



The Absolute Return Letter

September 2005

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Summary

The sharp rise in oil prices has taken many by surprise, including us. When we predicted \$100 oil prices in March 2004 we didn't expect the price to reach \$70 within 18 months. However, we remain bullish on oil due to a phenomenon called 'Peak Oil'. As we explain in our first article, Peak Oil has played only a modest role in taking oil prices from \$30 to \$70 per barrel. This suggests that the bull market in oil prices is far from over, although an economic slowdown could temporarily provide some relief.

In the second article we take a closer look at one of our favourite leading indicators, namely the global liquidity indicator. Interestingly, this suggests that there may be some relief to come as far as oil and other commodity prices are concerned. Unfortunately that is not the full story - deteriorating global liquidity has far-reaching consequences. As we demonstrate, it even has the potential to create a full-blown crisis.

Enjoy the read.

Peak Oil

18 months ago, when we first predicted that oil prices would reach \$100 within 10 years, many of our readers thought we were barking mad. While that may not be entirely untrue, oil prices have in fact done their bit to justify our moment of madness.

Admittedly, the rise from just under \$30 per barrel when we first made our prediction to \$70 or thereabouts today has happened perhaps a little bit faster than even we thought possible and certainly a lot faster than most people expected only 18 months ago. This month we will revisit the story behind our bullish stance – a story we call Peak Oil¹.

Oil has always been a highly cyclical commodity. When the world goes into recession, the price of oil usually drops rather dramatically. But we have never before experienced a situation like the one we now find ourselves in. Much of the excess production capacity that kept a lid on oil prices for years has been swallowed up by incremental demand primarily from Asia, and the oil industry is now running on all 12 cylinders so to speak.

This argues for reduced cyclicity in the price. We do not suggest for one moment that the oil price will not drop next time the world faces the R-word, but we do believe that the days of \$15-20 oil prices are over.

The occurrence of Peak Oil has raised the base level, probably to about \$40-50, and the ceiling to levels well above the \$65-70 range that we are trading in at the moment. This essay is about the dynamics behind this shift. Let's begin with one of our favourite charts which illustrates worldwide oil discoveries over the past 70 years.

We Have Moved!

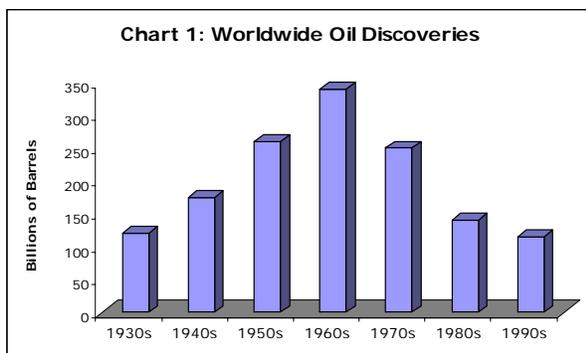
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Source: Simmons & Company

As you can clearly see from this chart, the 1960s was the golden age of oil exploration. More than 350 billion barrels of oil were discovered during this decade. We have not come anywhere close to that number again. New discoveries have in fact been lower every decade when compared to the previous one. This decade is no exception.

Today, worldwide reserves stand at approximately 1200 billion barrels. 900 billion of those are in OPEC countries. The remaining 300 billion is scattered around the world. The oil industry uses a term for these reserves called 'proven reserves'. Actual reserves may be higher. Or they may in fact be lower. We cannot help thinking of the Shell incident which unfolded last year. Shell's proven reserves were written down dramatically following a detailed audit. Of the 1200 billion barrels of proven reserves today, 90% have *not* been audited. We just wonder what the true number is, but that is stuff for a future letter.

Back to the important observation about oil discoveries. Every oil field in the world has a finite production life. In the early stages, production usually rises until the well reaches a certain production level that can be comfortably produced every day without putting undue stress on the system. This level of production is called 'sustainable peak' production.

