Vol. 8, Issue 39
December 12
2014

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

"Everybody thought I had a duster.

You all thought Spindletop and Burkburnett was all the oil there was. I'm here to tell you it ain't, boy. It's here. There ain't a dang thing you gonna do about it. And there's more down there, bigger wells.

I'm rich, Bick! I'm a rich one. I'm a rich boy. I'm gonna have more money than you ever thought you could have.

You and the rest of you stinking sons of Benedicts."

If you have ever seen the movie Giant, you might remember this quote from the James Dean character Jett Rink. He has hit oil on property he obtained after the death of a member of the wealth Benedict family, who were cattle barons. Standing on the Benedict's front lawn, as it were, covered in the stuff, he is letting the patrician Benedicts know where the real money and power will be in Texas moving forward.

While there is certainly still money to be made in cattle, as the Benedicts originally did, there is far more to be made in crude oil. To this end, according to the USDA, at a price of $5.29/lb., the 'retail equivalent value of the U.S. beef industry' was $88 billion. *(http://www.ers.usda.gov/topics/animal-products/cattle-beef/statistics-information.aspx).* By comparison, the US currently consumes around 19 million barrels of crude oil every day. Even at the now reduced price of $60/barrel, the math works out to be $1.14 billion per day. Multiply that by 365, and you get $416 billion, for crude, in the United States alone

Daily global consumption is around 91 million barrels, according to the EIA, which translates into $5.4 billion per daily, and $1.99 trillion annually. That is a lot of hamburgers. But you know what? It is going to continue to go up.

For a very long time, the US completed dominated global economic statistics. For instance, in 1944, at the height of WWII, the US economy was 35% of the global total. In 2014, it is estimated to be around 18.5% or so. As a result, the US slice of the global economic pie is about half what it was 70 years about, and seems to be stabilizing around the current level, largely at the expense of Western Europe and Japan.

In the meantime, China, in particular, and India, to a lesser degree, have dramatically increased both their share of global output, but also their share of global energy demand. As a result, while we have seen crude oil prices plummet over the last couple of months, most agencies assigned with forecasting such things predict global oil consumption will be higher in 2015 than it was in 2014, an all-time high….from what I can tell.

In short, global demand is pretty robust, having increased from roughly 80 million barrels/day to 19 million. This while US and European demand has fallen. How now brown cow? Right? Yeah, the Chinese and the rest of Asia, including India ARE the future of global crude oil consumption. They WILL be driving more cars and consuming more energy in aggregate. As a result, I have a pretty

Inside this issue:

My formula for success is rise early, work late, and strike oil.

J. Paul Getty

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good feeling about long-term demand. What about long-term supply? Therein lies the rub.

The recent explosion, poor word choice, in US oil production has thrown a wrench into short-term oil supply. Simply put, we have been too good, too fast in getting the stuff out of the ground. This has caused a bit of a mismatch in the global supply vs. demand equation, with demand going up a slightly slower pace than supply. As a result, crude oil prices are under attack, although the speed at which they have fallen suggests there is something else afoot...which we probably won't learn about until much later.

However, and this is pretty much indisputable: North Sea oil yields are declining as are Venezuelan. The former due to Mother Nature, and the latter largely due to the complete and utter mismanagement of the country's oil industry...never mind the fact it is 'heavier' and requires special refining. Other oil fields seem to be topping out, or at least don't show the promise of those in the US and Canada.

Make no bones about it, this relatively sudden, massive growth in energy output has been a huge economic driver in recent years. Consider what I submitted to the Montgomery Advertiser for this week's column:

> **I know you wrote about gasoline prices a couple of weeks ago. However, oil prices continue to fall through the floor. What impact will this have on the economy moving forward?**

Intuitively, lower prices at the pump will help the US consumer. Since consumer expenditures make up around 68% of the equation the government uses to calculate the economy, anything that puts a few extra coins in the pocket should help the US. Right?

Well, yes and no. You see, what we spend on gasoline is in the equation. If we spend less at the pump, it is imperative to spend it someplace else to make the numbers work in nominal terms. Ideally, we should spend it on a good or service that has a large multiplier effect, and creates wealth for Americans.

