WHERE CAN ONE GO FOR HONEY ?

Oil Prices And Equities: The Conundrum

All bets are off!

In the aftermath of Hurricane Katrina, it is just not possible, today, to make very accurate predictions as to the likely direction of the prices of equities, of oil, and/or of commodities, although manufacturers of heavy earth-moving machinery, producers of equipment, used in refineries, along with wholesalers and retailers are likely to be in for a bit of a fillip as the reconstruction of the US Gulf States and its infrastructural facilities get underway.

However, there are so many imponderables and unknowns that it would be foolhardy to try to be definitive about the short-term prospects of any one, publicly listed company, or even of any particular industry.

The US Government, clearly, is going to make concessions where-ever possible in order to alleviate the suffering of the tens of thousands of Americans who, today, are at their wits' end as they struggle miserably after having lost just about everything that they owned.

The Labour Department of the US Government is going to see the unemployment rate rise as the American jobless file claims in an effort to try to obtain Unemployment Insurance, their jobs, having been lost – because their employers no longer exist.

Last Friday, at a Press Conference at Washington, D.C., Treasury Secretary John Snow announced that Dr Alan Greenspan, the Chairman of the US Federal Reserve, had been summoned to the White House in order to pick his brain as to the best action to take in order to come to grips with this emergency, the likes of which the US Government had never, in its entire history, had to tackle.

No doubt, the question of the future direction of interest rates was among the topics, high on the US Government's agenda when it met with Dr Alan Greenspan.

The devastation of The Gulf States encompasses an area of some 90,000 square miles. Reconstruction of the area will take years before full restoration can be effected.

The **I**nternational **E**nergy **A**gency (IEA) has agreed to provide the US with 60 million barrels of crude oil, during the next month or so.

That is equivalent to 2 million barrels of crude oil per day.

The IEA is not a US Government department, being based in Paris, France.

Its membership comprises 26 countries, which include, inter alia, the United Kingdom, Germany, Japan and France.

The US Government announced, last Wednesday, that it would open the *'tap'* of its Strategic Petroleum Reserves of some 700 million barrels of crude oil, the crude oil, being stored in 5 underground salt caverns in Texas and Louisiana.

That should take the pressure off oil price rises on international markets, but these moves, by themselves, must, obviously, be viewed as being very temporary measures and, no doubt, as soon as is practicable, the US Government will want to top up its Strategic Petroleum Reverses, depleted to the extent of the urgent requirements of The Gulf States; and, the IEA will want to replace its *'gift'* of 60 million barrels of crude oil, also.

To put things in perspective, the devastation, left by Hurricane Katrina, covers an area more than 90,000 square miles, which is almost equal to the land masses of Greece and England, combined.

About 95 percent of oil production in The Gulf of Mexico has been shut down; and, about 90 percent of the production of natural gas in the region has stopped, also.

The Gulf of Mexico accounts for about 25 percent of the total oil production and about 24 percent of all of the requirements of natural gas in the US, today.

It gets worse, however, because The Gulf of Mexico accounts for about 47 percent of all of the refining capacity in the US.

With the shutdown of the refining capabilities, it means that some 2.40 million barrels of refined oil have stopped being produced.

And this is equivalent to about 14 percent of total refining capacity of the US.

It will be months, and in some cases, years, before normality can be restored to many of the oil and gas installations in The Gulf of Mexico.

With the world, thirsty for oil of all types, the supply situation is going to get tighter and tighter as the months roll on, one could speculate.

And the price of a barrel of light sweet crude oil should, logically, rise to the $US80-plus level, at least, one could surmise.

However, there are other forces at work, here, and these forces may well take a hand in holding down oil prices for a short period of time, at least.

Non-action is not an alternative in the current state of affairs, as far as the US Government is concerned, because the situation is desperate beyond previous imagination.

But markets have a way of righting themselves and supply-demand factors will, in the fullness of time, determine prices in free market economies.