As the field is depleted, it becomes harder and harder to maintain the sustainable peak. Certain "tricks" have to be introduced to help production along. One method widely used is to inject water as oil is extracted. This keeps up the pressure in the reservoir and makes further extraction possible. In the largest oil field in the world – Ghawar in Saudi Arabia – over 15 million barrels of water (about 3 million cubic metres) are injected every day in order to extract about 5 million barrels of oil (just think of the logistics – water is not exactly a free-flowing commodity in Saudi Arabia).

Where are we going with all of this? Well, you reach a point where water can no longer do the trick, and production starts to decline. Usually,

once production starts declining, it is irreversible. Many of the oil fields discovered in the 1960s either have experienced a decline in production already or are very close to this point. As less oil was discovered in the 1970s and 1980s, we can conclude that the world as a whole will reach its peak production level at some point during this decade. *Perhaps we have already peaked!*

The United States has most certainly already peaked. In fact it happened many years ago and is one of the main reasons for its rapidly rising trade deficit in recent years. Iran peaked in the late 1970s. Iraq, Kuwait, Oman and Syria have all peaked in the last 10 years. Russia is in the process of peaking. The Gulf of Mexico will peak in the next couple of years. Closer to home, the North Sea peaked only about 5 years ago. The list goes on and on.

This is important because demand for oil is growing faster than ever before, primarily due to the emergence of India and China as economic powerhouses. 2.3 billion people in the two countries alone will want the same living standards as have been bestowed upon us. Improved living standards require energy. Lots of it. If India and China were to consume the same amount of energy as, say Latin American countries, the world would have to somehow find an extra 20 million barrels in addition to the 85 million barrels that are consumed every single day.

Before you despair, let's not get carried away. Peaking does not mean the world is running out of oil. There is in fact plenty of oil around. Peaking means, however, that the industry cannot easily meet growing demand. They cannot just open the valves and let the oil flow to the tune of an extra 5-10 million barrels per day if demand requires it. Peaking means more focus on marginal development projects with higher production costs. Peaking means increased use of water to maintain current output levels, which again drives costs higher. And peaking means it will be harder for OPEC's member countries to cheat with their quota, because they don't necessarily have the oil to cheat with.

Many observers today assume that the projected growth in demand for oil will be met primarily by Saudi Arabia. We have seen estimates suggesting Saudi will double or even triple their production over the next 20 years. As always, the proof is in the pudding. Given the age of Saudi's seven largest oil fields (which between them produce 90% of Saudi's total daily output of 9-10 million barrels), we would seriously question their ability to increase the daily production to 20-30 million barrels.

We are often accused of being too pessimistic. Whilst we don't disagree that there is indeed a lot of oil left in the ground, this is not really the point. The question to ask instead is, what is the cost of extracting increasingly marginal reserves of oil? The irony of the current situation, as stated by Goldman Sachs in a recent report on the oil industry, is that *"it is the potential risk that the Middle East has adequate supplies that is supporting prices, not that [the world] is running out of it"*.

In other words, if the industry knew for sure that OPEC production has already peaked or soon will reach its peak production level, much more money would be made available for investments in higher cost projects. It is the uncertainty that is holding many investors back.

When we wrote our first piece on oil in March 2004, we didn't expect the oil price to reach \$70 as early as August 2005. Peak Oil is *not* an overnight phenomenon. It is not like we will wake up one morning realising that the supply/demand balance is suddenly out of whack. Other factors must therefore have played a role for oil prices to reach \$70 this soon.

And that is precisely what has happened. A number of incidents have provided the fuel for higher oil prices, none more important than the bottleneck problems in the refining industry. But underneath it all, the disturbing realities of Peak Oil have allowed these various different catalysts to play a bigger role than most of us thought possible.

At the same time, if we are proven correct that we haven't seen the full impact of Peak Oil yet, oil prices could still go a fair bit higher, subject to the global economy behaving reasonably well.

