

Wescap Management Group

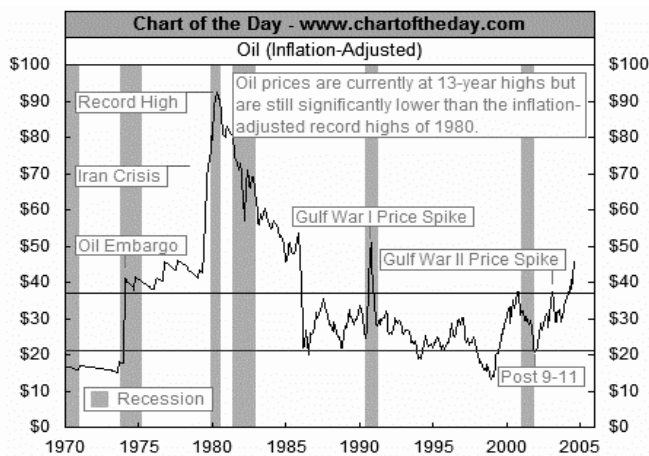
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For WESCAP Clients and Interested Readers

Oil: What Do Higher Prices Really Signify?

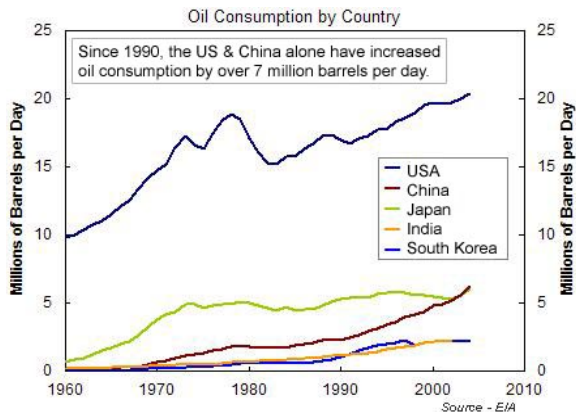
Is Oil Expensive?

While crude oil prices have recently shot up to unprecedented levels, when adjusting for inflation, they are still no where near the heights reached in the early 1980's



(see graph above). Perhaps a case can be made that prices were unusually low during the mid-1990's. Production of crude oil has been dropping in the U.S. for over 30 years, and worldwide production could top out within 10 years (no new huge fields have been found in decades).

Yet demand is ever increasing, with the U.S. still accounting for the lion's share of demand. China's demand has surged to second place and is increasing at such a high rate that it is having a major effect on reducing the



small surplus margin that currently exists between demand and production capacity. Currently, it is estimated that there is only capacity to produce another 1 million barrels/day of crude above current demand. With world oil consumption estimated at 82.4 million barrels a day, demand only need increase 1.2% to reach 100% of estimated worldwide capacity. At current growth rates, this could occur in 2005 or 2006.

This doesn't take into account supply disruptions caused by weather, worker strikes, accidents, wars or terrorist attacks. Any one of these can reduce production capacity. It's no wonder that each supply disruption sends oil prices spiking.

Oil demand is relatively inelastic in the short run, meaning price changes don't have much influence on consumption. Thus when demand approaches the capacity to produce, prices can skyrocket.

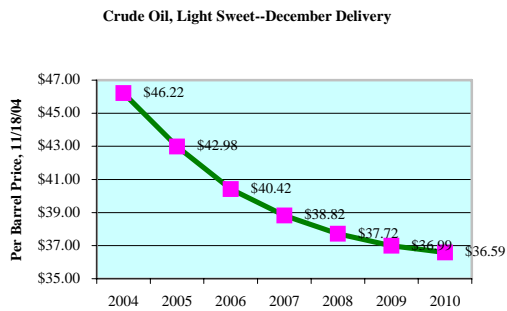
In the U.S. about 67% of the 19.7 million barrels of petroleum products used daily is used for transportation—cars, trucks, rail, and aircraft. There are no reasonable energy substitutes for these vehicles. Thus, if prices go up enough, consumers cut spending elsewhere, even to the point of triggering recessions. It is also hard to find cost efficient substitutes for the remaining oil used primarily for chemicals and fertilizers.

