

THOUGHT CONTAGIONS

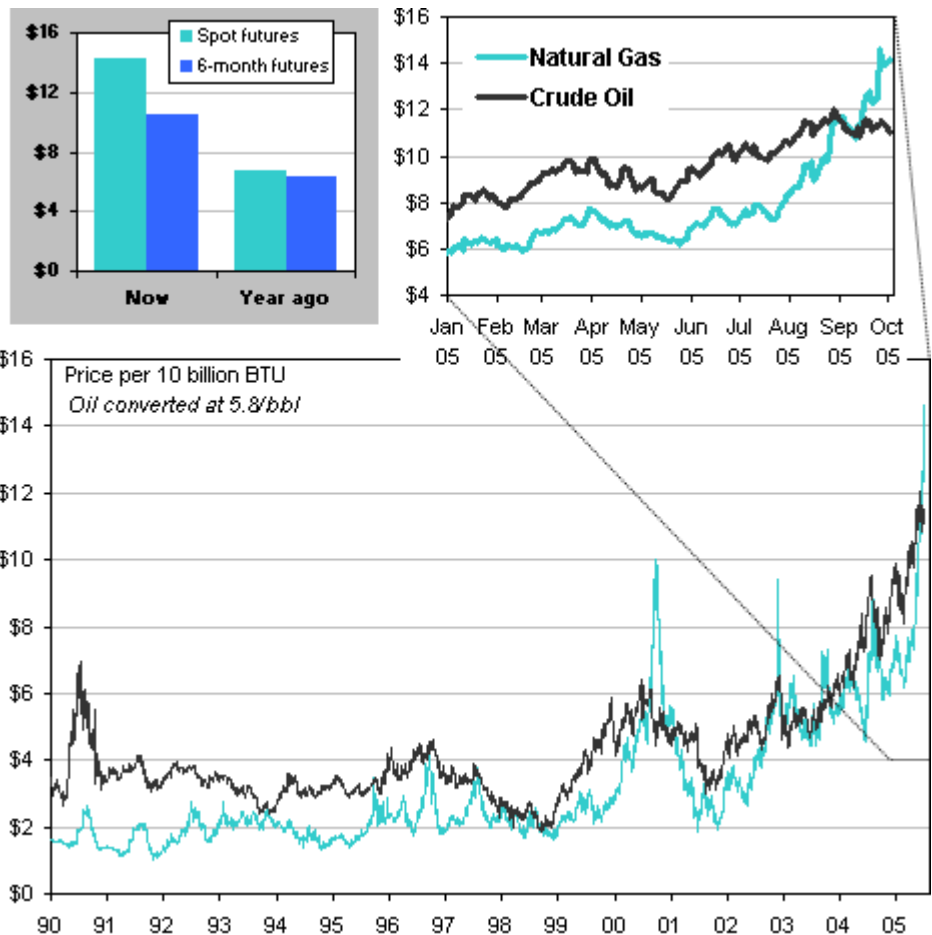
Played Out

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The pro-energy and anti-consumer consensus is ripe for reversal.

In conversations with investors over the last couple weeks, we've heard two **themes** repeated with such frequency and urgency that we are tempted to say that a **consensus** has formed, one which **contrarians** ought to consider betting against. First, we are hearing investors speak with too much pride and self-satisfaction about how spectacularly their **energy plays** have performed this year. Second, we are hearing investors express too much certainty and too much fear about a **recessionary** collapse of **consumer demand** in the face of higher **gasoline** and **natural gas** prices. Both these themes have had some currency all year long as energy prices have risen and expectations for a "**soft patch**" have persisted. **Hurricanes Katrina** and **Rita** have acted as force-multipliers for these themes, and they've now become so obvious that it's hard to believe they are not fully priced -- and then some. To make money on them from here, you'd have to believe that the fundamentals behind these themes still have room to accelerate, or that **investor sentiment** about them still has room to become more positive -- and we don't see how either of those things is possible. If energy is fully loved and a consumer recession is fully feared, it would seem that there isn't much risk at this point in something along the lines of shorting **Exxon Mobil** and using the proceeds to buy **Wal-Mart**.

