

THE BEST OF THE INTERNATIONAL FINANCIAL MEDIA

MONEY WEEK

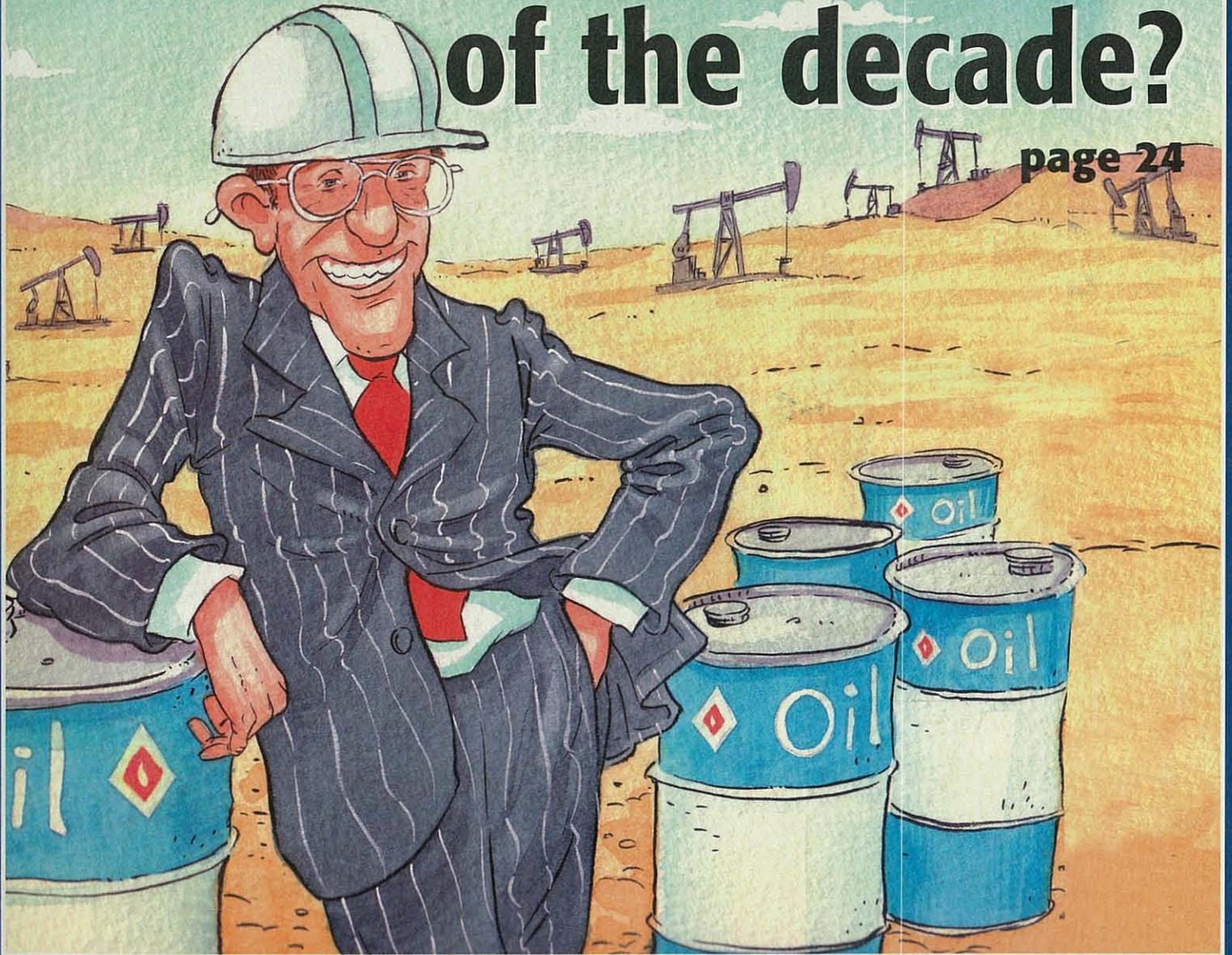
INFORMATION YOU CAN PROFIT FROM

11 MARCH 2005

ISSUE 221

The best investment of the decade?

page 24



Are tech stocks set to make a comeback at last?

