Tapping into Oil

With oil near record highs, climbing to more than $75 a barrel this year, the idea that the oil price will drop below $50 anytime soon is becoming increasingly difficult to justify. The first quarter of 2006 makes a good case that the new price range for oil is more likely to be between $55 and $70 a barrel. While this may not be good news for consumers, high oil prices are very good for oil companies and those who invest in them.

The price of crude oil is the engine that drives the energy industry. Despite its handsome price appreciation in recent years, the energy sector maintains one of the lowest price-to-earnings ratios around. The total P/E on the energy sector is only 10.4, versus 15.4 for the S&P 500, based on expected earnings for 2006, making it one of the cheapest sectors in the S&P 500.

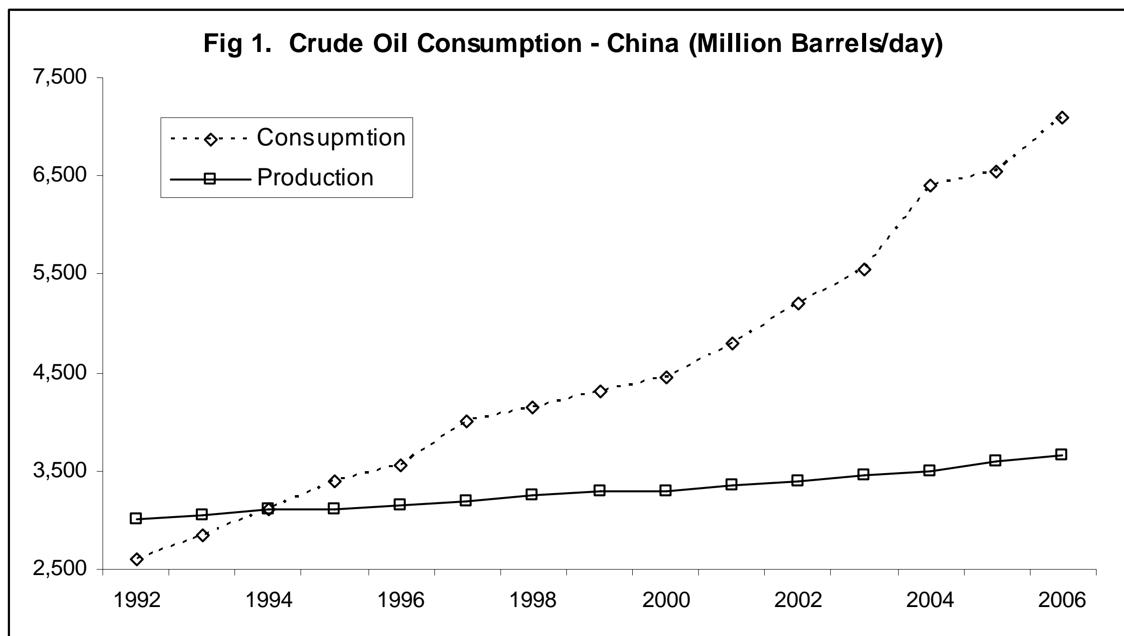
Adding to an already devalued energy sector, many Wall Street analysts continue to use $45/barrel oil or less when they set their target prices for oil stocks. Citigroup Global Markets, for example, recently raised its forecasts for oil prices in 2006 to $60/barrel but is still using $45/barrel oil to set its price targets for oil stocks.

Not only does the energy sector represent good value, it also has the highest expected growth rate, according to Thomson. Economic growth in the U.S. and most developed countries is highly correlated with energy use. In simple terms, economic growth requires an increase in energy consumption.

This is particularly true of the less energy efficient economies which require much higher energy inputs per unit of economic growth, including China, India, Malaysia, and several other dynamic Asian economies undergoing rapid industrialization.

