



## E-lumination

July 13, 2006

### A follow up on the oil and gas stocks—which got shmooshed today.

Many oil and gas stocks took a pounding today while the price of oil hit a new all time closing high of \$76.70 per barrel. There appears to be a disconnect between the two, unless you use “Wall-Street-think” to understand the situation. We told you in our July 11, 2006 newsletter called “Oil Stocks Update” that “conventional wisdom on Wall Street is that oil will return to the \$50 per barrel region once the political instability in Iraq, Iran, and North Korea are resolved.” Now you can add the most recent Israeli-Palestinian conflict which was widely credited with moving oil prices up today.

The real point is that all our research leads us to the conclusion that \$45-\$50 per barrel is seen as the “normalized” price range that oil would trade at, if not for all the international tensions. For example, Deutsche Bank recently revised its pricing outlook for West Texas Intermediate Crude (WTI) and now has a price target of \$62 in 2007; \$55 in 2008 and \$45 for their “long term” price target. We believe that most of the major Wall Street firms are using \$40 to \$50 per barrel pricing when calculating long term earnings and cash flow projections for oil related firms. Even some oil company executives themselves are publicly using such numbers. One of our favorite technical analysts is Richard Suttmeier. His research report, dated today, states that if oil breaks back below \$70.80 that the “risk” increases to a drop back to “support” at approximately \$51.

It stands to reason that if you believe these targets are reasonable that you would be selling off your oil stocks when oil prices exceed \$70 per barrel. There is no telling how far these stocks will fall if oil does retreat to \$51. The other factor influencing stock pricing is that natural gas prices have already collapsed back to longer term trend lines, and supply seems adequate for the near term. Therefore it seems that many Wall Street types sense no urgency to own gas production or gas exploration companies—and many companies do both oil and gas production (as in “oalngaz”).

It is also quite reasonable to observe that natural gas prices did spike way up and have since retreated dramatically. Therefore why wouldn't it be reasonable to assume that oil will eventually do the same thing? Wall Street believes it is reasonable and they are marking down the price of oil and gas related stocks by selling them off.

So who the heck is little ole' K&A to question Wall Street's collective wisdom? Furthermore, why would we second guess the charts that give us the clues to sell these stocks? Because we have a hunch that this is one of the times that Wall Street is making a big mistake. If you don't think Wall Street makes big mistakes, think again. Does the name Enron mean anything to you? How about Long Term Capital Management? We could go on, but we suspect by now that you get the point we are trying to make. All that research money doesn't necessarily lead to perfect analysis. Sometimes it doesn't even

lead to good analysis. Sometimes it leads to herd mentality that is not at all insightful, and we think this is one of those times. Everyone is headed in the WRONG direction; and at the same time.

The DJIA sold off 1.44 percent today. The S&P 500 sold off 1.24 percent today. Encana (ECA) sold off 2.48 percent today. Nabors (NBR) sold off 3.25 percent today. The Philadelphia Oil Services index fell 2 percent today. In other words much of the “oalngaz” world got shmooshed today. The big Wall Street houses were marking down the energy related stocks. We see it; we understand it; and normally it would scare the bejeebers out of us and we would be selling too; but not this time.

We wrote our first significant paper on “**The Oil Patch**” on June 23<sup>rd</sup> of last year; after commenting on the topic in each of our last several annual reports to investors. In it we said the following: There is a lot of speculation, and possibly some fear, built into the current pricing structure of oil. It is still possible that we could see prices back down in the \$40's before we see \$80. But I've got a distinct feeling that we will see \$80, and possibly higher. Earlier this year one lonely analyst at Goldman-Sachs speculated that oil could be priced at \$100 per barrel by the end of the year. Most other Wall Street mavens laughed and ridiculed him. I suspect those smiles are a little tighter on people's faces right now.

Let me get down to explaining the problem and why I am more and more concerned that prices will zigzag their way up, and not down. It seems that we use about 84 million barrels of oil per day throughout the world right now. Approximately 21 to 22 million are used right here in the good ole USA. The good news seems to be that if we continue to use oil at that pace, by everybody's best reckoning, we probably have a 40 year supply of oil left on the planet. The bad news is that is probably a lie! The worse news is that doesn't help to have a 40 year supply of something that you can't deliver today-when it is needed. It isn't a matter of how much we've got left. It is a matter of how much can be delivered to the market place each and every day—refined that is! You remember that little relationship of supply vs. demand don't you—and what happens if one gets out of balance with the other?

This excerpt is from a paper written on June 23<sup>rd</sup>, 2005, which can be found in our 2005 Archives at <http://www.kaassets.com/pubs/2005/2005Illuminations.htm>.

