# Marathon Strategic News

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**Commentary by Nicholas Terezis, CFA**

## Economic Outlook

As we go into the last inning of the election cycle, the perception of risk has heightened under the daily barrage of news from the Middle East and increasing uncertainty over the presidential election. In spite of the geopolitical concerns, high oil prices, and increasing interest rates, we are in a period of continuing economic growth. Gross Domestic Product should be 3%-4% for the remainder of this year and will likely be in the same range next year.

Long-term investors should look beyond the current lackluster stock market. So far this year corporate profits have soared while the stock market has gone nowhere. A combination of soaring profits and stagnant stock prices has made the stock market an even more attractive investment from a valuation standpoint. If economic growth and earnings continue to be favorable – which is the most likely scenario – the stock market should resume its upward path.

## "Bubbling" Crude

Everywhere you go, all you hear about is the price of oil. You can't turn on a TV or pick up a newspaper without someone saying that the price of oil looks like it will probably keep going higher. Contrarily, I believe the price of oil is untenably high. Further, the price movements (to a lesser degree) resemble manias and bubbles of the past, such as the tulip bulb craze of the 1600s, the Florida real estate bubble of the 1920s, the Hunt Brothers silver bubble of the 1970s, and most recently the Internet bubble that we experienced a few years ago.

There are legitimate reasons for the short-term price of oil being higher. However, speculators have ignored the totality of the situation (the fundamentals) and have driven oil prices to unsustainably high levels. Given the recent supply issues, I believe that the fundamental price of oil today should be \$30-\$35 per barrel, not the lofty current price of \$55 per barrel. However, once various short-term supply issues are resolved in the next 6-24 months, I believe the price of oil should further decline back to a range between \$25-\$30 per barrel.


***When investing, don't listen to hype and hot investment ideas. Time and time again, over-priced investment bubbles eventually pop.***

### The Short-Term Problem

In 1999 there was much more short-term oil supply than demand. Many speculators conveniently forget that the result of this was oil prices dropping to prices as low as \$10 per barrel! While \$10 per barrel was too low, it illustrated the slow nature of supply adjustments in this industry.

Five years ago, the oil producers experienced terrible financial pain from oil prices being so low. As a result, they severely curtailed their investments in capacity expansion. This made perfect sense at the time because more than 6 million barrels per day of excess capacity were available.

Over the past five years, this excess oil capacity has slowly been utilized as the global economy has grown. In fact, prior to the recent hurricanes in the Gulf of Mexico, there were only an estimated 1 million daily barrels of excess oil production capacity (approximately 1% of the total daily supply). Given the inevitable and unpredictable potential for supply disruptions, this has proven to be too small of a production capacity buffer.

In 2003, unexpected oil supply disruptions resulted from a labor strike in Venezuela, internal conflict in Nigeria, and lower than expected Iraqi post-war production. Global inventories were run down, and the price of oil moved higher. In 2004, there has been a surge in oil consumption from developing Asian countries, and supply disruptions resulting from hurricanes in the Gulf of Mexico and instability in Iraq. I do not believe that the unforeseen supply and demand changes that occurred over the past two years would have significantly impacted oil prices if we had more excess capacity.

Unfortunately, oil companies cannot just turn on the spigot and start increasing the flow of fuel – it takes time to create the infrastructure necessary for extracting oil from the ground. This lag time for increasing production capacity is the real reason that oil prices are so high.

**Oil Resources Are Still Plentiful**

In 2000 the US Geological Survey (USGS) released its comprehensive assessment of worldwide petroleum resources[1]. The USGS identified at least **three trillion** barrels of oil resources. At projected global consumption rates, this translates into more than 50 years of oil supply! Speculators' claim that "Saudi Arabia will run out of oil in five or ten years" is ridiculous and unfounded – but it serves their mania's purpose.

**Oil Supply is Abundant, But Slow to Change**

With oil trading around $55 per barrel, all oil producers are scrambling to pump every last drop of production – and they should. It is only a matter of time before the high oil price causes significant investment increases in drilling equipment and decreases global oil consumption. During the last twelve months, the number of active oil rigs has already increased by 9%[2]. I believe that the price of oil will continue to go through periods of feast or famine, because unexpected events will always occur (sometimes several at a time). Further, the lead time required for increasing production can take a couple of years.

