



## Illumination

April 26, 2006

### How high is high for oil?

It was a little over two years ago that oil prices began their run up to levels that may be starting to pinch consumer's pocketbooks.

I readily admit that as this current trend was getting started K&A had less expertise in the oil and gas area than we do now. But I did recognize that a very fundamental shift was underway in the global commodities and financial markets. The first time I ever seriously mentioned oil in our newsletters was April 3, 2004 and the comment was short, and as follows:

[“\(Oil\) prices have now crept up to the \\$35 to \\$38 range and may be headed higher.”](#)

**Illumination, April 3, 2004**

A few days later I made our first serious mention of commodities. By that time we had started adding commodity related positions to suitable portfolios. Here was the observation that was made back then:

[“Commodities, as an asset class, can be a good portfolio diversifier because they have a negative correlation to both equities and conventional bonds and a positive correlation to inflation. So in the short term, if you are fearful of a spike upward in interest rates to defend the dollar or to ward off rising inflation; or if you are fearful of a downturn in equities that may be related to terrorism, commodities may smooth out the bumps for your portfolio.”](#) **Illumination, April 8, 2004**

By April of 2004 the globe was already well into the new bull market in commodities that has now taken almost all prices toward nominal record highs. But most investors hadn't even noticed yet. During the remainder of 2004 I continuously reminded our readers that K&A thought the path of least resistance for oil prices was upward.

[“Unfortunately the price of oil still seems to be rising and we suspect that we might see \\$50 per barrel before we see \\$35 again.”](#) **Illumination, August 13, 2004**

“And what about the price of oil? You have to bet now that it will hit \$60.00 before it hits \$45.00. You can’t bet on it going down until it actually does. There still seems to be way too much momentum on the upside.”

**Ellumination, October 18, 2004**

“Gas and oil are commodities but we treat them as a separate asset class. Not only are they “commodities” they are “political commodities” which takes them out of the world governed by pure supply and demand functions. They are the stuff of wars and global tensions. Think IRAQ!

If we could predict the price of oil we could have skipped everything we have written so far and simply gone long or short oil—depending on that prediction. But we can’t. In fact we can’t think of anything more uncertain than reliable data on supplies and therefore the direction of prices. We think it is a reasonable bet that prices will remain manipulated, and high.” **K&A Annual Report to Investors December 2004**

By summer of 2005 I was already signaling that \$80 per barrel might be in our future. As of today we are almost there. Here is what I was writing then:

“Don’t get me wrong. I am not setting you up to make the case that oil prices are going straight up. There is a lot of speculation, and possibly some fear, built into the current pricing structure of oil. It is still possible that we could see prices back down in the \$40’s before we see \$80. But I’ve got a distinct feeling that we will see \$80, and possibly higher. Earlier this year one lonely analyst at Goldman-Sachs speculated that oil could be priced at \$100 per barrel by the end of the year. Most other Wall Street mavens laughed and ridiculed him. I suspect those smiles are a little tighter on people’s faces right now.”

**Ellumination, June 23, 2005**

“We believe that the long term (5, 10 to 20 years) pricing path is upward. In fact today the Saudi’s reported to the world that they do not have the reserves to keep up with global demand over the next 15 years.” **Ellumination, July 15, 2005**

It was about the time of that announcement by the Saudi’s that I began to seriously understand that the fundamentals of the oil business were really changing. After spending literally hundreds of hours on the research effort, by 2006 I found myself becoming a member of the “Peak Oil Production” minority. Stated simply that means that:

“K&A Asset Management, LLC has reached the conclusion that “it is more likely than not” that the world has either reached “peak oil production” or will within the next few years. We have spent hundreds of hours researching this topic. We have not treated the topic superficially or lightly. We believe that “peak oil production” will have serious economic ramifications including the probability that oil prices will continue their upward trend.

We acknowledge that the trend of rising prices may be interrupted by cyclical and/or seasonal conditions that will moderate prices. However we are convinced that the long

term secular trend dictates that supplies of oil will be unable to keep up with currently forecasted demand and that the price of oil will continue to rise for the foreseeable future. We would encourage all our readers to investigate this topic on their own and to reach their own conclusions.” **Ellumination, March 12, 2006**

So where does this leave us today?

