainly are fickle. Last week I suggested to some friends and associates that I wanted to put together a piece explaining why the market-cap oil component of the major indices was getting so large that stocks appeared to be rallying when in fact most stocks were going down; this fell on bored and deaf ears—even economists’! But with oil now hitting new records once again, everybody suddenly wants to read about the market and oil. There is no doubt that stocks are teetering on a bear market. The recently prevailing wisdom that the price of oil had peaked and it was time to short lasted but a few days. Some acted on that belief. I bet they’re not in a good mood right now.

Those of us who are old enough to remember know that we are essentially reliving a pretty dismal era of the latter 20th century known as the Carter Administration, a confluence of formidable circumstances surrounding what was then termed by the former president as a “malaise.” Whenever I see that word “malaise,” it reminds me of ptomaine poisoning, symptoms of which “usually involve nausea, vomiting and/or diarrhea...” according to a widely known health web site. Isn’t that pretty much how you feel when you’re filling up these days at \$4.30/gallon, knowing that the price that’s making you sick is going to look like a bargain by the end of the summer?

Not only is that realization sickening, so too is the awareness that we have done all this to ourselves, precisely as we did in the 1970s, have learned nothing from it, have done nothing about it, and are even stupider and bolder today in our conclusions and assertions as to what we’ve done and what we ought to do than we were when the man from Plains, Georgia, donned his green cardigan sweater and grandiosely turned down the White House thermostat, also declaring “the moral equivalent of war.”

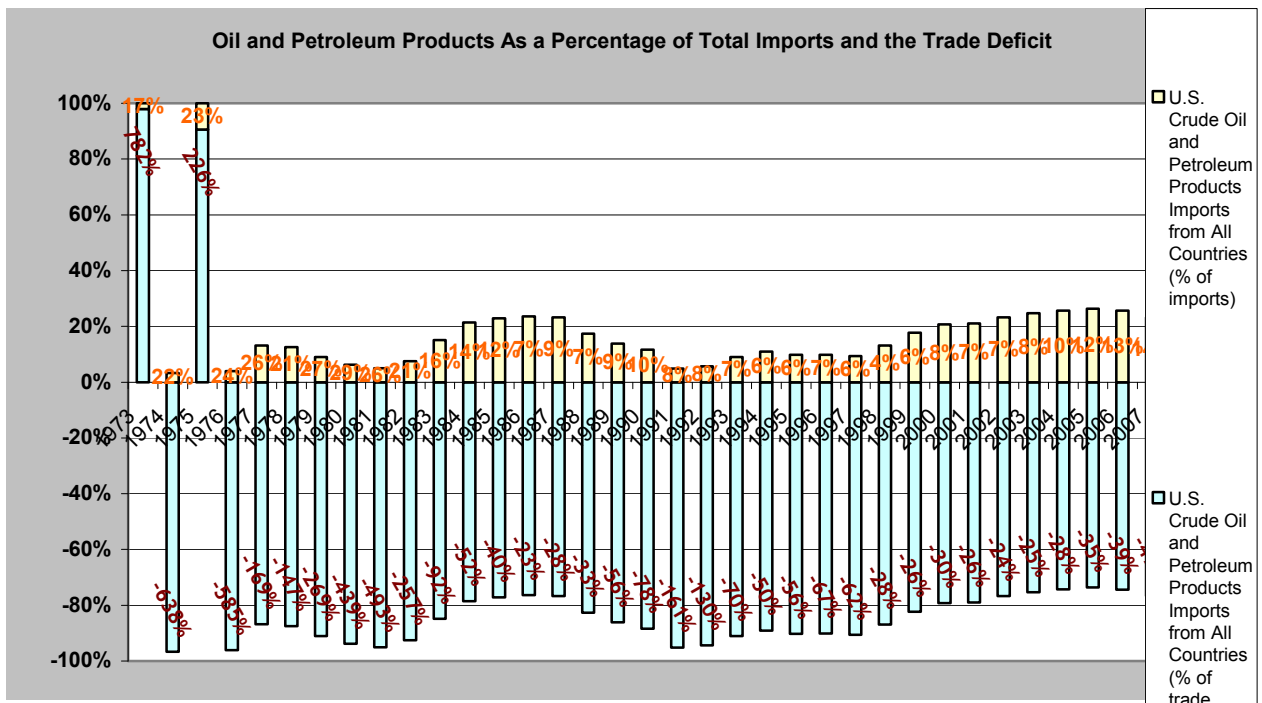
“It’s Big Oil!” cry many. Others finger the “Bush-Cheney-Halliburton” conspiracy and a war in Iraq that’s “all about oil.” Still others blame “the speculators.”