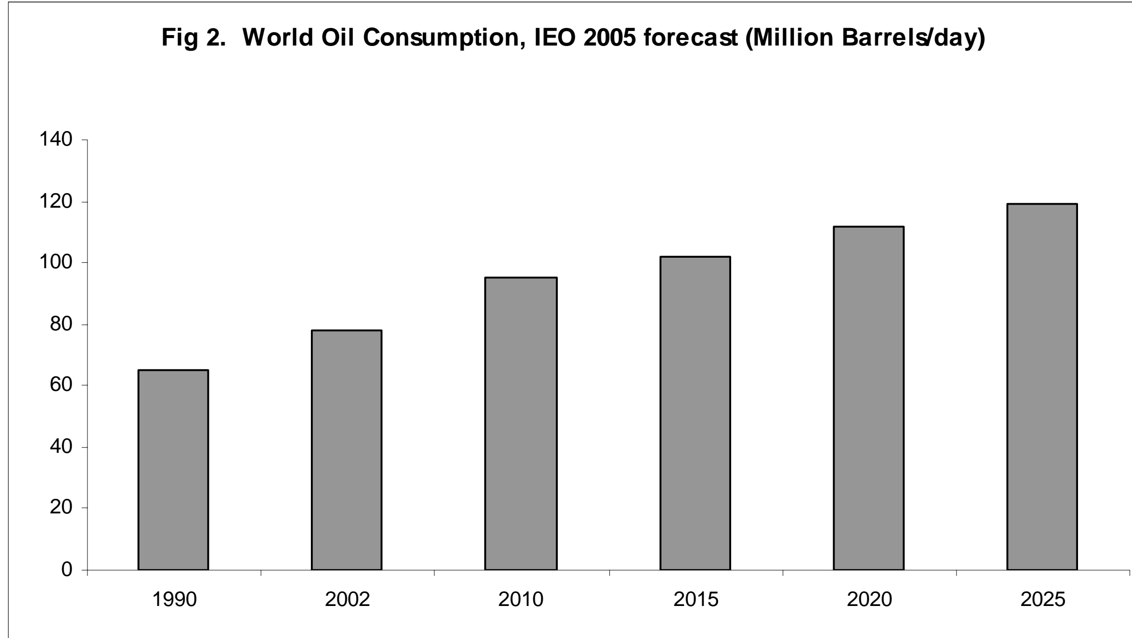
Over the last five years China has seen its' economy grow at an incredible pace of over 9%. For 2006 it is estimated that the country will again grow at near double digit rates. India, another dynamic economy, has seen its' economy grow at a rate of 6-8% over the last few years, and it is expected to grow nearly 8% in 2006.

Due to the dynamic nature of the Asian economies, the incremental demand for energy – and specifically crude oil – is skyrocketing. Figure 1 illustrates the incredible demand increases from China in the last decade. Note that China's oil production, while not declining, has not kept pace with demand growth.

