KEEL POINT

INVESTMENT BULLETIN

Volume I, No. 8
August 2012

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Energy Prices, the Economy, & the Market

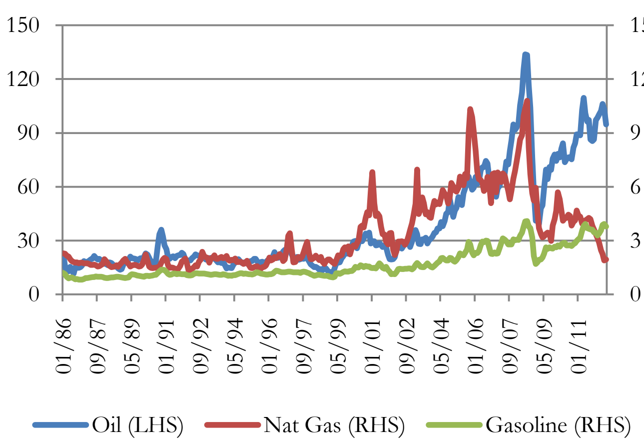
There has rarely been a boring year in energy markets. Recent history alone can illustrate this observation. In the 2008-09 crisis natural gas prices tumbled by 70% while the cost of oil fell to just one quarter of its peak. Since then oil prices have reflated, getting to within 25% of their summer 2008 levels on two occasions: the Arab spring and earlier this year when Iran threatened to close the Straits of Hormuz, a major transport lane for Middle Eastern oil. Conversely, natural gas has barely recovered as the shale gas revolution has dramatically increased supply of the commodity. At the end of 2009 US prices reached $5.70 per thousand cubic feet (mcf), a little more than half the peak in summer 2008, but have slid ever since and are now hovering in the $2-3 range.

In the discussion below, we focus on two aspects of energy prices: the price level and the volatility of prices. We consider the impact on both the US economy and stock markets. And as natural gas production is on an upswing in the US, we examine energy from the standpoint of both gas and oil.

Oil

The price level of oil is exceedingly important for the US economy because we are a net importer of the commodity. According to the US Energy Information Administration (EIA), the US imported 3.3 billion barrels of oil in 2011 (or 8.9 million per day). At an average price for the year of $95, that's a one year cost to the economy of $309 billion (or $846 million per day) equivalent to 2.0% of GDP.

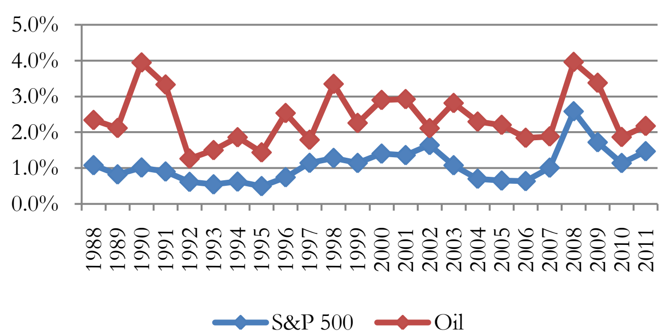
Figure 1: Energy Prices
WTI Crude ($/barrel), US Nat Gas ($/mcf), Gasoline (US city avg, $/gallon)
Source: EIA



Ignoring other factors, it could be said that each $10 increase in the price of oil costs the US economy 0.2% of GDP. At our current pace of growth (1.5% in 2Q12 per the BEA), each 0.2% is very meaningful. Consumers bear this cost primarily through gasoline prices (charted in Figure 1). The economy is worse off at the margin for each disposable dollar that goes to imported oil rather than consumption of domestically produced goods and services.

The cost to the US economy would be less of a concern if the oil price level was stable. Our timeline above mentioned at least three events in the last five years that have sent prices rapidly up or down. This is not new for oil markets. Such is the life of a globally traded commodity that is principally extracted in the unstable Middle East. By way of comparison, we graphed the volatility of daily price changes for oil versus the S&P 500 (Figure 2). In every year since 1988 oil has recorded a higher standard deviation. This adds complexity to the business decision making process and delays investment. Market impact is less straightforward; it depends if higher (lower) prices are interpreted as signs of global growth (recession) or a drag on (boost to) company profits.

