



Cottonfield – Market Update: Oil Price and Interest Rate

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When we try to assess today's investment environment, we are facing an overwhelming number of factors that create a degree of complexity investors may not have had experienced ever. Any one of those economic, business or geopolitical factors alone but even more so in combination may impact today's investment environment materially and fast. At the same time, market and economic mechanism, that used to work in the past, have turned useless as our guiding posts. Today's investor is challenged as never before to make the right decisions at the right time. The art really consists of being able to separate the wheat from the chaff and simultaneously to think in successive but not really clearly definable investment periods.

Following, we focus on those 2 factors representing in our opinion at this point the "wheat". By doing so, we purposely omit all others factors that still may be able to shock the investment environment at any time.

The 2 factors are:

- Oil
- US interest rates

We believe that increasing oil prices combined with higher short-term interest rates bear the potential to endanger our standard of living we do enjoy today.

As to the **Oil**:

In the last few days, the oil price has reached new highs in this current cycle. Yes, we experienced significantly higher prices in the 70s (expressed in today's Dollars), but today's circumstances are very different. The most important difference stems from the fact, that today the price is really driven by a clear problem of supply – demand. While the press currently continues to focus on the supply – demand problem as a problem of a lack of refinery capacity, when adopting a somewhat more distant perspective the underlying problem is much more severe.

According to Exxon (Energy report 2005), the world consumes about 80 millions of barrels of oil per day. Growth estimates by the International Energy Agency expect that oil consumption will increase in 2005 by 1.8 mio barrels / day – a number which last year amounted to 2.5 mio barrels. Simultaneously, it is well known, that production is running currently at or very close to full capacity. Still worse according to various opinions, in order to compensate for future production declines due to depletion of existing oil fields, already today new oil sources should be found to the extent of 6.7 mio barrels / day. Going forward into the near future, we are facing really a shortfall of 8.5 mio barrels / day or more than 10% of today's production, and this just to meet today's need without rendering account to future growing needs. More specifically, North Sea oil production contributing in 1999 about 9% to worldwide production has fallen off so far this year by 10% when compared to 2004. Mexico producing about 3.4 mio barrels / day last year, announced recently that it expected its production to irreversibly fall possibly as early as middle of 2006 by 10 – 15% annually. Russia currently contributing about 10 mio barrels / day to world production disclosed that its annual production growth is tapering off and that it would achieve growth in 2005 of only about 3.5% or half of the average production growth of the past 5 years.

So far, our focus has been on the obvious supply – demand problem as arising under normal circumstances. Extraordinary circumstances in form of supply disruptions may exacerbate the problem exponentially, at any time resulting in a shock to economies and oil price. Such circumstances may include: Attacks on Saudi oil installations and worldwide supply lines,

disruption of the already reduced Iraqi production by Curds stepping into the political vacuum in the country; Iran stopping its deliveries due to an attack related to its nuclear development programs; Venezuela deciding not to deliver oil any longer to the US and divert it to China instead, infighting in Sudan and other African producer countries; OPEC to admit that their reserves have been overstated (as was the case with Royal Dutch); and whatever, we are able imagine.

Our conclusion is: The oil price, even though there might be some short-term volatility follows a clear trend and investment case. Even if new elephant fields are found they will not be developed in time to make up for the coming shortfall. Alternative energies are either commercially not viable, or, as in the case of nuclear energy not ready on time insufficient supply to compensate. Gas and LNG are available but are subject to similar price increases as oil is. The only reason for a decline in oil prices hence forward may arise from a weakening demand. But we all know that demand will only decrease in case for the following 3 reasons: 1) a severe recession or a depression, 2) the substitution by new energy sources, or 3) a decimation of the world population.

So, as we look at **US interest rates**:

They do not seem to be raised due to inflationary fears, at least not as long as the statistical data tracking inflation do not provide for a more comprehensive measurement of inflation. The Fed made it clear yesterday, that it would continue to raise the Fed rate. To us it seems the Fed continues to raise rates primarily for the following reasons:

- To dampen the continuing growth of real estate prices (housing bubble)
- To create an interest rate buffer, that is large enough so the Fed can stimulate the economy again in the next recession again
- To support the U.S. Dollar by way of an attractive interest rate differential relative to other currencies and to herewith ensure the financing of the huge government debt volumes.

By increasing the interest rate, the Fed is walking a very fine line. The economic reaction to rate increases experiences typically a delay of several months. So the danger is, that the Fed tightens too much and today's extremely high levels of indebtedness of governments and consumers will result in increased debt default volumes and debt servicing cost. This is when the consumers and the governments may not be able any longer to stimulate the economy.

For some time already, we have asked ourselves the following **question**: As oil price and U.S. interest rates continue to grow simultaneously, when will the U.S. economy capitulate? When will it reach the level when the pain becomes too big? Will it happen at a combination of oil price and interest rate of USD 80 / barrel and 5%? Or later or earlier?

We do not know, but we believe that we will know. Today, investors must face this scenario and it would be short-sighted to look the other way. In the end, it all is only a matter of time.

As investment advisors, we have taken this scenario and its implication for the investment environment seriously for some time already. As a result, our clients have greatly benefited from raising energy prices early on, while now we are in the process of preparing the investment portfolios of our clients to the scenario when oil price and interest rates combined take their toll on economies and financial markets.

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