June 12, 2008

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Habits, Bubbles, Inflation, Oil and Global Trade

"If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it [from] *them with some part of the produce of our own industry, employed in a way in which we have some advantage. The general industry of the country, being always in the proportion to the capital which employs it, will not thereby be diminished… but only left to find out the way in which it can be* [best] *employed* [to] *the greatest advantage."*
Adam Smith, The Wealth of Nations – published in 1776

When Adam Smith published this passage in his book, The Wealth of Nations (1776), he was describing the significance of land, labor and capital as the most prominent factors contributing to a nation's wealth. His ideas became as popular as they were controversial because they were contrary to economic policies practiced in Europe at the time. In essence, Smith's ideas rested on the belief that rational self-interest in a free-market economy leads to economic well-being. So logical and well articulated were these thoughts, that Smith became known as the "father of economic studies".

One only has to watch CNBC's Kudlow & Company, to become acquainted with the brilliant and esteemed Larry Kudlow's prime motto and tribute to Adam Smith's work, that: "*Free-market capitalism is the best path to prosperity*".

In a free-market economy, much like we have in the USA, individuals have the right to freely pursue their own interests as they please. In this capitalist system, the dynamics of supply and demand are minimally influenced by government intervention and prices for goods and services are established in the marketplace. This contrasts with communist or socialist economies where prices and freedoms are government controlled. This concept is important to think about when considering the direction of political ambitions in the USA.

Free market capitalism, however, is not without its challenges to economic well-being (AKA, prosperity). In my humble opinion, challenges to prosperity occur when habits and bubbles cloud rational self-interest to the detriment of a nation's quality of life. And, quality of life diminishes when the effects of inflation outpace disposable income (gross income less income taxes on that income). To help explain these challenges, let me introduce some additional economic theories that were later developed from Adam Smith's initial work. These are the concepts of comparative and absolute advantage and the law of diminishing returns (David Ricardo, 1815).

Comparative advantage is said to be the most influential driver for believing in global (international) free-trade. When defined in terms of productivity differences, comparative advantage is often confused with the concept of absolute advantage. To illustrate: If the US has higher productivity and resources for agricultural production than the Middle East, while the Middle East has higher productivity and resources for producing crude oil, economists would say that the US has an absolute advantage in agriculture production and the Middle East has an absolute advantage in crude oil production. From this, it should be logical that if the US focused on agriculture production and the Middle East focused on crude oil production, then resources could be shifted from lower productivity industries to higher productivity industries and the total combined output of agricultural products and crude oil would rise – hence, comparative advantage. With greater output, and after an appropriate trading pattern is introduced, both countries could end up with more of both goods than before, meaning that both countries can gain from trade.

As a result, one might believe that the solution to the current spikes in food and oil prices can be solved from increased international trade – trading more food for oil. The fact of the matter is that both of these commodity complexes have long been advantaged by international trade and we as consumers have greatly benefited from it. Nevertheless, our gains from it now seem less evident and offer less impact.

Diminishing returns? The law of diminishing returns in economics states that if one factor of production is increased while the others remain constant, the overall marginal returns will decrease after a certain point. Thus, for example, if more and more wells are added to an already producing oil field, at some point each additional well will add relatively less output (supply) than a predecessor well did, simply because there is less and less of the fixed amount of existing oil field reserves in the Middle East to work with.

Currently, we are seeing greater crude oil demand coming from a broader base of global consumers and the push for greater production from our international trading partners has reached the point of diminishing returns. **Supply** is not currently keeping pace with **demand** and oil and agriculture prices are rising everywhere as a result. We can see this in the “bubble-like” ascent of oil and food prices. Since 1998, the price per barrel of crude oil has gone from $11.91 (nominal) to $137 today – a 10 year average annual compounded inflation rate exceeding 125%. The Middle East does not have infinite oil reserves. Talk of protectionism and instituting wind-fall profits taxes, are certainly not the answer either. More to the point, we need to increase the supply of crude oil in the global marketplace. Did you know that the USA is sitting on, perhaps, the largest oil resources on the planet? Then, why do we continue to send billions of US dollars to foreign countries when comparative advantage is providing us diminished returns? Why do we continue to allow ourselves to be held hostage to the likes of Iran, Venezuela and other regimes who hate us so?

In a 2005 report coming from the Rand Corporation (www.rand.org), “the Green River Formation, which covers parts of Colorado, Utah and Wyoming, has the largest known oil shale deposits in the world, holding from **1.5 to 1.8 trillion** barrels of oil. Of that, [based upon technology available in 2005] roughly 800 billion barrels are recoverable – more than triple Saudi Arabia’s proven reserves.” And another large formation, known as the Bakken Shale Formation, was found under parts of Montana, North Dakota and Canada. These resources are barely being exploited right now as government intervention, in the form of protectionism, is keeping these resources from being developed. Talk to your friends and neighbors – involve your local government representatives – weigh the advantages of tapping into these national resources! While it would certainly bring greater prosperity to those regions, it might even solve our government’s budget problem, improve the chances keeping social security benefits alive and reduce loss of life due to oil related geopolitical tensions. It just seems that dealing with the environmental issues would be far more productive than reducing our nation's quality of life, safety and well-being.