So what does all of this mean? We believe that the world is slowly (very slowly) coming to the end of the oil era, to be replaced by a combination of alternative energy sources. Wind energy has a big future we believe. Not so many years from now, a lot of us will drive in cars fuelled by bio-diesel made from corn, sugar and other agricultural products. Nuclear power, whether we like it or not, will probably make a comeback.

We have some interesting investment ideas in these areas that we would be delighted to share with you. Our own fund (the Absolute Return Multi-Strategy Fund) is also positioned to benefit from higher oil prices.

Our good friend and business associate, John Mauldin, wrote in a letter earlier this year that a \$100 oil price is not a problem; it is the solution. We couldn't agree more. The quicker various alternative sources of energy become economic-

ally viable, the better. The world will be a better place for it too.

Niels C. Jensen

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Footnotes:

¹ A term borrowed from Matthew R. Simmons, CEO at Simmons & Company. It was Matthew Simmons who first inspired us to our current thinking on energy. You can read more about Simmons & Co on www.simmonsco-intl.com.

Deteriorating Global Liquidity

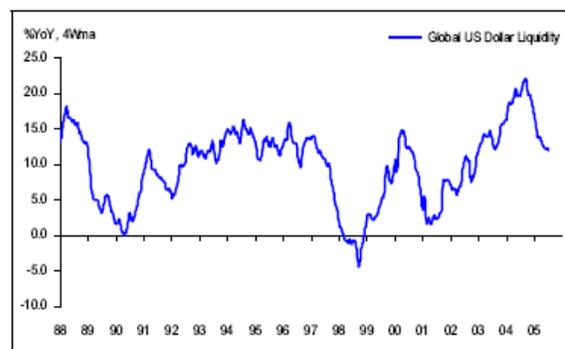
As you now know, we believe the global oil supply/demand balance will be tight for years to come. However, that doesn't mean oil prices are immune to economic cycles, and below we will take a closer look at one of our favourite leading indicators, namely the global liquidity indicator.

Global liquidity may be defined in numerous ways. We tend to like the way Merrill Lynch defines it, mostly because it has proven an excellent predictive measure over the years. According to Merrill Lynch, global USD liquidity equals the sum of the U.S. monetary base plus reserves held in custody by the Federal Reserve for foreigners (mostly Asian central banks).

If the U.S. current account deficit grows, as has been the case in recent years, global liquidity would be expected to improve, because the countries having a current account *surplus* with the United States would be expected to buy U.S. government bonds for at least some of the surplus dollars.

This way, the U.S. current account deficit has played an important role in terms of providing stimulus to the global economy in recent years, a fact often ignored by those being so critical of the large deficit.

Chart 2: Global USD Liquidity



Source: Merrill Lynch

So let's take a closer look at the global liquidity indicator. As you can see from chart 2, the

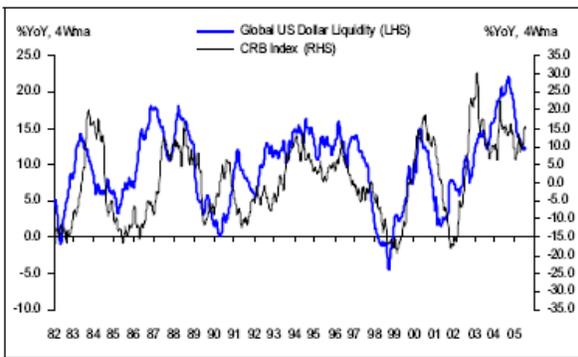
growth in liquidity has actually *decelerated* quite sharply in the last 6 months, reflecting several factors.

For a start, the U.S. monetary base itself is experiencing slower growth, which is not at all surprising given the rise in the U.S. Fed Funds rate. At the moment it grows by approximately 3% per annum, substantially less than the nominal growth of the U.S. economy.

