

We're Nearing Crunch Time for Oil

by: Jim Kingsdale posted on: May 04, 2008 | about stocks: [DBO](#) / [OIL](#) / [USO](#)

It's looking increasingly like Crunch Time for oil will be in effect during the 2010 to 2016 time frame. I'm being optimistic in forecasting an end date for it, but the starting time is, if not etched in stone, predictable with some substantial certainty. If any new reader wants to understand why supplies will diminish sharply around 2010, click on [megaprojects](#), [Mexico](#), [Saudi Arabia](#), [Russia](#), [oil demand](#), and [oil supply](#). You should be up to speed in about half an hour.

Crunch Time is when global supplies will start diminishing while demand is still trying to grow. It's when the price of oil will move into the stratosphere as poor countries and poor people are priced out of the market and competition for oil is mainly between the wealthy. As I've analogized before, it will be similar to the competition for waterfront real estate in Palm Beach. And you know the price of that.

Prior to 2010 oil supplies should be able to grow somewhat, or if not grow at least compensate for the decline in older fields. After what I suspect will be a successful near term test of the \$100 support level, the oil price should continue edging up, perhaps exceeding \$200 by the end of 2009. But just as \$100 oil is now starting to look like a bargain after we've seen oil pushing \$120, so will \$175 oil seem like a bargain when oil is trading at \$200, etc.

The reason I suspect that Crunch Time may last only for about five years after it begins is that a number of new trends now being formed are likely to hit the market place in sufficient scale starting around 2015 to have an impact collectively. All of these trends will get stronger over time. They include:

- Substantial new oil supplies from Brazil and Khazakhstan. Also possibly from Nigeria, Iraq and Mexico.
- Scalable cellulosic ethanol capacity.
- Substantial changes in the car fleet toward more plug-in hybrids and fewer gas hogs.
- Adjustment of populations to depend more on mass transit, less on cars.
- Adjustment of industrial production and distribution from trucks to rail.

All of the above is, of course, a hazy – and, as I said, optimistic - guess. Nobody can know the timing or exact impact of these inter-related mega-trends. It's like forecasting a battle among resurrected dinosaurs whose general dimensions are known but whose battle strategies and skills are not. But even though we cannot be certain about dates or degrees of difficulty, given the awful human dimensions of the oil shortage we will face I think it is incumbent on us to start making educated guesses about the future in order to increase the chances that as a society we might finally do something intelligent to mitigate it.

Time for Natural Gas

Natural gas sells for about half the price of oil on an equivalent BTU basis, plus it's cleaner burning, thus causing less environmental impact. Not only is gas a better bargain and better quality product than oil, but gas demand also "sports some strong fundamentals." North America gas supplies may come under pressure over the next few years as demand increases for fertilizer and as natural gas usage in transportation and electrical generation increases.

Overseas, natural gas demand strains can be sensed in the fact that recently Iran has gotten bids from China, India, and Switzerland to finance their gas projects in contravention of U.S. efforts to isolate Iran. The willingness of such countries to ignore strong U.S. pressures indicates how important new gas supplies are to them and perhaps - in the case of Switzerland, which may be acting as a proxy - to other unnamed countries.

Chris Skrebowski recently [indicated](#) that the availability of sufficient gas to supply Europe, particularly after 2009, is looking increasingly precarious. The short story is that the visibility of sufficient supplies of natural gas in Europe and Asia, given current trends, is a little hazy. The implication for North American gas is that Europe and Asia will give us stiff competition for LNG shipments. I have also recently posted a number of pieces ([found here](#)) indicating such intensified competition. The impact of competition for LNG, obviously, is that it would tend to boost the North American price of natural gas.

The price of gas in Europe and Japan is already much higher than it is in North America. My sense is that the North American price over the next year or two may appreciate more rapidly than oil prices. Therefore I have tilted my stock portfolio toward the gas side. You may notice that for the first time XTO Energy ([XTO](#)) is one of my top five holdings. Moreover, as mentioned above, I have added to my options-on-futures portfolio a long position in late 2011 natural gas.

Current Oil Outlook

What about the near term outlook for oil? There's been a lot of talk about why oil is "so high" - how much of that is due to speculation and how much to the weak dollar. I suppose the rest must be caused by supply and demand.

In that regard, recent postings include evidence of [very high Chinese use](#) of oil, [weak supplies from Russia and OPEC](#), [increasing domestic demand among oil exporting countries](#), and rapidly [declining production at Mexico's giant Cantarell](#) field. On the other hand, to the extent this information relates to the supply side it should have much more impact on the out years (the Crunch Time) than on today's market.

Here are some comments from one man in a position to know the fundamental forces acting on the price of oil, Chevron ([CVX](#)) CEO David O'Reilly as interviewed in *The Wall Street Journal* on May Day. You can read the whole interview [here](#).

WSJ: Gas use in the U.S. is down. Do you see signs of that happening elsewhere?

D O'R: No. I was in Turkey a couple of months ago. The price of gas is almost \$11 a gallon. They're selling a record number of automobiles. Traffic is backed up all over Istanbul.

WSJ (paraphrased): What about cellulosic ethanol?

D O'R: It's years off yet.

