Basic Points

BIG FOOTPRINTS ON THE SANDS OF TIME
and little footprints of Fear

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Basic Points

An Investment Journal

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Overview

The fifth anniversary of Nasdaq 5,000 came and went this month. The Street gave the occasion—the moment of its greatest financial success and its greatest impact on the lifestyle and savings habits of Americans—little more prominence than Stalin or Khrushchev would have accorded to the observance of the birthday of Czar Nicholas II.

It was also the anniversary of the lowest level of client interest in *Basic Points* and my weekly Conference Calls. Had Nasdaq continued on its march toward equaling the Dow-Jones Industrials, an event widely predicted by the Shills & Mountebanks, this "Old Economy" relic would have joined numerous other portfolio journals in extinction. So I take this occasion to pay tribute to those who hung tough in their belief that Nasdaq had not repealed all those disciplines in investing that make security analysis a true profession. One widely-accepted definition of a profession is an occupation accorded recognition as a distinct and useful service to the public because its members have proved their expertise in applying the principles of an extensive body of written knowledge that has shown its validity over an extended period of time. Nasdaq at 3,500—let alone 5,000—was an egregious affront to time-honored investment disciplines.

That prominent Wall Street strategists who were bullish on techs back then still have high-profile jobs should be of concern to the Street. In their defense, it could be a question of tenure: An astronomy professor who insisted that emanations from flying saucers could be causing tsunamis would be tenure-protected, and perhaps the Street follows this humane example in its personnel practices.

The world is still in its first recovery phase from the fall of equities and the economy triggered by Nasdaq's collapse. The bull market in bonds that had begun in 1981 continued to new peaks as those plunges accelerated, and it may have finally topped out after the greatest surge in history. Equities are struggling, and there are signs that the global economic recovery triggered by an aggressive Fed and an equally aggressive Bush is losing momentum.

The bull market in commodities remains robust, drawing daily derision in high places about the inevitable bursting of "the bubble." That so much of this public puritanical piety is produced by bubble-blowers of yesteryear, who cheered Nasdaq's run to 5,000, should make the wise treat it with caution—or contempt.

This month, *Basic Points* considers two extremes of investment time. First is time measured in eons—mineral assets that have lain in the earth for hundreds of millions of years, notably the Alberta oil sands and the major mines. Those buried treasures are now being claimed through huge footprints on the landscape. Second is time measured in months—the possibility that this time of Fed tightening amid rising inflationary pressures will, like several of its predecessors, end in a sudden rush to the exit by holders of financial assets—those individually tiny footprints of Fear that can collectively trample markets.

The indicators of financial strain remain quite complacent (apart from the sticker shock when Harley-Davidson suddenly had more market cap than General Motors), and there is no talk of coming panic.

We are reducing our market risk further, reducing total equities to 45%, just 5% above our minimum. We are also reducing our bond duration back to benchmark levels, after seven months of long duration exposure. Our enthusiasm for the commodity stocks and dividend-oriented stocks remains undiminished. However, the seemingly endless series of bad news stories of bad behavior by leaders of major financial institutions has led to significant underperformance by the financial stocks relative to the S&P. Historically, that has been a precursor to painful stock markets.

In that sense, the stock market is an institution of correction, and when many of the biggest names on Wall Street misbehave, punishment comes in the market itself. Since Adam Smith defined the principles of a free market economy in a book written as a work of moral philosophy, the system that would be given the label "capitalism" by its leading critic, Karl Marx, has always depended on "honesty and fair dealing" (the motto of the Harris Bank) to function effectively. When too many of its biggest names are revealed as unethical, confidence in the system erodes. The market's p/e is the arithmetic expression of that confidence. It is contracting, at least in part, because too many men whose employment contracts entitled them to vast riches violated their basic contract with the investing public.

Recommended Asset Allocations

American Portfolios

U.S. Pension Fund

	Allocations	Change
Domestic Equities	24	-3
Foreign Equities	21	-2
Domestic Bonds	25	unch
Foreign and Foreign-Pay-Bonds	15	unch
Cash	15	+5

Foreign Equity Allocations

	Allocations	Change
European Equities	6	unch
Japanese and Asian Equities	5	-2
Canadian & Australian Equities	6	unch
Emerging Markets	4	unch

Bond Durations

	Years	Change
Global	3.75	-1.25
U.S.	4.25	-2.00
Canada	4.50	-2.00

Basic Points

BIG FOOTPRINTS ON THE SANDS OF TIME
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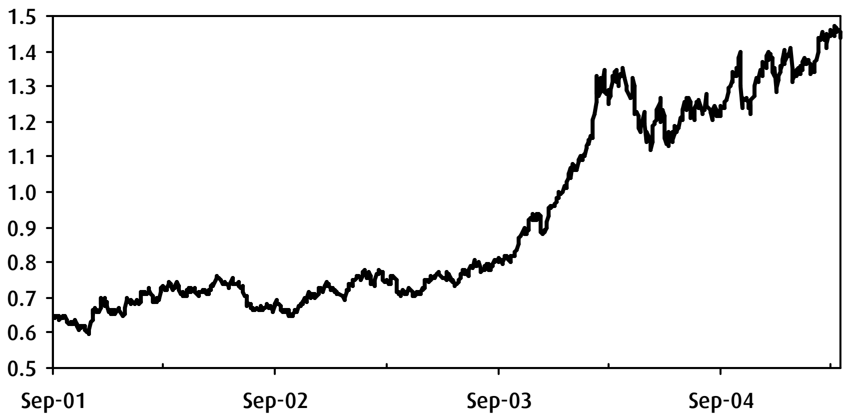
1. Those Bright-Shining Metals

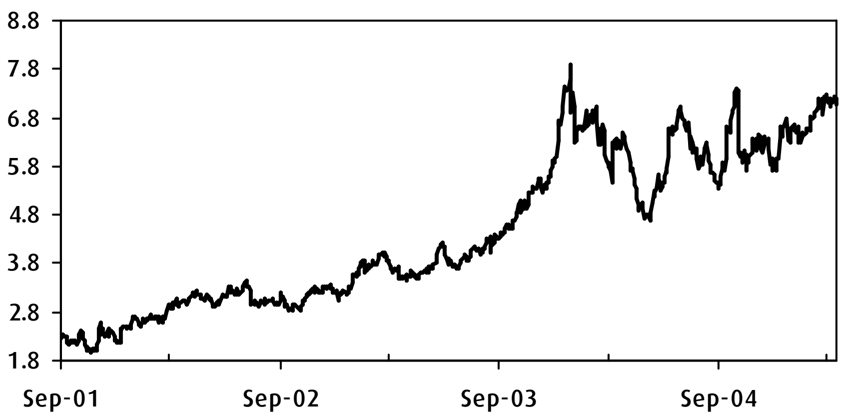
"This time of rising global attention to the base metals took a long time coming."

What is the peak for the base metals?

Copper (LME)
September 11, 2001 - March 2005

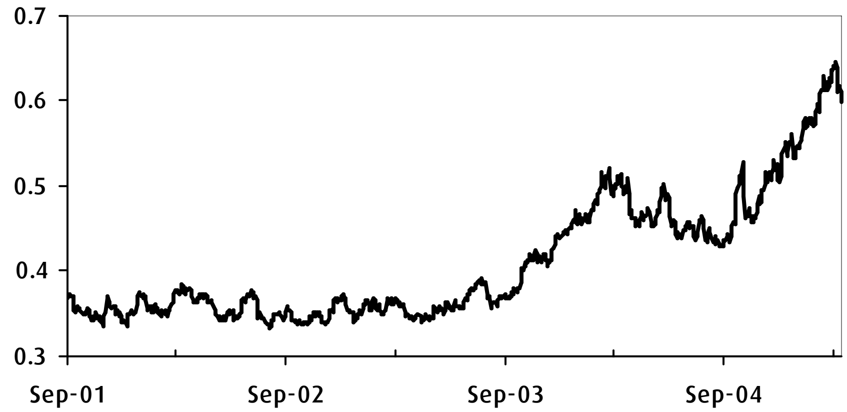


Nickel (LME)
September 11, 2001 - March 2005



This time of rising global attention to the base metals took a long time coming.

Zinc (LME)
September 11, 2001 - March 2005



"From time to time in recent times they've been glamour materials, but those times of glory have been brief."

Base metals have been in the ground 600 million to 1.8 billion years. From time to time in recent times they've been glamour materials, but those times of glory have been brief. Each of those times led to the imprinting of huge footprints on the land, particularly for open pit operations. Even the underground mines have big footprints around the headframes.

The recent surge in demand for base metals has astonished the Street, and, it should be noted, the top managements of many of the major mining companies.

Decades of disappointment for the mining community had led, by the onset of the Millennium, to the near-universal conviction that the metals were the butterflies of the global economy. When the formerly dull metals took on a radiant shine, it was the short-lived sheen before they lost their beauty—for what would, in each case, seem forever.

That boom/bust sequence evolved into a far worse experience when the industry experienced a Triple Waterfall collapse from 1980 to 2001. (Copper ran from 60 cents a lb, in 1977 in a classic three-wave rush to $1.32 in January 1980, before plunging to 65 cents in 1984. It had some spectacular intervening rallies, notably when Asian traders cornered the market briefly in 1988, driving it all the way to $1.60, but it then re-entered its bear market, reaching final bottom at the time of 9/11—at 60 cents, where it had all begun. In inflation-adjusted terms, of course, copper was back to 1950s levels.)

