

This month's newsletter has been dedicated to the outlook for oil prices. Even if you usually do not read our newsletter, this is probably the one you should read, as there are compelling reasons why the energy market will change dramatically over the next several years.

We have recently engaged Strategic Economic Decisions Inc. (SED) to provide economic and strategic research to Absolute Return Partners and its clients. Our piece on oil prices this month is the first result of our arrangement with SED.

The Case for Higher Oil Prices¹

Oil is essential to everything we do. And because oil is critical to our economy, changing oil prices can have dramatic impact on financial markets. In this month's newsletter, we will focus on the longer-term outlook for oil prices (we don't pretend to know what will happen in the short term). Let's jump to the conclusion right away. We believe we will see \$100 per barrel oil prices within 10 years.

Until the first oil crisis in 1973, no one gave much thought to oil prices. Oil was essentially taken for granted. Then came the (in)famous OPEC meeting in the autumn of 1973, where export restrictions were imposed on OPEC members. Oil prices reacted instantly and rose by 70% to \$5 per barrel. By early 1974, the price had risen to over \$7. The next 5 years were relatively calm with only modest price increases, but then came the second oil crisis in 1979. Prices moved swiftly towards \$20, and by 1981 prices were approaching \$40 per barrel.

The following 18-19 years were relatively uneventful, barring the occasional hick-up caused by incidents such as the Iraqi invasion of Kuwait. Fast forward to 1999, and you will notice that every time the oil price exceeded \$20 per barrel between the early 1980s and the late 1990s, the price retreated relatively quickly again to \$10-20 per barrel.

Then something strange happened. In 1999, the oil price yet again passed the \$20 mark, but this time it didn't look back, and oil is now approaching its fifth year above \$20 (with only a brief period below \$20 in late 2001/early 2002). What has made the difference? It is the answer to this question that leads us to believe that oil prices are entering a major bull market.

¹ This article is inspired by a recent article in *Strategic Economic Decisions'* February 2004 piece called "Is an Energy Market Sea-change Now Underway?" authored by Matthew Simmons, CEO of Simmons & Co.

The price of oil, like any other commodity, is a function of supply and demand. Let's begin with the supply side. It is generally assumed that the world will not run out of oil in our lifetime. We agree with that. The point missed by most people, however, is that oil supplies running out and oil supplies peaking are two vastly different things.

Few people paid any attention when U.S. oil production² peaked in 1970. Even fewer people noticed that Soviet production peaked in 1987, and virtually nobody is aware today that North Sea production actually peaked 3 years ago. It is often assumed that modern oilfield technology will prolong the life of most fields. This is in fact an illusion. In reality, better technology has caused the depletion rate to increase, and the ultimate consequence of this is an even steeper decline once production has peaked.

The big question now is whether oil is as plentiful in the Middle East as nearly everyone assumes. Let's go to Saudi Arabia for an answer, but before we do that, it is time for a confession. Reliable data for any OPEC producer is hard to come by. We suspect that this is a deliberate act on behalf of OPEC, because it makes it harder for outsiders to assess what is really going on. The simple truth is that the region relies on a handful of aging oilfields for the majority of its production.

At face value, the oil story in Saudi looks great. The country reportedly has about 260 billion barrels of proven oil reserves and it has in excess of 100 oil and gas fields. No other country on this planet comes even close to these numbers.

When digging a bit deeper, a very different picture emerges. Between 1940 and 1965, five giant oilfields were discovered in Saudi. These five fields have produced 90% of all oil coming out of the country between 1951 and 2000, and the largest field (Ghawar) has accounted for close to 60% of Saudi's oil production since 1951.

All five fields are using water injection aggressively to keep the oil flowing at high pressure levels. We estimate the daily use of water to be in the region of 12-14 million barrels – a big problem in itself, because water is a scarce resource in Saudi (you can use salt water, but that corrodes the equipment).

² ex. Alaska.

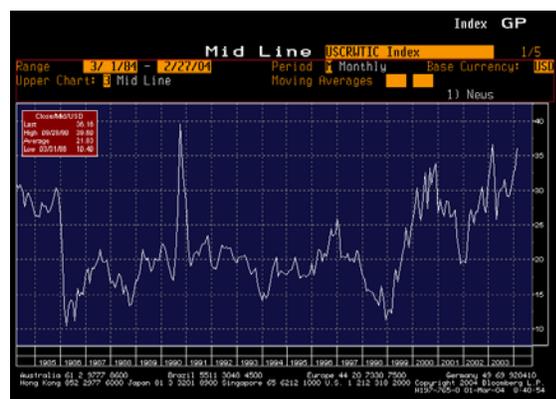
The point we are trying to make is that there would be no need to use water if the pressure from the reservoir itself was good. In other words, it is a strong indication that these fields are approaching the peak of their life cycle. Furthermore, once the production has peaked, the decline will be steeper due to the use of water.

