

## **When Oil Prices Decline: Analysis of the Price of Energy**

As petroleum prices record weekly records and economies of the world absorb the fallout, it is time to take a minute to consider the reality of the situation and what can change the status quo. While hysteria can be its own reward, it has no place in investment decision-making.

On the demand side there is the fact that gasoline demand in the United States is already declining about one percent with this figure showing signs of accelerating as motorists trade to more fuel-efficient vehicles and drive less. Adding to this decline is the decision by the White House to stop adding 60,000 barrels of oil per day to the strategic petroleum reserve as of July 1. While the percentage decline may not sound impressive bear in mind that the US, with less than 5 percent of the world's population, uses about one quarter of the world's energy.

Internationally demand shows signs of deceleration. Countries such as China that subsidize gasoline prices appear to be taking steps to ration price-controlled fuel with the intent of letting motorists buy additional gas at world market prices which can be up to ten times higher. This action should not only make energy use more efficient but also slow the amount of greenhouse gasses emitted from the developing world.

On the supply side, Saudi Arabia has announced an additional 500,000 barrels per day increase in production to begin next month. The growth of biofuels beyond corn-based ethanol is picking up steam in many parts of the world. Technology for the disposal of polluting byproducts in the production of coal-based fuel and energy is advancing, making coal-based gasoline a realistic alternative. At even half of current prices the extraction of oil from tar sands and shale is commercially viable. Finally, alternative energy vehicles such as electric-powered cars could in time present themselves as an alternative to gasoline engines, even as hybrid technology eases the transition.

Putting all of these factors together, it would appear that a reasonable guess as to energy prices would be \$100 per barrel by the end of the year. Beyond this point there would seem to be more dynamics for even lower prices going forward from there.

In fact the greater danger in this scenario is the prospect that, like the 1980s, alternative energy development will be left to atrophy as oil prices come down. It is incumbent upon the government to prevent this if necessary by raising taxes on energy sources to keep prices high and continuing to put pressure on consumption. Taxes are levied on tobacco and liquor to promote social conduct; energy use should be no different. The tax revenues raised can be used to increase the income level at which income taxes are imposed. This would address the argument that consumption taxes fall more heavily on the poor due to the fact that they consume a greater percentage of their income.

In terms of financial market impact, the results of this forecast would be for energy-dependent companies to be helped while energy providing firms would see profits level off if not decline. Consumers would be beneficiaries due to the impact of energy prices as a regressive tax on consumption. Retailers should feel the increase in consumer demand.

However, the legacy of the housing bust will mitigate the positive impact of lower energy prices on the overall economy. As the housing market corrects with foreclosure sales establishing a base level for housing values, consumers will no longer see their homes as a source of wealth beyond whatever is accrued by paying down the principal of the mortgage. This change in the perception of housing as a good (like a car) rather than an investment (like a stock) should lead to higher savings rates by consumers who will channel income into savings and investing rather than buying more housing than they need in a leveraged attempt to make more money on the same.

Replacing consumer demand as an economic driver will be domestic substitution of imported goods. High energy prices, a weak dollar and shipping rates that have doubled since 2000 have made domestic manufacturing competitive in ways that many people did not envision even a year ago. These trends will help underpin the next economic upswing. While the auto industry is the most popular example of this trend, other companies are looking to expand domestic manufacturing facilities in order to remain competitive as well.

While the current times make for a rough transition, the experience of high energy prices will prove beneficial if the world's economies adapt in ways to offset the expense. With fewer resources devoted to energy consumers will be free to devote more resources to other areas such as savings and investment. Since energy is effectively a tax on the economies of the world by the providers of the same, market solutions to high energy prices will pave the way for lesser dependence as well as lower environmental impact per amount of energy used.

## **The Economy**

Economic activity continues to confound those who predicted a recession by now. Consumer spending is above forecast due to demographic influences mentioned last month. Exports are continuing strong as the economies of foreign countries create demand for various goods and the declining dollar makes domestic goods competitive in overseas markets.

While it appears that a recession will be avoided, the basis of the next expansion appears rather elusive. With housing still not having hit bottom and the financial sector back on its heels, there does not seem to be a strong impetus for above-average economic growth in the next 18 months. What growth exists will come from exports, capital goods, and any beneficiaries of lower petroleum prices.

## **Inflation**

Inflation continues to be goosed by high energy and food prices. While lower petroleum prices will help both areas, there are other sources of inflation which have not yet become completely manifest.

The chief source of inflation will be the higher cost of imported goods. As the dollar falls and imports become more expensive, domestic goods producers can raise prices in tandem with their foreign competitors. A second source of inflation pressure is the higher minimum wage coupled with a more restricted labor market. As the US economy becomes increasingly service-oriented the cost of labor will become a more material factor in inflation than the cost of energy.

## **Interest Rates**

Interest rates have gyrated wildly the past two weeks. Based on comments by the Federal Reserve regarding the growing threat posed by inflation, futures contracts on debt indicate that the bond market anticipates interest rates being a full percentage point higher by this time next year.

This forecast is off the mark. Without the recent hyper-demand for real estate it is difficult to make a case for sharply higher interest rates. Some forecasts for the housing market do not have it bottoming nationwide until 2014. Also, the prospect for higher taxes with the next administration should curtail government borrowings. While it will be rational for the credit markets to put a higher premium on loans to reflect recent default experiences, this is not the same thing as having interest rates increase due to underlying demand for loans.

### **The Stock Market**

In the near term stocks will continue to churn as financial sector disasters obscure the performance of commodities and manufacturing. A recent article in *Barron's* indicated that over \$1 trillion in market values have been erased in financial stocks. If a stock market index were constructed in which financial stocks were not included, such an index would be off two percent year over year rather than the fifteen percent decline recorded with the financial sector included in the total.

At some point financial stocks will be a buy, but as yet there is not enough stability in collateral values to make that call. So long as international demand stays robust companies with either export demand or foreign operations should do well.

At some point the profits earned by foreign countries will find their way back to the US in the form of asset purchases, including takeovers of American companies and their stocks. This possibility, along with foreseeing some end to the financial sector write-offs, should underpin the stock market in 2009 and beyond.

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