



FINANCIAL SENSE WRAPUP

with Tony Allison

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Something's Got to Give

\$90 oil may one day seem like the good old days

BY TONY ALLISON

In the decade ahead, that “something” may just be oil shortages, rationing, and much higher prices. If this comes to pass, it will have many political, economic, investment and lifestyle implications. As a nation, we are woefully unprepared on any level to deal with a sustained supply shock of crude oil; the one commodity the global economy desperately needs to sustain itself and enable future growth. The peaking of fossil fuel production may ultimately be the defining issue of the 21st century.

This is not a “bearer of bad tidings” article. It's more about anticipating and preparing for change. Significant change is on the way if in fact peak oil is beginning to knock on our front door.

More Demand, Less Supply

As oil has zoomed past \$90 per barrel recently, analysts and pundits have pointed to speculation and geopolitical tension in the Middle East and Nigeria. While these factors play a role, especially short term, the overriding reason for consistently higher prices comes back to supply and demand. We may see the oil price drop soon for a short period, but oil hasn't gone from \$20 per barrel to \$93 per barrel in five years on speculation and geopolitical tension alone. This past summer the IEA (International Energy Agency), normally optimistic to a fault, issued a report warning of problems ahead. The IEA projects non-OPEC oil production will peak in 2010. It is their way of preparing the world's consumers for higher prices in the years ahead.

The problem is that supply and demand issues are not something we must prepare for in 2010. They are here today, and likely to increase in the years ahead. Global crude oil production hit an all time high in May 2005 of 74.3 million barrels per day. By July 2007, crude production was down to 73.3 million barrels per day, a drop of a million barrels. Total liquid energy production, including crude, topped out at 86.1 million barrels per day in July 2006. Today it is 85.1 million. Beyond speculation and geopolitical problems, world demand is now 88 million barrels per day. The gap is helping to drive prices higher, and future projections indicate the gap will grow substantially.

Global Oil Consumption Growing Rapidly

According to the BP Statistical Review, oil consumption has soared over the last decade outside the US, up 63% in India, 85% in China and 62% in the Middle East. And as consumption grows in the Middle East, the amount available for export lessens. These amazing jumps in oil demand were not predicted 15 years ago, as few if any analysts could see the new Industrial Revolution taking off in Asia.

Today everyone sees growing demand as 40% (China and India) of the world's population rapidly modernizes and consumes more energy. Even today, with the huge leaps already taken by China and India, China still uses less energy per capita than Mexico, and India's per capita energy consumption is half of China's. In the ensuing decades, that will shift dramatically as modernization in Asia continues at a breakneck pace.

A Granite Mountain

Matt Simmons, investment banker and author of “Twilight in the Desert” states the problem succinctly.

“There is a bona fide need for oil demand to grow from 88 million barrels a day next year to 100, then 105, then 110, and 120 by, say 2030. The problem is that use and supply will always have to equal out. And the supply of oil, the growth, has petered out. Crude oil supply peaked in the spring of 2005. We’re bridging the gap by natural gas liquids and refinery processing gains and inventory liquidation. And that basically can’t last. So we’ve got a global energy train that’s headed right towards a granite mountain, and there’s no tunnel through the mountain.”

Numbers are easy to project, but finding the oil is hard. To go from today’s 88 million bpd to 100 million would require discovering the equivalent of two North Sea oil fields (at peak production). North Sea was discovered in 1968 and took 10 years to bring to production. Incidentally, the North Sea oil fields peaked in 1999, and production has been declining steadily since.

U.S. Lacks Refining Capacity

The United States was once the Saudi Arabia of the world, exporting its excess crude oil around the globe. But oil production in America peaked in 1970 at 9.6 million bpd (today it is roughly 5 million bpd), and now we must import over 60% of our energy needs, including large amounts of refined gasoline and jet fuel, because our refinery capacity has remained stagnant for decades. The BP Statistical Review listed US consumption at approximately 21 million barrels a day, but refining capacity is only 17.5 million barrels per day. One would think our politicians might look at current policies regarding the disincentives to build new oil refineries anywhere in the US.

The supply and demand imbalance is the central factor behind rising oil prices, but the cost of finding new supply is an issue as well. Crude oil will continue to be discovered, but the cost of recovering the oil will grow as companies look to deep sea oil drilling, tar sands, and oil shale production. All these methods are extremely expensive in terms of labor, materials and energy expended. Oil will be available the rest of this century and beyond, but the cost of producing a barrel of oil and refining it will likely continue to rise.