WSJ: When you hear politicians talk about oil independence, what's your reaction?

D O'R: Unrealistic.

WSJ: Won't ever happen?

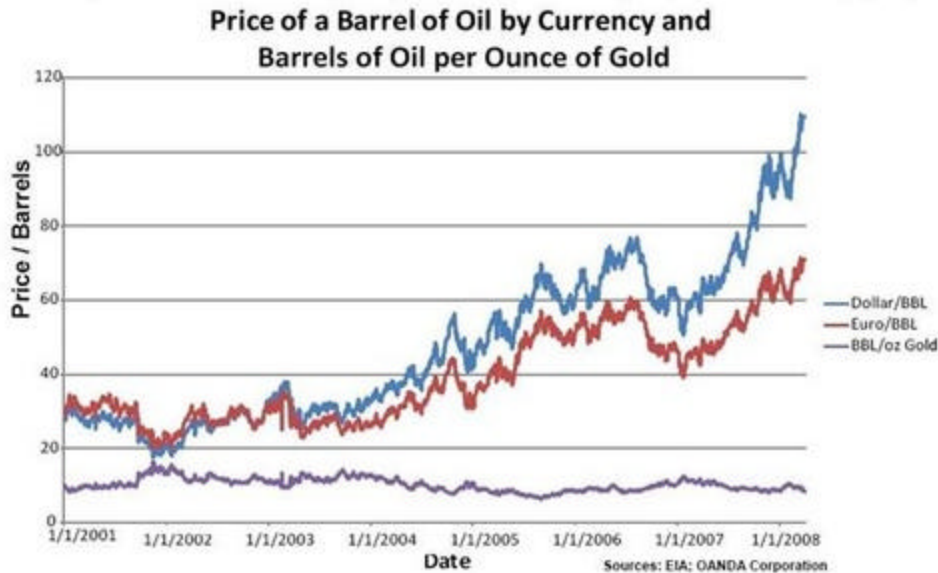
D O'R: No.

O'Reilly credits booming global oil demand for the rise in oil prices. Is he right?

It IS the dollar!

I wrote about [the role of speculators](#) recently. My take, the short version: the best reason to think there has been some speculative push to recent oil prices is that most of the really scary facts about oil supply (the Saudi decision to stop building capacity, Mexican decline, Russia peaking) have their greatest impact in the out years more than today. So that suggests speculation.

What about the dollar? Well, if you measure the price of oil, a global product, in dollars as we in the U.S do, then fluctuations in the dollar must by definition impact the dollar price of oil. Here's a chart from the U.S. Energy Information Agency that shows how much of a difference the currency valuations have made since 2001:



This chart clearly shows that oil has not been getting more valuable in absolute terms as measured against gold. Rather, all currencies have been depreciating compared with both gold and oil – but the dollar has depreciated more than the euro.

Could this be a reason why the OPECers are not pumping more oil but rather are saying that it's all the fault of speculators? Maybe what they really mean by “speculators” is not the traders or their customers in a personal sense, but rather that the markets simply don't think currencies are such a hot thing to own compared with certain truly useful things like oil.

I imagine that a chart of oil vs. copper or wheat or the stock of First Solar ([FSLR](#)) would show the same lack of appreciation in the price of oil that the chart of gold vs. oil shows because all these things have appreciated substantially compared with a dollar bill. On the other hand, oil vs. U.S. residential real estate or oil vs the value of an hour of labor outside the executive suite - things that have depreciated against the dollar - would show a full hockey stick shaped chart.

So what are we to make of this? Is it helpful? I think it is.

1. It tells us that the U.S., the most profligate oil consumer in the world, where humongous trade and budget deficits have become the financial theme of the Bush years, now pays the same price for oil in gold-adjusted terms that it paid in 2001. Meanwhile the Europeans, with fairly balanced budgets and far lower oil consumption per capita also pay the same in gold-adjusted terms for their oil but they pay about half the increase that Americans do in terms of their own currency.
2. It suggests that the world is in fact reasonably well supplied with oil as OPEC has stated since the price of oil in terms of gold has not risen, but
3. It also suggests that oil – unlike a residential house, an hour of labor, or a flat screen TV – is in sufficiently tight supply that it is failing to lose its value in the

face of a currency that is depreciating much more rapidly than other currencies (which are also depreciating) compared with gold, and finally

4. It tells us that when the price of oil begins to appreciate vs. gold we will know for sure that demand is seriously outstripping supply.

As an energy investor, all this is a little humbling. It suggests that if I had invested in stocks related to virtually any commodity when I started investing in oil stocks I might have done just as well or better because all the commodities have appreciated against the dollar.

But I'm not about to give up on energy. If I'm right in my view as discussed at the start of this letter about the next seven or so years, oil and natural gas will begin to outperform gold, agricultural commodities and, especially, base metals. That's because the supply of oil, unlike supplies of gold or the other commodities, will stop increasing and will start declining in absolute terms. That will make all the difference.

Meanwhile demand for base metals is likely to crash because the declining supply of oil is likely to cause a stagnating world economy. Economic stagnation may possibly be exacerbated by a financial crisis if my views about Crunch Time are more or less correct. Not a happy thought, sorry to say.