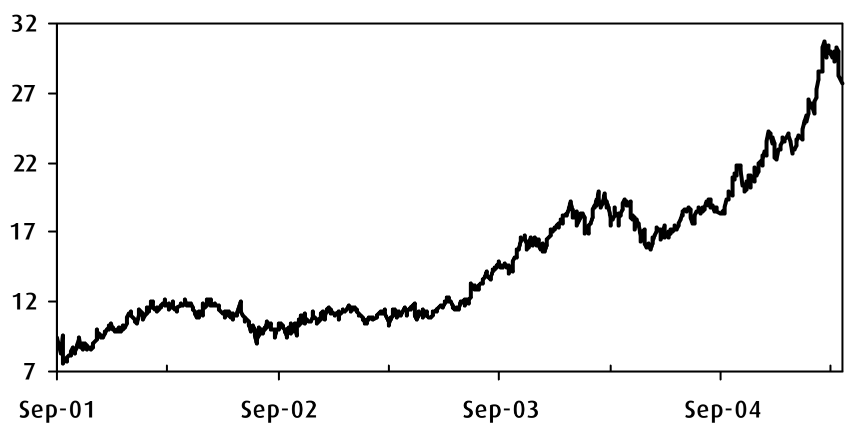
When your company produces a product that gives you a decent return on capital only two years in five, you learn to husband your resources in the good times. It's called survival. Opening new mines had, by the 1990s, become a process in which long-suffering stockholders financed management's "testosterone-driven urges to open bigger mines than their competition." (That is a scrubbed quote from remarks made to me in 2002 at Ayers Rock in Australia by the recently-retired head of Rio Tinto's Australian operations.) It took nearly two decades for investors to learn that this process of paying up in order to open a series of Pandora's Boxes was a one-way ticket to capital destruction. (Even today, after huge rallies, the "Diversified Metals and Mining" category of the S&P 500, which was a well-recognized and well-followed group 17 years ago, is just one-tenth of one percent of the Index weight.)

"...this process of paying up in order to open a series of Pandora's Boxes was a one-way ticket to capital destruction."

Those companies who survived the Triple Waterfall Crash of the base metals industry did so by resisting the temptation to assume that "it's different this time," and take on debt at the top of the metal market. Chip Goodyear, CEO of the biggest base metal miner, BHP Billiton, has for years enunciated the principle that all metals prices must eventually fall back to recession lows, so his company would not hang on to low-grade properties that were profitable only during the good years.

They've been good years for Goodyear. But he has just announced that it is different this time.

BHP Billiton
September 11, 2001 - March 2005



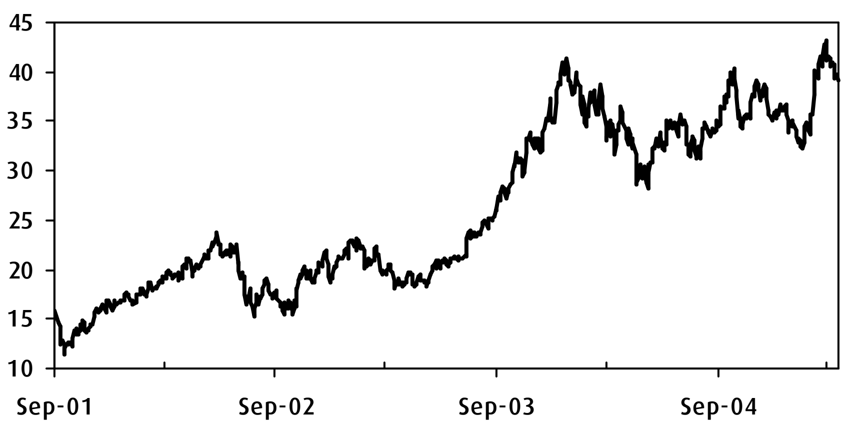
In justifying his costly takeover bid for the big Australian company, WMC, Mr. Goodyear explained that this time there are two overlapping cycles: the normal metal cycle, driven by economic activity within the OECD, and a longer cycle, based on the new middle class of China and India.

"...there are two overlapping cycles: the normal metal cycle, driven by economic activity within the OECD, and a longer cycle, based on the new middle class of China and India."

Within two days of this Damascene Conversion, Derek Pannell of Noranda announced that his company was no longer interested in selling itself to China Minmetals, because of this new, longer cycle based on China and India.

Noranda
September 11, 2001 - March 2005

Inco
September 11, 2001 - March 2005



These pronouncements came less than two weeks after Scott Hand, CEO of Inco had told the attendees at the BMO Nesbitt Burns Global Resources Conference that his company was bringing on two major new mines over the next two years, and he did not believe they would come on stream at a time of collapsed nickel prices.

That's three of the smartest people in the world's mining industry who believe that the pattern of previous decades is no longer a sure-fire formula for failure.

"...the pattern of previous decades is no longer a sure-fire formula for failure."

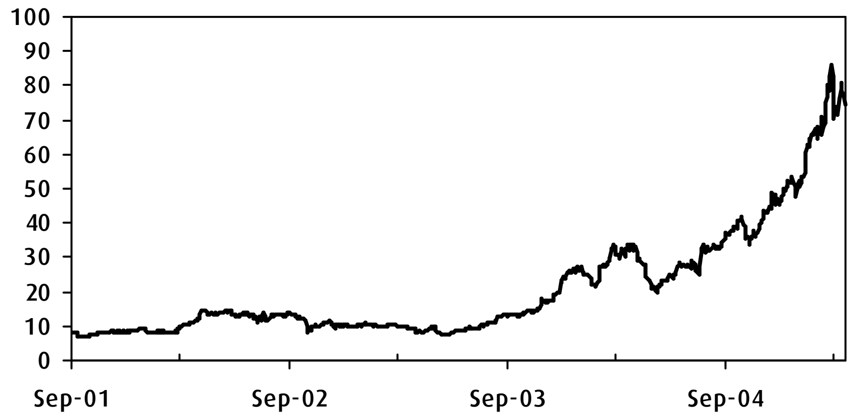
Skeptics, including the top managements of some other big companies, shake their heads. They warn investors to use sharply lower metals prices in evaluating mining companies. The management of Phelps Dodge insists on using 85 cent copper in its long-range forecasting. Those few people left on the Street who follow the mines are more generous: they use $1.10.

Two years ago, at the Prospectors and Developers Association Convention in Toronto, a senior officer of a major mining company dismissed my claim that the building of homes and cars for the new middle class of China and India would mean a cycle lasting into the next decade, saying, "I'd love to believe you, but I just want my company to be there four years from now, when I'm due to get my pension." His stock has more than quadrupled since then. The insider selling data in the months after our conversation showed that management took early opportunities to sell. They could have been very rich had they waited, but they had been through too much. That conversation was the basis for the maxim I've been telling investors ever since: "The best investment opportunities come from an asset class where those who know it best love it least, because they've been disappointed most."

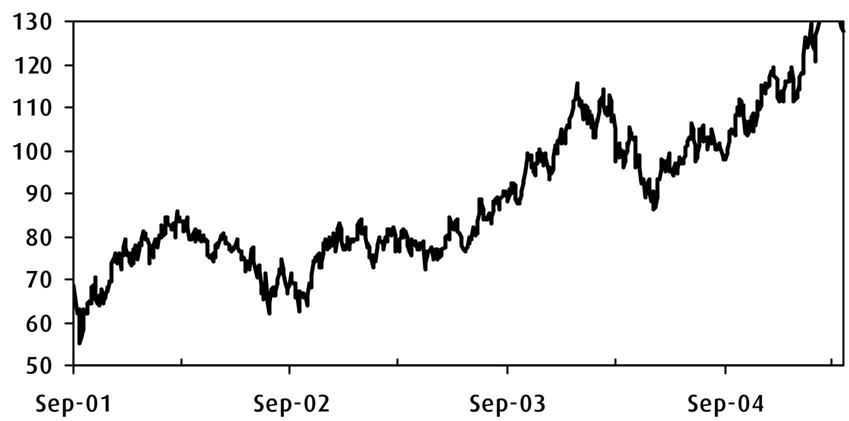
Two of his colleagues, who were in attendance at this year's Resources Conference, walked out in disgust during my keynote speech, when I talked of a long cycle.

Some other charts showing why the doubters think we're at a top for the metals.

