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Rising Cost of Debt Much More Dangerous

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For years, even through the terrorist attacks in September 2001, consumer spending has continued to rise. Interest rates remained low, and credit has been easily available. Home prices soared. Debt — and leverage through debt — became an accepted way of life. Savings disappeared. Soon, very soon, we're going to have to pay for our folly.

You don't need government statistics to tell you that prices are rising. In fact, for some items, prices are rising at an even faster rate than the 0.5 percent increase in the Consumer Price Index in August. Without food and energy increases, the CPI rose only 0.1 percent, but I don't know anyone who exists without food and energy for a month!

There are other components of the CPI that tend to minimize the impact of higher costs. The CPI's housing component is figured at the rental-equivalent cost. But with so many people buying homes, rental demand has eased, so rents have been held down. That puts downward pressure on a big component of the CPI, even as monthly mortgage payments get larger as home prices soar.

If you're a senior consuming health services, your cost of living is certainly rising at a more rapid rate than the index. Ditto if you're the parent of a college student. And ditto in spades if you're a first-time home buyer. If you're a cab driver or have a long commute to work, your budget is certainly strained by the rising cost of energy.

Is inflation the issue?

Rising prices are a symptom of inflation. But the real definition of inflation is the excess creation of money, which destroys the value of the money



we hold. And that process of inflation is directly related to the actions of the Federal Reserve Bank.

The Fed has been fighting the possibility of inflation for well over a year, raising interest rates and tightening up on the money supply in a less-noticed attempt to wring the inflationary potential out of the economy.

The banking system had been awash in low-interest, easy money following the Fed's easing going into the year 2000 transition, and in its efforts to stem the potential impact on the economy after Sept. 11, 2001.

The Fed is almost certain to raise interest rates this week in its battle against inflation. If the Fed keeps tightening up on the price and availability of credit, consumers will have to start making choices. Rising energy costs, not only for gasoline but home heating oil and natural gas, will take a toll on other consumer spending.

In the 1970s, the Fed tried to accommodate both higher energy costs and war by creating more, not less, availability of credit. The result was inflation. Even with Alan Greenspan gone, they're not likely to make that mistake again.

The Truth About Oil

Pain at the pump has plenty of Americans ticked. Chances are, though, they are angry about the wrong things. Here are five myths many people believe about today's oil pinch — and what the real story is.

BY JOHN BIRGER

(FORTUNE Magazine) — A fellow road warrior pulls up to the pumps at Fillup's Food Store in Panama City, Fla. He looks at the nearly \$3-a-gallon price of unleaded, and then with one word sums up the feelings of drivers nationwide: "Crazy."

Crazy indeed. Not that long ago, though, it would have been madness to suggest that oil could go from \$18 a barrel to \$65 in four years—and even crazier to suggest that such a run-up wouldn't spark a painful recession, with consumers spurning trips to the shopping mall and businesses crippled by cost hikes. Conventional wisdom has held that there are price thresholds that can't be breached without affecting spending habits. In 2003, for instance, Republican pollster Frank Luntz spoke of \$2-a-gallon gasoline as a "magic number" that, if crossed, would harm Republican reelection hopes. Well, gas passed \$2 a gallon a month before the 2004 election, and the oil guy in the White House still won. Two bucks wasn't so magic after all.

A sustained run of \$3 gas could be what finally kicks the legs out from under the U.S. consumer—already, Wal-Mart is blaming lackluster sales on high gas prices—but it's hard to know for sure. After all, so much of the conventional wisdom on

oil has been wrong. That's a problem, because if the U.S. is ever to make progress on treating its oil addiction, it needs to understand its source.

MYTH NO. 1: GAS STATIONS ARE GOUGING CONSUMERS.

REALITY: If consumers are getting gouged, then gas station owners are being impaled. When gasoline prices spike, as they have in the wake of Hurricane Katrina, windfall profits rarely accrue to gas station owners. Kim Do, owner of a Coast station in Pleasanton, Calif., reports that in the immediate aftermath of the storm, she lost 8 to 10 cents on every gallon of gas she sold. "Customers are very angry—they call my prices a rip-off," Do says. "I tell them, 'I'm just like you.'" In fact, because retail prices are stickier than wholesale ones, gas stations make the fattest profits when prices are falling—a point made in a recent study by Berkeley economist Severin Borenstein.