Admittedly, we have not been bullish enough on **oil** over the last year, seeing it primarily as an **inflation play** and an overdone demand story (see, for example "[Oil In Perspective](#)" August 25, 2005). But as we pointed out immediately after Katrina rolled through the **Gulf Coast**, even when a



seemingly catastrophic **supply shock** entered the oil equation, **crude** failed to hold new highs (see ["Water In The Streets"](#) September 1, 2005). When the subsequent release of crude from the **Strategic Petroleum Reserve** was **undersubscribed**, it became obvious that the market is quite adequately supplied, and indeed crude is now trading well below its pre-Katrina levels.

With the edge of panic off the crude market, the focus of energy bulls has shifted to natural gas, currently trading at all-time highs in the wake of infrastructure destruction by Hurricane Rita. But we would caution against imagining that these highs can be sustained. At these levels, the price of natural gas per 10 billion BTU exceeds that of crude oil. This is a sharp inversion of a stable **historical pricing relationship**; as the chart on the previous page shows, in the past such inversions have been both rare and short-lived. Similarly, the **natural gas futures market** is in extreme **backwardation**, with contracts six months out trading 26% below the spot month contract. A year ago, the backwardation was only 5%. These signs of extreme **technical stress** are arising against the backdrop of the *force majeure* closure since September 22 of the Gulf Coast's **Henry Hub**, which is the contractual nexus for **NYMEX** futures deliveries (yesterday the hub operator, **Sabine Pipe Line**, began for the first time to lift *force majeure* from some of its system interconnects). With **local gas distribution companies (LDCs)** appearing to have already lined up or to have on hand supplies needed for the winter, we are not looking at *actual* shortages absent another major hurricane. Thus today's extraordinarily high natural gas prices would seem to be the products of **risk aversion** and technical stress, and are likely to be reversed before very long. Energy bulls who have pinned their hopes on natural gas may end up as disappointed as **Internet** bulls who switched from **dot-coms** like **Pets.com** to **"infrastructure plays"** like **JDS Uniphase** after the peak in March 2000.

Beyond these technical arguments, we still think that **inflation pressures** are an important key to understanding energy prices -- and the evolution of those pressures supports the thesis that energy prices have seen their highs. We have long argued that the high energy prices of the last year or so have embodied **rising inflationary expectations**, the market's judgment that **the Fed** has kept **monetary policy** too **easy** for too long. With the Fed heading toward a **normalized fed funds rate** of 4.5% by the January 31, 2006 **FOMC** meeting, we think inflationary pressures should significantly abate (see ["Full Circle, and More"](#) October 3, 2005). As the Fed's excessively easy posture of the last two years continues to come through the pipeline and becomes visible in backward-looking headline inflation statistics, energy prices will be cited as the *cause*. But in our model, energy prices are an *effect*, not a cause -- and as Fed policy moves from easy to normal, that effect will diminish.

All that said, no doubt consumer energy bills this winter will be higher than last winter. But they will probably not be as high as implied by today's fuel prices, both because those prices are headed lower, and because consumers have the power to consume less energy when its price becomes excessive. We're already beginning to see energy **demand destruction** in **gasoline** over the last month. And consumers can also **substitute capital investment** for energy expense, even by so humble a gesture as buying a sweater (at Wal-Mart, perhaps). With **household net worth** at all-time highs, **incomes** rising and **balance sheets** in great shape, we don't see an impending consumer meltdown simply by virtue of somewhat higher energy costs.

Bottom line: Two popular investment themes -- long energy plays and short consumer plays -- are likely to fail if for no other reason than that they are *too* popular and are thus fully discounted in stock prices. Beyond sheer contrarianism, we think the theses behind these themes are ripe for reversal. Raw energy prices have likely seen their highs, and residual high retail energy prices are not likely to trigger a consumer recession. **TM**