



## Oil Shock / Whiskey & Gunpowder Whiskey & Gun Powder



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The disconnect between what oil experts are saying and what oil is actually doing is widening to Grand Canyon proportions.

Recently, the Organization of Petroleum Exporting Countries cut its forecast for growth in demand in the third and fourth quarters of 2005 by 600,000 barrels per day... the International Energy Agency lowered its fourth-quarter demand for OPEC oil by 700,000 barrels per day...and Morgan Stanley economists have flat out called oil a "bubble."

Sounds bearish for oil prices, right? Not so fast. What we can observe happening in the oil markets is actually very bullish for oil prices.

For example, bookings of supertankers for oil exports from the Middle East soared to the highest monthly level this year in July - - and shipping costs doubled along the way, according to Bloomberg. Oil production in Norway -- usually the No. 3 global exporter, behind Saudi Arabia and Russia -- has hit an 11-year-low...and China's oil-thirsty economy is humming along at 9.5% growth, shrugging off any and all efforts to slow it down.

These don't sound like the ingredients for lower demand or too much supply for me.

What's more, speaking of OPEC, the Saudis also recently told the world's leading industrial powers that OPEC will not be able to meet Western oil demand in 10-15 years. This was the first time -- ever -- that OPEC has made such an announcement.

Now consider this: What if OPEC is lowering its forecast in preparation for cutting its production quotas at its next meetings. Why would OPEC do that? Well, either it wants higher prices, or it sees difficulty in meeting current production levels starting as early as the third quarter. Either way, that's bullish for oil.

And if you think we'll be able to take care of our own energy needs ourselves without some drastic changes...think again. U.S. strategic oil reserves are equal to just 70 days of supply.

In fact, despite ratcheting back demand growth, the IEA still expects oil demand to rise to 85.9 million barrels a day by the fourth quarter of this year. That's higher than global refining capacity of about 84.5 million barrels per day. But the IEA has a history of being too optimistic -- the squeeze could come a lot sooner than Wall Street is willing to believe.

It's as if we're finally heading toward the end of the oil era. And the transition -- as we've seen at the pump recently -- may be a brutal one. The oil gauge is slowly moving toward empty...and the world's largest suppliers say they won't be able to fill us up again.

This is a core economic shift that will be an underlying trend in the financial markets -- and your daily life -- for decades. It is crucial that you understand the implications, the dangers, this shift represents.

We've seen oil crises before -- the last one most people remember is the 1973 oil embargo. But history is dotted with energy emergencies that make the oil shock of the '70s look tame. Heck, Britain was hit hard by an "energy crisis" some 400 years ago. At the time, wood provided basic energy plus the charcoal needed to smelt iron. But the forests were quickly disappearing. Shortages got so bad that laws were passed restricting woodcutting.

Luckily, Britain made the switch to coal. Coal had been in limited use since Roman times, but when the wood shortage hit, coal was adopted to provide heat. Still, it took another century to learn how to make coke to smelt iron. The result helped spark the Industrial Revolution. In short, an energy crisis forced a seismic shift in the economy and society.

Today, we're facing another kind of energy crisis...

The largest declines in oil production last year occurred in the U.S., where output fell by 160,000 barrels a day, and in Britain, where output declined by 230,000 barrels a day. We're near the bottom of the barrel for many of America's oil fields. America imports 58% of its oil -- and we import more and more oil all the time. In fact, U.S. oil imports jumped 5.3% last year over 2003, versus a 5% rise for the world. So our dependency on oil from people who'd like to kill us is increasing, and increasing faster than the global average. The world's energy use is increasing rapidly. Global oil consumption grew by nearly 2.5 million barrels per day last year -- more than DOUBLE the 10-year average rate. Oil already pushed past the \$60 mark recently, and financial markets initially plunged on the

news. How will they react when oil breaks \$70... \$80... or Goldman Sachs' recently predicted \$105 per barrel?

Most economists pull the 1970s oil crisis out as an example of how rising prices eventually crimp demand and send prices lower. But let me give you two reasons why it's different this time: China and India.

Over the last three years, China has accounted for over a third of the global increase in oil demand. As GDP increases, so does a country's oil use. And Chinese President Hu Jintao says China aims to quadruple its GDP, to \$4 trillion, by 2020.