“Oil Is Just Another Bubble”

Sorry, it’s most definitely not. Today’s high energy prices are the *fundamental market result of our own actions*, and those of our overseas neighbors.

1. Energy *demand* is high because a third of the world’s population (in just two countries, China and India, a thought to ponder all by itself) are propelling a meteoric rise in economic output and capital expansion forming the most dramatic increase in prosperity, living standards and political importance the world has ever witnessed. In just the past few years India alone has created *from scratch* a prosperous middle class of *400 million people*. This is a country that experienced widespread famines more recently than World War II.

2. *Supply* is inadequate to meet the needs of this growth. Commodity prices have always behaved in a much leveraged fashion in response to minute fluctuations in the relationship between supply and demand. For the past three decades since the Three Mile Island incident, Americans have insisted upon resisting drilling offshore, drilling in the Gulf of Mexico, drilling in Alaska, drilling in the lower 48, building refineries, developing nuclear—all right here within our own borders. This is just as plain dumb as attempting to manage a busy restaurant with inadequate food provisions, a shortage of kitchen staff, and only one or two operating burners on the stove. It's nuts, and we've done it laboring under the misconception that adhering to this Lilliputian policy has accomplished something positive for the environment that is important and valuable enough to bear the consequences of wringing the lifeblood out of our economy. Since the early 1970s imported oil and petroleum products have accounted for as low as 4.2% and as high as 29.3% of total imports. Last year we stood at the average of around 13%-14%, but that was based on an average barrel price which has since doubled already this year. Until the American people grow up and get wise, the political blockade on practical progress to increase domestically sourced energy supplies will continue, and our living standards will inexorably decline as more and more of our wealth is transferred to foreign oil producers. The implications of transferring these American trillions abroad in terms of national security and geopolitical stability is further staggering; no price tag can be placed on that.



3. *Currency translation* has added another fifty percent to the bill. Since its inception at parity with the dollar a decade ago, the Euro has gained on the greenback to its current relationship of about one and a half to one. That means one third of the \$130 oil barrel price emanates from the deteriorating dollar. You can thank reckless government fiscal mismanagement for that, but you can also attribute that recklessness to the public's demand for goodies and entitlements politicians are only responding to, as politicians always do. *It's we who are to blame. Currency translation is not only a major reason energy costs more in dollars, it's a reflection of policy flaws and market skepticism that underline a huge transition of capital from financial to hard assets, a fact that portends titanic concerns regarding the prospects for future economic growth and job-creation.*

On top of all this, we're at war in the very region of the world we're dependent upon the most for oil, and in addition to that, this region is inherently politically unstable and virulently anti-American, as is pretty much every other foreign locale producing oil.

Finally, it is still true—as it has always been—that, while there are certainly domestic “alternatives” to oil (most notably coal, natural gas and nuclear) for many things we currently depend upon oil for, we are still pretty well locked in to oil for our transportation needs for the short and intermediate term.

Government Is Gouging Us for Energy as Much as Big Oil Is

If there is one thing that astounds and worries me in all these circumstances more than all the other factors, it is the apparent will of the American public to turn to their government for solutions and relief. *Qualitatively* (it can't be quantified), this may be more troubling than any of the very challenging fundamentals comprising *quantitatively* how our foreign oil dependence is at the root of the crippling price trends. Why the public wants to turn to venal and incompetent politicians to solve a problem they are in no position to solve—and in many ways have *caused* and *exacerbated*, while also having taken advantage of to *shake us down for billions in taxes*—is outside my comprehension.

