



The Absolute Return Letter June 2008

The Untold Story

“If you look at the facts, they show that the price of oil is about supply and demand”

Henry Paulson, U.S. Treasury Secretary

A cat amongst the pigeons

In the rather mundane world of investments, rarely has one individual caused as many ripples as Michael Masters¹ did when, only a couple of weeks ago, he chose to share his thoughts on commodity prices with the distinguished members of the U.S. Senate Committee on Homeland Security and Governmental Affairs. If ever a cat was put amongst pigeons...

Masters merely suggested that speculative demand is behind much of the recent rise in commodity prices and that U.S. lawmakers must curb speculators' access to commodities if they want to get commodity price inflation under control. The debate is reasonably straightforward. Are commodity prices driven by economic fundamentals (i.e. a function of supply and demand) or are speculative investors (primarily pension funds, index funds and hedge funds) to “blame” for the stratospheric rise of commodity prices in recent months?

I actually touched on this subject in last month's letter and do not intend to repeat myself. However, it appears to me that a number of hard facts have been swept aside, as the move in oil prices has become rather one-sided in recent months. Even if you believe in the concept of *Peak Oil*², it is important to recognise the fact that oil prices, like all commodity prices, are sensitive to economic up- and downturns. In the following I intend to take a hard look at those arguments underpinning the bull story on oil prices.

The Supply and Demand Story

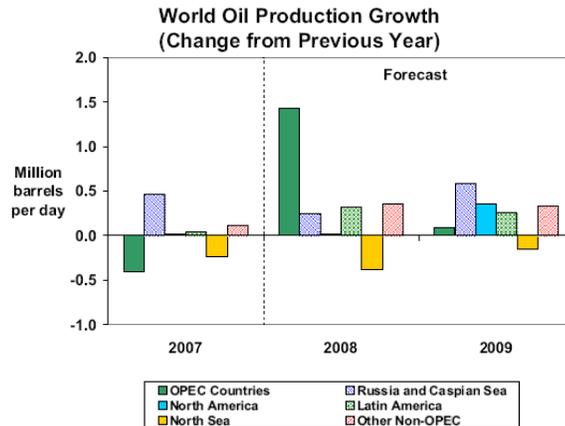
The notion of Peak Oil has led many to believe that global oil production is actually in decline. When I did my research in preparation for this letter, I was astonished to learn how many so-called ‘experts’ seem to confuse Peak Oil with global production decline. In reality, global production has risen every year since 2002 and it continues to grow. Peak Oil is a local phenomenon (at least until now), with large oil producing countries such as the United States, Venezuela, the United Kingdom, Norway and Indonesia all in terminal decline.

¹ A U.S. based hedge fund manager.

² Peak Oil is a concept originally conceived by the late Dr Hubbert, an American geophysicist. All the way back in 1949, he predicted that fossil fuels would have a strictly limited life span (and he was widely ridiculed for this prediction). He defined Peak Oil as the point in time when the maximum rate of production is reached, after which the rate of production enters its terminal decline.

According to the U.S. Energy Information Administration (EIA), global output this quarter should reach 86.2 million barrels per day (mbpd). And it doesn't stop there. Following a couple of years with limited production growth, total output is likely to accelerate again soon as new oil fields come into production. It is now estimated that well over 3 mbpd will be added between now and late 2009 (see chart 1 below).

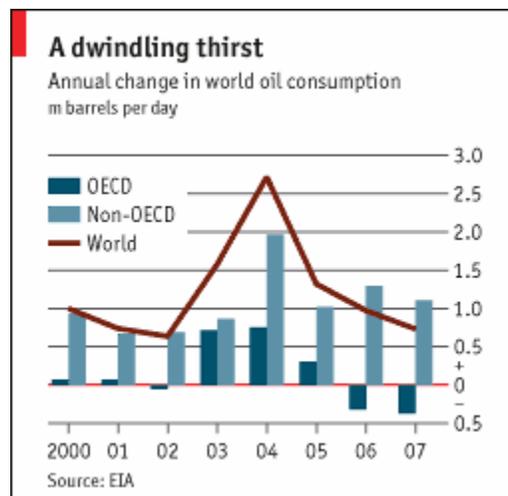
Chart 1: Estimated Growth in Oil Output



Source: EIA, Short-Term Energy Outlook, May 2008

The EIA estimates that, by the second half of next year, daily production will be approaching 89 million barrels. Meanwhile global demand continues to be robust if you believe the stories which run in the mainstream media almost daily. In fact, as you can see from chart 2 below, demand growth has been slowing steadily since 2004, and some estimates now suggest total consumption to grow by no more than about 0.3 mbpd in 2008. It is also worth noticing that the new production will be kicking in at a point in time where global economic growth is likely to be slowing down.