Secondly, and perhaps more surprisingly, foreign reserves deposited with the Fed are not growing as fast as the current account situation might otherwise suggest. After all, with the U.S. current account deficit being higher than ever, you would expect foreign reserves to continue to grow rapidly. Why is that not happening? There are several reasons for this, but let's focus on two important ones.

A substantial part of foreign reserves held by the Fed belong to Asian central banks. Virtually all Asian countries are importers of oil. The sharp rise in the price of oil has created a new situation, where the growing U.S. current account deficit is not matched by a corresponding growth in the Asian surplus, simply because they are spending more dollars on their oil purchases, just like we are.

Chart 3: Global Liquidity v. Commodity Prices



In addition to this, because of the sharp rise in the Fed Funds rate (the cost of money in the U.S.), speculators are borrowing considerably less in U.S. dollars than they used to. This is a major contributor to the deceleration of global USD liquidity.

However, since there is little evidence of any meaningful de-leveraging going on in financial markets around the world, it is probably safe to assume that much of the speculative borrowing has simply moved from U.S. dollars to other low cost currencies such as euros and Swiss francs. This may also explain why Euroland is one of few areas in the world where the monetary base continues to grow at a healthy rate (10%+ per annum at the latest count).

But back to our main story. We assign much significance to the liquidity indicator, because global USD liquidity has proven so valuable in predicting the trend in financial markets. We can best illustrate this by borrowing a few more charts from Merrill Lynch.

As you can clearly see from charts 3 through 6, global USD liquidity is strongly correlated with commodities prices and Asian stock prices and strongly negatively correlated with credit spreads and stock market volatility.

Chart 4: Global Liquidity v. Asian Stock Prices

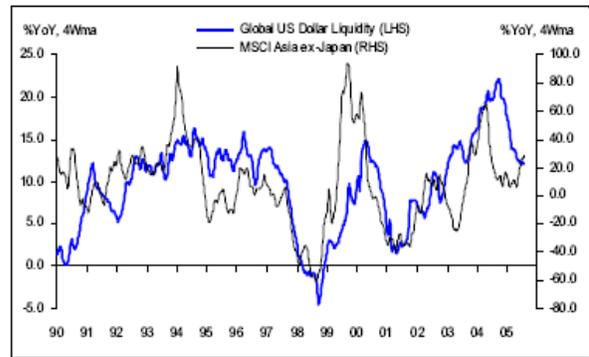


Chart 5: Global Liquidity v. Credit Spreads

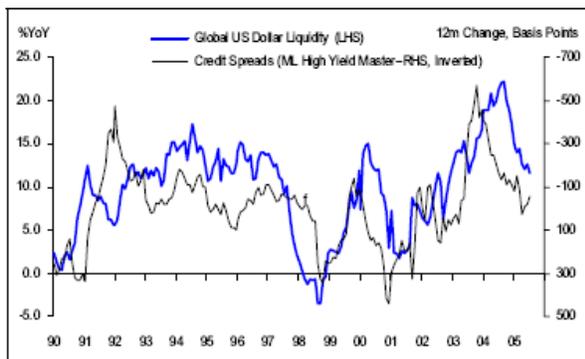


Chart 6: Global Liquidity v. Volatility



Source (Charts 3-6): Merrill Lynch

But the story gets worse. If you take another look at chart 1, you will notice that there have been 3 periods since 1988, where global liquidity deteriorated quite badly, namely 1988-90, 1997-98 and 2000-01. *All three situations resulted in a crisis of some sort!*

The slump in liquidity in 1988-90 was at least partly responsible for the most dramatic crisis the U.S. banking industry has undergone since the depression in the 1930s – the so-called savings & loans crisis. Large parts of the U.S. banking systems were on the verge of a complete collapse.