Pumping gasoline is a dog-eat-dog business even when prices are normal, especially with Costco and Wal-Mart now muscling in. Low profit margins on gas are why so many gas stations double as convenience stores. "The objective is to get you to fill up on coffee, not gasoline," quips Gene Guilford, director of the Independent

Consumers have been attempting to maintain their lifestyles in spite of rising energy prices, but they do it at a huge hidden cost. Our savings rate as a nation has fallen into negative territory. That means that in an attempt to keep up with rising prices, we've been paying for our lifestyles with mortgage loans and credit cards.

Even worse, we've been spending money abroad in record amounts to buy foreign goods to the tune of \$770 billion a year. Stuck with the dollars we've sent overseas, foreigners have been reinvesting them in Treasury securities at a rate of around \$65-\$70 billion a month. In other words, foreigners will be subsidizing the federal Katrina rebuilding deficit by buying our Treasury IOUs.

Let's hope the foreign appetite for dollars doesn't dry up. If foreign central banks stop finding those Treasury bills attractive, interest rates would have to go much higher to attract lenders to finance our debt. Global oil producers would demand more of those less-valuable dollars to pay for the oil they ship. And then the house of cards that we call consumer debt would fall faster than any hurricane winds.

Gold bugs rejoice

The gold market recognizes the danger, with gold prices rising to \$459 an ounce on Friday. That potential loss of confidence in the dollar is why the Fed must raise rates in spite of the government's need to borrow money to help the rebuilding effort.

The Fed recognizes reality — and so should you. If you're living on the edge with credit-card debt or an adjustable-rate mortgage, wake up to the new reality. Debt has suddenly become much more dangerous. And that's The Savage Truth.

http://money.cnn.com/magazines/fortune/fortune_archive/2005/10/03/8356719/index.htm

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2001. But in a market as big and wide-open as oil, there are thousands of traders all over the world making the action. Unlike California power prior to the crisis, oil is a freely traded commodity. The markets, not the magnates, set the price.

**MYTH NO. 2:
HEDGE FUNDS ARE INFLATING
THE PRICE OF OIL.**

REALITY: No, it's the Trilateral Commission in cahoots with the World Bank. Just kidding. Still, even many sophisticated people believe that hedge funds are driving up prices. Sean Cota, a Vermont heating-oil dealer who sits on the executive committee of the Petroleum Marketers Association of America, points out that average daily trading volumes in NYMEX crude oil and heating oil futures have risen dramatically—61% and 36%, respectively—since 2000. When the trading volume of oil grossly exceeds consumption, he argues, that is a sign that hot money is firing up the market. “Prices are now being set by fear and greed, not by supply and demand,” he concludes. His estimate: At least \$20 of the current \$65 price of oil is a byproduct of speculation by hedge funds and investment banks. Germany's Economy Minister, Wolfgang Clement, recently put the figure at \$18, a sentiment echoed by Chancellor Gerhard Schröder.

That is not, however, an accurate reading of how financial markets operate. Take Cota's concerns about excessive trading volumes. Futures trading in all commodities far surpasses the amount consumed by end users. And according to NYMEX, hedge funds account for less than 3% of volume in oil futures (a figure Cota disputes). In any case, basic market theory states that high volume leads to more, not less, efficient pricing. That's why thinly traded stocks tend to be more volatile—and vulnerable to manipulation—than heavily traded names like Microsoft or GE.

“People make these kinds of arguments because they have their own ideas about where prices should be,” says Stephen Figlewski, a finance professor at New York University's Stern School of Business and founding editor of the *Journal of Derivatives*. “Oil producers think prices should be high, and oil consumers think they should be low. But if the price isn't where they want it, the one thing they all agree on is that it must be someone else's fault.” The truth is that emotion—fear of dwindling supply—drives oil prices harder than speculation ever will.

