



## E-illumination December 7, 2006

### Is it still all about oil?

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Today is the 65<sup>th</sup> anniversary of the start of World War II between Japan and the United States. I consider myself to be a student of history of this war and have read more about the events of these years than any other period in American history. Some historians recognize that one of Japan's several underlying motives for entering into the war with its Pacific neighbors involved securing long term access to natural resources including oil.

One irony of the current conflict in Iraq is that the U.S. has been accused of doing the same thing. I am not attempting to make a judgment or comment on that theory in the context of this letter.

It is not lost on me however that 65 years later, oil and energy are still at the epicenter of national self interest, economics, and politics for countries all over the world; not just the U.S., Japan and Iraq. There is increasing debate over whether or not there will be enough to go around in the future.

There are now four trends related to oil that seem to dominate events in this new century. First, it is a lot more expensive than it used to be. Second, most of the supply has now been "nationalized" by governments of the countries that have the oil. Third, there is a global scramble going on to secure long term access to supply. Fourth, dealing with changes in price and the consequences of those changes are daily exercises that dominate the investment landscape.

In addition there are two other factors which must be considered in the context of all decisions related to oil. The first is that I remain absolutely convinced that no one has a truly accurate reading on how much is still available. "Reserve" numbers are nothing if they are not completely "politicized". The second is that 65 years ago the U.S. had relatively easy access to known reserves. After World War II the "deals" got made that assured those resources would be even more reliably available. That condition has changed dramatically to the point where a significant portion of available supply is now in the hands of governments who are no longer friendly to the U.S. Another large portion of available supply is in a country in which internal "regime change" could tip the scale to put the overwhelming majority of supply in unfriendly hands. Think Saudi Arabia.

With all this taken into consideration, watching the price of oil is a daily exercise around K&A. Only three weeks ago we wrote a newsletter called "Cheap Oil for Christmas".

One of our comments in that letter was, "Oil is setting up to fall back to the \$50 per barrel range—which we must admit surprises us a bit. But that is what seems to be happening...."

We showed you this chart so that you could see the trend yourself.



It now looks like we may have written that newsletter on the day of the short term cycle low for oil prices. On that day the overwhelming majority of professional traders were betting that OPEC could not hold the line on announced production cuts, and therefore supply would be outstripping demand, and prices would be falling.

It is only 3 ½ short weeks later and those same traders now seem convinced that OPEC is holding the line. “Oops” might be the appropriate expression.

This second chart shows you what happened after we wrote that letter. Oil prices went up roughly 7 percent. We honestly can’t tell you where prices are headed in the short term, but we can tell you that the stock market is indicating that professional investors think that

high prices, and therefore strong revenue streams for oil companies, are here to stay. Why do we say that? Even though oil prices are well off the highs posted in July, several oil stocks are making new all time highs right now or matching their all time highs. That indicates bullishness to us.

Exxon Mobil, Chevron and Marathon have all posted new highs this week. Devon and ConocoPhillips are matching old highs posted earlier this year. The “XLE” which is an index fund comprised of several oil related stocks just posted a new all time high. Before anyone jumps on me for pointing this out, I acknowledge that many oil and oil service sector stocks are not at “all time highs”. The good news is that three of the four that we own for our clients ARE! So enough already.

There is another consideration regarding oil pricing that we want to put on the table for your consideration. Oil is traded throughout the world in U.S. dollars. After all, following WW II we were the only economy left standing and we therefore influenced the world disproportionately, and we have possessed the global “reserve” currency ever since. The U.S. dollar actually began its ascendancy to become the reserve currency of the world after WW I. The job became unequivocally complete after WW II



But the dollar has been in long term decline relative to other currencies for many years now. Recently it has been approaching the bottom of its trading range for the 5<sup>th</sup> time since 1985. So far, when it has fallen to these levels, it has always managed to “bounce back” and it has remained the unquestioned “reserve” currency. But stop and think about that for a moment. If it has been the world’s reserve currency for only a limited time, then others have preceded it.

Just look back to the “age of Europe” from the middle of the fifteenth century, with Portuguese supremacy spanning about 1450-1530; to the Spanish from 1530-1640; to the Dutch from 1640-1720; to the French from 1720-1815; and finally the British from 1815-1920. In those years each of their currencies tended to act as the “reserve” currency of the then known world. The British pound probably became the first global reserve currency in the 19<sup>th</sup> century.

The U.S. emerged after World War I and became truly dominate after World War II. But the sun has been setting on the U.S. dollar for the past 20 years. Here is a picture of the decline of the dollar since its high back in 1985. The RED line traces the declining top of this DESCENDING TRIANGLE pattern. The GREEN line across the bottom defines the long term bottom of the trading range. Imagine the RED line and the Green line eventually meeting at some point in the future to complete a “descending triangle”. That is the most likely outcome of this long term pattern.



Stockcharts.com explains that, “A “descending triangle” is a bearish formation that usually forms during a downtrend as a continuation pattern. There are instances when descending triangles form as reversal patterns at the end of an uptrend, but they are typically continuation patterns. Regardless of where they form, descending triangles are bearish patterns that indicate distribution.” (Chart by John Murphy)

“Distribution” is code for “selling off”. Our best guess at this point is that the dollar’s price relative to other major currencies will bounce again and eventually approach that descending RED line once more. But somewhere in our future lurks the almost inevitable event that this “descending triangle” breaks down and the Green line is penetrated to the downside. At that point there is no telling how far the dollar falls—and what happens to the pricing of oil to adjust for that fall; or what currency the suppliers will demand for payment!

At this point we deliver the punch line. Our long term thesis, has been, and continues to be that the longer term pricing trend in oil is upward, and the longer term pricing trend in the U.S. dollar is downward. Our tactics adjust from time to time to take advantage of shorter term counter moves within those long term patterns. But our long term strategy relative to the two asset classes remains intact. Oil up. Dollar down.

All the best,

Paul Krsek  
For K&A Asset Management, LLC  
December 7, 2006

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*Sincerely,*

*Paul Krsek*

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