



## MARKET OUTLOOK

Third Quarter 2008

**A**t mid-year investors are bruised by rising prices for the things they buy and falling prices for the things they own. When we looked at the market six months ago, oil was under \$100 per barrel. Now it is over \$140. Meanwhile, the market has declined 15% and is on the edge of the technical definition of a bear market. Oil is up and stocks are down. We think this pattern could begin to reverse this year, but we like to have a reasonable and rational basis for our analysis. We ask ourselves, what reason do we have to think oil prices will begin to decline, and why should we think stock prices might go up?

In an atmosphere of breathless reports about “peak oil” and permanent shortages, we think it would help to run through some data. We look for evidence to support or refute the pessimistic view of a world running out of oil in the face of limitless demand. The evidence suggests the world has already adjusted to higher oil prices by reducing consumption, and we expect oil prices will come down as a result of this reduced demand. So let’s run through some data on oil production and oil consumption and see we are producing plenty of it and using less of it.

The U.S. Energy Information Agency on June 30th revised its final consumption data for April 2008, showing U.S. oil demand was only 19.8 million barrels per day (bpd), which was 863,000 fewer barrels than the original report for April 2008 and 3.9% lower than April 2007 U.S. oil demand of 20.6 million bpd. To wit, U.S. oil consumption as of April 2008 is less than it was a year ago. As more recent data are released, we expect to see continued conservation and reduced consumption. One of the basic rules of economics is that when consumption declines, prices decline until suppliers find the equilibrium point that meets demand. We have not

seen that reaction in the oil market yet in 2008, but we fully expect to see it soon.

How big is the change in U.S. consumption? According to BP’s Statistical Review of World Energy 2008, total worldwide oil consumption growth 2006–2007 was 990,000 bpd, of which China accounted for 325,000 bpd. The April reduction in U.S. oil consumption more than offset one year’s growth of Chinese consumption, and it turns out we were not alone in our response to the high price of oil in April: China’s crude oil imports declined in April to 3.5 million bpd. China is the second largest consumer of oil after the United States. With the two largest consumers ratcheting down their consumption levels, the price of oil should fall unless production has fallen, too. And there is ample evidence, again taken from the U.S. Energy Information Agency, that developed countries can grow without consuming more oil:

Country (2006 Consumption Rank)	Peak Oil Consumption	Peak Level
U.S.A. (#1)	2005	20.8 mbpd
Japan (#3)	1996	5.7 mbpd
Germany (#5)	1998	2.9 mbpd
France (#12)	2001	2.1 mbpd
U.K. (#13)	1996	1.9 mbpd
Spain (#14)	2005 & 2007	1.6 mbpd

The data suggest consumption has indeed fallen. Can we determine whether or not it is reacting to already reduced levels of production? The answer is that production has not fallen, according to the International Energy Agency’s recent report. World oil

supply was up 1.8% year over year to 87 million bpd as of the IEA's report issued in early June. The most recent data point, therefore, suggests consumption reduction is not responding to reduced production. The price rise in oil we have seen in 2008 is not due to a world running out of oil.

We should note that American ingenuity in the face of high oil prices is already manifesting itself in numerous alternative energy projects started by entrepreneurs. One ZWJ client is working with landowners in the windiest parts of New England to develop wind energy stations in a joint venture structure. Some whiz kids at MIT have developed affordable solar energy conversion prototypes, and they are trying to commercialize their application. Watch this MIT video [http://techtv.mit.edu/file/1076/?skin=popup&file\\_type=flv](http://techtv.mit.edu/file/1076/?skin=popup&file_type=flv) or visit the company website <http://www.raw-solar.com> for more. Meanwhile, research teams at all the big energy companies are working on future technologies like hydrogen fuel cells. The world was running out of whale oil about the time we found shale oil in Pennsylvania, and we have been running out of oil ever since we hit our first gusher. Let's not underestimate the creativity of free people backed by some capital, particularly since current high prices for oil combine with social and environmental pressures to find alternatives.

A reasonable conclusion is that a world not running out of oil but using less of it should see the price of oil decline. That is our conclusion on the future price of oil. If that conclusion is proved correct, it has positive implications for other budgetary items where we have been experiencing sharp price increases. Furthermore, a change in the price of oil would reverberate positively throughout the economy inasmuch as it would allow us to allocate our cashflow differently.

Collectively in the U.S., our personal cashflows are increasingly focused on food, gasoline and other high

frequency items. We saw a compelling chart of the year over year change in various components of the Consumer Price Index (CPI). High frequency items are up a lot: gasoline (+21%), eggs (+18%), bread (+16%), air fares (+14%), utilities (+11%), milk (+10%) and even fruit (+6%). On the other hand, items we do not buy with high frequency are painting a different picture: televisions (-17%), video equipment (-13%), information technology (-6%), toys (-5%), and furniture (-2%). Gasoline, air fares, and utilities are obviously connected to the high price of oil, but the others that are up have significant distribution and delivery costs. Oil prices are an important variable cost component for most of the products we buy, and a reduction of oil prices implies higher margins for non-energy companies and more cash in our pockets for alternative uses.

Very generally, a reduction of the cost of oil should lead to an easier time for consumers trying to make ends meet. Admittedly, the world economy splurged on debt thanks to the easy money policies of central bankers after the technology bust and September 11, 2001. We are working out of that now, and the workout will continue to be painful for many of the participants. But a reduction in the cost of oil means more of our budgets can go to other things. It means the workout of the mortgage problem can happen faster. It means companies that sell goods and services should see increased sales and higher margins as dollars formerly committed to oil are freed for other purchases.

All of this suggests to us that the stock market should begin to recover during the balance of the year. We should get some kind of bounce from declining oil prices in the near term. Looking further out, we expect the longer term debt problems to improve as we keep working down our collective debt load. Without denying that the market is down from where it was, we think the world is looking up.

Charles L. Abney III, CFA ■ Tres R. Carpenter, CFA ■ Krista L. Cosgrove, CFA ■ Stacey D. Ewing, CFA ■ Clayton F. Jackson, CFA  
John B. Shepard, CFA ■ Charles J. Wallace, Jr., CFA ■ Kevin C.H. Yang ■ Bradford S. J. Young, CFA

*ZWJ is an SEC Registered Investment Advisor dedicated to serving the investment needs of individuals, families, foundations and institutions. Every investment account is separately managed and individually tailored with stocks and bonds, in response to a client's unique financial objectives, income requirements, risk tolerance, and tax situation. Inquiries and referrals are always encouraged.*