In so many ways, if you take the $10 you save filling up your tank, and immediately buy Chinese made candy at the convenience store, that probably won't have the same long-term economic impact as saving up, say, $100 and buying something meaningful, preferably locally made that has a decent margin for the producer.

Then there is the fact a lot of the economic growth in states like North Dakota, Texas, Wyoming, and Oklahoma has come from the explosion in oil drilling we have had in the US over the last 5 years or so. While these states have arguably been the most directly affected, companies from around the country, and world, have been shipping products and services to support this boom.

Closer to home, coal mining and oil & gas extraction are major industries in Alabama. Throw in other states like New York, Pennsylvania, and West Virginia which have been turning coal into liquid fuel, and using hydraulic fracking to coax natural gas out of the earth, and you can determine energy has been a significant economic engine of late.

So, any slowdown in domestic exploration, production, and transport due to lower energy prices will have a greater overall economic impact than it would have had 5 or 10 years ago, when these industries were in decline.

Even so, whenever I say this time is different, I usually end up finding out it really wasn't. Historically, low energy prices have been good for economic growth, so I am going to stay the course here. However, the reason why I am staying the course might be a little different than you imagine.

You see, low gas and energy prices will put a lid on overall inflation. There are no two ways about it. So, if inflation is under control, or at least seems to be, guess what? The Federal Reserve can take its sweet time before raising interest rates, or move slower than they would have.

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> This will be the greatest benefit from these lower prices at the pump.
>
> After all, virtually everyone was counting on the Fed to do something, anything, about short-term rates in 2015. If crude and natural gas prices stay low, we can push all that unpleasantness out into 2016 and even beyond. If there isn't any inflation, using the calculations, why be aggressive in raising interest rates to throttle it? You wouldn't.
>
> Trust me, this decline in crude is a welcome present for Chairman Yellen and the rest of the Fed. They didn't really want to have to raise rates next year, and, thanks to OPEC's stubbornness, it looks like they might not have to do so.

OPEC's stubbornness? That's right, but I should really change that to Saudi Arabia. It is attempting to keep the price of oil low, yes low, in order to keep US producers from exploiting more fields. You see, most OPEC member countries, including Saudi Arabia, have one-trick economies: oil. The United States doesn't. If it isn't profitable to drill for oil, US investors and companies will look for other alternatives. In many OPEC countries, if it isn't profitable to drill, well, tough, as you are drilling anyway.

As proof, perhaps, consider this sentence which I copied from Wikipedia, which got its information from a report by the Saudi government: *"The petroleum sector accounts for roughly 92.5% of budget revenues, 90% of export earnings, and 55% of GDP."* Then there is this about the next largest producer in OPEC, Iran: *"In FY 2009, for example, the sector (oil & gas) accounted for 60 percent of total government revenues and 80 percent of the total annual value of both exports and foreign currency earnings."* Finally, here is Iraq, the third largest OPEC producer: *"...crude oil export revenues accounted for over two-thirds of GDP in 2009."*

You see, this a gamble by OPEC, one which it will lose: to drive US producers out of the market by keeping oil prices low, at the expense of short-term economic growth in member countries. To hear the Saudi oil minister put it, this all about maintaining market share vis a vis the US. Okay, if you are willing to lose potential revenue to maintain your market share, so be it. The genie has been unleashed in the US, and it will be hard to put it back in the lamp….tread at your own risk. Yes, exploration and new drilling will slow, as oil tries to find a bottom, but producing wells will continue to produce….as the variable cost of bringing the stuff up after it is already tapped ain't the same number as what it "costs" to bring it up when it ain't already operating.

This should be fun….waiting out the Saudis, probably until March or April. So, let's raise a glass to our good friends the Saudis, and the rest of OPEC, who have given us great Christmas gifts this year: lower interest rates for longer; a little extra cha-chin in the pocket, and a bit of a breather for an industry that was, arguably, starting to get a little overheated. In the meantime, you know, as I wrote for my newspaper column, unless this time is different, expect a slightly better than originally expected economy during 1Q 2015….and repeat after me: "oil & interest rates….oil & interest rates….oil & interest rates, etc."

In "Giant," oil was power and money, and it still is, only Jett Rink apparently didn't know much about interest rates, which are the other piece of the puzzle.

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