

Woody Brock: Oil Prices in the Era of Thugocracy

Robert Huebscher

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Dr. Horace "Woody" Brock is the founder and president of [Strategic Economic Decisions](http://www.sedinc.com) (<http://www.sedinc.com>), a consulting firm focused on economic forecasting and market analysis. His clients include the world's largest hedge funds, private equity firms, and corporations, and he is a frequent speaker on economic topics. Dr. Brock was the keynote speaker at the Portfolio Construction Conference held in Sydney, Australia, on August 28, and this article is based on that talk, as well as our conversation with him afterwards.

Nearly five years ago, Woody Brock forecast that oil prices would soar, although at the time he did not know by how much. His predictions were accurate and, equally important, they were accurate for the *right* reasons.

Brock provides a sparkingly clear explanation of the behavior of the oil markets, and a dire prediction for their future. Arguing that this crisis is badly misunderstood, Brock dismisses the idea that speculators are driving prices, as well as any role that OPEC might play.

Brock's Analytical Framework

To analyze the oil markets, Brock eschews an approach that relies on data and the resulting information overload that can hinder the understanding of market dynamics. Instead, he begins with a sound theory to determine which variables matter and why. (Incidentally, he claims that all great theories have no more than five variables.)

"We are brought up thinking that crunching numbers can get an edge," Brock says. "But the degree to which this can be accomplished is much less that you think."

To illustrate his views, Brock cites Einstein's work in general relativity. Einstein did not spend his time observing a multitude of data points. Instead, he constructed his theories based on the laws of mathematics and physics. In 1919, Einstein's theory was tested and ultimately proven by observing the bending of



light in an eclipse. When Einstein was offered the photographic plates from this experiment, he turned down the offer, supposedly said that he would be sorry for the Almighty if the results did not agree with the theory.

Brock cites Einstein's observation that "Good theories are good because they work better."

Brock's has developed and tested theories that explain some of the most important economic issues. For example, his work has shown that the only truly important variable in forecasting long-term equity returns is the valuation of earnings (i.e, the P/E ratio). Earnings growth, interest and dividend rates play much smaller roles. The great bull market from 1980-2000 was the result of P/E ratios climbing from 8 to 33, after which they receded to 15. In the current decade, earnings growth has been "fantastic" and interest rates low, yet anemic returns have resulted from the decline in P/E rates. [See the [article](#) by Vitaliy Katsenelson in today's issue on this same topic.]

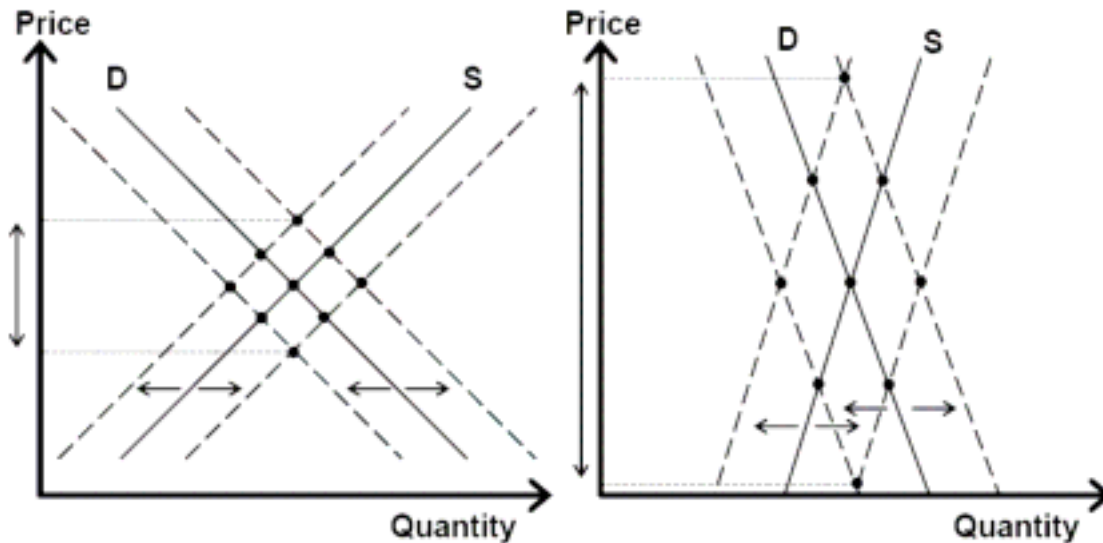
He has also studied the claim that government deficits can be inflationary (e.g., the claim that when the government funds a major program, such as a war, through deficit spending, this inevitably is inflationary). Brock has shown that deficits are inflationary only when they are "monetized," through the printing of more money and the increase in the money supply. His works also extends to the question of whether foreign governments could drive down the value of the dollar through capital inflows, which would result if they were to sell their holdings of US treasury securities. Brock shows that governments cannot, in general, impact interest rates at all, but can indeed cause massive overshoots of the dollar up or down. "The dollar does all the work," says Brock.