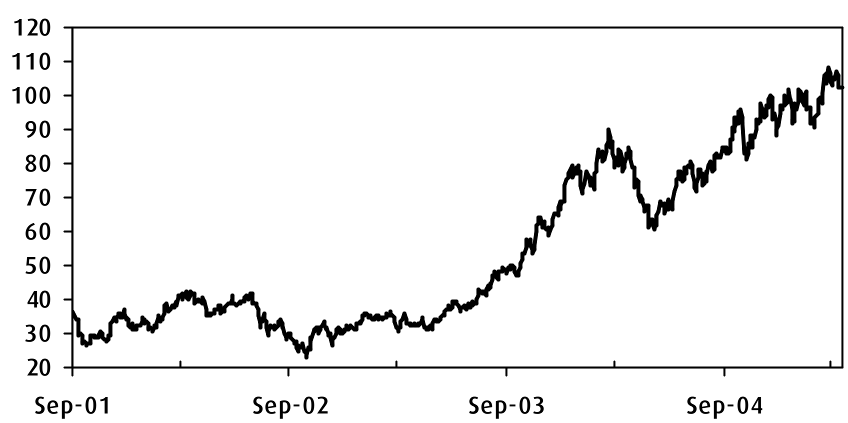
Cleveland Cliffs
September 11, 2001 - March 2005



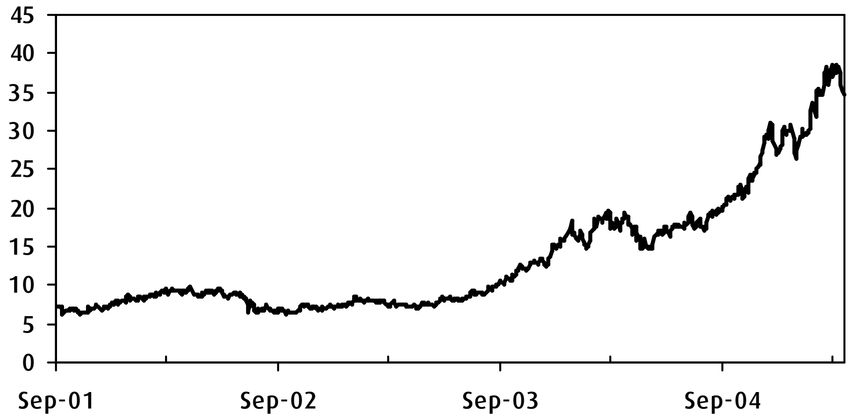
Rio Tinto
September 11, 2001 - March 2005



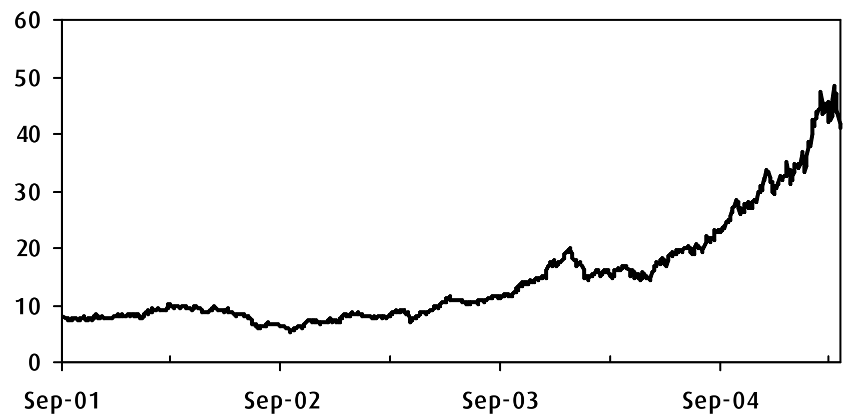
Phelps Dodge
September 11, 2001 - March 2005



Teck-Cominco (TSX)
September 11, 2001 - March 2005



Cameco
September 11, 2001 - March 2005



"...the most important new trend of our time was the emergence of a new middle class in China and India."

With the OECD economies weakening under the weight of oil and rising interest rates, these stocks could be very vulnerable if the companies were relying on metal sales only to the advanced industrial nations, as has been the case for decades.

Basic Points has for more than two years argued that what future historians will say was the most important new trend of our time was the emergence of a new middle class in China and India. Each new middle class dwelling includes indoor plumbing, electricity, and basic appliances—and a significant number of all members of this new class will own cars. Assuming compounded GDP growth of 6-8% in those countries whose combined population is 2.3 billion, there could be more than 300 million new middle class inhabitants by

2015. That is something on the order of four times the size of the new middle class formed in North America, Europe and Japan between 1948 and 1963—the time of the greatest mining boom in history.

"Their economies have evolved very far and very fast, but they have not been stress-tested by a severe global downturn."

In the case of China, annual percentage increases in consumption of the key industrial metals since 2001 have been approximately three times the announced growth in GDP. That powerful growth has slashed inventories worldwide to the lowest levels seen in many, many years.

How soon will the metals peak?

Each day brings news that the OECD economies are slowing down. That means the top for the OECD metal cycle may be near.

Can the second cycle—Asia's middle class—remain robust if exports to the OECD countries stop growing?

We may find out soon.

An optimist would say that the pattern of annual metal consumption growth displayed by Taiwan and South Korea as they moved from subsistence to middle-class economies will repeat itself in China and India. Metal demand will not collapse when recessions hit the OECD, because of the continued growth of the middle class in a process described by Jane Jacobs in her landmark book, *Cities and the Wealth of Nations.*

A pessimist would say that these economies are utterly dependent on selling their output to the OECD countries, and they'll be devastated when recessions hit North America and Europe.

A realist would say that the next recession will be the first since China's and India's combined share of consumption of metals and energy was decisive for global commodity prices. Their economies have evolved very far and very fast, but they have not been stress-tested by a severe global downturn. So how can anyone be sure how they will respond? As Chou En-Lai said, when asked how the French Revolution had influenced Chinese history, "It's too early to tell."

What is clear is that these economies' share of global GDP will continue to grow, and their share of global resources will grow even faster. Whenever the next global recovery comes, their appetite for metals will be even bigger than today—and the available supply of resources will not have kept pace.

Today, the world is experiencing a scarcity of metals that restores pricing power for an industry that has known two decades of disappointment.

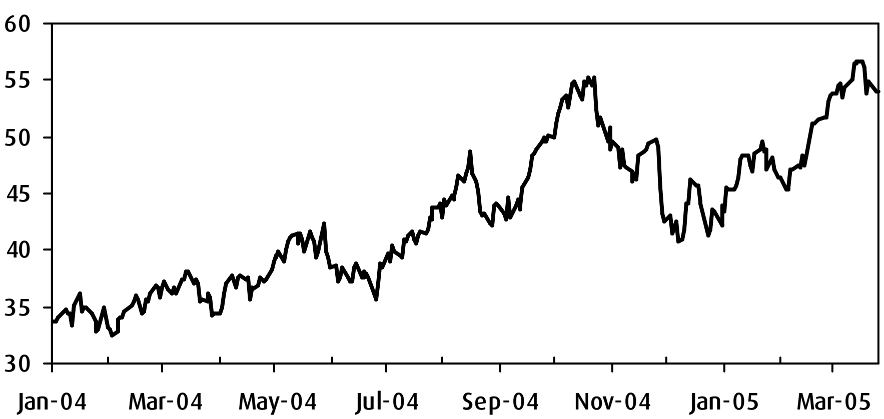
Tomorrow, the world will be experiencing a severe and prolonged shortage of metals that will be one of the biggest challenges China and India will face as they rush forward.

"What is the peak for oil?

It depends on which peak you mean."

Oil: the Bad News/Good News Story

Crude Oil
January 2004 - March 2005



What is the peak for oil?

It depends on which peak you mean.

Hubbert's Peak is the peak production level for any conventional oil reservoir, after which it enters inexorable decline.

That peak had been reached by most of the world's major producing fields as the Third Millennium dawned. New reservoirs join that list of the slowly senescent decliners each year. Perhaps the biggest oil story of 2004 came when Saudi Arabia announced that it was

“Isn't waterflooding petroleum Viagra for aging wells?”

releasing an extra 500,000 barrels/day last summer when oil (as measured by West Texas Intermediate) first reached $50 a barrel. They also announced plans to bring on 5 million b/d by 2012. This was a Page One story that produced many calls and emails from nervous clients wondering whether I would recommend profit-taking in oil stocks "now that the Street's view of vast oil oversupply has been confirmed."

I demurred. It was obvious that we were now at or near OPEC's peak production level, with global demand still rising, so I thought it best to await developments. When they came, they were in a Page 16 story with the actual details of the Saudis' petrogift to an oilshocked world. Page One readers surely assumed this first flow would be a half-million barrels daily of the benchmark Saudi Light, the high-end product that any oil refinery can process.

Instead of the light we got the dark: the new oil was (and is) heavy, sulphurous oil that only a few refineries had the spare capacity to use.

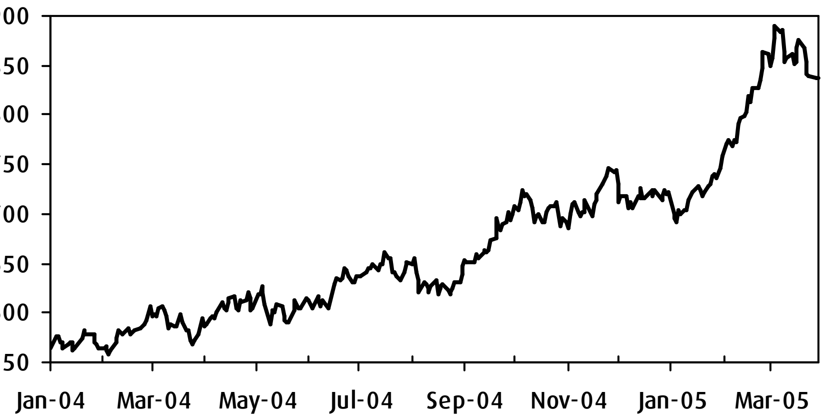
What about those 5 million b/d of new production by 2012? It turned out that only 2.5 million barrels would be net additions to Saudi output: declines from existing fields will slash production by 2.5 million b/d.

As if that weren't bad enough news for consumers, the Saudis claim they need at least $32 a barrel to justify this new production, because it requires waterflooding. Desalinating water from the Gulf and pumping it out to the desert, and then pumping it down into oilfields, is expensive.

Waterflooding on newborn Saudi wells? Isn't waterflooding petroleum Viagra for aging wells?