Already, China's and India's economies are roaring, and their energy use is ramping up, as their citizens are making the switch from

*Today's energy crisis is transforming the world -- from geopolitics to the financial markets to the gas pump to the price of 75% of everything you consume on a daily basis.*

bicycles to scooters to cars. Last year, more than 1 million cars were sold in India. Car sales there are roaring along at a 20% growth, and sales are expected to surge for another 10 years. Meanwhile, China is seeing

auto sales grow by 16% a year, with 2.79 million cars and light trucks sold in the first half of this year alone. Newly mobile consumers in both countries will need oil and gas -- and lots of it.

Both these countries have roaring economies that use more and more oil every month. They are competing with the United States for global energy resources. This wasn't the case back in the last oil crunch. It could make this one drastically different.

I'd like to be able to tell you that the U.S. government is doing everything it can to prepare for the coming energy emergency...but I can't. In fact, when I think about how little prepared this country is for the changes that are about to hit us, my hands automatically clench into fists.



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# Oil - Inflation - Silver & Gold by the Optimist

Crude oil at record high prices above \$60 per barrel inspired uncountable current articles on the inflationary effects of high energy prices and the historical ratio of gold to crude oil. As in his previous commentaries, the Optimist strives to present a

positive perspective for readers to consider. The uplifting message for today is that high oil prices will not cause higher inflation, and that inflation adjusted oil prices will not stay this high for long. The Optimist hopes that helpful message will

provide a soothing reassurance to consumers who must struggle to find the funds to pay the crude oil inspired increased prices for gasoline and heating oil, for food, and for everything impacted by higher transportation costs.

## Energy costs are a tax

There are few more certain economic relationships than that rising energy prices will directly translate into escalating prices at the gas pumps, in the grocery store or restaurant, and in the mailbox at home when the monthly utility bills are delivered. Increasing transportation costs will also push a broad spectrum of prices higher. Although those persistently rising prices will feel like inflation, it is worthwhile to take a closer look. Since early 2002, crude oil has tripled in price from \$20 to more than \$60 per barrel. While it is obvious that a price increase of that magnitude has a continuing and substantial impact on the economy, the proper perspective is not that rising crude oil causes inflation to rampage throughout the economy. The high price of crude oil should be more clearly viewed as a tax on essential economic elements within our society. This could be more easily visualized if crude oil was still at \$20 per barrel, with an additional \$40 per barrel of tax imposed by our helpful benefactors and protectors in the Government of OPEC.



Although businesses must raise prices to pass increasing taxes along to the consumer, taxes are not inherently inflationary. Instead of raising the general level of prices throughout the economy, taxes increase the prices of the items taxed and at the same time absorb funds which might have been otherwise used for discretionary purchases. The net

result is that taxed items become more expensive, but consumers have fewer funds for other purchases. When consumers will not or can not further increase their debt to continue unessential purchases at the same level as before a tax increase, then the added taxes result in less consumption and a slowing economy.

## A tax raises some prices, but depresses others

**\$** Higher crude oil prices selectively increase the costs of energy, food, transportation, medical, and many other essential sectors, but at the expense of the consumer having fewer remaining funds for other purchases. Consumers who are near their maximum tolerance for debt will react to higher costs for essential commuting travel to work by making fewer discretionary trips to the mall and by purchasing fewer luxuries. Although travel by automobile is essential in most parts of the USA, consumers stressed by high energy prices will tend to keep their old car longer or to replace it with a used car and to significantly delay the optional

purchase of a new car. Everyone needs a place to live, but high energy prices will discourage potential home buyers from looking at new homes with a long commute to the office, and will focus their attention on the positives of renting an apartment closer to work instead. By increasing the prices of essentials, and thereby separating the consumer from a surplus of spending funds, high crude oil prices indirectly reduce the demand for non-essentials such as luxury items, new cars and houses. Just as a tax removes potential spending funds from the economy and transfers those funds to the tax agency, high crude oil prices absorb funds that the consumer would otherwise have available to spend on other purchases.

It should be obvious that a very high tax rate focused on a few essential sectors will depress the overall level of economic activity, and that the slowdown will exert downward pressure on the prices of non-essential sectors. Similarly, high crude oil prices raise the cost of essential transportation, utility, food, and comparable items, but also have a depressing effect on consumers who are left with no surplus of spending funds. The net result is that the prices of essential energy-impacted areas increase, but the slowing economy depresses the prices of non-essential areas.

## Inflation adjusted crude oil prices are much higher than average



The chart shows crude oil monthly prices after adjustment for the change in the consumer price index. The time scale is 1946 through July 2005, and the earlier prices are adjusted to the CPI equivalent of July 2005 dollars. The average CPI adjusted price is less than \$30 per barrel, and crude oil is now more than double that long term average. Crude oil prices obviously can go higher from this level, but there is also ample room for prices to fall substantially to get back to the long term average.