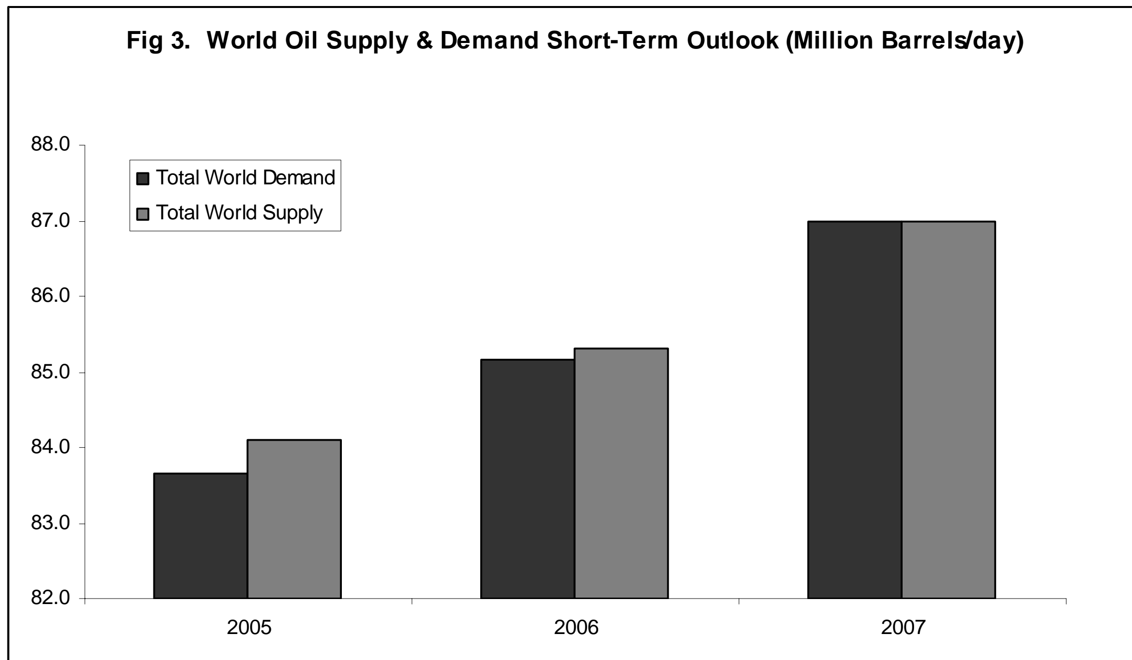


Source: US Energy Information Administration (EIA), 2006

While global demand for crude oil is growing at an impressive rate, and is expected to increase steadily over the next 20 years (see Figure 2), the incremental growth in world oil supply has not kept pace. The excess supply which as recently as five years ago stood at around 5 million barrels per day has almost disappeared. By 2007, the IEA expects the global demand and supply for crude oil to be equal for the first time in history (see Figure 3).



Source: US Energy Information Administration (EIA), 2006



Source: EIA Short-Term Energy Outlook, April 2006

Without any legitimate substitutes for crude oil in the global transportation sector, short term demand is inelastic and as it approaches supply limitations, prices become much more volatile and tend to trend upward. Crude oil supply disruptions in Iraq, Iran, Nigeria and Venezuela are beginning to have a much larger influence on the price of the commodity and this trend is likely to continue as the world becomes increasingly dependent on oil from these politically unstable countries.

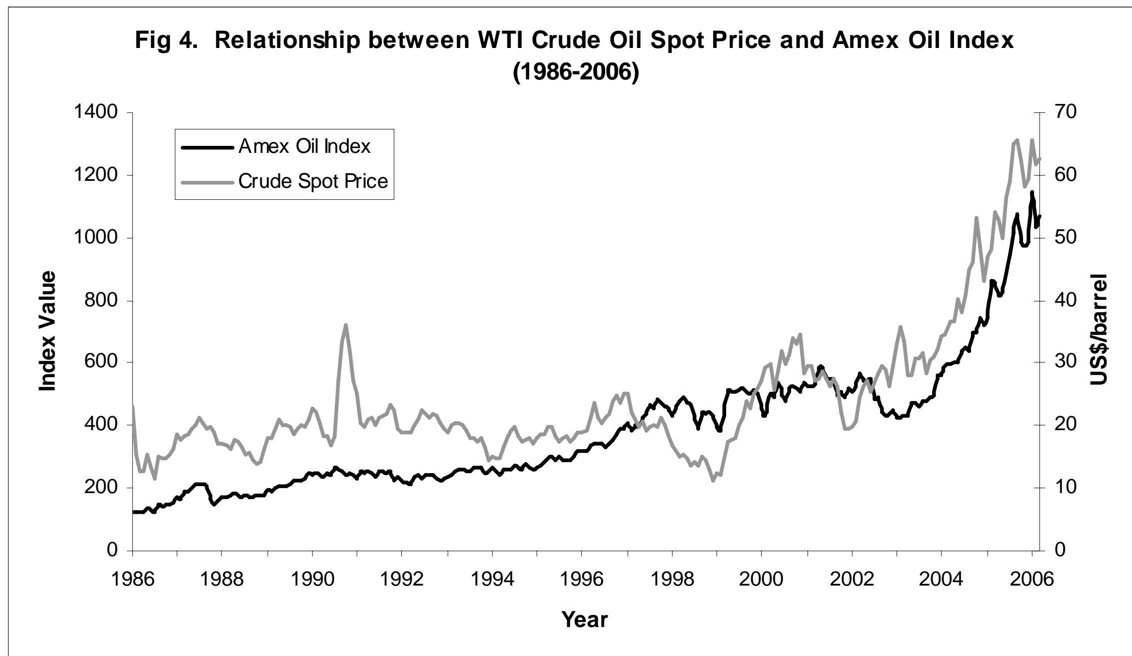
Over time, the high oil price will encourage exploration and new production but projects to increase production from non conventional sources have long lead times. Short of a major global economic slowdown, oil prices should stay high during the next few years before companies add crude output and refining capacity.

