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MONDAY, SEPTEMBER 17, 2007

Where Is Oil Headed? A Contrarian Says \$45 -- Part II

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So what are people missing?

I have never seen the gap between reality and the perception of reality as big as it is right now. The perception of what I call Chindia, the idea that demand growth globally is robust and is going to be led by the emerging-market economies of China and India, is still strong. It is a great idea. But when you look at the data, you will see it doesn't match, and when you talk about peak oil and see what is happening to non-OPEC supply, there is a problem because supply growth this year is going to be one of the largest in almost 30 years, and next year looks like it is going to be similar to this year. Guys like me care about the totality of non-OPEC supply growth, even biofuels, or non-oil fuel, which are a subset of the non-OPEC supply curve. Biofuel supplies, which include soybeans for diesel fuel and corn for ethanol, will be up this year roughly 350,000 a day versus last year. That's a big number, about 40% in terms of its volume. It is going to be up by a similar volume in 2008. This is in response to higher average oil prices and concerns about availability.

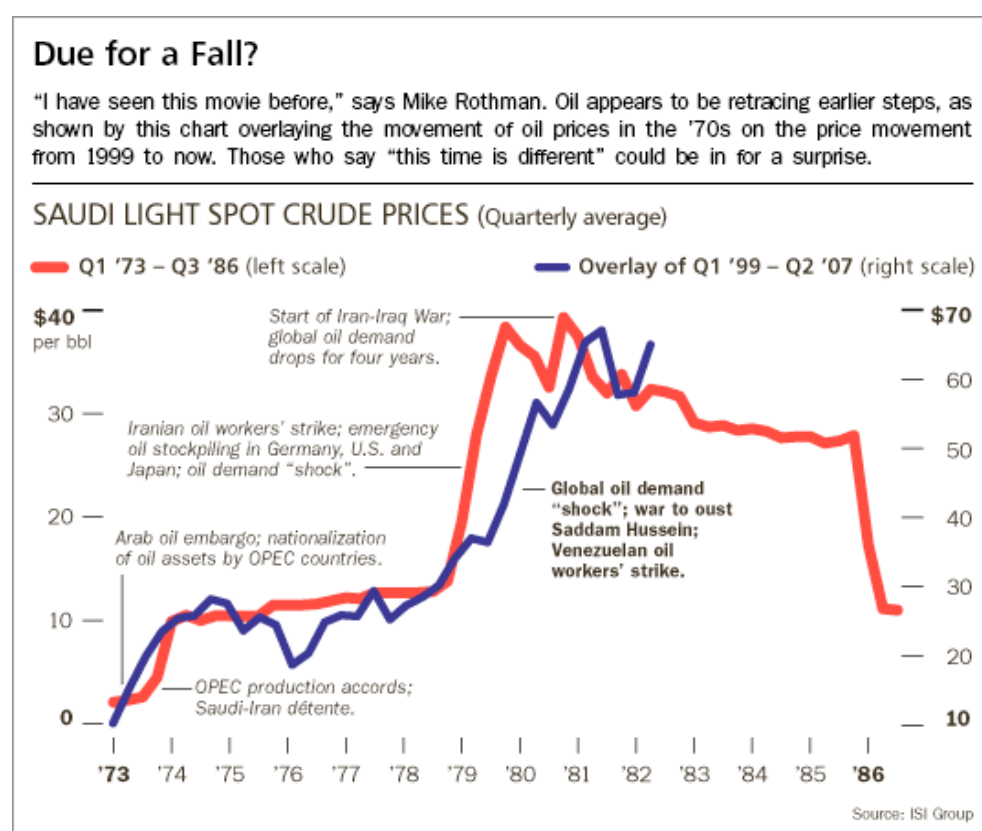
Why the big disconnect between perception and reality?

I've got to tell you I don't know what the answer to that is. I do feel like I'm going through the reverse of what I went through in 2000 through 2003. In 2000, I was described as a "foaming at the mouth" oil bull. At Merrill Lynch we had a view the oil price would average in the mid- to upper 20s. We thought OPEC would adjust production, and when we spoke with investors about our views, they looked at us as if we were taking drugs. The catalyst that actually repriced energy equities and moved the whole back end of the oil-price curve was when Royal Dutch Shell wrote down reserves in early 2004. That was the catalyzing event.

I don't think people are aware that demand has really fallen off so much. The rate of global oil-demand growth has really slowed pretty dramatically since '04. I've had to make a large downward revision for the second quarter, and it looks like I am going to have to make another one for the third quarter. A chart of the OECD [Organization for Economic Cooperation and Development] countries shows demand growth has been negative, with the exception of a small gain in the second quarter; that's the first time since 2005 that there's been some growth in demand, and it was modest. That's the worst showing since the '80-'82 recession.

What about demand in the U.S.?

We have seen a very recent significant slowdown in U.S. oil-demand growth. Also, jet-fuel demand historically has been a leading or coincident indicator for the economy, and jet-fuel demand has turned negative. That is not an economic forecast. But when jet-fuel demand is really soft, you have got to worry about whether something's going on with the economy.



Well, is demand slowing because of high prices or because the economy is slowing?

That is hard to say. Guys like me count barrels. But when you see oil-demand growth slow, you figure there are two things going on: There is substitution and there is conservation. People try to do more with the same number of barrels or they use alternatives. They may use more coal. They may increase their burn of natural gas in place of oil. They drive less. They may car pool. I'm not going to sit here and make up answers that I don't know. I just know that the rate of oil-demand growth has really been much lower than what has been forecast. I know I have had to make very big negative downward revisions in demand over the last three years, and it tells me that higher prices affect consumption. Three of my five kids drive, and last summer two of them stopped driving because I wouldn't buy their gasoline.

But in the bigger picture, global demand was supposed to be so strong that it wouldn't affect oil prices.

That's the "Chindia" story. I don't debate that demand in developing countries will grow. But the argument is that it is going to grow as it did in '04, at 15% or 16%, regardless of oil prices.

And you say 2004 was an aberration?

I haven't seen anything like it in 26 years. It wasn't even clear that what happened in '04 truly represented consumption. We don't know if some of it was stockpiling for precautionary reasons by developing countries. When you measure oil demand in a developing world economy, you're looking at disappearance, because the data for actual consumption by countries is very difficult to come by, and in many cases nonexistent. Then the question is whether that volume makes sense given other types of data. All I know is that for the last three years, I've revised my numbers down for China. It is not that they are not having oil-demand growth, but it is not 15%. It is 5%. It is 4%. It is 6%. It is 3%. It ain't 15%.

So if you were the "foaming at the mouth" bull back in 2000, what would you call yourself now?

It is very hard for me to say that I am a bear when I think oil is going to land at \$45 to \$50; historically, oil prices eventually settling at \$45 to \$50 is quite high. But compared to what the market is pricing and compared to probably most of my contemporaries, my forecast makes me a bear. We recommend underweighting the sector right now.

I'd say nearly a 50% price drop is bearish.

The concern is about the magnitude and speed and timing of the unwind given a precipitous drop in prices. It will be painful for companies. I have seen this movie before. There are a huge number of similarities between '99 up to now and the '73-'80 cycle.

Thanks, Mike.

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