

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## What are the Implications of High Oil Prices?

*By Gil Hanoch, August 2008*

It's been nearly four years since I wrote the article "Could High Oil Prices Be Good?" (Hanoch, October 2004) and oil prices went up significantly since then. This article presents the main factors affecting oil prices and the potential implications on your investments.

### Causes for higher oil price:

1. **Increase in demand:** Given the rapid development of various emerging markets, notably China and India, combined with worldwide population growth, oil demand is growing rapidly, mostly by cars for personal use. This is not likely to be a cyclical factor and the trend may continue for many years.
2. **Limited Supply:**
  - a. **Declining oil reserves:** Oil is a limited resource on earth, and as we come closer to depleting it, prices are likely to go up irreversibly.
  - b. **Tension in oil producing countries:** Tension in the Middle-East, strikes and political instability in Venezuela, and growing instability in West Africa increased oil prices. This factor may have a limited time horizon.
3. **Weaker dollar:** Since the price of oil is denominated in dollars, the weak dollar made oil artificially more expensive. Given the cyclical nature of currencies, next time the dollar strengthens, oil should become cheaper.
4. **Speculators:** Oil price is determined in the futures market. The futures market is a wonderful tool that helps big oil consumers (like airline companies) hedge the risk of rising prices and set their upcoming oil cost in advance. It is also a place for speculators to bet on higher oil prices. They bid up the price beyond the demand dictated by actual oil consumers and have created a large premium to the price – like a pyramid scheme. Once the price deviates too far, or government regulation addresses this, the bubble may burst and erase the premium, causing a big decline in the price.
5. **China's managed energy prices:** Oil price in China is controlled by the government and held artificially low, resulting in higher demand. Refineries lose their incentives to produce, given their rising cost of input compared to the fixed product price. As a result there are already supply shortages in China. This artificial situation is not likely to be sustainable, and controls are likely to be lifted at some point.

### The implications on your life:

Because oil demand is expected to increase in the long run and oil reserves are a finite resource, you cannot expect oil prices to decline to low levels in a natural way in the long run. A bursting speculation bubble or a stronger dollar can have a dampening effect on prices for a limited period, but the lasting effects of accelerated demand around the world and depleting reserves should bring prices back up.

Given these factors, the only way to lower the long-term cost of energy is to use renewable energy alternatives to oil. Unfortunately, implementing these renewable alternatives costs money upfront, and as long as oil price is tolerable, only people that are highly concerned with their long-term well being at the price of a current burden are going to accept this high initial cost.

As the price of oil goes up, the financial benefit of renewable alternatives grows. The result is a clear tradeoff between current comfort and future comfort:

1. Low oil price provides current comfort, making travel, food and many other products cheaper.
2. High oil price provides future comfort by accelerating the development of renewable alternatives that can ultimately completely free us from dependence on the limited oil supply.

A complete departure from the dependence on oil may take many years, but there are already current activities underway given the current price of oil. Here are a few examples:

1. Hybrid cars are being sold in big numbers (over 1,000,000 cars so far) and offer real savings in gas consumption and total costs to their owners.
2. People are reducing their energy consumption by improving the insulation of their homes, buying solar panels and energy-efficient appliances and light bulbs.
3. The once expensive Canadian and Venezuelan tar sands are now highly competitive with conventional crude oil. These massive reserves are estimated to be approximately equal to the world's total reserves of conventional crude oil. Note that this is not a renewable source of energy, but is an example of how time can be bought for developing renewable alternatives.

### **The implications on your investments:**

**Short-Term:** As the price of oil goes up, it has two competing impacts on your stock investments:

1. It increases the value of the energy sector in your portfolio.
2. It increases the cost of doing business for other sectors, making them less profitable.

The net effect on your portfolio is slower growth or declines during spurts of oil price appreciation.

**Long-Term:** As the price of oil goes up, renewable sources of energy are developed and become more competitive with oil and more widely used. It increases the profitability of all companies other than oil related companies, having a positive net effect on your portfolio, with higher growth.

**Bottom Line:** Stock portfolios are held for long-term growth and income, and as such, they are likely to benefit from the long-term financial benefits of higher oil prices.

### **Conclusion**

If you have the means to withstand the strain of high oil price on your current lifestyle, you can benefit from the potentially nice long-term portfolio growth and improved future lifestyle that high oil prices may bring. The higher the oil prices, the bigger the current pain, but also the sooner the long-term solution will be in place.

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