

Wednesday, January 14, 2009

Don't be surprised to see the Saudis embrace "Peak Oil"

My first post of the year. I did mention briefly last year that I had gone long on oil. That position is of course, taking some heat. I started going long at about \$46/barrel oil and it still had lot farther to fall. There is an old adage "The graveyards of Wall St. are littered with the skulls of those who were too early". They were probably margined out the hilt.

Fortunately, I'm not. So I just wait, well actually I've been buying more oil all the way down. I find this a lot different than piling into, say Nortel in 1999 somewhere north of \$1000 and averaging down all the way to, maybe today where they hit .12 on their bankruptcy filing. Oil isn't going to file Chapter 7. There is a finite amount of oil in the world, and we use more and more of it almost literally every day. So softness aside, I see the price going nowhere but up from here. Keep in mind there's a reason I call this channel "This is not investment advice", because it's not. Do your own due diligence, remove cellophane before eating, etc.

But oil is too cheap. David Skarica points out in his newsletter that the gold-to-oil ratio is the highest it's been in decades, and the last two times it approached anywhere near these levels were 1994 and 1998, shortly before multi-year bull runs in the commodity.

In an age where all international currencies seem dead-set on a race-to-the-bottom, I like the idea of using commodity ratios to gauge the relative values of asset classes. All the goldbugs (including me I guess) are positing an eventual return of a 1:1 DOW/Gold ratio, but couldn't tell you if that's at DOW 5000, Gold \$5000/oz or DOW 900, Gold \$900. Without the ratio, it's easy to let monetary inflation or deflation bamboozle you into thinking you're rich when you're really not. With the ratio, a 1:1 DOW/Gold means "life sucks" in the financial markets. That will also be, by the way, as good a signal as any to start looking for a real end to this secular bear market we're in.

So with Skarica's Gold/Oil thesis, he notes that any time it's been 22:1 or higher, oil blasted off on a multi-year run. Right now it's somewhere north of 30:1, what value investors would call "under-valued".

It's so undervalued, in fact, that oil at \$37/barrel or so, many oil producing nations are caught below their cost. I've been reading Jim Roger's Hot Commodities over the holidays and one thing he says is that when the price of any commodity falls below it's cost to produce it, you've pretty well hit the bottom in that commodity, because producers will just close up shop until things pick up. That reduces supply, and that forces the price up.

But we're talking oil here, not cocoa or oranges. If some country decides to stop pumping they may very well earn themselves a dose of "shock-and-awe" from the West (for purely humanitarian reasons, of course). So what is it that value investors call "the catalyzing event" which could presage the turnaround in the price of oil?

Well, from this side of that last oil spike price, all that downplaying of "peak oil" probably looks regrettable to any country who earns most of their revenues from oil exports and vehemently denied there was any truth to all that "peak oil" nonsense. File it in the drawer beside "global warming", and forget about it. The Saudis claim they can increase production all the way to 2035.

Maybe not.

At this stage of the game we've seen OPEC ordained production cuts, an Indo-Pakistani war brewing, Israeli invasion of Gaza and all the usual culprits of world tension do nothing for the price oil. What's left?

Maybe one morning we wake up and Saudis say "You know what? Turns out Matt Simmons was right after all. Our latest study shows our supplies peaked in 2003...it's all downhill from here for us...".

I wonder what the price of oil would do then?

Posted by Mark Jeftovic in This is not investment advice at 20:07