Having noted that irrational tendency, multiply my above concerns by ten in mulling over who is actually cashing in on the energy crisis. *The answer: government itself, and it's high time we did the “peasants, pitchforks and torches” thing about it.*

Here in Connecticut where I live, our state is number two nationally in the price of gasoline. About six to seven dimes are taken out of our pocket by the feds and the state in addition to the price we pay per gallon of gasoline that's already tripled in just four years. Any third-grader can do the math. ExxonMobil's profit margin is just shy of 11%. Yet government is getting *seven dimes a gallon—or half again what Big Oil gets—in pure energy-crisis profiteering, without producing so much as one drop of gasoline.*

You want a windfall profits tax on the villainous profiteers? Then *demand* it in the form of a *decrease* in Big Government's taxes on oil and gasoline. Why should *government* rake in one and a half times the profit margin ExxonMobil earns when they do nothing but stick their finger in the pie like Tony Soprano? How can government justify committing this morally inexcusable extortion, compounded by the nerve to call Big Oil executives before Senate committees to castigate them for their "obscene profits" and "unconscionable salaries?" Why in the world does the public view the government as the "good guys?" Here in Connecticut the gross receipts tax is about to kick in with yet another steep scheduled rate increase affecting all energy sales, and yet the general sentiment here seems to be to look to *the most obscene energy crisis profiteer of all—government*—to find "solutions" and "relief." And—*get this!*—while the Connecticut state government is rolling in more oil and gasoline tax revenue than ever thanks to rising prices, and even allowing the scheduled tax rate on those rising prices to continue to rise, these government profiteers are piling up massive deficits because their spending outpaces the energy-tax windfall! Can you believe it? And we want to trust *them* to solve our energy problems and take the energy industry to task? *Please.*

I don't think there is even one fundamental quantitative fact concerning all energy matters that compares in importance and gravity to the qualitative underlying gullibility of the American public in trusting the villain known as government to come through for them as their hero, because that is what is at the root of the flight from financial assets to hard assets, and it reflects a basic "no vote" in the markets concerning government competence and dollar worthiness.

The Principle of Substitution

In economics there is a little axiom known as the Principle of Substitution. It boils down to the simple fact that if you don't like the high price of cucumbers, you can switch to another vegetable that's cheaper, obtaining a roughly equivalent value without making a critical sacrifice. Choice and competition are two of the better things a free economy can offer to sticker shocked consumers pinching their household pennies.

Unfortunately, there is no other vegetable to substitute for the high-priced cucumber known as a \$4+ gallon of gasoline. Gasoline is an exception to the Principle of Substitution and sticker shocked consumers have no alternative, and there won't be one for years to come. This is the main reason skyrocketing oil prices can't be compared with your run-of-the-mill "market bubble."

The tech bubble burst in 2000 because there were no earnings to justify the ridiculous run-up in the vast bulk of technology stocks that were going to "change the world" and didn't. On the other hand, ExxonMobil was profitable 10 years ago when oil was \$10 per barrel, and it's profitable today with oil at \$130+/bbl. And \$4+/gal. gasoline has definitely changed the world. Investors dumped techs and substituted value stocks.

As for the comparison with real estate, one could argue that real estate has fixed supply and therefore shares a basic fundamental characteristic with so-called “nonrenewable fossil fuels” (a point of considerable controversy I won’t address in this piece). But there is an overriding distinction. The real-estate bubble was financed with a huge mortgage overhang predicated on the assumption that lenders and borrowers could count on being protected by ever rising values; there is no such overhang financing energy producers’ income streams. Motorists go to the pumps, residential heating-oil consumers call their suppliers and pay right then and there on the spot. There is no debt pig wending its way through the python of future energy purchases assumed in energy-industry business models, nor do they depend upon rising prices. All they assume is that people need to get around and don’t want to freeze to death.

It’s a C.O.D. affair, quite unlike real estate. This is why truckers are literally pulling over and walking away when they run out of diesel, sometimes even leaving perishable foodstuffs worth hundreds of thousands of dollars to rot on the roadside, when they can’t afford to fill up in order to complete a haul. These isolated failures in the “here and now” keep the energy business from having to deal with the sort of systemic and accumulated debt-induced foreclosure mess that burdens the real-estate and banking businesses now.