1997-98 gave us the crisis in Russia and Asia as well as the collapse of Long Term Capital Management. Again, deteriorating liquidity was a major factor. Finally, the liquidity slump in 2000-01 was partly responsible for the crisis in Argentina, and we also “enjoyed” the experience of Enron and several more corporate disasters, just to round things off.

It is virtually assured that a significant deterioration in global liquidity will cause some sort of crisis somewhere. *It always does.* We cannot say for sure where the skeletons will pop up this time, but we have certainly noticed that Indonesia is taking a bit of a battering at the moment. The local stock market has lost more than 10% of its value in local terms, government bonds have taken a similar knock, and the Indonesian Rupiah is down 7-8% against the U.S. dollar – all in the last two weeks.

Although Indonesia is an OPEC country, it is actually a *net importer* of oil and it has, like many other Asian countries, a system in place whereby retail energy prices are heavily subsidised. Maybe Indonesia is a sign of things to come with oil prices hovering around \$70 per barrel?

In fairness to Merrill Lynch, it ought to be mentioned that they are actually arguing for global USD liquidity to rebound over the next several months. They base their argument on the modest revaluation of the Chinese renmimbi against the U.S. dollar which, they say, will bring speculators back to Asia in large numbers.

We do agree with Merrill Lynch’s assessment that many Asian currencies are undervalued relative to the U.S. dollar, the euro and sterling. We also agree that if Asian central banks continue their policy of continuous intervention in order to prevent their local currencies from appreciating in value, then there is a decent probability of the growth in global USD liquidity reversing its current down trend.

However, we disagree that large numbers of speculators are lining up to throw money at Asia. Indonesia is an important reminder to all concerned that investing in Asia is not a one-way street. The region is in fact quite accident prone as evidenced by the 1997-98 crisis, and many investors would have burned their fingers on Indonesia in August.

When global liquidity starts to deteriorate, according to the laws of economics, either GDP growth will slow or financial markets will suffer, or both will take a hammering. There is no other way out. Given all the yellow flags that the global liquidity indicator is throwing at us, we see no reason to be heroes. As our friends at GaveKal put it:

“We are rapidly moving to a period of more fools than money. And in such times, fools and their money are soon parted.”

Niels C. Jensen

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Postscriptum:

We have not discussed the implications for currency markets in this essay. All the above is actually quite bullish for the U.S. dollar and bearish for the euro and sterling. More about this next month.

Latest!

As of 1st September, we have reduced our allocation to traditional (long-only) equity strategies from 14% to 9%, as our concerns about the near term outlook for equity markets are mounting. The single biggest beneficiary of this re-allocation is alternative equity strategies, although other asset classes have benefited as well. See our model portfolio for more details.

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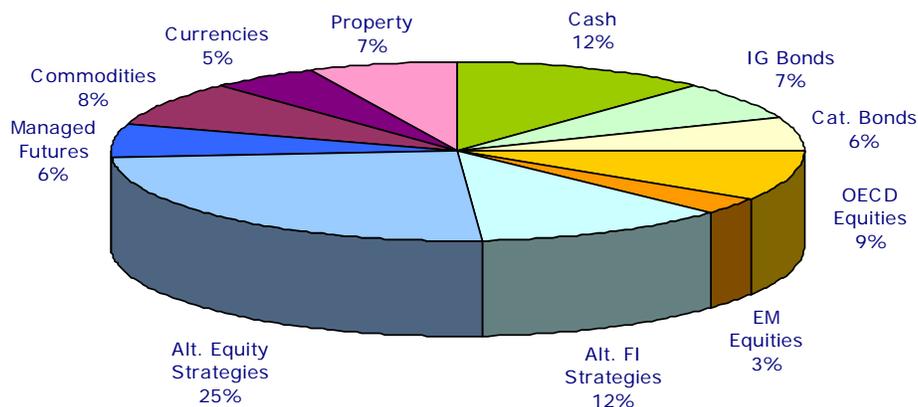
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Model Portfolio 1/9/2005



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