Has the Energy 'Tsunami' Been Aborted?

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Stocks are clearly in panic mode; prices no longer correlate remotely with valuations. My son asks me, as the market tanks another 500 points, who is buying. Someone has to be buying. It's a brilliant question. I suppose the answer is that people who think the price being offered discounts all the risks of continued panic are buying. So the price must be dramatically lower - that's the only price able to find a buyer.

What started the stock market tanking is the global credit market chaos about which we seem to read a new chapter nearly every day and the fact that it has a certain open-endedness about it. Open-ended risk is the most perverse sort of uncertainty. If the market hates uncertainty it loathes an open-ended uncertainty.

As we're told endlessly, banks are unwilling to lend to each other or nearly anyone else. Why? Because they can't value the mortgage backed securities (MBS's) that make up a big category of assets on their books and other banks' books that could determine each bank's creditworthiness.

The MBS uncertainty corresponds to nobody knowing how many U.S. mortgages will default which will depend on both how bad the U.S. economy gets (how many mortgage holders loose their jobs) and how low the prices of the homes fall. But even more important, the MBS's are leveraged to those factors so if the economy and home prices fall enough some of these MBS's could actually become worthless. That is part of the open ended nature of today's uncertainties.

A second source of lending risk is the fact that many institutions and even corporations may have underwritten credit insurance policies (called credit default swaps) which could become substantial liabilities that are now hidden from view. There are over $60 trillion of those out there and nobody knows either who owns the insurance or who carries the default risk. In a weak economy some of those defaults may well occur. So not knowing where the risks are is sort of like walking around in a city where the plague is raging - you just don't want to be in touch with anyone else.

The Lehman (LEH) default swaps are now being settled, others are coming. I have no idea what the true risks are and it seems like nobody else does either. All we can do is hope they don't explode the markets further.

So the three legs of the open ended risk stool are:

1. How low home values will fall,

2. How long and deep a recession the U.S. will have, and

3. How much damage to the credit quality of how many banks and companies will be done by toxic credit default swaps.

These three legs are also inter-connected, unfortunately. They are sort of like three suicide bombers strolling around a town square in explosive vests. If one vest goes off it could also set off one or both of the other two. So this is another part of the open ended aspect of the uncertain economic risks facing stocks.

The governments' task is to isolate each risk and reduce it. With the $700B "bailout plan" the U.S. decided to finesse the basic causes of the risk and instead simply transfer the ultimate risks - at least the MBS's - from banks to the U.S. government. That transfer will be useful if it helps enable banks to start trusting each others' balance sheets again resume lending. Unfortunately it takes time to implement and its success is not guaranteed.

In case these are not enough risks for the stock market, we also face the more standard list of impacts from an economic downturn that always hurt stocks:

1. the risks are <u>international</u> (almost global)

2. <u>U.S. cities, towns, counties, and states</u> will increasingly be under pressure from falling taxes and rising costs which could put their bonds at risk

3. <u>credit card and car loan defaults</u> will increase from a weak economy and impact banks' asset values

4. <u>corporate earnings</u> decline for most companies in a slow economy.

The Good News

Probably the best news is that some experts think the current "mark to market" valuations of mortgage backed securities which are as low as 20 - 30 cents on the dollar vastly underestimate the true likely values. A recent analysis by John Mauldin points out that even in the worst conceivable circumstances the higher-rated MBS's may be worth at least 70 cents on the dollar.

As Mauldin writes, "Let's think Armageddon and that 50% of the mortgages default and they only recover 50% of the loans. That would only be a total loss of 25% to the entire collateral of the deal, but it would mean that the new investor still get all of my 70 cents plus another 13% back! The proud new owner could get up to 92% of the monies paid."

Mauldin's analysis supports many experts - including some at Treasury - who think the government has a generous amount of maneuvering room with its new $700B pool to buy the MBS's from banks at a higher price than they are currently marked on the banks' books and yet still have room to eventually turn a tidy profit for the U.S. taxpayer.

Some other strengths to bear in mind include the fact that governments around the world and particularly in the U.S. are truly focused on the need to take effective action. Solutions will require government action - the problems are too large to simply "wait out the cycle." New programs will emerge. While the election cycle may unfortunately add a few months to the time spent devising a full U.S. response, the Treasury has a $700B weapon that it will start using fairly soon. If that has the desired effect of unlocking the credit markets, a necessary first step toward recovery, it could launch a huge relief rally.