First let me acknowledge that believing in the concept of Peak Oil Production is probably comparable to believing that the earth revolved around the sun during the time of the Inquisition. No one gets it yet. The good news for them is that when they figured it out—it wasn't too late. We may not enjoy the same fate. If oil production has peaked or is about to peak, that is very bad news for an oil thirsty planet.

There were a couple of major oil related conferences this past weekend that I hoped might shed some light on current conditions and pricing trends. One conference did, and one didn't.

Dr. Paul Horsnell is the managing director and head of commodities research at Barclays Capital, the investment banking division of Barclays Bank. He was a panelist at a Canadian Energy Research Institute conference looking at the short and long-term outlook for oil prices.

He made the following comments, as reported by Bill Graveland for ResourceInvestor.com. Check out his “girly people” comments:

*"We're still working on a base case where we see prices averaging close to \$70 (U.S. a barrel) this year assuming the geopolitical element didn't get too hot. Clearly if the geopolitics came on a bit quicker, especially the concern in Iran, then all bets are off and we're going to get higher averages," he said.*

*With oil prices climbing \$15 in the last month alone Horsnell said the price that consumers are seeing today is reasonable. On Monday, the June contract for crude on the New York Mercantile Exchange closed at \$73.33 a barrel.*

*"That is a much more realistic pricing in of the risks which were already in the market one month ago. What you have had now is the market waking up to and saying yes, that is a very serious situation in a world where the use of nuclear force against a major oil producing country cannot be ruled out," Horsnell added, referring to reported U.S. military plans against Iran over its nuclear ambitions. Horsnell said current prices have nothing to do with speculators or what many analysts refer to as the "fear factor".*

*"It's a nonsense concept - this idea that there's a price and then you add a premium. Fear sort of suggests these are sort of soft, girly people who trade oil and they're not," he said.*

*"These are big strong men and they're not running around in fear."  
Increased world demand and depleted reserves, along with geopolitical fears  
about Iran, Nigeria and Iraq has added to the problem.*

The second major conference was the 10<sup>th</sup> annual International Energy Forum at which delegates from all the major producing and consuming nations were in attendance. I HAVE YET TO FIND A SINGLE SIGNIFICANT COMMENT THAT CAME OUT OF THIS CONFERENCE. But I did find a picture of the delegates. Here they are; and they are a fine looking bunch of men at that! The guys that are smiling are probably from the producing nations and the guys with the straight faces are probably from the consuming nations. (Just kidding) Some of the producers are clearing hiding their smiles in order to be modest!



Does the old adage "silence is golden" apply in this case?

The silence from the 10<sup>th</sup> annual International Energy Forum leaves me to speculate what actually went on at the conference. On another note, Friday is the deadline by which IRAN is to reply to the UN regarding their nuclear program. Any bets on oil at \$80 by Friday?

Oil prices have retreated a bit in the past three days and I found this chart at RealMoney.com that gives us a snapshot of what is going on. Significant technical support seems to come in at about \$68.50 per barrel (the top blue line). More support comes in at about \$65.14 (the 50 day moving average) and at \$63.18 (the 200 day moving average). If all those support levels were broken it would be anybody's guess as to how low oil would go.



We frankly admit that we still don't know whether Dr. Horsnell is right, and that there is no premium in oil pricing related to international tensions.

We find that unlikely. We believe that there is a lot of hot money, or speculative money in the oil markets that could be helping to prop up prices. We have heard other competent analyst assign anywhere from \$10 o \$20 per barrel of speculative fluff in current oil pricing.

Nigeria's oil minister did declare last week that if global tensions related to Iran, Nigeria, Venezuela, Iraq, etc. were suddenly out of the markets that oil prices would settle back into "the high \$50's or low \$60's. The only problem is that we don't expect that to happen.

Regardless of where prices are headed in the short term, given all the information and data available to us, we suspect the long term trend remains upward, not downward. If oil prices do get back to "the high \$50's or low \$60's" we should enjoy it while it lasts.

Eventually the guys at Goldman are probably going to be proven correct and we will see \$100 per barrel oil. That is the most likely consequence of "peak oil production".

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 For K&A Asset Management, LLC  
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