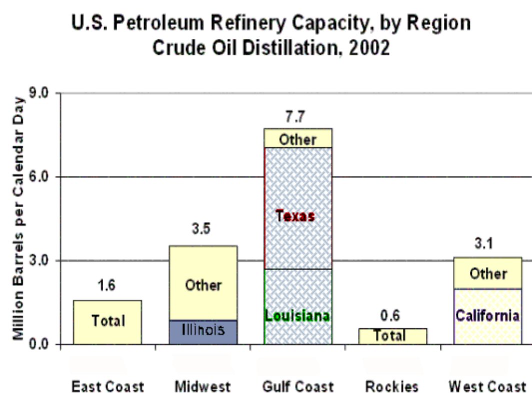
Stanley E. Rulapaugh, CFA **October 1, 2005**

Even when the experts all agree, they may well be mistaken.

John Ruskin, 1819-1900

The energy situation seems to get worse by the day even though gasoline prices have declined a few cents from the highs. There are still missing oil platforms and some may have sunk. One of the four major petroleum pipelines from the Gulf of Mexico to the north is out while two are working at reduced capacity. The latest available refinery report shows that more than a quarter of U.S. refining capacity is down and won't be back up for some time. Gasoline inventories went up in the latest report but the bad news is that diesel and home heating oil inventories declined just as winter starts. Not a good sign. I've read that we are importing gasoline from Europe where they have excess capacity. Excess, that is, until workers at a Total refinery in France decided to strike last week. If the strike continues for very long, half of France's gasoline and heating oil output could be jeopardized. And if we can't get our refined products from Europe . . . ?



The chart on the left is a great illustration of a failure to diversify our refinery capacity. The middle bar shows three divisions; Louisiana, Texas, and other. Clearly Louisiana and Texas dominate the bar and the chart. That concentration won't change during the next fifty years because that's where the oil and gas are concentrated. Unfortunately, that's also where the hurricanes like to visit. We know from prior exploration that oil deposits exist on the continental shelf all around the USA. If we started exploring here and in Alaska today, and we were lucky enough to find oil, it would be a hundred years before we could develop the fields and build refineries in sufficient quantities to change this chart. Up to now there just hasn't been the political will to develop our own reserves. Politicians, particularly those facing an election next year, demand we "do something," whether it is a government mandate for greater fuel efficiency, price controls or useless investigations.

Greater fuel efficiency sounds good but basic algebra shows that this is a meaningless gesture in the short term. Assume Congress passes a law tomorrow that new cars and trucks must get a minimum of 50 miles per gallon immediately. The first effect would be the destruction of the domestic automobile industry. That aside, there are currently more than 260 million vehicles on the road. Assume the average mileage is 18 miles per gallon. Each year we build and sell 16 million more cars and probably scrap eight million. Next year, if the un scrapped 252 million still get 18 mpg and the new 16 million get 50 mpg, the resulting gas mileage for the fleet is 20 mpg. Big deal. But no one is talking about mandating 50 mpg. The talk is 22 mpg which means it will take dozens of years before any meaningful gasoline savings takes place.

Price controls. Hawaii is trying it now at the wholesale level. On the islands, gas prices can't be higher than a complicated formula allows. If I'm an oil company and can sell gasoline on the mainland for $3.25 a gallon, why would I ship any to the $3.00 price-controlled islands? So far, no breathless reports of gas lines on Hawaii. Just wait.

"Let's investigate!" Investigate what? Investigations are nothing more than a feel-good solution that accomplishes nothing. As I said in an earlier piece, no one investigates when gas is $1.00 a gallon so why investigate at $3.00 a gallon. Price gouging does not exist if a willing buyer fills up the tank from a willing seller. I find it ironic that the very folks who want us to drive less to improve air quality are the same folks who complain the loudest when the only thing that will make us drive less - high prices - are in evidence. The SUV may be a thing of the past without government intervention. Used SUV prices have crashed and some car dealers send trade-in SUVs directly to auction. This just proves we need a rule that everyone who runs for public office must take, and be required to pass, an elementary economics class.