A Decline of Light Sweet Crude

In addition, the supply of light sweet crude is declining rapidly. Heavy sour crude will be the substitute, but it is more expensive to refine, and many refineries are not equipped to refine heavy sour crude at any price.

There have been calls for OPEC and Russia to step up production, but why should they? Their economies and in large part their futures, depend on their oil reserves lasting as long as possible. Why not cut production and conserve more of your most precious asset? That may be the current strategy, but there comes a point where the price will severely impact global growth and oil demand will decrease. But clearly that point has not been reached.

Mexico Oil Shock on Horizon

Another area where “something’s got to give” is Mexico. Mexico has long been one of our most secure and reliable sources of crude oil supply, and the second leading oil exporter to the US after Canada. Cantarell is Mexico’s key oil field, and the second largest in the world after Ghawar in Saudi Arabia. Unfortunately, Cantarell production peaked in 2006 at roughly 3.7 million barrels a day. It is now estimated that production will drop to 2.4 million barrels a day by 2010.

Even more disconcerting is a recent admission by Pemex, (Mexico’s state-run oil company), that Cantarell may run out of oil in 7 years. This admission by Mexico has been lightly reported, but figures to become a huge story in the next few years. Even before the seven years are up, Mexico may become an oil importing country. Pemex is concerned about Mexico’s rapidly rising domestic oil consumption. There would appear to be little hope for preventing a Mexican oil shock. Even if large investments in new development wells were made quickly, Pemex reportedly indicated that its reserves would still likely run out in approximately 10 years.

Beyond the obvious issue of less reliable supply coming into the US, is the issue of economic distress on our boarder. Mexico’s oil industry subsidizes many aspects of Mexico’s economy, and losing its crown jewel in less than a decade can only lead to a traumatic adjustment period ahead for Mexico, and perhaps its neighbors.

Prepare for Change

Change is seldom welcomed by most humans, but it can often bring about positive results. It is impossible to know what year the effects of peak oil production will barge into our living rooms, but change is on the way. The adjustment period to a permanent supply crunch will likely be very difficult, but some effects may be beneficial. For example, we could see a re-birth in local farming and manufacturing, as food and industrial products become exceedingly expensive to transport. We would see more public transit, more freight train transportation, more bicycles, more energy efficiencies of all kinds working their way into society. Ironically, many of these scenarios thrived 100 years ago.

New industries, (and new jobs), will spring up as a result of the high cost and lack of availability of crude oil. Air and water quality will improve over time as alternative energy sources become a more significant part of the economy. Fortunes will be made by entrepreneurs inventing new energy-efficiency and alternative-energy technologies. Investors who back the successful ventures will also make a handsome profit.

In the meantime, capital will continue to flood the critical global energy sector. The best companies, with the best prospects, in relatively stable geopolitical areas, will be extremely profitable in the years ahead.

The global grab for the remaining fossil fuel will not be pretty as nations fight over every barrel. But if we can survive, the light at the end of the tunnel will hopefully signal a new dawn, not the proverbial oncoming train.

Today's Markets

Wall Street advanced Monday as investors appeared unconcerned by record oil prices and speculated that the Federal Reserve will cut interest rates later this week to boost the slow economy.

The Dow Jones industrial average rose 63.56, or 0.46 percent, to finish at 13,870.26. Broader stock indicators also gained. The Standard & Poor's 500 index rose 5.70, or 0.37 percent, to 1,540.98, while the Nasdaq rose 13.25, or 0.47 percent, to close at 2,817.44.

Light, sweet crude for December rose \$1.67 to settle at a record \$93.53 a barrel on the New York Mercantile Exchange after rising as high as \$93.80.

Gold approached the key \$800-an-ounce level on Monday, as the dollar continued to fall amid expectations that the Federal Reserve will again cut interest rates on Wednesday. Gold for December delivery finished up \$5.10, or 0.6%, at \$792.60 an ounce, having earlier reached a high of \$798.30 an ounce.

The Fires

On a personal note, the massive wildfires in San Diego made for a chaotic, stressful week. My family and I had to evacuate for a short period, and thankfully our neighborhood escaped any damage. I would like to offer my gratitude for the courageous efforts of the firefighters who battled multiple firestorms in brutal conditions, saving thousands of homes. It was a horrific week for those who lost their homes, but it was also inspiring to see San Diegans helping their neighbors through so many acts of kindness, courage and generosity. The fires certainly put into proper perspective the value of family and friends. Our city has seen better days, but last week may have been our finest hour.

Wishing you a good evening,

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