As usual, the Page 16 story turned out to be the one that made money for investors. I was able to recommend that clients add to their oil portfolios, not sell. That recommendation has worked well.

Amex Stock Exchange Oil Index
January 2004 - March 2005



"...Hubbert's Peak has arrived in Saudi Arabia."

Why?

Because the combination of the news that there's no new Saudi Light coming on stream for the next seven years plus the 27% projected decline from existing fields means Hubbert's Peak has arrived in Saudi Arabia. The Kingdom's decline rate will be among the world's fastest as this decade wanes. Most importantly, Hubbert's Peak must have arrived for Ghawar, the world's biggest oilfield, and Wall Street's most-cited reason for assuring us month after month that oil prices would plunge because there were so many billions of barrels of readily-available crude overhanging the market.

The Street's perception was a tad outdated: OPEC had 15 million b/d of excess capacity in 1986 when the Saudis decided to rein in OPEC cheaters and head off further development of major projects abroad, including the North Sea and the Alberta oil sands. By 2002, OPEC's unused capacity was down to the one million b/d range, which is, effectively, too tiny to give the cartel the power to set prices.

The grim news from Ghawar has been replicated in the world's #2 field, Mexico's Canterell. Its production entered decline last year, and the Pemex people say there's nothing much they can do to halt its decline. The North Sea had a bad year, with significant production declines for both Norway and the UK. Declines from existing fields will be temporarily offset as a few new fields, such as Buzzard, come on stream later in this decade, but the pattern is clear: North Sea wells age faster than the hardy Scots whose prosperity is so dependent on them. (Aging has the reverse effect on the value of the other well-known liquid associated with that part of the world, so Scotland can be said to be, to a minor extent, hedged.)

OPEC will regain that power within a few years as production declines and rising oil demand give its eleven members greater power than ever.

"OPEC will regain that power within a few years as production declines and rising oil demand give its eleven members greater power than ever."

The International Energy Agency, having failed to since 2001 to predict the runup in oil prices, has, it would seem, tried to compensate recently by issuing reports that tend to the lugubrious. In its continuing attempts to justify its failure to alert the world to the risk of $50 oil, it points out that the increase in global oil demand last year was the greatest since 1976. Apparently, all those years of improving automobile efficiency, insulating homes and buildings, and wearing sweaters, are behind us, and from here on, energy demand can only be constrained by runaway prices. The IEA also noted recently that an increasing share of non-OPEC production will be coming from smaller, higher-cost oilfields.

With OPEC's excess capacity apparently tapped out, oil consumers have lost their security blanket against petrochills, and oil traders and speculators have the largest-scale commodity free market the world has ever known.

Free markets are like free political systems: they can be messy and unpredictable, little people can get hurt, the powerfully greedy can be powerfully rewarded, and conspiracy theories can run rampant—and can sometimes be right.

Even today, some Iraqi Sunnis yearn for the return of Saddamism, with its somewhat predictable system of order enforced by the mass murder and torture of Shiites, Kurds, and the occasional dissident Sunni, all operating under the umbrella of protection supplied by Continental Europe and the international Left. Similarly, there are some—on both Wall Street and Main Street—who feel nostalgic for the days when OPEC kept oil prices predictable—and predictably cheap.

The mainstream Western media were routinely more critical of OPEC than of Saddam, choosing to characterize OPEC as a greedy cartel that kept prices too high because of the need to finance luxuriant lives for Arab elites, and tolerant of Saddam as a typical Arab strongman. (Their willingness to ignore Saddam's sins may have been assisted by CNN's coverage from Baghdad, which gave him a pass in return for keeping its pass to house their correspondent in Iraq. CNN's solicitude for Saddam's feelings extended to favorable coverage of the Iraq election in which he got his usual Ivory Soap percentage level of purity at the polls.) The media had it all wrong: OPEC's pricing umbrella was actually beneficent, because it prevented the world's oil industry from collapsing during the years when oil stocks were in a two-decade Triple Waterfall decline. (In 1982, oils were 28.5% of the weight of the S&P; two decades later, their weight was less than 5%. Had OPEC kept oil prices at $12 a barrel or less, that weight would have been under 2%, because most of the world's oil companies would have gone broke, and those that survived would have virtually eliminated exploration spending. Had that happened, OPEC would rule the economic world, and oil would today be worth at least $100 a barrel.)

"Had that happened, OPEC would rule the economic world..."

With the federal election campaign out of the way, some of the leading American media are taking a serious look at the possibility that oil shortages are here to stay and are not, as Michael Moore and his followers alleged, a plot between the Bush family, the Saudis, and Halliburton. On March 25th, the Op-Ed page of *The New York Times* published three essays on this subject, and all took the view that oil shortages are very real and very threatening. Most notably, Kenneth S. Deffeyes, a professor emeritus of geology at Princeton, and author of *Beyond Oil: The View from Hubbert's Peak*, stated that global oil production will peak this year or next, and then decline. He had been a colleague of Hubbert's at Shell during the 1950s. As far as I know, this is the first time that *The Times* has printed discussions of Hubbert's Peak on the Op-Ed page without printing scathing rebuttals.

The world is truly changing.

Pricing Oil Stocks

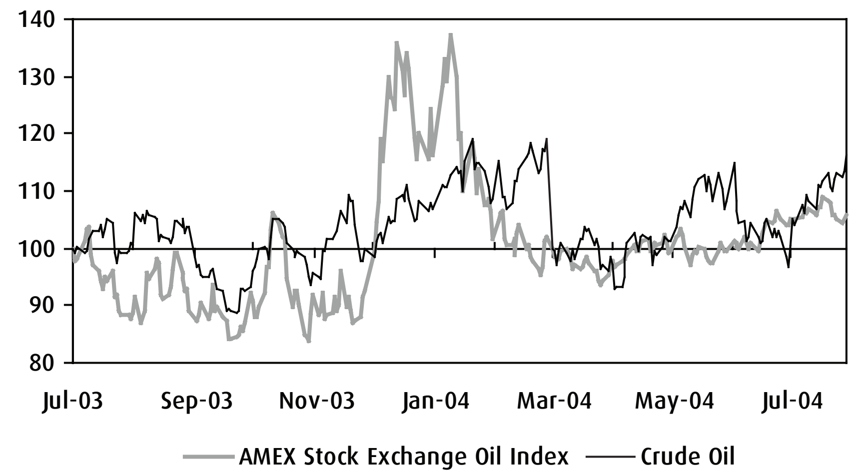
What has been bad news for both Street forecasters and consumers has been good news for oil stocks.

"...Wall Street's sustained prediction of an oil price plunge was delusionary."

Although *Basic Points* has been recommending strong overweighting in oil stocks for four years, I never predicted $55 oil. I simply maintained that Wall Street's sustained prediction of an oil price plunge (over 14 straight quarters) was delusionary.

As this chart shows, investors are buying US oil stocks, but they aren't bidding them up faster than crude oil: although the companies' profit margins are obviously climbing faster than oil prices, the stocks track crude very closely:

Relative Strength of Crude Oil vs XOI Index
March 2004 - March 2005



Investors are clearly unwilling to pay up for the soaring upstream profits of the oil industry.

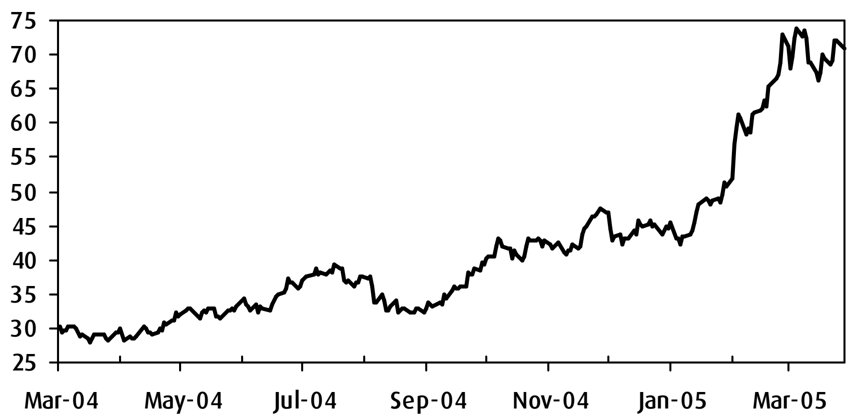
However, the powerful performance of oil stocks has meant that Street strategists have a new argument to back the recommendation they've been making most of the time for three years: sell overpriced oil stocks and buy cheap tech stocks. Since these oil stocks are 'way up from the prices at which the Street recommended selling them, then they must be the new bubble.

Downstream Profits Also Boom

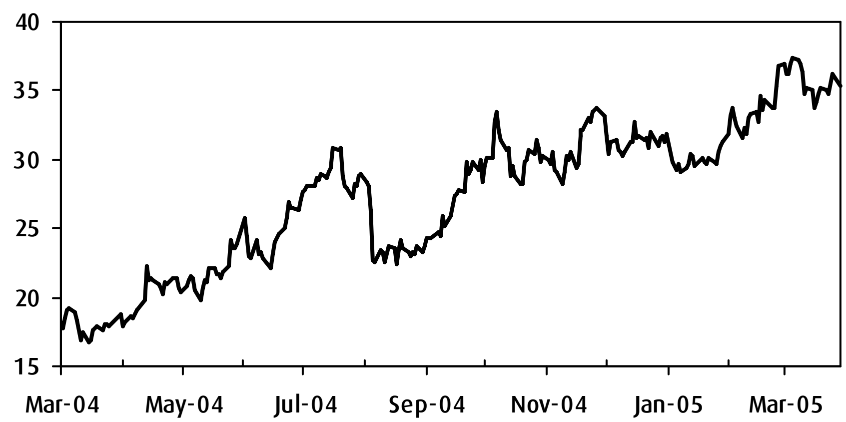
Nor are investors willing to pay up for the record level of downstream profits of the oil industry, a reality that may not appear to a casual observer of the performance of the "pure" refiners:

"This year, the Street...expects to be vindicated..."