As oil prices rise, equity prices must be affected, but how much equity prices will be affected will depend on many other factors, many of which cannot even be identified, definitively, today.

It is surprising, really, that equity prices have held up as well as they have during the first 8 months of this year, considering that the price of a barrel of crude oil has risen by about 46 percent, from $US48 to about $US70, during that period of time.

The consensus behind the fact that equity prices have risen, in spite of record-high oil prices, has been put down to a number of factors, with healthy economic activity, in many parts of the world, and with the rapid expansion of production facilities, especially in Asia, being among the 2, most-important reasons.

Oil-price rises were demand-driven, during the first part of this year, not due to shortages, imposed, artificially, by The Organisation of Petroleum Exporting Countries as was the case in 1973 when the Arab oil producers determined to punish the West because of its support for the State of Israel.

The higher prices of crude oil have been absorbed by industry for the most part over the last year or so, but, it is worthy of note that the growth of service industries, internationally, has tended to curb, to some extent, the importance for crude oil, relative to the situation that existed in 1973.

Also, earnings of many energy companies have risen, dramatically, since the beginning of this year and, because many of them are constituents companies of key indices of equity markets, their weighting on these indices has been profound.

As with all price gains, when commodities are perceived to be in short supply, innovation comes to the fore and substitutes are found in order to replace those commodities whose prices are considered to be too high.

So, as with the dog, chasing its tail, if it ever manages to get its teeth into the fleshy part of the tail, it will cause pain to the animal, causing it to bleed.

Technological innovation and measures to conserve energy will have the effects of reversing the price of crude oil in the fullness of time, to be sure.

As has been seen of late, the price of crude oil and the price of equities have been linked – and for very good reasons.

As **TARGET** has stated, many times in the past, when oil prices rise to a certain level, they have a very negative effect on corporate profits since profit margins are squeezed … and, then, slashed to the proverbial bone.

Transportation companies, for instance, use copious quantities of refined oil in order to keep their vehicles moving on the roads, their aeroplanes flying, and their ships, plying the oceans of the world.

Crystal Cruises, reputedly, one of the best, 5-star cruise lines of the world, recently sent a circular to existing and prospective passengers, informing them that the 2006 gala dinner, traditionally held at The (very swank and very expensive) Beverly Hills Hotel, California, had been cancelled because no hotel could accommodate a party for 321 Crystal Cruises' guests (!).

Instead, passengers, scheduled for the world cruise on The Crystal Serenity, are, now, told that they may board the ship one day earlier at Long Beach, California – so that they may settle in and get comfortable.

One need not speculate too long as to whether or not this cruise company is trying to save money because it is, already, the most-expensive cruise line in the world; and, its customers may very well baulk if it raised prices, once again.

Transportation companies have had to impose fuel surcharges on customers over the past year or so, in order to redress the balance … or see Bottom Lines either badly dented or completely disappear.

The imposition of fuel surcharges has a cascading effect right down the line: Consumers have to consider ways to rejig household budgets; the High Street retailer sees fewer purchases; luxury items are crossed off the list of things to buy; and, of course, the family motor car's life is extended another year or more rather than consideration, being given to buying a new one.

So, if record-high oil prices are maintained, demand will, eventually, wane, simply because industry and consumers cannot afford to pay the freight.

Margin squeezes could well result in cutbacks by industry because, as in the case of Crystal Cruises, management knows only too well that there is a limit to passing on costs to consumers.

And so equity prices should, logically, be hit.

But the problem is: When may one expect this scenario to be manifest in view of the destruction, caused by Hurricane Katrina?

Markets do not embrace uncertainty, usually, and oil-price increases must have a telling effect on US industry, as a whole.

The US economy, logically, should cool, if one may rely on economic logic.

And, if the US economy stumbles, badly, it could well lead to a worldwide economic slump.

In which case, cash would be king.

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