My sister the real estate maven tells me there are a lot of home buyers "on the sidelines" waiting for the deals to get better and prices to stabilize. She thinks we could be six months or so away from a bottom in housing prices. Apparently Alan Greenspan recently make a similar prediction. I'd trust my sister first. While I don't know if it's 6 or 18 months to a housing bottom one thing that's crystal clear, I think, is that when evidence of a bottom in home prices does emerge the stock market will bounce back like a trampoline jumper. If it doesn't do so based on other information available earlier.

At some point a bottom will be reached. If this is it one would love to have the courage to act because stock prices now seem crazy-low. But so far all attempts to call a bottom have been wrong. And the conventional wisdom is to give up the first 20% or so and make sure it's the real thing (a few higher highs and higher lows) before acting. Maybe that's right or maybe it's best to start buying in slowly starting next week and simply take your lumps if you are wrong because you know eventually you will be proven right.

Oil Pricing in the Coming Recession

What about the energy investor? Has the energy "tsunami" been aborted? No, but it has been put on hold for another couple of years, probably. As readers know, my recent analysis of the Wikipedia oil production megaprojects compilation indicated that 2008 and 2009 will be years of plenty for oil supply relative to demand. That analysis assumed oil demand levels that I now suspect were too bullish given the evolving recession. Depending on how steep and long the recession is, oil prices could go lower than the $80 - $100 range I recently predicted.

Limiting the price fall is the fact that some oil production could get shut in as uneconomical below roughly $80. Also, OPEC might cut production as it is now starting to consider - although an oil supply cutback by OPEC during a global economic crisis would be the worst public relations move in history. But markets tend to overshoot. So it would not be outside the realm of likelihood for the oil price to decline into the $70's or even the $60's for a short time. But I suspect oil is more likely to trade around the low end of my predicted $80 - $100 range and possibly stay there for a while.

Other analysts think the oil price will fall much further. Here is a prediction that oil will fall to $50 and the source is not without some credibility: Merrill Lynch:

“Oil May Fall to $50 in Global Recession, Merrill Says (Update2)

By Angela Macdonald-Smith

Oct. 2 (Bloomberg) — Crude-oil prices may fall as low as $50 a barrel next year, about half current levels, in the “unlikely” event of a global recession, weighing on shares of petroleum producers, Merrill Lynch & Co. said.

Such a scenario, where global growth in Gross Domestic Product falls to 1.5 percent, isn’t the base-case forecast, the bank said today in a report. Merrill cut its 2009 average price estimate for West Texas Intermediate, the U.S. benchmark oil grade, by 16 percent to $90, citing falling demand and the start of new fields in Organization of Petroleum Exporting Countries.”

Oil Investment Strategies

So what is the energy investor to do? Well, it seem pretty obvious that in an environment of down-trending stocks and down-trending oil prices and with good reasons to think that both trends may continue for a while the better part of wisdom is to have plenty of cash. And it suggests that energy stocks may not have the best upside when the turn comes.

By that logic I should probably be just about 100% in cash. Actually the funds I manage outside the EIS account that is referenced on this site are overwhelmingly in cash. At a minimum I think an investor should have at least three years of cash on hand based on the likelihood that by three years from now the economy will have started to recover. Of course, the stock market will begin to recover sooner than the economy turns.

As it happens, three years from now is also about the time when the megaprojects analysis suggest that oil supplies will begin to tighten. Therefore I think that when we start to come out of the recession oil prices will likely rise much more rapidly than a normal economic expansion would cause. So my best guess is that energy stocks will be in the second or third wave of the best stocks to own in a recovery.

Longer Term Oil Prices

Looking down the road 3 - 7 years we must adjust our vision of how oil supply and demand will be impacted by this economic crisis. Following the logic of the below-listed impacts leads to what may be a surprising conclusion: when the oil supply crunch hits - starting sometime in or soon after 2010 - it will be much more potent because of the recession. Here are the predictable impacts:

1. Over the next few years of relatively low oil prices there will be less impetus to bring plug-in hybrid electric vehicles (PHEV’s) to market. They only make real sense if gasoline is well over $4, much more sense at $6 a gallon. But at $3 gasoline or less which is likely for a couple of years PHEV’s are not economical. So I won’t be surprised

if next year some car companies decide to slow down their PHEV development programs and aim for introducing them a few years beyond the time set in their earlier plans.