Do not confuse any of this commentary with the futures markets, which is an entirely separate financial arena. Leverage in that arena is most certainly a cause for concern, but it does not change the “pay as you go” nature of oil-industry revenue fundamentals, nor does it take precedence over the oil industry’s unique positioning vis-à-vis the Principle of Substitution.

Conclusion

Make no mistake. While I am saying that the energy crisis is real and that current high prices are not a bubble but are instead based on real fundamentals, that does not mean I am saying we don’t have it within our power to alleviate the pain. We most certainly do. *Energy prices can come down, because we have the power to change the fundamentals that drove them up in the first place.*

1. *We have real political power in this country that few other nations’ citizens enjoy, and we can use it. We can tell Big Government to get off our backs with energy taxes that match the Big Oil profits they complain about, and for which they produce nothing to obtain. We can tell them we want drilling for new oil here at home: off our shores, in the Gulf, in Montana, in the Dakotas, and in Alaska. We can tell them to get out of the way and to let new refineries be built; the oil companies have been begging for permission to reinvest the profits our government criticizes them for earning in new refineries, and which we sorely need to increase supply and bring down prices. We can sound off regarding the need for clean and scalable nuclear power; *even France has seen the light on this*, as have the Chinese, the Japanese and numerous other nations near and far whose economies are outperforming our own due in large part to their relative farsightedness on supply policy in contrast to our own.*

2. *We can benefit from pain at the pump in the way we invest.* To be sure, I am not in any way advocating that it's a good idea for the Average Joe to play with fire in the highly leveraged and volatile commodities futures markets, *because that's not a good idea without professional assistance and even then it's still very risky and requires considerable and liquid net worth just to qualify.* However, owning a diversified array of upstream, downstream and integrated oil shares *is* a very sound strategy and within most investors' reach. So is an equally diversified selection of quality issues in the emerging panoply of newfangled energy alternatives including fuel cells, wind, solar, *etc.*

I don't know which of these new horses in the race will win, place or show, but one or more of them inevitably will. *So diversification is the key.* In the beginning of the 20th century there were more than a hundred auto manufacturers. All but a handful are now out of business and even the survivors who collectively own the entire market can't seem to get it together on the whole. But that lifecycle took a hundred years. The emerging alternative energy business will experience a similar evolution in time but for now the profit opportunities are enormous *if you are diversified, diligent and patient.*

History shows that when you have a quantum leap in the way things are done—in this case, an emerging new segment of the world's economic lifeblood that could negate the now prevailing Rule of Substitution exception for many energy needs almost exclusively served by oil—you're talking about the biggest gold mine imaginable. Most of these new enterprises may well go the way of all flesh, *but if you can afford to own a diversified portfolio of dozens of these companies, the few that survive will earn profits for you that will offset by multiples the losses generated by the bulk that fail.*

This is the way human progress works; this is what the private equity and partnership capital portfolios of the largest investment banks on the planet are up to their ears in right this minute, and how historically these savvy professionals have made their greatest fortunes.

Everybody Benefits

What's especially nice about all this is that ordinary end users always get the most economic dollar benefit, no matter what happens in the financial markets. Even in the case of the busted tech bubble, notwithstanding the fact that there are still folks sitting around licking their April 2000 wounds when 80%-100% of their multimillion-dollar tech portfolios went up in smoke, *it is still true that the dollar benefit of the industry itself, the information technology revolution, is a multi-trillion-dollar benefit embedded in our lives today that didn't exist just a few decades ago—providing us with gigantic increases in productivity the dollar value of which dwarfs any of the personal fortunes associated with the rock stars of the industry such as Bill Gates or Steve Jobs. The same will be true when alternative energy sorts itself out and what Americans depend on for heating, cooling and getting ourselves around is sourced here at home. But this will be a gradual, incremental transition over time, not a magic bullet.*

In the meantime the surer investments for most people will be those dirty old time-tested oil companies that have been coming up with the goods for a century, regardless of whether oil prices were at cyclical peaks, troughs or in between.

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June 12, 2008.
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Reid Holloway created the RLH Volatility Model, a quantitative methodology for equity portfolio return enhancement and risk abatement. Visit <http://stocksthatwobble.com> to learn more.