**Oil Demand Slowly and Steadily Increases**

The US Energy Information Administration (EIA) projects global oil demand will increase by 1.9% annually over the next 20 years. This is just a slight increase over the last 20 years annual growth rate of 1.5%. China, the expected economic growth leader of the future is projected to consume oil at an increasing annualized rate of 4% over the next 20 years[3]. Again, if you listen to the exaggeration of some market commentators, you would think that they were going to double their consumption every other year.

**Other Energy Sources**

Higher oil prices deter consumption and encourage the emergence of new replacement energy sources. Someday we will exhaust our oil supplies. However, it is not likely to happen in the near future. We still have plenty of time for science to develop sound oil alternatives. Have faith. As distant as the transition to alternative sources of energy may seem, "necessity is the mother of invention."

Meanwhile, do not be drawn into believing the hype associated with the current price of oil. In the short term anything can happen to the price. However, I believe the price will come down once the supply or expectation of supply increases. In their analysis, the EIA credibly describes the price of oil being at most $35 per barrel in the year 2025. There is just too great of an oil supply in the ground for the price to be any higher. Further, there are too many countries willing to sell their oil for a reasonable profit. Above all, as an investor, do not make any rash investment decisions based on this short-term oil price volatility.

## World Oil Demand and Supply

**(in Million of Barrels per Day)**

| | | | | | | | Estimates | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **1960** | **1970** | **1980** | **1990** | **2000** | **2003** | **2004** | **2005** | **2010** | **2025** |
| **Demand** | | | | | | | | | | |
| United States | 9.8 | 14.7 | 17.1 | 17.0 | 19.7 | 20.0 | 20.8 | 20.7 | 22.7 | 28.3 |
| Japan | 0.7 | 3.8 | 5.0 | 5.3 | 5.5 | 5.6 | 5.4 | 5.4 | 5.7 | 5.8 |
| China | 0.2 | 0.6 | 1.8 | 2.3 | 4.8 | 5.5 | 6.7 | 7.3 | 7.6 | 12.8 |
| India | 0.2 | 0.4 | 0.6 | 1.2 | 2.1 | 2.3 | 2.4 | 2.5 | 2.8 | 5.3 |
| The Rest of the World | 10.6 | 27.3 | 38.7 | 40.8 | 44.7 | 46.3 | 47.0 | 48.5 | 52.6 | 68.7 |
| **Total World Demand** | **21.3** | **46.8** | **63.1** | **66.5** | **76.8** | **79.7** | **82.3** | **84.4** | **91.4** | **120.9** |
| **Supply** | | | | | | | | | | |
| OPEC | 8.7 | 23.6 | 27.4 | 24.5 | 31.3 | 31.7 | 32.7 | 32.7 | 46.6 | 75.7 |
| Former USSR | 2.9 | 7.0 | 12.0 | 11.3 | 8.2 | 10.8 | 11.3 | 12.2 | 12.9 | 16.8 |
| United States | 7.0 | 11.7 | 10.8 | 9.7 | 9.1 | 8.8 | 8.8 | 8.9 | 9.2 | 7.9 |
| The Rest of the World | 2.3 | 6.8 | 13.9 | 21.1 | 28.9 | 28.2 | 30.3 | 30.7 | 31.9 | 36.6 |
| **Total World Supply** | **21.0** | **49.0** | **64.1** | **66.5** | **77.5** | **79.4** | **83.1** | **84.5** | **100.6** | **137.0** |

Supply estimates for 2004-2025 are based on the US EIA's high unit demand scenario. The amount of oil supplied will of course depend on the demand. This chart is meant to illustrate that the long term capability to supply oil is sufficient to meet demand (if needed). Source: US Energy Information Administration and Marathon Strategic Advisors Estimates.

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1 U.S. Geological Survey, *World Petroleum Assessment 2000*

2 Baker Hughes

3 US Energy Information Administration

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