8

How to protect yourself from Brown's budget

36

The handbag that launched a global brand

38

£1.95



Is the oil industry the single best investment you can make?

Yes, says Bill Sarubbi

When we think of bull markets, we tend to think of them as a strong upwards movement in all stocks in a given market – as was the case from 1982-2000. But long-term bull markets can also exist within one specific group and sector, and it rather looks to me as if that is exactly what is happening in the energy sector. It has now been rallying for a few years, but I fully expect it to continue to do so for a good few years to come. Why? For two reasons. The first is inflation and the second is the very strong long-term supply and demand situation in the oil market.

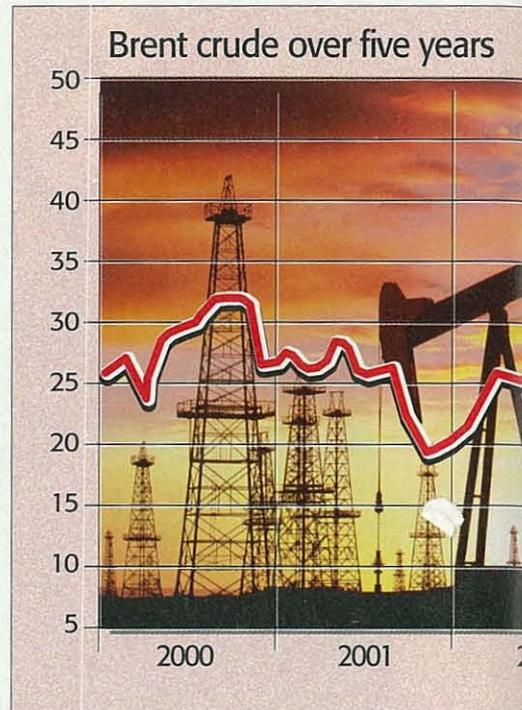
Inflation is back

Inflation is a red flag for a commodities bull of any kind. If we think of inflation very simply as the excess creation of money (via credit) over and above the demand for money, this makes sense. When you first introduce excess cash into the economy via the credit system (by having low interest rates that encourage people to borrow, see page 46 for a further explanation) economies and markets are spurred on. But go too far and things can go wrong: once all the available means of production have been drawn into play, the excess

money looks for new places to go. That's when you find things such as stocks, land and commodities suddenly seeing their prices soaring for no fundamental reason.

This is the situation that the US now finds itself in. The Federal Reserve's loose money policies have created debt – and, of course, the interest payments that go with it. Today in the US, debt as a percentage of GDP is at a record high: that means that the Fed can't raise interest rates fast – that could easily lead to a string of bankruptcies. The upshot? The Fed has no choice but to keep on inflating. That in turn means there is excess cash knocking about all over the economy, which leaves us with just one question: where is it going to go?

The answer, I think, is commodities. Over the last few decades, there has been a good correlation between the rise in the national debt – or money supply – and the stockmarket. From 1980 to the mid-1990s, the debt rose by fivefold. The Dow also rose by five times. Yet over the same time period, the price of most commodities has fallen: they've



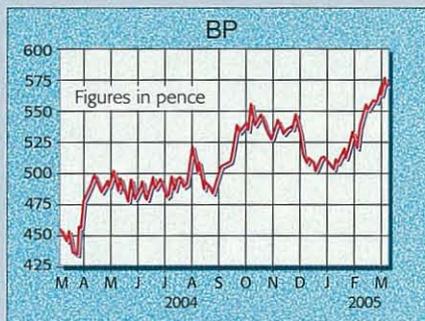
got a lot of catching up to do as they have to make up for over two decades.