Valero
March 2004 - March 2005



Tesoro
March 2004 - March 2005



Valero's EPS were $.42 in 2002, $2.55 in 2003, $6.52 in 2004, and are expected to be flat this year by the same analysts who hugely underestimated its earnings last year. Tesoro lost $2.10 per share in 2002, made $1.18 in 2003 and $4.79 last year. This year, the Street, which hugely underestimated its earnings last year, expects to be vindicated, seeing a decline to $2.31.

> "...there were few takers for the SaudiSourStuff."

Refinery earnings are notoriously erratic, so pure refiners always sell at low p/es. How should the major integrated companies be valued? Those companies, such as Exxon Mobil and Conoco Phillips, that had the free capacity to refine heavy crude earned spectacular profits when the Saudis sold their 500,000 b/d to a thirsty world. In the US where a new refinery hasn't been built since 1978, there were few takers for the SaudiSourStuff. But those that had the capacity made out big time, as gasoline, heating oil and jet fuel were priced off the crack spread from West Texas Intermediate, Saudi Light and Brent. The SaudiSourStuff sold at a big discount, but the discount proved to be far larger than the refiners' operating spread. So it was the best of all possible income streams for some Big Oil companies: they made record profits up and down.

It looks as if OPEC oil production increases in coming years will be heavily tilted toward heavy, sour oil. Surely the Saudis and others would have produced light crude when the market was going crazy for it. Although OPEC is suggesting it will expand output by another 500,000 b/d, there is no indication that it will be high quality product.

What are the chances of getting US permits to build the increased refinery capacity needed to convert low-grade crude into the 16 grades of designer gasolines?

It's too bad for the oil industry that they aren't National Football League franchises, worth more than $500 million each, asking for prime land close to downtown, plus hundreds of millions of dollars of taxpayer money to build football stadiums. That kind of permit is readily obtainable. The environmentalists may disdain it, but they won't tie it up ten years in litigation.

Oddly enough, the near-impossibility of getting approval to build a new refinery means that stockholders in oil companies benefit: they own oil in the ground that keeps rising in value, and they own refineries whose value keeps rising because no new competition can be built.

Latest word is that some OPEC producers have expressed eagerness to build the refineries to process their heavy crude. Although that is good news in terms of the availability of oil and refined products, it's bad news for the trade balances of the US and the other advanced industrial nations. High refining profits and good refining jobs will move abroad, adding to the Current Account deficits.

The explosion at Houston's huge BP Amoco refinery this week finally gives the NIMBY crowd a logical reason for opposing refinery construction. Not only are they noisy, air-polluting factories that attract endless flows of trucks, they can be dangerous. The death toll is said to be 15, with 70 injuries. This was one of the three biggest refineries in the US, producing 3% of the nation's refined product. If that much horror can come from a mere industrial accident, what could a terrorist do?

On a short time horizon, oil stocks and oil probably should trade together. But what if the time isn't a month, a year, or a decade?

One reason the Street and the media remain negative on oil profits is that $50 oil is hardly good news for the global economy. The extent of damage inflicted is a subject of constant debate among the economists. Not so long ago, many of them were complaining about the supposedly deleterious effects of the rise of oil prices from $20 to $35. The IMF's latest report is almost unbelievably reassuring, advising that the world could live quite well with $80 oil. (But, then, look at some of the countries the IMF has lent money to.)

"...$50 oil is hardly good news for the global economy."

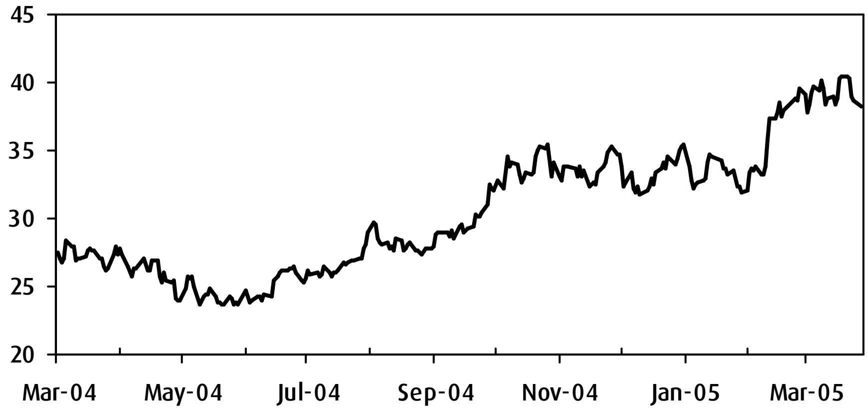
The US and Chinese are among the world's economies most exposed to soaring oil prices, not just because they are the world's two biggest consumers. Europeans and some other economies have been somewhat cushioned because their currencies' strengths against the dollar meant that the runup from $28 to the $40 range was largely offset by currency gains. But the dollar has now entered one of its intervening periods of strength, because of rising US interest rates and disappointing economic and political news from Europe and Japan. That means that most of the global economy is now exposed to oil price increases.

We may have entered a period when oil and base metals could be inversely correlated, after two years in which their prices rose together. If oil prices simultaneously fuel inflation fears, thereby triggering major interest rate increases, and also slow economic growth by cutting consumers' discretionary spending, then higher oil could mean lower metal prices.

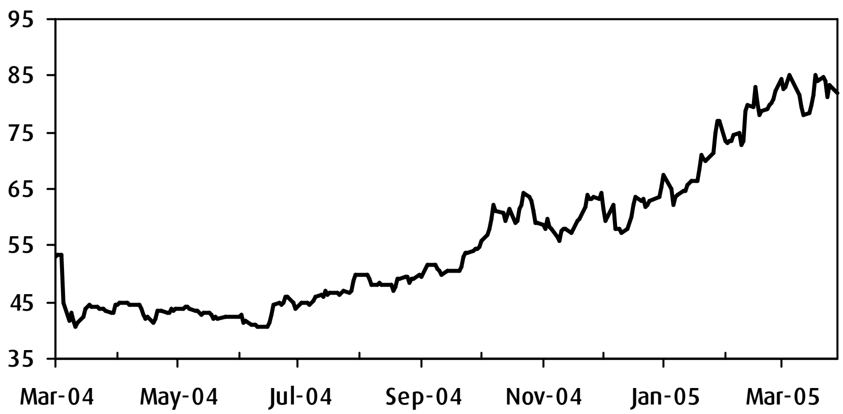
Given the market capitalization of the oil industry compared to the mining industry, the "winners" from this potential tradeoff would be much bigger than the "losers." It is too early to make that an investment recommendation, but it's worth watching. In previous economic cycles, oil price spikes caused recessions, which slashed metals prices. To date, energy and metals have prospered together, but this will not always be the case.

The Sands of Time

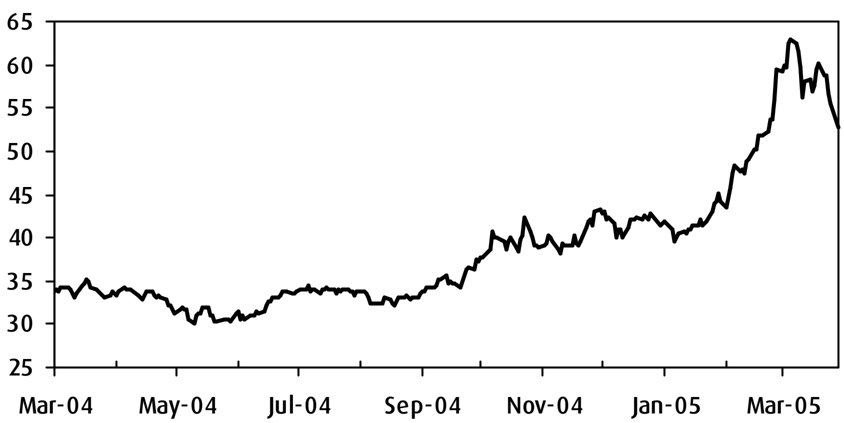
Suncor (NYSE)
March 2004 - March 2005



Canadian Oil Sands Trust
March 2004 - March 2005



Western Oil Sands
March 2004 - March 2005



Basic Points

The Alberta oil sands companies aren't like other oil companies.