That is almost two months before Katrina. Does anybody reading this know if any significant expansion in our refining capacity since then? The answer is that there has been none.

Did you know that it is now widely estimated that demand for oil has risen 1 million barrels per day since this was written last year? Does anybody know of any significant new oil discoveries since then? There have been none.

Actually production is falling in many parts of the world. From 2004 to 2005 our domestic crude oil production actually fell 5.7 percent and it has dramatically declined so far in 2006—despite all the new drilling and exploration that is going on. That data is readily available directly from the U.S. government at

<http://tonto.eia.doe.gov/dnav/pet/hist/mcrfpus1m.htm>. Today we produce less than 8 percent of the oil we use domestically, and our production has been declining every year since the early 1970's. The dream of "energy independence" from the middle-east is a total fiction in a fossil fuels based economy. That is not an opinion. It is a simple fact.

If you thought that OPEC was going to bail us out with new supply, then think again. Check this out from CIBC World Market Report dated June 7, 2006: [The call on OPEC has long been referred to as a measure of pressure on world supply, being the difference between world demand and non-cartel production. But increasingly, what bears watching is OPEC's call on itself, which is simply the difference between what it produces and what it consumes. Not only is the cartel, along with other key producers like Russia and Mexico, not able to increase production, but its own internal consumption rates are also soaring. So much so, that the group as a whole is likely to be exporting a little over three million barrels per day less by the end of the decade, a nearly 10% decline.](#)

You don't have to read that again. They said 10% decline; by the end of the decade. The end of the decade is only 4 years away. We know of no other advance in recovery technology or new discovery of reserves that can be on line by 2010 to take the place of this decline in oil supply.

The fact is that we are becoming more and more skeptical that there is a huge "terror" or "fear" premium in the price of oil; and we are becoming more aware that prices may actually be approaching equilibrium for the current supply and demand situation. Let's put that another way. Does it make sense to you that there is nearly a \$35 to \$40 per barrel "terror" premium in the price of oil? We thought global markets had gotten more efficient than that. Sure there is some "fear premium" in the market right now. After all the price of oil has started to drift back toward \$70 before this latest up-tick related to the conflict between Israel and Palestine. But we are extremely skeptical that the premium is as large as the Street seems to think.

If you have been a consistent reader of our newsletters you know that K&A is a believer that we have either reached, or will soon reach, the point at which global oil production peaks. "Peak oil production" and significant price declines do not go together.

We continue to update our research on the global supply and demand equation. It may take years before anyone can verify that the 2006 to 2010 period represents the time at which global production peaks. The fact is that no one wants to believe it. But we have found no data that dissuades us from the opinion that that world has entered the era of peak global oil production.

Just as "global warming" was considered to be a myth, or "bad science", ten years ago, and is now widely acknowledged to be true. We think that over the next five years the world will also come to recognize that we have entered the era when current supplies, plus new discoveries, will not be able to keep up with increasing global demand. We also firmly believe that there is no "alternative energy" source on the horizon that can provide sufficient volume of useable energy to take the place of oil any time soon. We're sorry

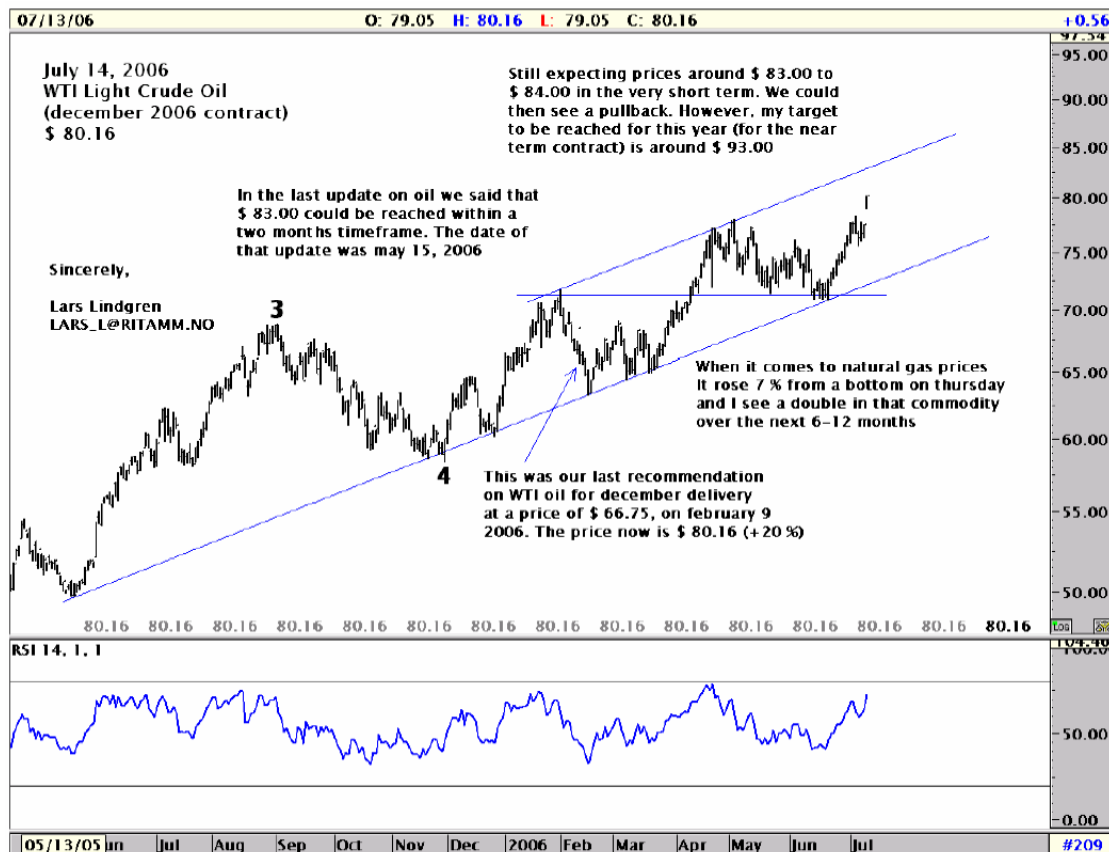
folks, but ethanol made from corn isn't the answer. Ethanol from sugar cane could sure help.