In 1980 the oil price was \$25-\$35 a barrel. So given the increase in money supply, \$50 hardly seems a high price. Indeed, \$50-\$60 should now probably be considered as more of a base for the oil price than anything else. Don't forget that in inflation-adjusted terms, energy is still pretty cheap: bottled water is, for example, still more expensive than oil in most places around the world.

The best oil companies to invest in – in the UK and the US

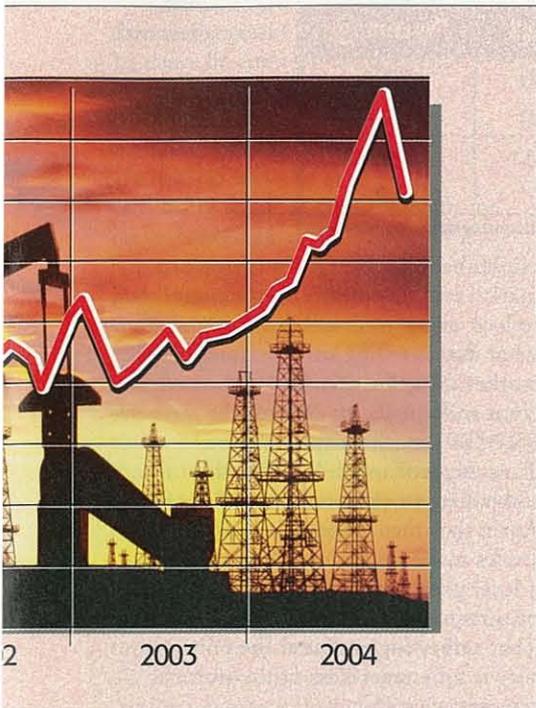
If you are a UK investor and you want to get into oil, look no further than our two majors, BP and Shell, says MoneyWeek's James Ferguson: historically they have tended to move in tandem, so if you are in for the longer term, it really doesn't matter which one you go for. The question is not which is better, but are they both still a buy? And the answer to that is a firm yes.

Higher oil prices look like they're here to stay, yet while BP and Shell have made back most of the ground they lost when their share prices fell in 2002, there is little evidence they have yet adjusted for today's oil price of \$53. In fact, Shell hasn't traded on such a low p/e since the late 1980s, when double-digit interest rates forced all equities into the cheap zone. Up until 2001, Shell's earnings yield was always higher than the yield on gilts. Ten-year gilt yields are now 4.5%, suggesting Shell should be on a p/e of over 20 times (1/4.5 =



22 times) instead of its current 11.12 times. There is an equally compelling case to be made for BP. Since last autumn, consensus analyst medium-term profit forecasts for the firm are up around 43%. Yet technically speaking, BP has been in a downtrend now since the all-time high way back in 2000. This is despite the fact that analysts are 20% more bullish on BP's profit outlook now than they were even at their most optimistic at the peak of the last cycle.

Outside the majors, investors should be more cautious – note that many of the more speculative stocks that call themselves exploration and production companies are often no more than cash shells. Worth considering, however, might be Gulf Keystone Petrol (AIM, GKP), says the Investors Chronicle – the firm's exploration programme in Algeria is going well and "the shares look good value." Otherwise, consider Sterling Energy.



The supply of oil is very tight

For some time now, there have been rumours around that oil production in Saudi Arabia has peaked. Consider this: Pumping water into wells tends to reduce the life expectancy of a well, but it is also a quick way to bring oil to the surface, and one that the Saudis appear to have been taking advantage of. The largest Saudi field is now showing a 55% water cut (ie, 55% of what comes to the surface is the water that was pumped in to force the oil out). Experience has shown that a

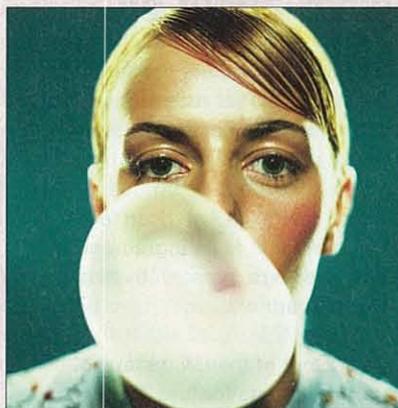
field collapses when this ratio hits 75%, so the situation looks relatively serious.

