MAINSTAY
CAPITAL
MANAGEMENT
LLC

Oil's Well

(6/30/05)

Many investors have questions about the rising price of oil and how it may affect the economy and the financial markets. When the price of crude oil reached $60 per barrel for the first time in late June, it prompted a precipitous two-day sell off in the major stock market averages. The surge in energy prices is hitting the economy at a critical moment. The Federal Reserve has been steadily increasing short-term interest rates "at a measured pace" over the past year. Rising interest rates are intended to slow inflation, but usually end up dampening economic growth as well. Higher energy prices act like a tax on the economy, hurting consumers and many businesses alike. The combination of higher interest rates and higher oil prices could mean a slower economy in 2006.

So what exactly is driving oil prices higher? Much of the recent volatility can be attributed to rampant speculation on the part of commodity traders and the hedge fund capital backing their trades. However, we believe higher oil prices are supported by fundamentals in the industry. Global demand is simply outstripping supply. Insatiable consumption in China and India alone continues to go unabated. These two countries now consume more energy per unit of gross domestic product than the developed countries of the world, and their energy needs will certainly rise as the industrial revolution there continues to take hold. The oil industry has little excess production capacity and has been slow to bring new fields onstream to meet demand. The major users of petroleum products are worried about bottlenecks and supply disruptions – and the bid on oil futures reflects those concerns. While $60 oil may have been unthinkable a couple of years ago, it may well be cheap in the face of the future balance of supply and demand. Indeed, we believe oil could spike well above $60 per barrel before the end of 2006.

As oil is hitting record highs, it's worth putting these prices in perspective. The price of oil is high, but only in "nominal" terms. The "real" cost of oil actually peaked 25 years ago at an inflation-adjusted $94.77 per barrel and has been declining for over two decades. Only in the past three years has there been a consistent uptrend in the price of oil. Additionally, while on an absolute basis oil demand is higher today than ever, when viewed in the context of a percentage of overall industrial activity, oil plays a much smaller role in our economy than it once did. Developed countries use about half as much oil per dollar of gross domestic product today than in the mid-1970s.

No matter how rising energy prices ultimately affect the economy, investors can benefit from the rally in energy stocks by owning energy sector funds and/or diversified equity funds that have a large allocation to the energy sector. Additionally, investors can benefit from the diversification aspects of an energy fund. Since this sector typically has a low correlation with the overall stock market, it can actually help reduce overall volatility in a portfolio. That said, this sector on its own has been, and promises to be, very volatile. Therefore, even the most aggressive investors should keep their allocation to energy stocks at less than 25% of their total portfolio.

Our current favorites in this sector include Excelsior Energy & Natural Resources, U.S. Global Investors Global Resources, Icon Energy, and Fidelity Select Energy. Diversified equity funds we currently like that hold a large stake in energy include Artisan Mid Cap Value, Kinetics Paradigm, and Diamond Hill Focus Long/Short.

Please note, we have no affiliation with and receive no compensation from mutual fund companies