## A slowing economy will moderate energy prices

While pessimists may see a glass full of inflation as the inevitable price increases caused by high energy costs work their way through the economy, the Optimist sees the glass of economic activity being drained dry by high energy costs. As consumers reduce their spending for non-essentials, discretionary sectors will lose jobs, will have falling stock prices, and will be reinforced with an array of negative news. All of those negatives will combine to persuade consumers to reduce unessential spending. The cumulative result of high real oil prices will be an economy which slips and slides toward recession.

A slowing economy in the USA will reduce energy consumption both at home and in key Asian nations which will encounter a decrease in the level of their exports to us. A global reduction in the demand for energy will significantly reduce the price of crude oil in international markets. The Optimist is happy he can provide the welcome news that the inflation adjusted price of crude oil will be lower in the future, even if the reason for that good news is a world wide reduction in the rate of energy consumption due to the traumatic recession that high priced energy would impose on the USA.



## The Fed will fight the deflation devil



So, do you think that maybe a brief recession would lower energy costs enough to put the USA back on track to a high level of growth and another decade of endlessly rising stock and real estate investments? If so, then you get my vote for the most optimistic person in the nation!

As yet another example of This Time It Really Is Different, the Optimist concludes that the USA will not again have another simple recession which proceeds to clean out the excesses of the prior expansion, and sets the stage for solid economic growth in the future. The unimaginable levels of debt and leverage in the USA makes the economy unstable and incapable of supporting the type of normal recessionary slowdown that the nation has gone through so many times before. What would have been a simple and mild slowdown in the past would now be magnified to intense proportions by the debt and leverage. If not given a lifeline, a slowing economy would fall relentlessly into a deflationary depression much deeper than the 1930s.

Fortunately, our friendly Fed is ever alert to that danger, and they keep a lifeline always at the ready. That is the same lifeline which the Fed used to rescue the economy when stocks crashed in 1987, when LTCM defaulted in 1998, in the months preceding Y2K, and

when stocks again crashed in March of 2000. That lifeline is a substantial increase in the money supply. So long as the Fed is able to sufficiently ramp up the amount of money in circulation, they can be sure to reverse a potentially disastrous slowdown into a new illusion of growth. That would be a perfect solution for the American economy, except for two small problems. First, the amount of money supply increase needed to positively affect the economy increases with each intervention cycle. Secondly, the liquidity can only be added, but it can never be removed because removing the stimulus of the added money supply would cause the very deflationary depression that the money was injected to prevent. For each crisis that is solved by increasing the money supply, there must be a correspondingly higher inflation caused by an increase in the amount of fiat paper which is chasing the same amount of purchasing opportunities.

## Inflation is a rising tide that lifts all price boats


The Optimist argued above that high energy prices, like any other tax, will increase some prices and decrease others. Inflation, in contrast, drives up the prices of everything at the same time. Obviously, some sectors appreciate more rapidly than others, but the great sloshing waves which result from more money supply being pumped into an economic system result in all prices rising from the financial pressure.

No doubt, some alert readers will hasten to observe that crude oil floats on the same rising money supply level, and therefore crude oil prices will also rise with inflation as the money

supply is increased. Although it is clearly correct to forecast that inflation will push the ups and downs of crude oil prices into a series of higher highs and higher lows, it is not easy to use that forecast to make investment profits in crude oil now. Even as the low end of the inflation adjusted channel for crude oil prices rises from \$20 in 2002 toward \$30, the nominal price of crude can drop significantly from current levels if traders see the potential for an economic slowdown.



## Silver and gold will prosper as inflation escalates



The investment strategy that is easy to implement is to buy silver and gold at current levels near the bottom (IMHO) of their long term up trend channels. No matter whether crude oil rises more or drops to \$30 in a reversion to

the mean, the Fed will insure continued inflation to prevent the economy from deteriorating into deflation. Silver and gold will shine as bright as ever in the environment of rising inflation ahead. Those investors who correctly placed bullish bets on crude oil have substantial profits to protect. In addition to congratulating those clear sighted investors, the Optimist respectfully offers the suggestion that they might

want to consider capturing some of their profits from crude oil, which is now much higher than its inflation adjusted average, and reallocating a portion of those investments into silver and gold, which will prosper greatly as inflation continues to surge through the economy.

