



INVESTMENT UPDATE



NOVEMBER 2006

CONSPIRACY THEORIES AROUND

In our most recent *Update*, we noted the stunning decline in the fortunes of the hedge fund Amaranth, which was caught off guard on the wrong side of the energy price drop. Amaranth apparently was not the only one. We are intrigued by how frequently, when the unexpected happens, people are quick to propose conspiracy theories. A current theory floating around the Internet is that the White House engineered recent energy price declines to improve the reelection climate. While, on first thought, this seems ludicrous in such a large energy market, consider the events as laid out recently by our friend, investment strategist Ed Yardeni:

(1) The average U.S. pump price of gasoline peaked at \$3.00 per gallon during the week of September 7, 2005, after the hurricanes shut down several key refineries near New Orleans.

(2) The Department of Homeland Security responded by suspending the Jones Act, a protectionist measure passed in 1920 that favored the merchant marines by prohibiting foreign oil tankers from stopping at more than one U.S. port to unload. As a result of the suspension, gasoline poured into the U.S. from Rotterdam and the price of gasoline plunged to \$2.13 per gallon at the end of 2005.

(3) Gasoline started to soar again during the spring and into the summer's driving season – peaking at \$3.03 per gallon during the week of August 2 – after Congress passed a law raising the ethanol content of gasoline. This caused its own problem as ethanol cannot be shipped in pipelines, only by trucks. So, a shortage of this additive boosted the pump price.

(4) At the same time, Iran's leaders talked up the price of crude oil, warning that if attacked, they might use oil prices as a weapon. Goldman Sachs' super-spike forecast for crude oil prices gained credibility as crude shot up to a record high of \$78.40 per barrel following the outbreak of the war between Israel and Hezbollah on July 12, 2006.

(5) About a week after the peak in crude oil prices, the National Hurricane Warning Center changed its forecast and predicted a milder hurricane season than in 2005, which it was.

(6) In June 2006, Goldman Sachs announced that its widely followed Commodity Index (GSCI) was too overweighted in petroleum, and reduced its unleaded gasoline weight from 8.45% to 2.3%. Fund managers, brokers, and individuals invest tens of billions of dollars in indexed commodity funds tied to the GSCI and were forced to sell gasoline contracts extensively to abide by the new weightings.

(7) Hank Paulson, the former head of Goldman Sachs, was appointed U.S. Treasury Secretary on July 10, 2006.

(8) Oil removed from the Strategic Petroleum Reserve during Hurricane Katrina has not been replaced yet. The law requires that a drawdown cannot persist "for more than 60 days with respect to each shortage."

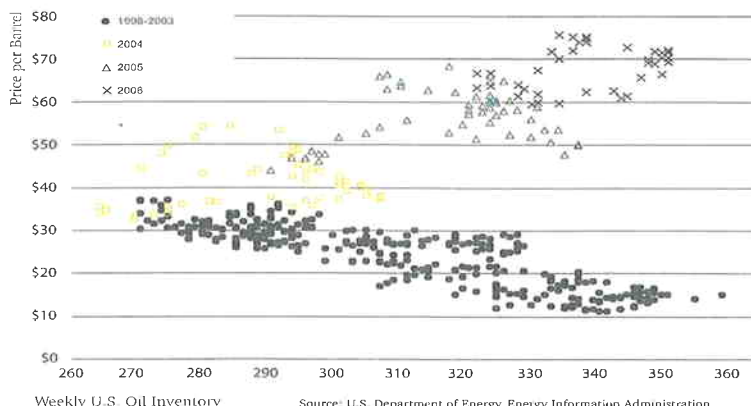
(9) In September 2006, Chevron and two partners announced the discovery of a huge oil field in the Gulf of Mexico.

Dum da dum dummmm! Coincidence?

You decide. Before you weigh in, consider a possible conspiracy on the other side of the coin, allegedly accounting for some portion of the prior run up in prices. The source is a

U.S. Senate staff report, issued on June 27, 2006 by the Permanent Subcommittee on Investigations of the U.S. Senate, entitled "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat." The report blames speculators for a portion of the energy price jump and concludes that the "traditional forces of supply and demand cannot account for these increases." It states, "Although it is difficult to quantify the effect of speculation on prices, there is substantial evidence that the large amount of speculation in the current market has significantly increased prices. Several analysts have estimated that speculative purchases of oil futures have added as much as \$20-\$25 per barrel to the current price of crude oil, thereby pushing up the price of oil from \$50 to approximately \$70 per barrel. Additionally, by purchasing large numbers of futures contracts, and thereby pushing up futures prices to even higher levels than current prices, speculators have provided a financial incentive for oil companies to buy even more oil and place it in storage. A refiner will purchase extra oil today, even if it costs \$70 per barrel, if the futures price is even higher." The Congressional report includes the chart below, which shows the relationship between U.S. crude oil inventories and prices over the past eight years.

