REVIEW & COMMENTARY
1^{ST} QUARTER 2005

The last spike

Oil prices, probably the most sensational topic to hit the airwaves in the first quarter, are threatening to spike upwards according to a few analysts. Lehman Brothers' Oil analyst recently suggested that crude oil prices could exceed $100US per barrel under extreme circumstances. Jeff Rubin from CIBC Capital Markets has also chimed in with a prediction of an average price in excess of $77US per barrel over the next 5 years. Despite Lehman's prediction being based on the equivalent of a 'perfect storm' for crude prices, the markets reacted by sending oil prices higher, at least temporarily. Interestingly, while oil inventories are at 3 year highs, crude prices are also at an all time highs; so much for that old theory about supply and demand. While there is nothing to say that oil won't hit triple digits, this reminds us of when gold last was in the spotlight and targets ranged from 800 to 2000USD an ounce. Gold never got there; we would be surprised if crude prices did any time soon. Thus, everyone seems to be predicting the same thing which usually suggests it won't happen. However, there is no question that SIM's past predictions of a return to the 30's is unlikely. We would be equally surprised if it hits $75US per barrel or anything higher in the next 5 years. Certainly, China has millions of unexplored acres that could contain some supply. Russia has significant proven reserves but has concentrated on debilitating the largest Russian Oil company in order to repatriate the company.

While high oil prices hurt our pocketbooks, there are some benefits. As investors, it has been one of the few bright spots in the market. Oil now represents 21.5% of the TSX/SP index. While many of the sub sectors were negative, the Energy sub sector posted a gain of almost 20% in the last quarter. Certainly higher crude prices have helped Canada, particularly Alberta. Due to strong indigenous resources, higher general resource prices have attracted a lot of attention from international investors. This is one reason why our currency has strengthened. Remember not so long ago, the loonie was trading at 63 cents US. There were equally numerous opinions back then, some from noted economists, that the Canadian government should peg the loonie to the US dollar in fear that if they didn't it might go down substantially further. It wasn't much later that the loonie reversed its course.

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Higher oil prices are dangerous. Many North Americans are starting to cringe at the cost of filling up their SUV's and cars. Home heating will be an even bigger eye-popper next winter if prices don't abate. This financial reallocation of consumers' disposable cash will work its way through the North American economies. The average consumer is heavily reliant on his car. When more of his income goes to fuel rather than purchasing goods and services, the economy will suffer. When faced with a weakening economy, the Central Banks will have little alternative but to either slow, or stop all together, their decision to raise interest rates.

Now, if we are right and the price if oil is closer to its high rather than readying itself for an assault on triple digits, let's have a look at what might happen and how it might affect equity prices. If we look at the U.S. economy which is presently trending toward 3.5% GDP growth, imagine what it might be if crude prices were down in the low $30's. It would be considerably stronger. Add to that a potential reduction of the financial burden of the conflict in the Middle East and the U.S. economy could be as strong as the late 1990's. If this were the case, the Central Banks' declaration of the need for higher interest rates would be more understandable. However, if crude continues to rise and the economy shows signs of weakness, they would have to slow, possibly even reverse, their intentions on the direction of interest rates.

Either way, it may be a win-win situation for our style of investing. Given our predisposition to income oriented equities, it would appear that they will provide the best risk/return alternatives in the capital markets in the year ahead.

Stodgell Investment Management Ltd.