However, not all is gloomy for oil users. The surge in prices will bring back marginal wells and justify higher costs and effort in extracting oil. Obviously there is a lag effect between higher prices and higher production, but some evidence of increased production already exists. Also, oil extraction increases are expected over the next 5 years from oil reserves found in the Gulf of Mexico and elsewhere. If demand slows to under 1% growth per year, we may have enough oil to go around for some time without more price shocks.

Moreover, as the next chart shows, this additional supply is expected to result in oil prices declining each year—from over \$47/bbl now to \$43/bbl in 2005 to \$40 by 2006, and lower thereafter. Nevertheless, even if correctly forecast, these prices are much higher than previously expected.

(Continued on page 2)

Oil: Higher Prices (continued)



Conservation/New Technologies

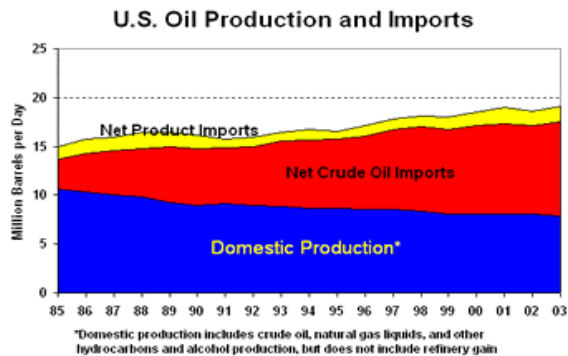
High oil prices eventually reduce demand via conservation measures and by adopting more energy-efficient technologies. In the 1970's, small engine cars replaced big engines. This time, it might be increased use of hybrid and diesel fueled vehicles. New low-fertilizer crops are also being developed.

However, it will take years for even the most feasible of these to have a noticeable impact (e.g. hybrid vehicles) and it could be many decades before the more exotic technologies, like hydrogen vehicles, become cost effective.

Trade Deficit, US Growth, Currency

The U.S. trade deficit is expected to be about \$610 billion in 2004, up from \$496 billion last year. China's fixed-dollar exchange regime is one major contributor to this deficit. Certainly another contributor is crude oil importation.

Net petroleum imports are expected to reach 11.8 million barrels/day this year and to double by 2025 (U.S. Dept of Energy). At \$45/bbl. and current import levels, this means \$194 billion/year is transferred to foreign producers. Fortunately, this amounts to a modest 1.7% of the over \$11 trillion U.S. Gross Domestic Product (GDP). Thus, while painful at the gas pump, the earlier oil increase of roughly \$15/bbl. should



only reduce the U.S. growth rate by about 1/2% this year—not good, but not a disaster. Plus, if oil prices decline next year, this will have a positive impact on future growth.

Much of the increase in the price of oil is also due to the U.S. dollar weakening against other currencies. The dollar has lost 23% against other currencies since 2002. Thus the

Trade-Weighted Dollar vs US Current Account Deficit



price of oil needs to rise 30% in dollars to be at the same price for non-dollar currencies. If the dollar continues to decline, as many economist expect, then oil should to continue to rise, when priced in dollars.

Investment Implications

The impact of dollar depreciation and strong worldwide demand for petroleum products could easily mean higher than expected oil prices.

Higher import prices could contribute to a round of modestly increasing inflation. Inflation and the impact of dollar depreciation could then lead to higher U.S. interest rates.

A beneficiary of this possible outcome is likely to be energy stocks, which are still priced inexpensively, even if oil prices fall modestly. These stocks are also a quasi-dollar depreciation hedge and can be owned alongside purer currency hedges such as foreign currency denominated small-cap stocks, bonds and foreign real estate.

World growth is expected to continue despite high oil prices. U.S. economic growth should slow only a little, and U.S. exporters should benefit from a cheaper dollar. Foreign economies are less impacted because in their own currencies, oil is not priced so high. Plus much of oil revenue is flowing to emerging markets producers.

We believe that having exposure to the above mentioned assets and countries can significantly enhance portfolio returns, while at the same time reduce certain risks.

About WESCAP: WESCAP Management Group is a registered investment advisor and fee-only financial advisory firm. WESCAP has been serving individuals and families since 1988. For additional information, please contact Rick Weinlein, Mark Gleason, or Joel Edstrom. You can contact us at (818) 563-5170 303 N. Glenoaks Blvd. Suite 905, Burbank, CA 91502, or via e-mail at contact@wescapgroup.com