The higher prices have already reached most of the industry - producers, refiners, pipeline companies, equipment makers and oil field service providers - which have all enjoyed new profits. Leading the charge are the world's largest integrated oil companies: Exxon Mobil, BP, and Royal Dutch/Shell. Last year Exxon Mobil, the world's biggest oil and gas stock, recorded the largest profits on record for an American corporation.

Aggressive independent exploration and production companies such as Apache Corp and Occidental Petroleum are also well-positioned to take advantage of improving prices. Apache will benefit from growing concerns about political turmoil as investors start paying a premium for stocks with reserves in safe places and Occidental Petroleum’s high oil leverage should provide strong margins in light of continued pressure on North American gas prices.

Investing in oil-service and oil-production stocks is an effective way of benefiting from rising oil prices since the primary driver of oil-stock prices is the price of crude. The best proxy for analyzing oil stocks as a sector is probably the Amex Oil Index, or XOI, currently comprised of 13 major oil stocks. It is designed to track widely-held corporations involved in the exploration for, development of, and production of petroleum.

Over the last 20 years, the correlations between the XOI and oil have averaged 0.85. When this correlation is squared, it yields an r-square value of 72% which implies that 72% of the daily price moves in the XOI over the past 20 years are likely predictable by the parallel daily price moves in crude oil. In other words, as goes crude, so ought to follow the XOI (see Figure 4). This relationship between oil and oil-stock prices is even strengthening as the correlations have been trending higher, averaging 0.93 or 86% over the last 12 months.



Source: Adapted from EIA and Commodity Systems Inc, 2006

For the more sophisticated investor, new avenues for commodities investing are emerging in the form of exchange-traded funds. Exchange-traded funds, as you may know, trade just like regular stocks and are becoming increasingly popular as a substitute for index mutual funds.

Unlike conventional mutual funds which discourage frequent trading, ETFs are useful for traders who want to quickly move into and out of particular industries or other market segments. Energy ETFs like the Oil Service HOLDRS Trust ETF and iShares Dow Jones Energy ETF consist of shares in major oil and gas service corporations, exposing investors to top performance and diversification within the entire industry for smaller fees and commissions than the average mutual fund.

Recently, the first exchange-traded fund that tracks oil prices became available as a legitimate candidate for long-term investors. The U.S. Oil Fund tracks the movement of West Texas intermediate crude oil futures, which is the U.S. oil price benchmark. Because oil is traditionally traded via futures, the fund continuously buys the shortest-term futures contracts available to track oil prices closely.

However you choose to harness the power of the bull-run for oil, we think oil prices must remain strong in the medium term to encourage further investment in production – which should benefit all investors with exposure to the energy sector. Unlike gold, oil has core material value entwined with economic activity across the world and is not a luxury item or gauge of investor fear.

There may indeed be, as the oil bears argue, a risk premium of about $10-$15 a barrel in the current price of oil related to political tension. The risk premium in oil, however, looks very permanent in light of the increasing political uncertainty of supply. The only way to guard against the possibility of even worse supply disruptions and the negative impact subsequent oil price hikes will have on corporate profitability in the broader market is by making sure you have some oil stocks in your portfolio.