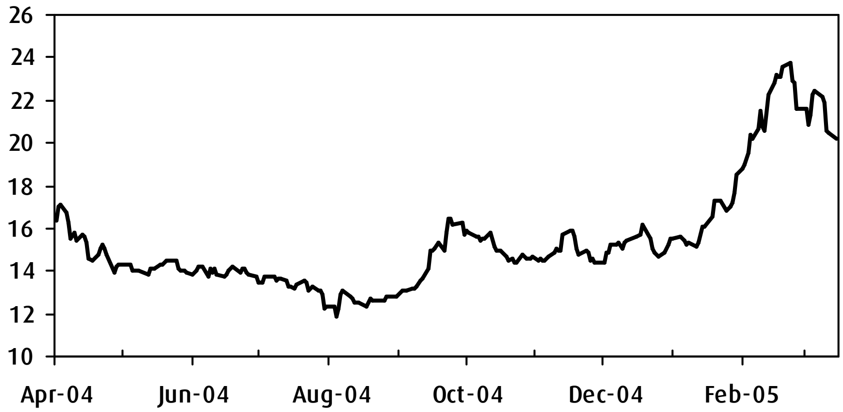
First, they don't drill for oil and pump it in liquid form from reservoirs. They mine it, or they melt it. If they mine it, they must dig up and process roughly two metric tonnes of sand to produce one barrel of oil. If they melt it, in what is called in situ production, they must inject enormous quantities of high-pressure steam produced from natural gas-fired boilers into the sands. (According to one company, it takes 1 mcf of gas to produce a barrel; another source says 15 mcf are consumed for every 100 bbl of produced, a ratio that troubles some environmentalists, who ask why clean fuel is used to produce dirty fuel. You can't please everyone.)

"The Alberta oil sands companies aren't like other oil companies."

Second, their reserves—proven, probable and possible—date to the late years of this century. Or, to express this duration in other terms, these companies will be producing oil from the sands many decades after most social security schemes in the OECD have gone broke, or slashed benefits, or have swallowed up the economies that spawned them, the way General Motors' pension and health plans have engorged the automaker.

Third, their operating costs are subject to wide variations, unlike the relatively predictable costs experienced by operators of mature conventional oilfields. These are complex mining and chemical plant operations. The pioneers—Suncor and Syncrude—struggled for decades to produce oil consistently at a cash cost of less than $20 a barrel. They have long since driven wellhead costs far below that level, but they remain subject to the vicissitudes of brutal winter weather, production outages from fires and mechanical failures, natural gas prices, steel prices, labor rates in a market where skilled union workers are scarce and expensive, provincial royalties—and the rising value of the Canadian dollar. However, new technologies keep coming to Northern Alberta, with the latest being a process from Opti Canada in a joint venture with Nexen. If it works as promised, wellhead costs will drop to single digits and stay there. (These could be called technology stocks, except that they produce an absolutely necessary product which is in short supply worldwide, they have honest accounting, low p/e ratios, their top execs didn't become instant billionaires by selling out before a stock price collapse, and latte liberals are about as numerous as Whooping Cranes on their vast operations.)

Opti Canada
April 2004 - March 2005



"Although all oilsands operators were hurt by this Reverse Cinderellaism, a conspicuous loser was Shell Canada."

What the oil sands companies produce is called bitumen, a highly viscous combination of hydrocarbons and sulphur which will not flow in its natural state. They add diluents, which are light hydrocarbons, so the stew can be moved through pipelines to upgraders and refineries. The bad news from Fort McMurray last New Year's Eve was that the price of bitumen and the heavy crude that it produces had plunged to uneconomic levels, whereas diluent prices had soared.

According to Husky's Annual Report, the effect on heavy crude was that it was trading at $12.27 a barrel, against an average price last year of $28.75 at a time its synthetic crude, which is upgraded heavy oil, was trading "just under $50 a barrel." That meant that 39% of Husky's total reserves were uneconomic, in the eyes of the SEC. "Notwithstanding the economics at December 31, 2004, on January 10, 2005, the price of Lloydminster heavy crude oil had returned to $21.56 per barrel, a price sufficient to return 98 % of the reserves subtracted by negative revision to the proved reserve category."

Although all oilsands operators were hurt by this Reverse Cinderellaism, a conspicuous loser was Shell Canada. Its parent company had to delete hundreds of millions of barrels of its offspring's stated reserves from its SEC filing—the latest (and, shareholders, fervently hope, the last) ShellShock.

Big Oil has responded with a brief to the SEC prepared by Cambridge Research Associates that asks the Commission to use wider-range data: reserves that were highly profitable shouldn't be immediately worthless. It also asks some review of the SEC's approach to distinguishing proved from probable reserves.

This legal and accounting technicality may have been a mere abstraction two years ago, when Big Oil was beginning to unzip its wallets to respond to oil's move through $32, amid unexpectedly strong demand from China, unanticipated strength in demand from the rest of the world, unanticipated problems for some OPEC members in meeting their production quotas, and the anticipated effects of the war in Iraq. For the first time since the brief spike caused by the first Iraq war, Big Oil was worrying about the world's supply of oil, and about its own Reserve Life Indices.

"Big Oil has a very big problem."

Not to worry, said the spokesmen for Big Oil. We're ready to make big deals with Russia and Venezuela, which mean we'll have lots of production from sources outside the Gulf States. Lord Browne of BP reiterated his view that oil prices could fall back to $20 a barrel.

As this publication has been documenting, Big Oil's deals with Russia and Venezuela have gone from low-cost and low-risk to high-cost and high-risk. So, although the industry has record cash flows and record levels of cash, it has few prospective drilling targets that could lead to major new reserves in politically secure areas of the world. (It didn't help that the Paris-based International Energy Agency, a subsidiary of the OECD, kept underestimating global oil demand; last fall the IEA issued a mea culpa about its sustained failure to project China's surging demand: China wasn't an OECD member, they said, so its rapid move from being an unimportant consumer to status as the world's #2 oil buyer wasn't monitored closely. Living an expense-account life in Paris is a tough, stressful job, but somebody has to do it, so we shouldn't be too critical of those botching *boulevardiers*.)

Big Oil has a very big problem.

It's the world's best hope against total reliance on OPEC, and it has the lion's share of the resources needed to find and develop the hydrocarbon resources the world needs.

How is it responding to its twin embarrassments—an embarrassment of riches and an embarrassingly low Reserve Life Index?

"It's probably no coincidence that international media have discovered the Alberta oil sands in recent weeks."

To date, it has talked of reducing its club membership by one: Unocal is in play. First it was CNOOC of China that said it was angling to buy it; now one or two long-established club members have said they're thinking of bidding.

But whoever gets Unocal, Big Oil's problems will remain. It's probably no coincidence that international media have discovered the Alberta oil sands in recent weeks. Hundreds of billions of barrels of recoverable oil in the most politically secure area of a politically secure country at a time of $50 oil are worth press coverage, even if it means flying to Fort McMurray in winter, rather than to Caracas or Abu Dhabi.

Big Oil's chances of making strategic deals on prospective properties outside the Gulf are complicated in this cycle by the new global reach of Chinese and Indian oil companies. The fast-emerging rivalry for mineral resources between those two fast-growing economies is already roiling the planning of the established companies. These new players are able to get around boycotts imposed by Western governments or pressure groups against such oil-rich nations as Iran and Sudan. After listing major deals made by the Chinese or Indians with those pariahs, the FT notes, "Hardly a week goes by without Indian or Chinese companies announcing smaller energy accords from Ecuador to Gabon." It notes that India's petroleum minister predicts that India's oil import dependency will rise from 70% of consumption to 85% in 15 years. (Another study asserts that China's import dependency by then will be 80%; it's only a few years since China was a net exporter.)

The whole world knows about China's soaring demand for oil, and about its determination to make title claims to oil-bearing properties in disputed regions. What room will there be in the future for Big Oil to make the kind of deals with weak governments and weak companies for important oil and gas properties that have been so important throughout its history?

I remain of the view that, once the SEC issues are resolved, Big Oil should get into those big Alberta reserves in a big way. Those record cash hoards are reducing the companies' Return on Capital Employed—a key metric for comparing the effectiveness of corporate managements.

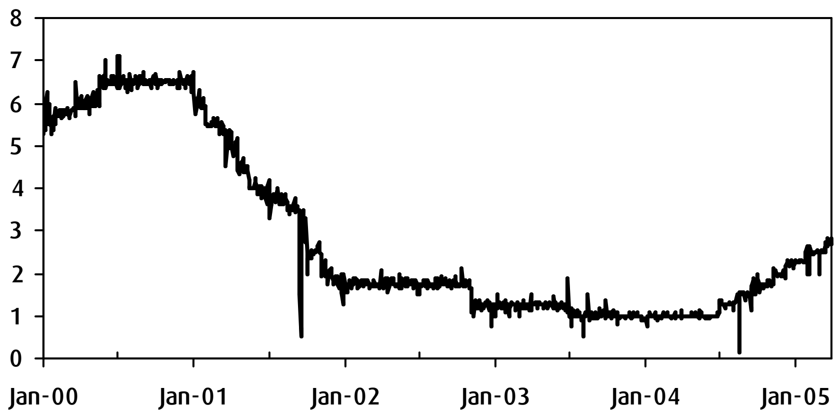
Meanwhile, the clock ticks on the time left in their Reserve Life Indices. Since this Millennium began, Big Oil has failed to replace its output. The entire US natural gas production industry has failed to replace its output for decades.

"...the clock ticks on the time left in their Reserve Life Indices."

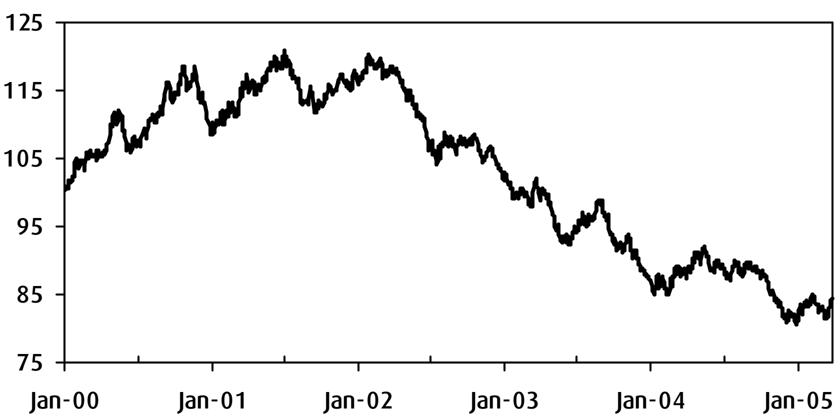
It's all about Time.