In the paper we wrote in June of 2005 I wrote, **“We are still John F. Kennedy’s country and we can do the unimaginable. We can dream, plan and invent our way out of this oil dilemma, but I suspect we don’t have a moment to lose.”**

That was more than one year ago and while there is lots of “noise” in the market place, and some sincere private efforts to develop new energy resources; there is no plan or effort in place on a national scale that will get us out of this problem.

Check out this chart that we received today from one of our technical charting and research services. This is the WTI Light Crude Oil December Futures contract chart which closed at \$80.16.

Note in the first paragraph of annotation on the chart that the near term target is \$83 to



\$84, with \$93 as the year end price target. Also note the comment about natural gas prices...”**I see a double in that commodity over the next 6 to 12 months.**” Current futures pricing in the actual marketplace supports that opinion.

This is a chart from Lars Lindgren. Like any chartist or analyst Lars has not proven to be infallible; but we have found him to be overwhelming reliable in his analysis. We subscribe to his charting for currencies and various commodities, including oil.

So let's wrap up this diatribe. Our point is simple. We don't think oil prices are going to retreat to \$40, or \$50, or even \$60 any time soon. We think that is fiction and potentially Wall Street's next big mistake.

In fact, we think the opposite is true. We think that prices are likely to hover at \$70 or higher for a long time to come. We simply do not see the additional supply of oil coming on line that would allow for a significant price reduction. If you are willing to assume for a moment that we are right, then you have to take the next leap of faith (or analysis) regarding oil related stocks. You have to ask yourself what happens when Wall Street analysts start applying \$70 per barrel pricing to earnings and cash flow analysis for stocks, rather than the current \$45. It doesn't take a rocket scientist to know the answer to that question. Stock prices will take another big leg up. So we will continue to hold a significant allocation in oil and gas related securities. We may do some selling and buying within the allocation to strengthen our position, but we do not foresee reducing our allocations to oil and gas in either of the Mendocino or Hatteras model portfolios. We intend to double the current allocation in the Bonavista and Halifax models during this time of price weakness in oil and gas related securities.

#### **Postscript:**

I started writing this newsletter on Wednesday and it has taken me until Saturday morning to get the time to finish it. This morning Bank Credit Analyst (BCA), our lead macro-economic research service had this to say in one of their weekly bulletins.

*“Energy stocks have been on a rampage in the last few years and should continue to enjoy upside going forward. While the latest supply-driven surge in crude oil prices is slightly worrying given the negative implications for demand, the current bull market has lagged the increase in profits, as valuations have compressed throughout the bull phase. This phenomenon partially reflects industry cautiousness: oil industry executives have consistently warned that commodity prices will correct, fueling an undercurrent of skepticism about profit sustainability. However, it is better to watch what insiders do rather than what they say. Insiders are still in a buying frenzy almost three years into the bull market, a sign that they still see good value in the price of their shares. The bull market in energy stock still has legs, remain overweight.”*

We use BCA for a couple of important reasons. First, they are totally independent, like K&A. They are not “Wall Street”. Second, they have been providing top quality independent research since 1949. They are headquartered in Montreal, Canada.

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For K&A Asset Management, LLC

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