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Oil sense and nonsense

The oil price rise is generating some absurd analysis, but also interesting opportunities.

Jonathan Lipow — 20 Oct 05 16:31

With oil "stabilizing" in the \$60-70 per barrel range, there has been a lot of talk about the impact of high oil prices on global output and inflation. Nearly all of this talk is simply a distraction. What investors have to focus on is the long run implications of higher oil prices, and what this means for portfolio strategy.

First, let us consider the popular obsession with the "inevitable" oil shock induced recession that the press claims is around the corner. While it is certainly true that a decline in oil production would trigger recession as it has in the past, today's high oil prices are the result of burgeoning demand rather than supply disruptions. In other words, people concerned with oil induced recessions are effectively saying that rapid economic growth causes recessions. The claim is nonsense.

The argument that rising oil prices will induce inflation is equally silly. Inflation, or more accurately excessive inflation, is a situation in which rapid growth of the money supply pushes up prices so quickly that it becomes difficult to tell whether a price for a particular good has risen because it is in short supply or just because all prices are rising. It is the resultant confusion that makes inflation so costly to the economy.

Oil is getting costlier because it is in short supply, not because there is excessive liquidity sloshing about the global economy. Hence the proper functioning of the price system requires that oil prices rise.

So what do high oil prices mean for investors in the long run? The starting point for any analysis is to understand that while oil prices may soon breach the \$100 per barrel mark, in the long run, oil prices must stabilize somewhere around \$30 - \$45 per barrel.

How can I say this with confidence? The answer is that various technologies exist that make it possible to profitably convert less convenient and currently far cheaper sources of energy into liquid transportation fuels. These technologies become economically viable when the long-term price of oil exceeds \$30 per barrel.

What technologies are we talking about? Primarily methods of converting coal and natural gas into clean liquid fuels. Such methods are hardly something new. The Nazis exploited this approach extensively during World War II in order to fuel their war machine using coal based fuels.

Of course, today's methods while based on the same scientific principles are far more efficient than those used by the Nazis. Today, CTL ("coal to liquids") and GTL ("gas to liquids") plants are operating in the US and South Africa, while new plants are being built in China, Nigeria, and Qatar. Far more are planned.

So what does this mean for the world economy? As GTL and CTL plants come on line, oil prices will stabilize at lower levels than those we see today. The price of coal and natural gas will rise substantially as these fuels steadily replace oil as the source of transportation fuel. Meanwhile, higher prices for coal and gas will lead to higher electricity prices, and render unconventional methods of generating electric power such as solar, wind, and "inherently safe" nuclear reactors economically viable propositions. And, as a side effect, global CO2 emissions will not rise anywhere near as fast as is currently projected.

How should investors exploit these trends? One obvious idea is to invest in utilities that rely heavily on nuclear power. Higher electricity prices will fall straight down to their "bottom lines." Examples would include Germany's E.ON (NYSE: EON) and Korean Electric Power (NYSE: KEP).

Another "no brainer" is to invest in railroads. Due to their energy efficiency, railroads will benefit long term from relative oil scarcity. America's CSX (NYSE: CSX) and Genesee and Wyoming (NYSE: GWR) are my current favorites, while China's Gunagshin (NYSE: GSH) is a more speculative alternative.

Firms that produce coal and natural gas will also be big beneficiaries. Amongst coal producers, America's Peabody (NYSE: BTU) and China's Yanzhou Mining (NYSE: YZC) are good selections. As for natural gas, no firm is a match for Russia's Gazprom (OTC: OGZPMY).

Investors should not shy away from oil firms either. Oil firms' valuations have not risen anywhere near as fast as spot oil prices, reflecting the markets' sober assessment that oil prices are heading back down to more reasonable levels. America's Chevron (NYSE: CVX) and Spain's Repsol (NYSE: REP) are good choices. Both firms have large natural gas deposits, and Chevron is heavily involved in commercialization of GTL technology.

What about firms directly involved in GTL/CTL technology? America's Headwaters (NYSE: HW) and South Africa's Sasol (NYSE: SSL) are solid profitable choices. As for the coming boom in nuclear power, America's Duratek (NNM: DRTK) is a leader in the management of radioactive waste streams, and is superbly positioned to benefit from nuclear power's renewed popularity.

Then, of course, there is General Electric (NYSE: GE), a firm involved in wind power, nuclear power, clean coal technology, energy conservation, and a myriad other unrelated activities.

Dr. Jonathan Lipow is Chief Economist at [Forum Consulting and Business Development](#), which represents Vanguard and Wellington in Israel. He was formerly Vice President of Banc of America Securities responsible for business development in Israel.

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