Note too that it may not just be Saudi Arabia where oil production is peaking: according to many, global production as a whole will peak by 2010 (see box on page 26 on *Hubbert's peak*). And don't forget that there is also a high level of political risk in Saudi Arabia, where the rulers have consistently made the mistake of not spreading around the lucrative returns from oil quite enough. That means that the Saudi royal family faces considerable opposition: instability could pinch production at some point.

Another major problem with oil is one that Jim Rogers recently pointed to in *Barrons*: no one invests in the means of production when they are unlikely to recoup the investment. The price of oil fell by about 66% from 1980-1999, so people stopped looking for it. Why bother drilling for oil when it only fetches \$10 per barrel? During the 1990s, most investment capital chased higher returns in the technology sector instead. The result, predictably, has been that new sources of oil have not been discovered and older, cheaper sources have been overexploited. Production in the North Sea and Australia has already peaked, for example. To find new sources there must be investment in exploration and drilling – and it is only with the recent higher prices this has become financially feasible.

Continued overleaf

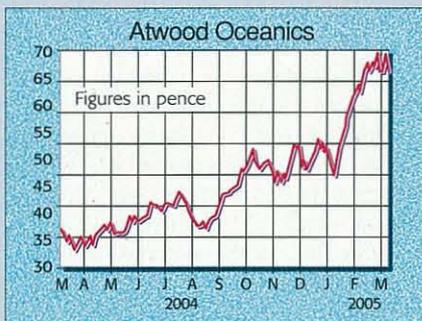
Black goo everywhere



When we think about oil, we tend to think of it as fuelling our cars, our electricity and our factories – 46% of the world's oil supply goes into our cars, for example. But we use oil for a great deal more than we think: we eat it, we wear it and we regularly rub it all over our bodies. Oil is used to make over 3,000 products. It's used in plastics to make everything from toothbrushes to heart valves and children's buckets and spades. The lighter oils – aromatics such as benzene – feature in perfumes and petrolatum is used in beauty products, thanks to its emollient properties. Refined oil is also crucial in the manufacture of road surfaces, roofing, bubble gum, synthetic rubber and synthetic fibres, such as nylon. Oil is the key stone of our world. What would we do without it?

"The shares trade on a multiple of four times 2006 cash flow," says Red Hot Penny Shares, "which is attractive."

In the US, you are probably better off avoiding the larger companies, says Bill Sarubbi: they have been lagging the wider sector since 2000. Each of the following four firms are involved in a fast-growing segment of the energy patch and are classified as either mid or small cap. Atwood Oceanics, Inc. (ATW) is engaged in the international offshore drilling of exploration and developmental oil and gas wells in offshore areas and related support, management and consulting services. During its 36-year history, the majority of the company's drilling units have operated outside of United States waters. It has conducted drilling operations in most of the major offshore exploration areas of the world. The stock has moved a long way since I first began recommending it in 2003, as we can see in the chart. But I expect it to continue to do very well. On a fundamental level, the



firm should benefit because sea drilling is profitable with oil over \$35 a barrel, a level unlikely to be seen again soon. But at the same time the technical position looks good. The shares have only recently ascended from a huge multi-year base and this is the type of technical launching platform that leads to longer-term outperformance.

Transocean Inc. (RIG) provides offshore contract drilling services for oil and gas wells, related equipment and work crews, to drill oil and gas wells. The firm operates with a particular focus on deepwater and harsh environment drilling services and should, like Atwood, do well out of the fact that sea drilling is now profitable.