Even if speculators were dominating trading of oil and gas futures, it's still not clear that would lead to higher prices. Futures require two to tango. A hedge fund cannot purchase a contract to buy oil at \$65 a barrel in November if someone else isn't prepared to take the bearish side of that bet. That someone else can be an oil company looking to offset some risk or another hedge fund looking to profit from falling fuel prices. Data from the Commodity Futures Trading Commission show that the week before Katrina sidelined much of the Gulf oil industry, 14% of all short, or bearish, positions on crude oil were held by “noncommercial traders”—a subset that includes hedge funds and banks. This same group held only a slightly larger share—16%—of long, or bullish, positions. “For every hedge fund that's made money, I know a lot that have lost money,” says Morgan Stanley chief economist Stephen Roach.

Still dubious? Consider this: The average hedge fund has gained only 2.1% year so far this year. The average managed futures fund (the type most likely to invest in oil) has actually lost money, dropping 6.6%. Why? Because many have been shorting oil, according to Merrill Lynch hedge fund analyst Mary Ann Bartels. So if hedge funds really are driving up oil prices, they're doing a lousy job of profiting from it.

**MYTH NO. 3:
WE'RE RUNNING OUT OF OIL.**

REALITY: This one is true. Sort of. Unlike wind or water, oil is not a renewable resource. So by definition we're using it up, in the same way that we are all dying all the time. The real question is, When will it become impossible (or impossibly expensive) to recover enough to meet demand? Answering that question is not easy. New discoveries and new drilling technologies have transformed the science of exploration, which is why global reserves have doubled since 1980 (to 1.3 trillion barrels) even as consumption has soared.

There's no shortage of oil experts, however, who say that the industry cannot keep up the pace, and that the age of ever-expanding reserves is over. These “peak oil” theorists argue that we need to prepare for an era in which supply trails demand, particularly given the fast-growing needs of



China and India. The guru of the peak-oil set—and author of its latest manifesto—is Matt Simmons. A leading energy banker in Houston, Simmons spent years poring over oilfield engineering reports and concluded that some of the world's most important fields are thinning out. “I believe the Middle East has no spare capacity,” he says. He's even more pessimistic about some newer fields like those in Russia and the deep waters of the Gulf of Mexico. Simmons is no kook—his book on the subject, *Twilight in the Desert*, is a must-read in energy circles. But there is a Chicken Little aspect to the peak-oil viewpoint. There have been a dozen or so oil shocks over the past 60 years—all replete with handwringing over in-the-ground reserves—and cheaper oil has returned each time. “The one thing I've learned,” says Roach, “is that oil is a mean-reverting commodity.” This time around, Roach expects high fuel prices to dent consumption—he's predicting a downturn in travel and other discretionary spending—while spurring oil companies to dig deeper and farther afield for oil.

The analysts at Cambridge Energy Research Associates have done their own painstaking global survey of oil production, and they couldn't disagree with Simmons more. In their view, production could rise 16 million barrels a day by 2010, leaving a comfortable gap between supply and demand.

The real problem with the peak-oil argument has less to do with engineering than with philosophy. It lacks imagination. Thirty years ago few thought it would be possible to produce price-competitive oil from Canadian oil sands. Today the cost of producing that oil is about \$20 a barrel and is still falling (see “The Dark Magic of Oil Sands”). Similarly, you can't rule out the idea that today's speculative energy technologies (see “Here Come the New Fuels”) will become cost-efficient by the time Middle East oil production starts to wane.

“The peak-oil argument underestimates the potential for technological progress,” says Economy.com's Thorsten Fischer, who expects oil to fall to about \$40 a barrel by next year. Simmons thinks prices could triple by 2010.

Peak-oil theory also overlooks alternative explanations for why oil exploration hasn't been terribly fruitful in recent years. It may be that there is oil to be found, but investors haven't given oil companies the requisite incentives to find it. Blame the dot-com boom. Having been burned by accounting cheats and profitless wonders, post-2000 investors demanded cash flow, dividends, and stock buybacks. So despite booming profits and revenues, Exxon Mobil spent less on capital and exploration in 2004 than in 2003. And the \$11.7 billion figure for 2004 was \$3 billion less than the company earmarked for dividends and buybacks. Of course, \$65 oil has a way of changing priorities. After years of stagnation, drilling-rig counts have soared 36% since April 2004. There are 2,895 active rigs worldwide, according to Baker Hughes, the most since 1986.