Little Footprints of Fear

Fed Funds Rate
January 2000 - March 2005

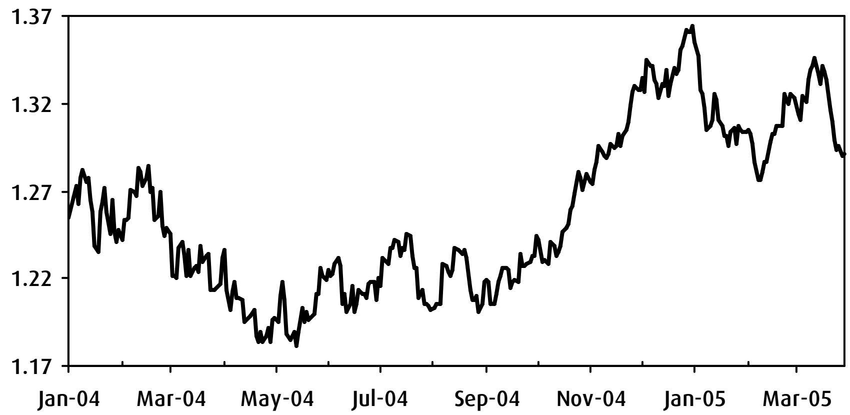


US Dollar Index
January 2000 - March 2005

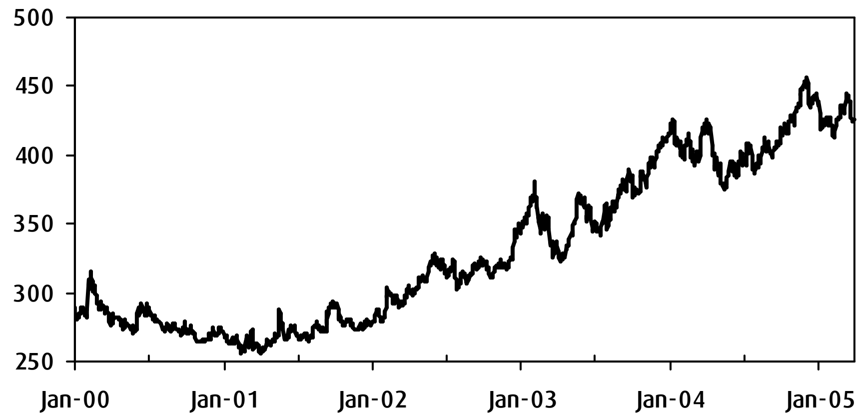


"There's another clock ticking: it has been nearly seven years since the last full-blown financial crisis."

Euro
January 2000 - March 2005



Gold
January 2000 - March 2005



There's another clock ticking: it has been nearly seven years since the last full-blown financial crisis.

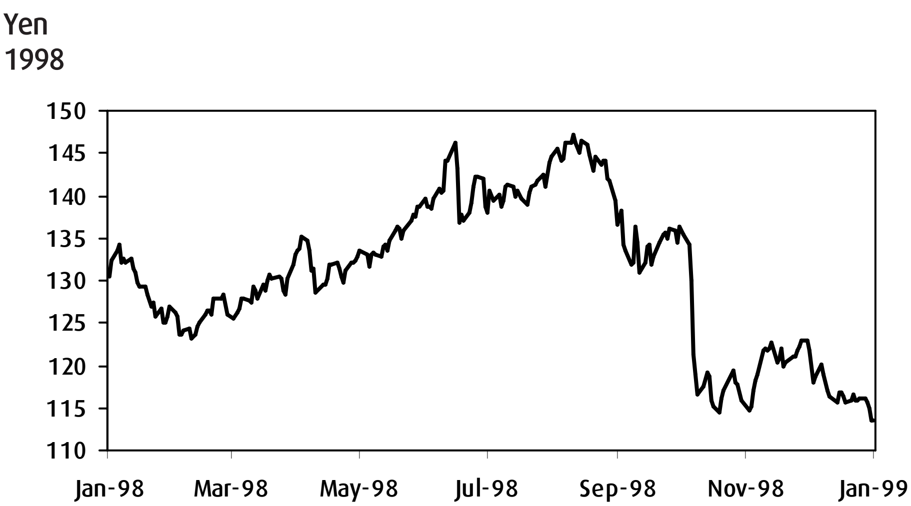
That was the collapse of Long-Term Capital Management, which followed Russia's default, which followed the string of Asian devaluations that began the day Hong Kong was absorbed into the maw of Mainland China.

It came at a time that global banks were trying to restructure the external loans for Indonesia. Although few commentators noted it at the time, it would be the first global financial crisis in which China became a major participant, and was the decisive problem-solver. Before it was over, Japan had been forced to revalue the yen upward in its largest one-day climb in history. China had made that a condition of its willingness to hold the renminbi's value. It was threatening to join the other Asians in devaluation, and if it had proceeded, a new, and more horrifying, string of global devaluations would have ensued.

Japan had devalued the yen in a stealth devaluation that maintained its competitiveness against the smaller Asian tigers. China told the leaders of the global bank syndicate that it would punish Japan unless Japan returned the yen back toward 120 to the dollar. Indonesia's bankers, facing a collapse of their borrower—and potentially of several other Asian borrowers—advised the Bank of Japan that unless it moved quickly, the crises of 1997 would look like mere blips.

"When it was able to force the Japanese to revalue upwards...China's prestige rose sharply."

Japan, seeing that China held the cards, revalued the yen upward *in a matter of hours*, setting the stage for the next Japanese recession.



By holding the renminbi's value even as every other Asian nation was devaluing, China acquired a leadership role that had been denied to it by memories of its invasion of India in 1962, and by American influence in the region through ASEAN. When it was able to force the Japanese to revalue upwards, thereby improving the competitive position of the other Asian economies, China's prestige rose sharply. It has been building on that reputation ever since. One reason it has held firm on the renminbi is that China maintained its currency's value amid regional crises, so it should thereby not be seen as capitulating to non-Asian pressure.

"Readers can doubtless supply their own financial Stephen King horrors to this list."

This summary of the last global financial crisis is by way of background to the next—whatever it should be, and whenever it should come. The 1987 crisis was almost entirely a dollar crisis, and it is unnecessary to remind readers of what happened on October 19th of that year. There had been an earlier crisis in 1984, but dramatic (and technically illegal) action by Paul Volcker prevented it from creating a global catastrophe. That near-miss came when the bank once located across the street from my office collapsed under the weight of a portfolio of bad loans (heavily petroleum-oriented: they didn't know about Triple Waterfalls).

That the Continental Illinois' collapse very nearly brought down the entire global financial system is a stirring story in itself, but not on this occasion.

What could produce a sudden rebirth of Fear?

Let me count the ways:

1. A major terrorist attack.
2. A spreading fear that General Motors will be forced into Chapter 11 to deal with its pension and health care liabilities.
3. A selloff in the US mortgage market, triggered by rising rates and fears for Fannie and Freddie.
4. A sudden breakdown in the dollar, triggered by a new runup in the trade deficit, leading to a cardiac event in the eurodollar market (a la 1987).
5. A runup in oil to $75.
6. A military crisis in the Taiwan Strait.
7. A bursting of the housing bubbles in the major coastal cities.
8. An overzealous Fed that tries a couple of fifty basis point tightenings at a time of negative money supply growth.

Readers can doubtless supply their own financial Stephen King horrors to this list.

My point is not that we are on the edge of an abyss. It is that, despite near-record levels of complacency in stock and bond markets (as measured by the VIX Index, the TED Spread, swap spreads and the spread between Aaa and Bbb bonds), the stock market is down year-to-date and the yield on the ten-year Treasury recently broke through the 4.5% barrier that had been the upper end of its trading range.

"Complacency...is not an enduring condition. It can either give way to euphoria or to Fear."

The Adjusted Monetary Base, my favorite liquidity measure, has been growing more slowly than nominal GDP for the past year, and now seems to be rolling over, as shown in the St. Louis Fed chart:

St. Louis Federal Reserve
Adjusted Monetary Base (averages of Daily Figures, Seasonally Adjusted)

Conclusion

Complacency, like other equilibria, is not an enduring condition. It can either give way to euphoria or to Fear.

Oddly enough, the slowing of the global economy could be a salutary condition for the Fear Factor. Rising interest rates and rising oil prices could do some of the Fed's work for it without Greenspan having to reprise the all-out tightening of 1994 that broke the back of the mortgage market, bankrupted Kidder Peabody, and very nearly derailed the economic recovery.