The other two shares I would recommend are Cooper Cameron Corporation (CAM), an international manufacturer of oil and gas pressure control equipment and Ensco International Incorporated (ESV), an international offshore contract drilling company.

Ten frightening things about oil

1 Oil price spikes have tended to be followed by global recessions: eight of the last nine were preceded by oil price rises.

2 Every year each American 'eats' 400 gallons of oil (it is an ingredient in many fertilisers, preservatives and even margarine).

3 At present in the UK, renewable energy accounts for just 3% of consumption. In the US, which accounts for a quarter of world-energy consumption, it is just 4.4%. In the world overall, it is 13.5% – which is encouraging, but not enough.

4 America has 5% of the world's population, uses 25% of the world's oil produced annually, but has only 2% of proven the world's resources. Currently it is managing to supply 46% of its own consumption, but with production falling this ratio is not sustainable.

5 Oil provides 90% of the fuel we need for transportation.

6 If America had to become self-reliant for oil, its reserves would last about two years nine months before they ran out. In the UK, we could last without external supply for nearly seven years if we stopped exporting.

7 The last elephant oil field (containing more than a billion barrels) discovered in the US was in Alaska's Prudhoe Bay. That was over 20 years ago.

8 Flying is the most oil-guzzling mode of travel. To make one gallon of jet fuel, ten gallons of crude are needed – it would take 770 gallons of crude to transport one person from LA to New York.

9 According to John Myers on Dailyreckoning.com, the average oil well in the continental US pumps around 300 barrels per day (bpd). In the Middle East, an average well pumps 10,000 bpd.

10 A year ago the UK became a net importer of oil. North Sea production peaked in 1999 at 2.9 million bpd and will fall to 1.7 million bpd by 2007.

Investment in infrastructure has also faltered worldwide. In the United States, no new refineries have been constructed for more than

20 years. Add to this the fact that Russian, Iraqi, Nigerian and Venezuelan production have all stalled at some point in the last few years and you begin to understand why the price of oil is on the up: it will take some time to bring more capacity on line, thus leaving supply trailing demand for years to come.

Too many people want oil

A recent study by Legg Mason tells us all we need to know about the demand for oil. If you assume that everyone living on the east coast of China (where a third of the 1.3 billion strong population live) and in Indonesia starts to consume the same amount of oil as the Japanese did at the same stage of industrial growth, then the world needs a daily oil supply equal to two Saudi Arabias every day. China's oil consumption has grown by somewhere between 7% and 15% annually – depending on which numbers you use. Indonesia's demand has been rising by 10%, while Mexico, Vietnam, India, Turkey and Thailand are also seeing consumption rise at a high rate. OPEC nations are consuming an increasing percentage of their own

Year	Price change \$	Percentage
1910	0.60 to 4.00	570%
1930	0.70 to 4.00	471%
1970	4.00 to 30.00	650%
2000	10 to ?	?

production – leaving less and less oil available for exporting.

The technicals look good too

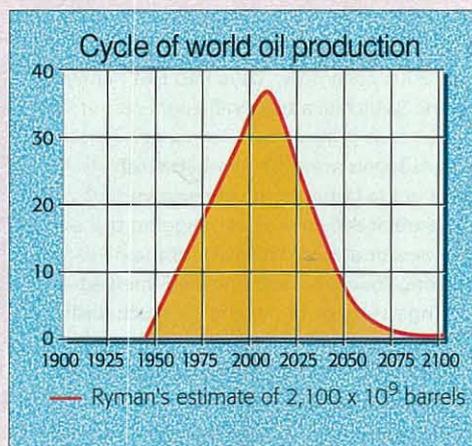
Having

established that the fundamentals of a market look good, it is always useful then to look at the technical position and see what that is telling us. First look at market capitalisation. In 1980, energy companies made up 28% of the S&P 500's market capitalisation. They then collapsed. In 2000, the technology stocks were 30% of the S&P. Again they then collapsed. Today, energy stocks make up about 8% of the S&P – a level usually seen by a sector that is near its nadir – as tech was in 1990. That rather suggests that the only way is up – regardless of the sector's renaissance so far.

