The Great Oil Price Debate

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Basic Economics or High Stakes Speculation?

Welcome to the great debate of 2008. In one corner, basic economics rules the day and supply/demand issues remain at the forefront of all discussions. In the other corner, naysayers claim speculators have prompted the dramatic run-up in oil prices and current levels have little to do with actual energy production and consumption.

So, what gives? Who's right? Are there any easy answers?

Let's Turn to the Numbers

With oil hovering just below $130/barrel, its price has virtually doubled over the past 12 months and has soared over 30% this year. Currently, it stands about 20% above the previous record highs hit in 1980 (on an inflation-adjusted basis) and noted Goldman Sachs analyst Arjun Murti is on record as saying that $200/barrel over the next two years is well within the realm of possibilities. Before you laugh (or cry), Murti first predicted a surge in oil to $105/barrel back in 2005. Gasoline has followed in lockstep as related prices advanced to just below $4/gallon by Memorial Day and many travelers were forced to alter their vacation plans. In fact, a recent RBC Capital Markets survey showed that about 90% of Americans have initiated certain lifestyle changes as they tighten their belts because of the higher energy prices.

Should the upward trend continue, undoubtedly consumer activity will be impacted to an even greater degree. Stephen Brown, an energy economist at the Dallas Federal Reserve Bank, projected that $150/barrel oil will reduce GDP by around 1.8% in the first year, a pretty frightening thought considering the first quarter 2008 GDP grew at a feeble 0.9% rate. At $150 oil, gas prices would move to about $4.50/gallon (and even more travel plans would be altered).

The Supply and Demand Corner

To many analysts, the price moves are well justified based on global production and consumption levels. Currently, the world is producing and consuming approximately 87 million barrels of oil per day, and even the most math-challenged among us can see that leaves no excess supply. Since 2004, daily output has grown by about 1.8%, while demand has increased by 3.7%. At that pace, the worldwide oil inventory situation will get far worse before it gets better.

Despite the price gains (and President Bush's pleas), OPEC has refused to lift its production targets. While some OPEC ministers blame the U.S. for failed economic policies, certain OPEC nations like Iran and Venezuela simply haven't invested enough in infrastructure to increase production even if they so desired. Likewise, Mexico and even Russia have watched their output decline due to aging oilfields and lack of investment. The International Energy Agency is currently conducting a thorough review of the world's oilfields and is expected to release a very pessimistic report that further supports this case for diminishing supply.

On the demand side, most economists focus on growth in developing nations as reasons that global consumption is on the rise. Demand in China is expected to increase almost 5% during 2008. However, amid all the China talk, the Middle East seemingly has been lost in the shuffle, though demand is expanding rapidly in that region as well. Since 2004, Saudi Arabia has seen its own oil consumption increase by over 20%, thus, cutting into its ability to export abroad.

All hope is not lost. From adversity often comes opportunity and Lehman's chief energy economist, Ed Morse, believes that some promising exploration sites in Brazil, Alaska, Norway, and elsewhere will prove quite beneficial as new deepwater drilling increases production capacity. Likewise, the Center for Strategic and International Studies has projected a global surplus by late 2009 as new wells come into production. Its director points out that oil companies are slow to commit to new projects for fear that supply/demand imbalances may be short-lived. However, once they recognize the challenges are not going away overnight, they will move to increase research budgets, although there are multi-year lag times from exploration to production.

The Speculation Corner

On the speculation side of the equation, conspiracy theories abound, including talks of bubbles and comparisons to the Internet mania of the late 1990s. Of note, analysts Paul Horsnell and Kevin Norrish of Barclays Capital scoff at the Goldman $200/barrel projection, calling it nothing more than "a piece of analyst bling." After all, Goldman manages one of the largest commodities index funds and has great incentive for a bullish oil market. Lehman's Morse estimated that the size of such commodity funds has skyrocketed from $70 billion in 2006 to $235 billion this past April, much of which has been invested in oil.

Michael Masters of Masters Capital Management LLC, a seasoned hedge fund veteran, testified before Congress in May about his concerns that institutional investors are contributing greatly to energy and food price inflation. He claims that over the past five years assets invested in commodity index funds have surged from $13 billion to $260 billion, and the total demand for energy-related futures contracts by institutional investors (848 million barrels) actually rivals the demand growth of China (920 million barrels).

Industry insiders have weighed in with some price projections of their own. Stephen Simon, Sr. Vice President at Exxon Mobil, thinks that crude inventory suggests a price of “around $50 to $55 a barrel” and notes a “disconnect between historical norms and current prices.” Urban O’Brien, Director of Government Affairs at Apache Corp, a Houston-based oil and gas producer, claims that “market prices bear no resemblance to supply and demand.” However, while some feel that the elevated prices are not justifiable, they cannot project exactly when the “mania” will end or put a dollar amount on how much shear speculation represents.

Capitalism at its Finest

Ryan Krueger, founder and Sr. Portfolio Manager of Krueger & Catalano Capital Partners, a Houston-based money management firm and hedge fund manager collectively managing over $150 million in assets, has heard both sides of the debate and lends a purely “capitalistic” perspective. “Color me as the guy who believes markets are never wrong, but opinions very often are,” he said. “The fact that speculation gets mixed in is a really silly debate, because there’s speculation in any market with bids and offers. I’ve learned in my career on Wall Street and now running my own firm that a more accurate definition of speculation is ‘I wish I had thought of that sooner’.”

Krueger’s firm has been overweight energy since it was 6% of the S&P 500 and crude cost $15/barrel. He began accumulating energy-related positions about 10 years ago, with the belief that world-wide demand would overwhelm supply. “We are not running out of oil. We ran out of cheap oil, because we exported capitalism around the world and you know what – a couple billion folks really like it. This should not be a crisis; it should be a celebration.”

In fact, Krueger believes the current energy crisis may be a blessing in disguise and just what the doctor ordered in terms of future development, innovation, and good old-fashioned capitalism.

“Heck, free gas is the last thing we need. The question is ‘how much are we going to cut back and change habits.’ High prices are the answer, not low prices. Look at the facts, and you will see Americans drove 11 billion miles less in March year over year. People will make changes when they’re forced to, as long as we stop trying to intervene.”

Krueger believes the Goldman prediction of sky-high prices will prove incorrect. He also doesn't expect to see $15/barrel ever again. "Those $200/barrel predictions disagree with capitalism and that's an argument, given enough time, that has a winless track record. New production and sources will be created at higher prices. Then again, we're not going back to $15 because capitalism is working and the enhanced demand is very real from new middle classes around the world."

The Debate Rages on…

Speculation? Supply/Demand? Energy analysts can make bold price predictions, but their job descriptions don't call for them to put their "money where their mouth is" and place their own (or their firm's) capital at stake. Energy execs have their own personal and corporate motivations to make promising forecasts (that may lead to enhanced investor activity and escalating share prices). Krueger, an investor and portfolio manager, says the free marketplace will work through these challenges and capitalism (and all of us) will be the ultimate winner. His unbiased opinion makes sense. Increasing global demand will lead to new production and innovation; high energy prices ultimately will change consumers' buying patterns; the markets will correct as stocks, bonds, and commodities find their true valuations. But, unfortunately, the days of $15 oil are a thing of the past.