**MYTH NO. 4:
THE U.S. IS RUNNING OUT OF REFINING CAPACITY.**

REALITY: So what? It's fair to say that in recent months supply has been straining to meet demand and that U.S. refineries had to work flat-out just to convert enough crude into gas to keep the pumps filled. Then Katrina came, knocking out 20% of the industry. But America's struggle to ramp up capacity—

we haven't built a new refinery in 30 years, though many existing ones have expanded—does not mean doom. There are many products that the U.S. happily consumes in which we are not self-sufficient—think kiwi fruit or funny t-shirts.

The U.S. should easily be able to import gasoline and other refined petroleum products from India, the Caribbean, South America, and other places where labor costs, NIMBYism, and environmental regulations don't cripple new construction. The Department of Energy projects that worldwide refining capacity will increase 61% over the next 20 years. Says Fischer: “There's little reason to build a new refinery in the U.S. if you can do it faster and cheaper overseas.” And while not all overseas refineries can produce gasoline that meets our environmental standards, who doesn't want to sell into the U.S. market? New plants will be, and already are, designed to meet

American requirements.

Finally, if oil companies don't want to build, their customers may beat them to it: In mid-September, Virgin Group founder Richard Branson announced plans for a \$2 billion refinery that will help his airline defray the high cost of jet fuel.

**MYTH NO. 5:
THE GOVERNMENT MUST INTERVENE TO
BRING DOWN ENERGY PRICES.**

REALITY: Nooooo! The last time the U.S. went down that road, in the 1970s, the end result was gas lines, shortages—and little change in prices. But evidently they don't teach much history in politician school anymore—a frightening number of elected officials seem ready to re-embrace price controls. U.S. Senators Carl Levin (D-Michigan) and Maria Cantwell (D-Washington) want to give President Bush the power to set gasoline prices. In Massachusetts, secretary of state William Galvin has proposed a moratorium on natural-gas price increases. Hawaii's Republican governor has signed a law imposing limited price controls on gas; it will be interesting to see how much gas is left for the state to control.

A confidence-boosting release of some crude from the Strategic Petroleum Reserve might help to calm tempers, but all in all, the best thing the U.S. can do to bring down oil prices is—nothing. Ask yourself, Which is more likely to deliver cheaper oil: bureaucratic controls or all those new drilling rigs that went up only because of the incentive provided by high prices?

Of course, “I did nothing!” won't fly as a campaign slogan. And in fact, there are things the U.S. could be doing to treat our oil addiction. Because here's another uncomfortable truth: The U.S. now imports almost 60% of the oil it consumes each year, and that figure will only grow. One unfortunate result: Prickly characters like Hugo Chavez have us over a metaphorical barrel (see “Oil's New Mr. Big”).

For starters, Congress could raise fuel-efficiency standards for cars. Even a 10% improvement would save the equivalent of two million barrels a day by 2025—more than we now import from Saudi Arabia or Venezuela. We could reverse policies that encourage consumption, like the absurd tax incentives for small businesses to buy pickups and SUVs. We could ease some of the moratoriums on domestic oil and gas exploration. We could think harder about how to diversify supply; displace oil from uses not associated with transportation; and kick-start, through the wise use of market incentives, the journey toward a future beyond oil.

Years of relatively cheap oil—and low gasoline taxes—have allowed the U.S. to get away with being extraordinarily inefficient in our use of energy; we don't get nearly as much economic activity out of a barrel as our economic peers. The U.S. will never be self-sufficient in oil, even if we pave Alaska and drain the Gulf. But we can, and should, get more for our oil bucks. The U.S. is vulnerable to oil tremblors like the kind we are experiencing now because we have made a series of decisions—about taxes, subsidies, housing, transport, lifestyles—that have led precisely to this point. With the Gulf still damp from Katrina, it's time to ask if we can do it better.