So how long can this bull market last? The energy group is now emerging from a 22-year bear market. Compare this to the food group's bull market. This group consolidated in a huge rectangle for 25 years and broke out in 1980. Foods then outperformed for the next 13 years. There is a good rule of thumb one can use to measure the subsequent upwards move after a nasty bear market: multiply the length of the bad times in the sector in years by 0.6 times 25, equals

Hubbert's peak; the end of oil

Shell geophysicist and radical economic thinker Dr. M. King Hubbert had a theory about how best to calculate oil production peaks. He believed that the production of oil over time follows a bell-shaped curve, peaking when half the oil has been extracted. This, he thought, was because oil doesn't just run out suddenly. Instead, the easiest oil is pumped first, followed by more difficult oil, until it gradually becomes uneconomic to keep going. In 1956, Hubbert used his theory to forecast that US production would peak in 1969, give or take a year – if Alaska were taken out of the equation. His prediction proved uncannily accurate: non-Alaskan US oil fields peaked in 1970. The US is no longer alone. The UK and Australia have already passed their own Hubbert's peaks and most forecasters using the model now believe that we will reach a worldwide production peak in 2010. This highlights just how tight supply is, and when combined with high and growing demand, is one explanation for why prices of oil must continue to rise.



15 years – so pretty close! Looking at the energy group, 0.6 times 22 suggests 13 years of outperformance. That tells me that longer-term, investors can consider putting their money in energy stocks.

One other thing worth looking at for reassurance that this bull market has barely begun is the wellhead price of oil. This is the cash price paid at the wellhead, a figure that has been recorded for the last 137 years and which can give us a clear idea of how the price of oil tends to move when it turns. The table (above left) shows us that it moves a lot: the last three major upswings have resulted in the wellhead price rising over 450%.

Finally, I want to point to market sentiment. Most fortunes are made by those who have measured what the market thinks and then adopted a contrary position. In the oil market, I would say that the opinion and spending habits of the Arabs provide a



The cash price paid at the wellhead is on the up

perfect contrary opinion indicator: they have consistently forecast oil and gas prices on the low side. So what are they doing now? The answer is that they are aggressively cutting costs – they just don't believe that prices will stay high.

I recently asked one Abu Dhabi official if they planned to raise the official price they use when trying to figure out whether future capital spending projects in the oil industry would be worthwhile. He said not: they had considered moving the price to \$25, but they then decided to leave it at \$18 per barrel – a level that seemed to them to be more likely. And this when oil prices are already above \$50!

Add all this up and it seems pretty clear to me that every sensible investor should be holding oil stocks. And if you aren't already, note that March is historically the best month of the year for holding oil stocks. Over the last 22 years, the sector has outperformed the S&P 77% of the time in March and April.

Bill Sarubbi is a fund manager and institutional advisor based in Vienna. For more of his work, see www.cyclesresearch.com, or email him on cyclesresearch@aol.com.

“The cash price paid at the wellhead gives an idea of how the price of oil tends to move, and in the last three upswings it's risen over 450%”

3 WAYS TO MAKE

£1,000,000

Be a player.

williamhillcasino.com/million

- 1

BIG MONEY

We pay out **£1,000,000s** in winnings each week.

We have the **highest table limits**, **biggest deposit limits** and **fastest payouts** on the web.
- 2

EASY MONEY

Win your share of **over £1,000,000** in progressive jackpot prizes **right now**.

Choose any jackpot game –
- Blackjack, Poker or Slots.
- 3

SMART MONEY

Earn **commission** by recommending players - our top affiliate has earned over **£1,000,000** to date.

For details phone James Lowe on **0113 291 8304**, or visit the website.

Over 18s only.

MW403