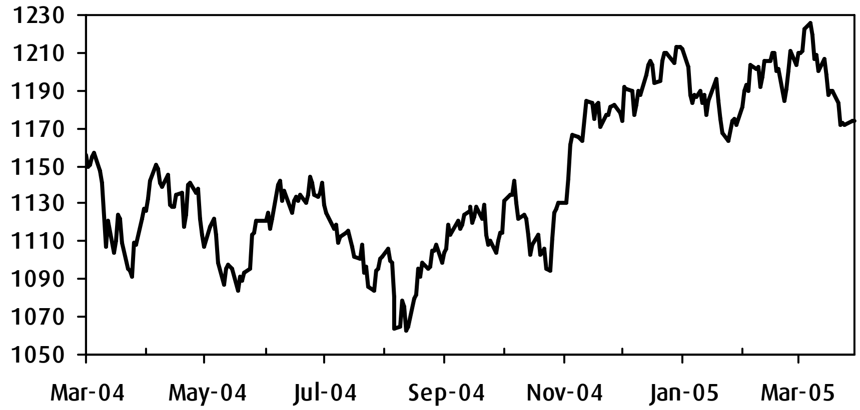
Nevertheless, the markets' complacency of winter is giving way as we enter the typically turbulent weather of spring.

If the Fed can get the fed funds rate to its desired neutrality (3.5% or so) without triggering a eurodollar crisis, then we can breathe easy.

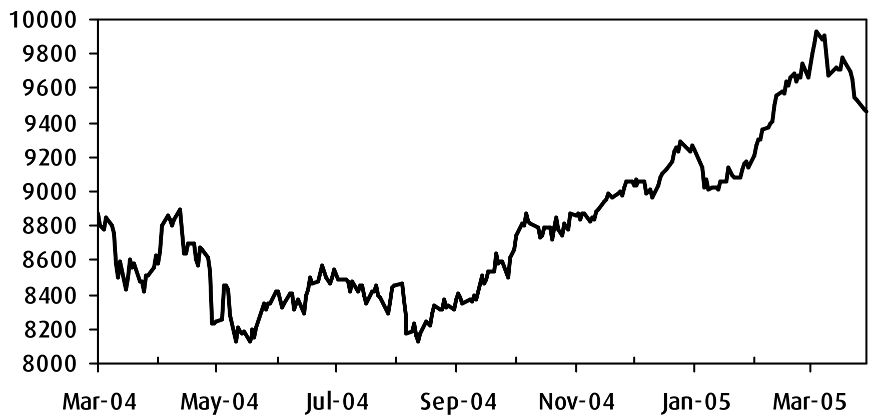
INVESTMENT ENVIRONMENT

"...when the falling asset class is outperforming, it means that there is too much liquidity, and unintelligent speculators are too prominent in the market."

S&P 500 Index
March 2004 - March 2005

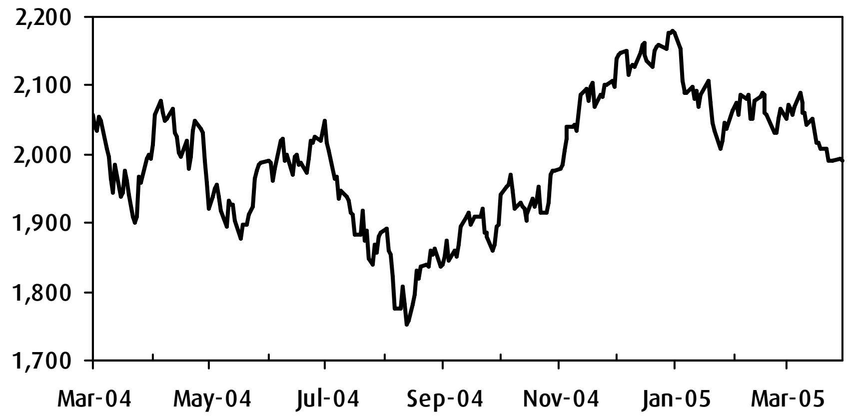


S&P/TSX Composite Index
March 2004 - March 2005



I reduced recommended equity exposure in September because the stock market rally was being led by Nasdaq. From studying Triple Waterfalls, I have learned that when the falling asset class is outperforming, it means that there is too much liquidity, and unintelligent speculators are too prominent in the market. All such periods of outperformance are doomed to be short, followed by nasty and brutish punishment for those who sought to win back some of their losses by getting back into the same game.

Nasdaq
March 2004 - March 2005

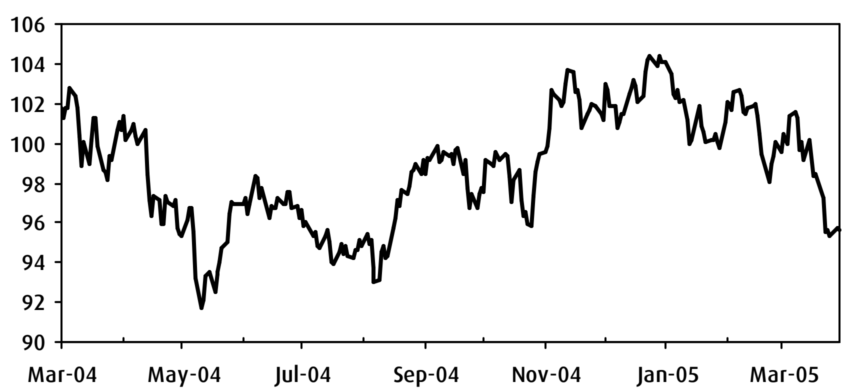


"...the stock market's two bookends are falling together."

Since yearend, Nasdaq has been leading US stocks down. Oil stocks joined in the descent in mid-March, so the stock market's two bookends are falling together. That suggests the correction has some distance to go. If this is just a correction, Nasdaq will continue to fall, but the Materials stocks will bottom out and lead the next rally.

The most worrisome aspect of this correction is the performance of financials, led by the banks.

Philadelphia Stock Exhange Banking Index
March 2004 - March 2005



One almost-never-broken rule of financial crises is that they come after a period of significant underperformance by financial stocks. I had been overweight the financials after 9/11, went neutral last fall, and am sufficiently concerned by developments within the financial system to go underweight now.

“Maybe we need to take a quick peek at another peak: housing markets—globally.”

Maybe we need to take a quick peek at another peak: housing markets—globally. The UK housing market, which had been the wonder of the housing world, is finally cooling out under sustained pressure from the Bank of England. Shanghai home prices are soaring, as are prices across the Pacific in San Francisco and Vancouver. To date, the only piqued people are those who sold too soon.

Each day in North America, one hears stories of people buying their third or fourth home "as investments." Living in Chicago, one sees signs of ebullience, but not of the mania one sees in Manhattan, Greenwich and Boston. Nevertheless, the swing away from 30-year fixed rate mortgages to floating rate mortgages, from healthy downpayments to zero downpayments, and from strict repayment schedules to interest-only loans tells us that something could go seriously wrong in housing if the Fed, awakened from its somnolence on that score, decides to attempt that most elegant and perilous of central bankerly maneuvers—pricking a bubble without bursting it.

With all the Street warnings about a commodity bubble, we hear few Street warnings about a housing bubble. Possible new aphorism: Greenwich people who live in 40,000 sq. ft. stone houses shouldn't throw stones—at stuff refined from stones.

It is time for the US economy to rest from its outperformance of the rest of the industrial world. The US economy has, once again, been doing the heavy lifting for the global economy—a feat achieved by daily ingestion of Fed stimulus and more than $2 billion of savings from abroad. With the Current Account deficit exceeding 6%, the US is overstretched. Unless some other economies step into the breach, global growth will slow significantly, and recession fears will reawaken.

INVESTMENT RECOMMENDATIONS

1. Reduce equity weightings in tactically-oriented portfolios toward the bottom of your target range.

2. Within the equities, underweight financials. Within that group emphasize the great dividend-paying stocks, such as Bank of America and the Canadian banks. Continue to underweight the Wall Street investment banks and those consumer credit lenders who emphasize subprime lending.

3. Reduce bond durations to slightly below benchmark levels. Underweight mortgage-backs and high yield.

4. Remain overweight the mines and oils. They have three vulnerabilities: Wall Street is eager for them to fall and will use its suasion to get holders to sell; everyone who owns them has big profits and may be eager to cash them against losses elsewhere; if investors perceive a serious slowdown in the global economy, many of them will want to underweight these "deep cyclicals."

   Their strength is that they are cheap relative to the market, and strategic buyers with deep pockets will be ready to pounce if shares of companies with long-duration reserves fall significantly. They are also the asset class that will have the best performance over the next 5-10 years.

5. Remain overweight the gold stocks. They have not been performing their usual role of trading up when the stock market goes down, because this market selloff coincides with a temporary rally in the dollar. Their value is that they reduce the portfolio's exposure to exogenous risk, and they are therefore a desirable asset as the markets rediscover risk.

6. Begin building cash reserves. If this is just a correction, you will have an opportunity to buy good stocks cheaper. If it is something worse, you will be pleased that you started the process early.

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Harris Nesbitt Corp. Disclosures

Company Name	Stock Ticker	Disclosures
Bank of America	BAC	
BP Amoco	BP	
BHP Billiton	BHP	
Cameco	CCJ	
Canadian Oil Sands	COS.UN	**4**
China Minmetals	-	
Cleveland-Cliffs	CLF	
Conoco Phillips	COP	
CNOOC of Canada	CEO	
Exxon Mobil	XOM	
Fannie Mae	FNM	
Freddie Mac	FRE	
General Motors	GM	
Halliburton	HAL	
Inco	N	**1**
Noranda	NRD	**1**
Opti Canada	OPC	
Pemex	-	
Phelps Dodge	PD	
Rio Tinto	RTP	
Shell Canada	SCUAF	
Suncor Energy	SU	**1**
Teck-Cominco	TCKAF	
Tesoro	TSO	
Valero	VLO	
Western Oil Sands	WTO	
WMC	WMC	

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