Adding insult to injury, over the past three decades, Saudi has spent vast amounts of money in order to replenish existing reserves. The result? 200,000 barrels per day from fields discovered in the last 30 years. Not exactly the solution to the world's energy problems!

Other producers in the Middle East have been facing similar problems. There is evidence of Iran and Oman already having peaked, and there are question marks surrounding Iraq's sustainability. In conclusion, on the supply side, there are very few bright spots. A high percentage of the world's oil production comes from a handful of aging fields in the Middle East, and a very intensive exploratory programme has not been successful at all.

The only bright spot on the supply side appears to be Russia, which, after a decade of below par performance, seems to be getting its act together again. Current production is about 7-8 million barrels per day, but there are indications that Russia will be able to increase production substantially over the next few years – perhaps to as much as 10 million barrels. The only problem with this is that Russia is consuming more and more oil due to raised living standards in the country, so only a small part of the oil may ever reach world markets.

West Texas Intermediate Crude Oil Spot Price:
(Last 20 Years)



Source: Bloomberg

On the demand side, the growing need for energy worldwide is increasingly going to challenge the producers of oil and gas. The International Energy Agency (IEA) estimates that the use of oil over the next 25 years will grow from approximately 80 million barrels per day to 120 million barrels per day.

Natural gas use is expected to grow even faster. Total energy consumption is expected to grow from about 200 million barrels of oil equivalents per day to over 330 million. These numbers are based on a projection that the world's population growth will slow substantially over the next two decades. Let's not even speculate about what will happen if this turns out to be wrong.

To put all these numbers in perspective, the world's need for energy this year will be about 50% greater than it was just 30 years ago. Over the past 3 decades, 80% of the world's energy has been used by 20% of the world's population. Today, there are 2 billion people in the world that have no access to oil, gas or electricity. There are another 2 billion people who use only a tiny fraction of the world's energy. And there are hundreds of millions of people in China and India who now consider it a "human right" to own a car.

China is already the world's second largest energy consumer and the third largest oil consumer behind the United States and Japan. China now imports 30% of its oil, 60% of which comes from the Middle East. Chinese oil demand has grown 8% per year since 1995, which makes it the fastest growing oil consumer in the world.

The IEA expects Chinese oil imports to grow rapidly for years to come. In 2003, China imported about 2 million barrels per day, In 2010 the number is expected to be 4.2 million and in 2030 9.8 million. China's dependency on imported oil would grow from 30% to 80% over the next 25 years, if these numbers prove correct. As a footnote, we would like to put on record that the IEA is usually quite conservative!

Our conclusion is simple. Sometime over the next decade, the supply/demand balance will change so dramatically that it is likely to lead to substantially higher oil prices, hence our bold conclusion that oil prices will reach \$100 within 10 years. The problem is identifying exactly when! You may say that the world will come up with other solutions to its energy problems before then, and we are the first to admit that the world does indeed offer many alternatives to oil: Natural gas, coal, nuclear and wind energy to name just a few.

The problem, however, is that the world will remain very dependant on oil for many years to come. Point in case: Today, oil accounts for about 40% of total energy consumption in the United States; however, 90% of the oil is used for transportation. It will take many years of technological innovations to significantly reduce the transportations sector's dependence on oil.

Another argument against our bullish case is based on the fact that the world evidently has substantial resources of oil (e.g. oil sands in Canada, oil in Greenland, etc.), and that it is only a matter of investing in better technology and improved infrastructure before these resources can be explored.

However, a study conducted by the IEA in November 2003³ established that the world would need to make investments of enormous proportions just to maintain current production levels. Before the study was conducted, the authors estimated that it would take perhaps \$1 trillion to ensure future energy supplies. After the analysis was completed, the IEA estimated that it would take \$8-10 trillion just to maintain the present level of energy supplies and a further \$6-8 trillion to meet the expected demand by 2030.

Obviously, investments at this scale will have serious implications for financial markets, a subject which we will touch upon in next month's newsletter, which will be dedicated to how you as an investor should position yourself. What will happen to bonds and equities? Which oil companies will benefit the most and how to participate in rising oil prices through means other than equities?

The Deficit that Matters

In Paul O'Neill's recently published account of his years as U.S. Treasury Secretary, he quotes Vice President Dick Cheney as saying to him: "Regan proved that deficits don't matter." Well, we believe they do, and here is why. We will begin our story in Edinburgh in 1671, the birth year of John Law⁴.

The son of a goldsmith, Law was well versed in the banking trade⁵. After an early, quite spectacular, business failure, Law began to promote the idea that if Scotland were to prosper, it needed paper money. Law suggested establishing a so-called Land Bank. The bank would issue paper notes backed by, and never exceeding, the value of the total state holdings of land, hence the name Land Bank. Holders of the notes could redeem their paper for an equal value in land.