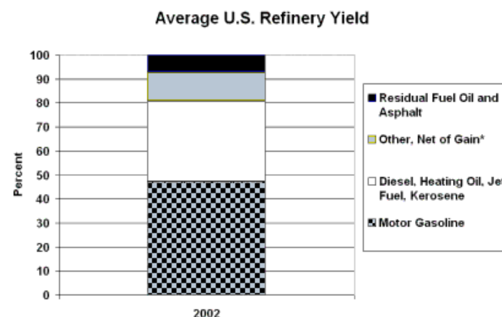
It took two hurricanes but Wall Street analysts and portfolio managers are beginning to understand the magnitude of the oil problem. I know that's hard to believe because Wall Street people are paid handsomely to anticipate events and to invest accordingly. Until two months ago the consensus price for crude oil was $40 a barrel. Since oil had been above $50 for months, the only way to achieve a $40 average is to have an equal number of months of $30 oil. Now that oil is at $60, we need a prolonged period of $20 oil and I haven't heard one person in the news or on CNBC believe that is in our future. The problem with pegging oil at $40 a barrel is that earnings estimates for oil companies have been too low for an extended period. That means that oil shares, expensive based on faulty earnings estimates, are now cheap based on the

revisions. For example, at the end of July, one research report expected oil to sell for $50 per barrel in 2005 but lowered the assumption to $42 in 2006 and $35 in 2007. This was typical. The risk to the forecast was that the pullback in prices would be sharper. If a $1.00 change in oil prices changes oil company earnings by as much as 2% per share, then the anticipated drop in oil prices would have a very negative effect on profits and, by inference, oil stock prices. The hurricanes changed all that. Now it is possible the $20.00 increase in oil could mean that oil company earnings would be up 40%. Exxon, for example, was expected to earn $4.30 under the old assumptions but could earn as much as $6.00 a share in 2006 under the new. And in 2007, instead of $3.50, Exxon could earn $7.00. This is a major change in sixty days and reflects a major miss for analysts and portfolio managers alike.

Money managers behave more like cows than cats. We learn early in our careers that you can get fired for making an extreme forecast and then being wrong. Staying close to the herd is job security. In my opinion far too many Wall Streeters missed this energy stock move and now must play catch up. This week I did an informal analysis of mutual fund holdings using the Value Line Mutual Fund Survey. Value Line's presentation breaks apart a fund's industry diversification including the energy and technology sectors. A majority of the funds reviewed held a lower than market weight in energy and a larger than market weight in technology. This indicates to me that fund managers are buying the last market, expecting technology to lead again despite the recent change in market leadership to energy.

Evidence exists that my analysis is correct. Today's weekend *Wall Street Journal* lauds a Goldman Sachs Analyst Arjun N. Murti for his once outlandish forecast that oil had entered a "long-term 'super spike' in which prices would fluctuate between $50 and a head-turning $105 a barrel." He made his forecast when oil was trading in the low $50 range. The *Journal* reports "critics scoffed" and compared his forecast to the faded dot-coms when foolish forecasting ruled the day. In my opinion, the disbelievers continued investing with the crowd (in technology) and missed a majority of the move up in oil stocks. In 1975, energy was 17% of the S&P 500 index. In 1980, 28%. In 1985, 12%. Today it's 10% so we have a long way to go before oil matches the 15% now invested in technology stocks.

Consider the chart on the right. This shows the proportion of products you get when a barrel of oil is refined. The checkerboard pattern on the bottom is gasoline, a little less than half a barrel. Gas is expensive because there isn't enough of it. The black and grey stripes at the top are asphalt and the ubiquitous "other." The white box in the middle, the "middle distillates," are diesel, heating oil, jet fuel and kerosene. These are in short supply also. On August 10 The Associated Press reported that "Airports in Arizona, California, Florida and Nevada recently came within a few days - and at times within hours - of running out of jet fuel." This was two weeks BEFORE the hurricanes hit the oil and gas producing areas in the Gulf of Mexico. If jet fuel is in such short supply that passenger airplanes are working as tankers, filling up at locations of surplus and flying to areas of shortage like Phoenix, only to pump it out into storage and then to pump it into other airplanes, don't expect lower prices any time soon. Especially not in the cold states. The *Old Farmer's Almanac* forecast is just out. "It's going to be a tough winter," Editor Janice Stillman said, "so get the shovels ready, get the mittens out, stoke the fire."



High gasoline, high heating oil, high diesel and jet fuel. I don't think this is a temporary blip for several reasons. We are importing in competition with the emerging economies. Our refineries are old and we aren't building new. The tanker fleet is stretched to capacity. Regulation is not on the wane. Natural gas supplies are being depleted faster than discoveries. Our clients have owned oil and gas stocks for some time now so whatever pain they feel when filling their gas tanks has been more than offset by the increase in the value of their oil and gas stocks. I don't plan to reduce these successful positions and am trying to find ways to expand our exposure to the energy business. In the short run I expect to see a big increase in the domestic inflation rate as companies pass the higher cost of raw materials on to customers. The Fed, wrong again, will use the inflation blip to justify raising rates even higher. Initially, this is negative for long-term bond holders and corporate profits. Rebuilding the Gulf Coast will be expensive but necessary. It will be economically stimulative which is good news for our industrial stocks. What we are watching is a major shift in the redefinition of what constitutes a growth stock.

Meanwhile, keep your tanks full and be thankful you live where it's warm.

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