Yet drilling for more oil doesn't have be the sole solution to these challenges – even if it is definitely more certain and impactful. We need to foster innovation for more efficient uses of oil; and, promote a steady incentive for developing alternative energy sources. However, these are only long-term solutions that will give us little to no relief over the short-term. The longer we wait to push for these initiatives, the longer it will take for supply and demand solutions to exist. Let your politicians know this!

Oil is an incredible staple commodity that is used for more than transportation and heating. It is used in so many products that efficiently preserve our other natural raw materials and resources that I am hard pressed to not see its by-products in any of my surroundings. Oil by-products are used in creating plastics, paints, fabrics, insulation, asphalt roads, detergents, lubricants, medicines, food preservatives, cosmetics, packaging and fertilizers – just to name a few. Yet, greatest consumption of oil does, in fact, come from heating and transportation uses.

How can we find relief over the short-term? Well, there may be several ways…

Reduce consumption. The first way, and quite possibly the easiest, is to simply reduce your usage of petroleum products. Up to this point, consumers have been lax to reduce consumption in the face of higher prices (in economic terms – demand has been almost perfectly inelastic to price changes). When gas prices spiked last summer, many people complained, yet few made any effort to change their routines or consumption habits. My good friend and colleague, Dr. Dan Elash, suggests that people do not generally change their habits unless they feel enough "pain" to prompt them toward change. Dan is a Ph.D. in Psychology who has spent a career as a qualitative business analyst and management consultant to executives and business owners nationally. If that kind of help interests you, Dan can be reached through our offices.

Dan asserts that people develop routines when they find comfortable ways of operating on a regular basis. Routines allow one to go through life – "on auto pilot" – in a reasonably effective and efficient way. When things change, we are willing to absorb a reasonable amount of pain while fostering the hope that things will return to normal. However, once we realize that the change is going to last, we have a dilemma. We realize our need to change. The upshot is that when we do choose to effect change in ourselves, we develop new routines relevant to the new environment. The result is that we can find more effective and efficient ways to accommodate our lifestyles.

It has been interesting to see how my oldest son is handling higher gas prices. He travels over 100 miles, round trip, to work as an energy trader for a small "green" energy producer. As his firm trades energy 24/7, he recommended they allow him to work four 10 hour shifts rather than five 8 hour shifts. They accommodated him.

Invest in a socially responsible way. This author thinks that speculative investment has played a large role in the parabolic "bubble-like" rise in crude oil and agriculture commodity prices of late. Yes, despite the argument that speculators can only participate in the futures markets and are not taking physical delivery of crude oil or wheat, etc., I think that speculation has posed a significant negative disruption to pricing in these markets. (As a side note: it has been reported that available tanker vessels are in very short supply these days, which leads me to believe that some speculators may actually be storing oil in offshore containers.)

Futures markets have always served as a leading indicator for the spot markets and sellers have no idea whether the demand they see represents buying for consumption or for speculation. At the same time, as mentioned above, we have been seeing near perfect inelastic demand across the globe. These factors only seem to shift prices higher for an unchanged or modestly higher level of true consumption. Given this almost perfect inelastic demand and due to our dependence on oil, speculators can easily “game” (manipulate) these markets and they may very well have.

Don’t get me wrong, speculators play a positive role in providing liquidity to the markets and I am a great believer in the virtues of opportunistically diversifying one’s portfolio. However, when this kind of investment leads to rampant inflation, the result can hardly be considered “rational self-interest” as the effects of inflation are detrimental to most other asset classes and to quality of life around the globe. It would seem that a call for socially responsible investing, as opposed to potential government intervention, would also be a positive “path to prosperity”.

Exert political pressure. Call for government to allow greater exploration and development initiatives. Our politicians are there to serve the public interest – we are the public. If we can persuade our government to show the markets that significant new supply will be coming, you’ll see speculation come out of the market; a reduction in any country’s building and hoarding of strategic reserves; and, prices will come down.

On a more positive note, the sentiment driven correction that began last October and bottomed in March has caused a number of dislocations in the equity markets that are ripe for a significant advance. All we need is for all these headwinds to become tailwinds. Allowing greater development our US natural resources would go a long way.

Finally, in our last market letter we announced that our firm changed its name to ELF Capital Management, LLC. This month we are proud to announce that we’ve moved into newly appointed offices in the downtown area of Charlottesville. This move puts us within walking distance of many fine restaurants, shops, theaters, hotels and concert venues. It is a bustling atmosphere and the Historic Downtown Mall is considered one of the finest urban parks in the country.

Sorry for such a long letter this month…

Our returns for May 2008 were down 0.33% for the month.