Chart 2: Annual Change in Global Oil Consumption



Source: The Economist

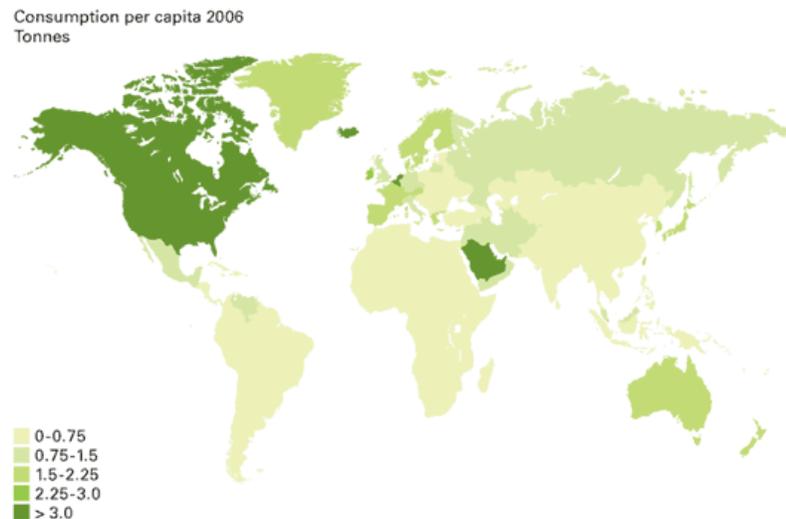
The Efficiency Story

China is one of the cornerstones of the energy bull story. It is widely assumed that it will have an almost endless appetite for oil over the

next few decades. An economy very dependent on industrial production combined with rising living standards, or so the argument goes, will demand enormous quantities of the black gold. Many go as far as to suggest that the growth in oil consumption will actually outpace GDP growth for the foreseeable future.

I found the chart below on BP's website. It is probably fair to say that most commentators expect larger and larger parts of the world to be covered in the dark green colour used to illustrate how North Americans (together with a handful of smaller nations) are the largest per capita consumers of oil in the world today. China, in particular, is widely predicted to go 'dark green' within a few years.

Chart 3: Per Capita Consumption of Oil, 2006



Source: BP Statistical Review, 2007

In reality, though, Chinese oil consumption has actually decelerated in recent years. Going forward, the EIA now predicts that Chinese oil consumption will grow from 8 to 8.4 mbpd from this year to next – well below the anticipated GDP growth rate.

By comparison, the 27 countries in the European Union gobble up just over 15 mbpd. Back in 1973, the year of the first oil crisis, the same 27 countries consumed 15.5 mbpd. The EU is living proof that you can actually grow GDP at a respectable rate and keep oil consumption steady at the same time.

As a side note, over the same 35 year period, U.S. consumption has grown from about 17.3 to 20.5 mbpd. The Chinese will unquestionably seek to learn from the Europeans rather than the Americans when they implement future policies. In a recent research note provided by Goldman Sachs³, it is estimated that if the United States, China, India and Russia could achieve the same energy efficiency as Japan, global energy consumption would drop by 20%.

The Demand Response Story

One of the favourite arguments amongst oil bulls is that oil demand is very inelastic. Don't count on it. As reported in last week's issue of *The Economist*⁴, Professor Gary Becker at University of Chicago has

³ *GS Global Economic Weekly*, May 21, 2008.

⁴ See "Double, double, oil and trouble", 29th May, 2008.

calculated that, whereas both supply and demand are fairly inelastic in the first few years after a major oil price move, in the longer term, consumption drops significantly and production rises steeply when oil prices double.

In this context it is also worth mentioning that, according to Stephen Jen at Morgan Stanley, half the world's population currently enjoys fuel subsidies of some kind. As the price of oil continues to rise, the situation becomes increasingly untenable for most of the governments providing these subsidies. One by one, they will throw in the towel and let prices rise to market levels. Anything else is fiscally irresponsible. Egypt raised petrol prices by 40% only a couple of weeks ago. So did Indonesia (+33%) and Sri Lanka (+25%). India, Taiwan and Malaysia are all giving it serious consideration, according to The Daily Telegraph.

As I pointed out in last month's Absolute Return Letter, Asia is by far the biggest importer of oil, and rising oil prices could do serious damage to economic growth in a number of those countries. At the same time, inflation is now out of control in many countries across Asia. This is a deadly cocktail. It is called stagflation. I still remember it from the late 1970s and early 1980s. Not to be recommended!

Chart 4: Largest Oil Consumers

Top World Oil Consumers (2006)		
Thousand Barrels per Day		
United States	20,687	<i>Low pop growth</i>
China	7,201	<i>No pop growth; subsidised energy prices</i>
Japan	5,159	<i>Negative pop growth</i>
Russia	2,811	<i>Negative pop growth</i>
Germany	2,665	<i>Negative pop growth</i>
India	2,572	<i>Subsidised energy prices</i>
Canada	2,264	<i>Low pop growth</i>
Brazil	2,217	
Korea, South	2,174	<i>No pop growth</i>
Saudi Arabia	2,139	<i>Subsidised energy prices</i>
Mexico	1,997	<i>Subsidised energy prices</i>
France	1,961	<i>Low pop growth</i>
United Kingdom	1,830	<i>Low pop growth</i>
Italy	1,732	<i>Negative pop growth</i>
Iran	1,686	<i>Subsidised energy prices</i>
Total, Top 15:	59,095	<i>(71% of World Total)</i>

Source: United Nations, own research.