Note also that cars have become a consumer discretionary purchase to a large extent. People who turn in their car every 2 or 3 or 4 years for a new one do so out of boredom with the car and the desire for "something new" - not out of transportation necessity. That motive for purchase will recede substantially in a long and deep recession. So car sales may slow for possibly 2 - 3 years. So the next 12 - 24 months could see both lower oil prices and slow car sales. That combination, I suspect, will reduce the car maker's appetite for taking risks like introducing a PHEV or pure electric vehicle.

2. The new and presumably more Democratic Congress may feel a reduced urgency to throw money and regulation at fuel efficiency. At a time of economic stress and enormous deficits due to lower tax revenues and greater social spending requirements Congress may well decide that subsidizing the purchase of PHEV's or other spending to increase fuel efficiency can be put off.

<u>For both of these reasons, then the transition of the fleet from gasoline to electricity is more likely to start in 2012 or even 2014 than in 2010.</u>

3. There will be some fall off in capital spending to develop oil properties. For example, the price of oil may well fall below the estimated $80 - $90 level needed for the sub-salt Brazilian fields to be profitably exploited. The same could be true of some Caspian production. So we may well see some production plans being deferred. Such deferrals could put off some fields now scheduled in the 2013 - 15 period. Therefore, <u>there could be less new oil coming on stream in the 2013 - 2015 time frame</u> (which is already scheduled to be very tight)

4. Economic recovery may well begin in the late 2009 - late 2010 time frame. Thus there could be robust global demand growth in place by 2012.

5. Oil supplies, according the the Wikipedia megaprojects analysis and also to a number of analysts such as Charles Maxwell, will start to become constrained by increasing decline rates and reduced production from new fields in 2010, with the trend growing in 2011 and 2012 and becoming very severe in 2013 and 2014.

What becomes obvious from this list of likely impacts of the recession and likely developments in global oil production is a sort of perfect storm coming to the price of oil in the 2010 - 2015 time frame. With a year or so of oil prices below $100 and perhaps below $90 or even $80, a consensus will build that there was an irrational "oil bubble" in 2008 caused by speculation but that in reality there is no need to worry about oil scarcity. Plenty of oil. However, just as the economy begins to stabilize and resume growth (say in mid- 2010), the era of real oil shortages will begin. Oil demand will grow just as people start thinking that oil is plentiful, just as oil shortages begin to start growing and just as the supply of fuel efficient PHEV's has been delayed.

Given this revised outlook, I suspect my predictions for $200 oil by 2011 and $500 oil in 2014 are looking even more likely. It is true that $200 oil will tend to cause the economy to slow again but I doubt it will push the global economy back into another recession for a while. People think that $140 oil this spring was a factor pushing down the economy, but I think oil was a very small factor. We are where we are now, I believe, because of the credit crisis and housing slump which started a year ago when oil was in the $70 - $80 area.

There has been a roughly 6% reduction in U.S. oil consumption. On the other hand, there has also been a huge increase in unemployment. People who are out of work drive less. For one, they do not drive to work. For another, they restrict recreational driving. So I suspect that a lot of the decline in U.S. gasoline consumption has been related more to economic weakness than to higher oil prices. I don't think $135 oil was an accurate data point for understanding elasticity of demand for oil; it was a very small contributing factor in our economic decline.

Energy Policy vs. Environmental Policy

I was having dinner with friends last week when one of them asked about offshore drilling. I said, "sure drill away - we'll need it by the time it comes out of the ground in 2015." That led to a discussion of the fact that one should not mistake drilling for oil for an energy policy. The only real energy policy is one that reduces oil dependence and the only way to do that is by transitioning to electricity for transportation - cars and rail. So things that make that happen like new light rail lines or electric vehicles are part of an energy policy.

What about wind, solar, geothermal, etc? They produce electricity more cleanly but we actually won't need a lot of new electrical capacity to allow for electric vehicles. Studies have shown that the present electrical infrastructure is sufficient to power 80% of our car fleet if the batteries are recharged at night when normal spare capacity is huge. Of course electric vehicles will increase the use of the present generating and distribution facilities. More wind, solar, geothermal, etc would make the additional required electricity more clean and renewable. But from an energy viewpoint, we could get along by using more of the existing coal and natural gas and nuclear capacity. So wind, solar and geothermal are part of an environmental policy, not an energy policy.

The EIS Portfolio

I refer you to the data on the home page for September EIS results. Suffice it to say they are sad and do not shower any honor on my efforts. I have found that even with a fair amount of cash, the downside volatility of my portfolio has been phenomenal. For a while in September I had a much larger cash position than at the end (or now). But around mid-month I talked myself in to putting back on a lot of my longs. That was obviously a mistake.

With hope that values will ultimately prevail over panic.