PRICES VS. TOTAL U.S. STOCKS
January 1998 to October 2006



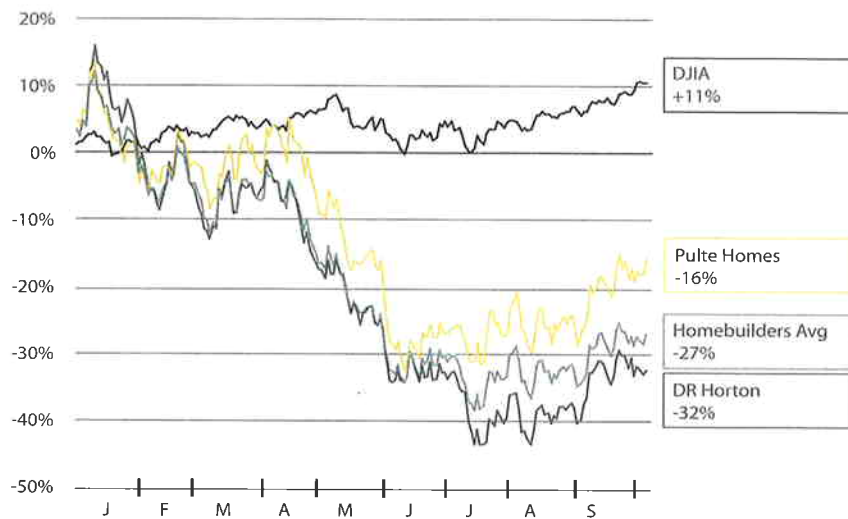
Source: U.S. Department of Energy, Energy Information Administration
Pricing: Cushing OK, WTI spot price
Inventory: crude oil ending stocks excluding strategic petroleum reserve



The relationship between physical supply and price clearly has changed since 2004. For the 1998-2003 period the chart shows that the price inventory relationship generally centered around a line sloping from the middle left of the chart down to the lower right. In other words, low inventories were accompanied by high prices, and high inventories were accompanied by low prices. The report states, "For 2004, 2005, and through May 2006, which is the most recently available data, the inventory-price relationships fall nowhere near this downward sloping line; if anything, the points seem to go in the opposite direction, such that higher inventories seem to be correlated with higher prices." Again, the report states that a "frenzy of speculative buying has created additional demand for oil futures, thereby pushing up the price of those futures." It notes a *The New York Times* estimate of "at least 450 hedge funds with an estimated \$60 billion in assets focused on energy and the environment, including 200 devoted exclusively to various energy strategies." Furthermore it states, "Goldman Sachs estimates that pension funds and mutual funds have invested a total of approximately \$85 billion in commodity index funds, and that investments in its own index, the Goldman Sachs Commodity Index (GSCI), has tripled over the past few years to \$55 billion."

The earlier chart implies that if the 1998-2003 relationship between U.S. oil inventories (currently the highest in eight years) and crude oil prices hadn't been distorted by speculators, then the price of oil would be below \$20 today! It cites several industry analysts' estimates that speculation has added about \$7-\$30 per barrel to the price of crude oil. Remember that the report was released at the end of June, when the price of crude oil was \$73.93 per barrel. The report notes that some OPEC officials feared that the price could plunge \$20 or more if there were a shift from "contango" (in traders' terms, futures prices higher than spot prices) to "backwardation" (futures below spot prices.) Ironically, the price did drop by about \$20 over the past few weeks, but futures prices remain well above spot quotes. This contango situation encourages stockpiling of crude oil inventories. In his parting comment, Ed Yardeni ponders whether it could be that there is simply no more storage available for oil? No wonder investors have been confused.

2006 PRICE PERFORMANCE
YTD through 10/9



Source: Wall Street Journal

THE DOG THAT DIDN'T BARK

We wrote about the drop in housing prices in our September 2006 *Update*. The decline's pace and severity caught many economists and investors off guard, which seems to be a theme this year. Since then, economists and investors have scrambled to revise each forecast to be more gloomy than the last. The dire pessimists predicted an impending collapse in consumer spending, a collapse of housing-related stocks, and a full-scale recession. Certainly for much of the year, housing stocks suffered significant declines. However, as the chart above indicates, since mid-July, many of these stocks have improved significantly and have outperformed the broad market.

One well-timed buy signal was the pronouncement in mid-July from Robert Toll, the CEO of Toll Brothers, a large home builder, that it was the worst housing market of the last 40 years. Any investor who bought immediately after this comment has been well rewarded. More recently, investors were cheered by September's unexpected jump in housing starts, thinking perhaps that this at least signaled a stabilizing market. Some investors even are speculating that homebuilder stock prices may be sufficiently low to attract private equity investors who might try to buy out some of these companies. Unfortunately, building permits continue to plunge. They dropped 6.3% in September, the seventh straight decline and the biggest fall in seven years. Year to date through September, permits were down almost 28%. Considering the ongoing large decline in building permits, existing home sales, and home prices, it may be too early to send the all clear on housing.

Regardless of the future path of housing stocks, this example does illustrate a point we have made before. The media is paid to capture our attention. Often, by the time you are reading of some startling trend, the impact is already reflected in the asset's price. Time and time again, investors act after they have read something only to find that other sellers have already cleared out. This lends some credence to the old saying, "buy on the rumor, sell on the news."

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