Figure 2: Review of Volatility
Standard Deviation of Daily Returns for S&P 500 TR Index & WTI Crude Spot Prices
Sources: Morningstar, EIA



Natural Gas

In some ways the natural gas story is the opposite of oil's. While the US is still a net importer of gas, the nascent shale gas revolution (the divergence of the blue and red lines in Figure 1 more or less pinpoints its birth) has the capacity to flip us to exporting. Shale gas reserves are astounding. A 2011 EIA report puts the amount of technically recoverable reserves of shale gas alone at 750 trillion cubic feet; by way of context, the US consumed 24 trillion cubic feet of gas in 2010.

The other part of the story is price. Natural gas, unlike oil, is a very regional commodity. Reason being it's much harder to transport; it requires parties to a long distance transaction to be able to liquefy or gasify the commodity. While the US market for gas has been routed by the supply side (see Figure 1), prices are much higher in Europe where contracts are sometimes linked to the price of oil. Prices in Japan can be four to five times higher as their power plants replace nuclear fuel with gas. The opportunity to supply these markets presents tremendous potential for the US economy. Likewise, the low price is a boon to US consumers and manufacturers.

So what does the energy market outlook mean for US investors? First, the natural gas story is one consideration that gives us confidence in a meaningful long term growth outlook for the US economy (a mitigating factor for the drag caused principally by the national debt yoke and possibly by oil prices on the economy). This economic growth potential underpins the equity markets which we believe will deliver value for long term investors who can withstand elevated volatility.

Second, it means there may be opportunities to exploit. In portfolios for which it is appropriate, we have investments in commodity linked futures via mutual funds. These are in portfolios to protect against inflation (often the oil-driven variety) among other reasons. Oil price fluctuations often cause disruptions in the broader markets as well. On the surface, volatility is not an investor's friend, but we consider a well-diversified portfolio one that includes allocations to investments that try to profit in these types of environments. □

Changing Leadership in China

President Hu Jintao of China is scheduled to step aside this fall as leader of the world's most populous country. His ten years in charge have been remarkable. China's economy and markets today are miles ahead of where they were in 2002. But, despite the progress, the leadership transition comes at a time of great uncertainty.

Economic growth in the ten year period from 2002 has been lighting fast. What was a $1.5 trillion economy is now $7.3 trillion, the second largest in the world. GDP per head has increased from $1,100 to $5,400 lifting many Chinese into the middle class. Perhaps nowhere is this more recognizable than in the market for cars. In 2002, the US held over a 10 million vehicle per year lead in auto sales which has since vanished. Last year, 12.7 million vehicles were sold in the United States whereas China moved 14.5 million.

Over the same time period China has elevated its role in international trade to become the world leader in exports. In 2002 they tallied $326 billion, 5th place in the world rankings and good enough for 5% of the total volume of international exports. Fast forward nine years and the economy is exporting $1.9 trillion, $400 billion more than the second place United States and 10% of the worldwide total.

Stock market returns have been outsized as well. From 2002 to 2011, the Shanghai Stock Exchange A Share index, consisting of a class of Chinese shares only available to nationals and qualified foreigners, returned 12.0% annualized in US dollar terms. The MSCI China index, a broader composite that includes Chinese companies listed on foreign exchanges, performed even better. Over the same period, the index advanced 18.9% per annum. By way of comparison, the S&P 500 delivered 6.2% a year to investors.

Table 1: Then & Now

Cumulative Growth Rates: 12/31/2002 - 12/31/2011
Sources: IMF, Morningstar, OANDA.com, World Bank, WTO

	China	USA
Nominal GDP	402.0%	41.8%
Nominal GDP-per-capita	378.2%	31.6%
Exports	483.2%	113.4%
Stock market (cumulative, USD terms)	177.9%	71.1%
FX Rate (CNY/USD; USD/CNY)	30.1%	-23.2%

However, challenges await. The new leadership, headed by Xi Jinping, will take the reins at a time when growth has only been slower once in the past decade, and that was in the tempest of the credit crisis. The current government has outlined the plan for future growth: a strategic shift from external to internal demand. The shift will be that much tougher because many of the sources of external demand (the US and Europe) are faltering.

We discussed our long term view of China, and emerging markets in general, last month. We will be watching the political transition closely this fall to try to detect any signs of instability or a rapid growth revival on the back of a potential stimulus. Already this year we have seen one casualty of the political system. Bo Xilai, former leader of Chongqing and a favorite to join the highest level of the Politburo, was forced out of his position in the party and his wife was implicated in a murder case. Bottom line for investors is we believe the growth potential is real, but we are constantly looking for ways to reduce the volatility associated with it. □