In a subsequent essay, Law further refined the idea of paper money, writing: "*What is important ... is not how much of it one had ... but how it got used*". Law believed that, to be of any use, money must change hands. Spending, he believed, is how a nation gets wealthy.

From here, it was only a short step to Law's ultimate idea, a paper currency not supported by land but by the word of the government itself. The government could for example back its promise to pay the notes with tax revenues. To this very day, Law's model serves as the model for every modern nation in the world.

When Louis the XIV died in 1715, Philip II took charge of the royal finances, which were in dire straits. He sent for Law who was facing the challenge of a lifetime. Years of war and extravagant spending had left the finances in very poor conditions.

Always in possession of innovative ideas, Law invented what we today would call a debt-for-equity swap. Outstanding debt was swapped for new shares in Banque Generale. Although the issue was very small, the success of this transaction inspired Law to greater things and he embarked on what is today known as *the Mississippi Scheme*.

Law convinced Philip II to back a trading company with monopoly trading rights over the Mississippi River and parts of Louisiana. Shares would be offered to the public and investors would only be allowed to buy them with the remaining government bonds outstanding.

The issue became an instant success. Speculators from all levels of society jumped on the bandwagon and Law was only too willing to oblige. More issues followed. People scooped them up with junk paper issued by the government, but no one seemed to care. No new capital was injected into the system and the Mississippi Company did not generate any profits. In the eye of the public, however, that was entirely irrelevant. They all felt richer.

People started to buy on margin, and legends were made out of ordinary people. Law, himself, became a hero, even more celebrated than the King. By 1720, Law was reputedly the wealthiest man on earth.

Then things started to correct – as they always do. In the spring of 1720, Law decided not to allow a well known aristocrat access to a new issue, and the count responded by rounding up all the notes he was in possession of, requesting the bank to change them to gold coins. The bank complied but the damage was done. Soon, other high profile people would quietly present their notes requesting gold coins instead, and, before long, mobs were trying to break down the doors of the bank.

Law responded by cranking up the printing press. The money supply almost doubled in the space of 3 months but to no avail. Nothing could save the bank, the Mississippi Company or indeed Law. The proud citizens of France were traumatized and to this day, the French are reluctant stock market investors.

Greenspan is not Law and the United States is a far cry from France anno 1720. Meanwhile, the budget deficit, although growing at an alarming rate, is still "only" 4.5% of GDP, below the levels experienced during the Reagan years. But that is not the point.

Last year, the deficit totaled \$375 billion, and the forecast for this year is \$520 billion. In order to fully understand what this means, the deficit must be seen in conjunction with the current account deficit and the private sector savings rate.

The math is quite simple. The sum of the private sector savings rate, the current account deficit and the public sector deficit must always equal zero, according to the logics of national income accounting principles.

So, during times like these, when the current account deficit is running at about 5.5% of GDP and the private sector savings rate is a negative 1% of

³ World Energy Investment Outlook

⁴ For a fuller account of John Law's life, we would encourage you to read "Financial Reckoning Day" by William Bonner.

⁵ At the time, goldsmiths were the bankers of their communities.

GDP, the budget deficit must by definition be 4.5% of GDP.

As a consequence, the *only* way U.S. GDP can be robust given a large current account deficit and given a normal private sector savings rate, is for the fiscal deficit to rise. The long term average private sector savings rate is 3.5% of GDP. If the private sector were to revert to this number tomorrow, and the current account deficit remained unchanged at 5.5% of GDP, the public sector deficit would balloon to about 9% of GDP!

In other words, the fix for the U.S. economy is *not* to reduce the public sector deficit per se. The aim must be to reduce the current account deficit, because that is what to a large degree determines the amount of bonds that the government would have to issue to cover the deficit (assuming the private sector savings rate remains fairly constant in the short term).

Viewed from this standpoint, the usual arguments about fiscal irresponsibility lose much of their power.

If one were to look at the government like a private household instead, there are some interesting observations to be made. Private households go through periods of positive savings rates (usually before having children and after the children leave home) as well as negative savings rates (e.g. when school fees drain the bank account).

Think demographics now, and fast forward about 10 years. Millions of middle aged people will approach a period of their lives where they start becoming a fiscal liability for society. Healthcare costs, measured as a percentage of GDP, will explode over the next couple of decades due to the aging of the population. If governments allow the fiscal deficit to run amok now, the healthcare and welfare bills to be paid 10-20 years from now may have to be paid with money that is worth about as much as the notes issued by John Law 300 years ago.

Therefore deficits *do* matter. But the guns are aimed at the wrong deficit problem. The public sector deficit problem is a result of the current account deficit; hence that is the deficit policy makers ought to focus on.

No changes have been made to the model portfolios this month.

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