The Oil Markets

But let's return to the oil markets. Brock cites three factors which have driven up oil prices. First, there has been accelerating demand, principally but not exclusively from Asia. Despite an increase in price from \$10 in 1999 to \$140 in 2008, global demand has increased, notwithstanding the recent drop off in US consumption. Second, peak oil has resulted in declining production [see our [article](#) on this topic]. Brock believes global oil production peaked about two years ago and has been declining at a rate "more than pessimists predicted." Mexico's output has dropped by approximately 30% over the past four years, and there have been production declines from Norway, the North Slope, the North Sea, and Russia. Lastly, a "pathological incentive structure," which he terms "thugocracy," is discouraging the exploration and development of new oil fields in ways not previously experienced.

Brock offers the following graphical representation of volatility in the oil markets:

**FIGURE 2: THE TRUTH ABOUT OIL PRICE VOLATILITY
– PRICE RISK AS A FUNCTION OF ELASTICITY –**



The diagram on the left represents a more stable commodity, such as cotton. On the right is oil, which is unique in that demand and supply are very closely in balance and, more importantly, there is no substitute for oil. We cannot drive our cars and heat our homes without oil, but we can substitute polyester for cotton.

The solid lines represent the supply and demand functions, and the dashed lines represent these functions after a change in either supply or demand. This change is represented by the horizontal arrows in the diagrams. Note that the size of these arrows is the same in both diagrams. The vertical arrows represent the changes in price resulting from the change in supply or demand. Proportionately the same change in supply or demand the oil markets results in a much greater change in price.

The steepness of the supply and demand functions creates the extraordinary price volatility in the oil markets. Economists term this jointly inelastic supply and demand.

We asked Brock why the most recent surge in oil prices seemed to start suddenly in the summer of 2007. He explained that the more meaningful trend began a decade ago, when prices were at \$10/barrel and prices have been rising ever since. The surge that began last summer was merely an artifact of the volatility that stems from the steepness of the supply and demand curves.



It is thugocracy that poses the most severe threats to the oil markets and hence the overall economy. Thugocracy is Brock's moniker for the anti-free market policies of certain governments. He singles out Russia's Putin, Venezuela's Chavez, and Boliva's Morales for moves that have threatened to or have actually nationalized oil production and distribution facilities. The result is that private companies are getting kicked out of these countries.

A staggering \$1 trillion per year must be spent over the next 30 years to develop new oil sources, but "nobody will spend this under the threat of nationalism," says Brock. Instead, companies like Exxon spend their capital on share repurchases. Thugocracy is not limited to oil producers; China exhibits the same behavior in its subsidies for domestic oil prices, which have artificially inflated consumption.

Brock says these countries are "utterly incompetent" of maintaining their current levels of oil production, much less developing new sources. If world supply cannot go to 100 million barrels per day (from the current level of approximately 86 million), Brock predicts either rationing or wars will result. "Every year we don't invest is another year that the markets stagnate," he says.

"Alternative energy is not a remotely possible solution in the short term," says Brock. He cites a Stanford study which showed that alternative energy could at best replace one-third of what might be lost through the failure to adequately develop existing oil reserves.

Economic and Market Forecast

Brock offers the following assessment of the impact of oil prices on world economies:

"We believe that the oil crisis is the single most disturbing development in the world right now. This is because of the disastrous cumulative effect on future prices of forever delaying investment in big new oil fields during a period of exploding global demand, and during a period when output from old fields will be declining. Ironically, such fields exist and we know where they are. All in all, we have reached a point where quantity-rationing of oil may well become commonplace within five years- with all the political and economic problems that rationing entails."

He further adds that "at the right price there is always more oil – *indeed more of everything* [his emphasis] – and a proper resource allocation process sees that more is produced." The right price is typically lower, not higher, despite growing demand, as has been the case with flat screen TVs.



Since late last year, Brock has forecast a “serious growth recession” for the US economy, lasting through all of 2009. He sticks by this forecast, although his fears have been heightened by the prospects of a more serious credit crunch.

In December of last year, Brock offered the following investment advice: “the months ahead represent a time when investors should seek to maintain the value of their capital, regardless of concerns about ‘missing a rally’.” His advice today: “Downside risks have appreciably increased, and an investor’s goal for at least the next twelve months should be to preserve capital.”

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