The Demographic Story

The Asian growth miracle, and China in particular, is usually emphasised as the key reason why oil prices can only go up in the long run. Nobody talks about the flip side of that story – the fact that baby boomers all over the world are fast approaching retirement; the fact that many countries around the world will see low or no population growth over the next many years. As illustrated in chart 4 above, amongst the top 15 oil consuming countries, 10 countries will see low, no or negative population growth between now and 2015. At least within the OECD it is fair to assume that, without population growth, GDP growth will be strictly limited and, without GDP growth, oil consumption will probably decline.

The Diesel Story

Do you drive a diesel car? If so, you will probably have noticed that diesel prices have risen even more dramatically than petrol prices in recent weeks and months. Many commentators have singled out diesel as a sign of things to come. We'd better get used to shortages they tell

us. So what are the facts? Well, it looks like the Chinese have cornered the market in the early part of 2008, buying whatever diesel they can get their hands on, pushing prices through the roof.

What you don't learn unless you dig deeper is that the Chinese government, still smarting from the Tibet PR disaster and the earthquake in the Sichuan province, is keen to avoid any embarrassment in connection with the upcoming Olympic Games. They have hence ordered Chinese oil companies to stock up on diesel in order to avoid fuel shortages which are a widespread phenomenon in China. At the same time, just before and during the games, the central government plans to switch from coal to diesel at some of the Beijing based electricity plants in order to improve the air quality⁵.

All this may work very well in terms of ensuring that the Beijing Games go down in history as a success for the Chinese. However, come August when the games are in full swing, and the Chinese coffers are bursting with diesel, you shouldn't necessarily be surprised if diesel prices suddenly fall out of bed.

The Tanker Story

This part of the story has been the most difficult to research. What we have noted, however, is that there has been a growing disparity between physical (spot) oil prices and prices on oil futures, the latter being significantly higher. What that essentially suggests is that, at current prices, there is more demand for paper oil than for physical oil. Now, when you listen to people with knowledge about these sorts of things (ISI Research, Stratfor, etc.), a rather disturbing picture quickly emerges. If there is such a shortage of oil as claimed by many commentators, why is it that it is virtually impossible to lease a tanker if you need one? Why is it that the Persian Gulf is currently littered with oil tankers, all filled with unsold oil? Why is it that Rotterdam Harbour is struggling to cope with the amount of oil coming into its harbour? Anyone out there with a good answer to these questions?

The Masters Story

All of which brings me to the last point I wish to make. Michael Masters really rocked the boat when he suggested that much of the recent rise in commodity prices has been driven by speculative demand. Many people took serious offence to his claim. One of the centrepieces of their counterargument focused on Masters' claim that commodity index funds have grown from just \$13 billion less than 5 years ago to about \$260 billion today. As (correctly) pointed out by Masters' critics, \$247 billion of new commodity investments over 5 years is a drop in the ocean in the fast growing pool of commodity assets.

However, the point completely missed by everyone, including Masters himself, is that index funds and ETFs are only half the story. According to the Bank for International Settlements⁶, as of 31st December 2007, the total amount of OTC commodity contracts outstanding came to \$9 trillion – up from \$7.1 trillion the previous year, bringing a total of \$1.9 trillion of new investments into commodity derivatives during 2007.

Let's assume that oil represents about 70% of those contracts, which seems like a fair assumption given that oil is about 70% of the major commodity indices. 70% of \$1.9 trillion is about \$1.33 trillion. Even if we assume that all those commodity contracts used zero leverage (which is most likely not true), such an amount of money going into the oil market in a single year is certainly enough to move prices.

⁵ Source: *The Economist*.

⁶ "OTC derivatives market activity in the second half of 2007"; BIS, May 2008.

Conclusion

We remain bullish long term on oil prices. We believe in the concept of Peak Oil and we believe that the oil left on this planet is located in increasingly inhospitable places. All this favours high oil prices longer term.

Recently the arguments have become increasingly one-sided, though. How can you ignore the fact, for example, that the oceans of this world seem to be full of oil tankers bursting with oil that nobody seems to want?

We see numerous parallels to the dotcom boom of the late 1990s when investors, much to their regret, chose to ignore a number of yellow flags, only to suffer the consequences when the bubble ultimately burst. Bubbles are relatively easy to spot (did you get that one Greenspan?); however, it is notoriously difficult to predict the timing of their demise.

We work closely with an independent economic consultant named Simon Hunt (of Simon Hunt Strategic Services). I have a huge amount of respect for Simon's work. In a recent memo he predicted oil prices to hit \$80-85 by early 2009 and \$60-65 a year later, based on the work of his cycles associate, WaveTrack International. Take it for what it is worth. I always listen carefully when Simon makes his predictions.

Niels C. Jensen

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The Millennium Wave Portfolio as at 30th April, 2008:

