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A brief history of America's addiction to oil

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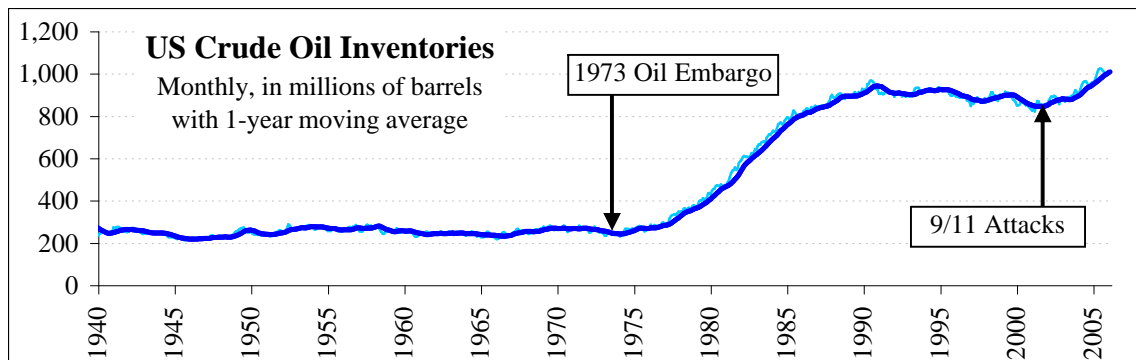
Every time oil prices pull back, the financial press repeats the misguided mantra that crude inventories are too high. The fact is, inventories are far from excessive. Rather, they reflect the strategic importance of oil and America's increasing dependence on foreign sources. Indeed, we believe that investors should expect crude oil inventories to continue rising along with prices. The higher inventories shield the economy from unexpected and uncontrollable disruptions in crude oil supply.

Oil inventories are strategic

As the chart below indicates, following the 1973 oil embargo, US crude oil inventories began rising steadily. Companies and the US Government correctly understood that maintaining larger inventories would help to avoid risks from further supply disruptions caused by OPEC. The increase in inventories continued for more than 16 years before stabilizing.

The attacks on September 11, 2001, triggered a similar change in perception – this time, the widespread recognition that inventories should be maintained to protect against supply disruptions resulting from terrorism or other political volatility. It is impossible to predict whether the current increasing trend of inventories will last as long or push as high as the previous one, but the increase appears ongoing.

Expect crude oil inventories to continue reaching new highs, even as prices increase



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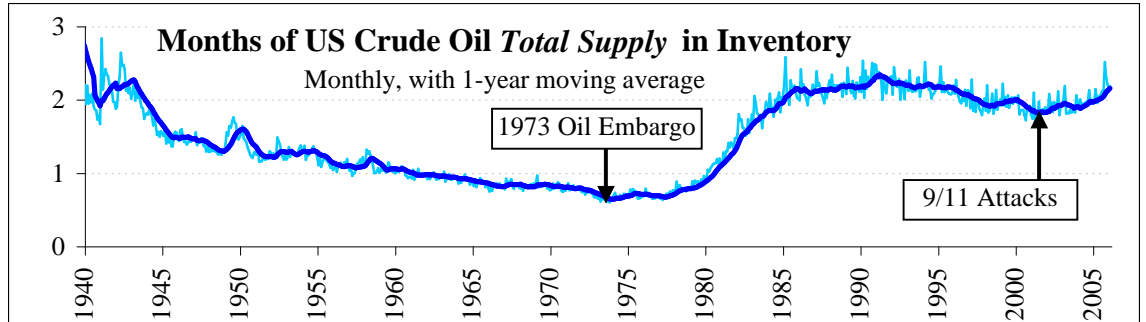
Crude oil data is from the Energy Information Administration (EIA), a statistical agency of the U.S. Department of Energy, and can be downloaded here: http://tonto.eia.doe.gov/dnav/pet/pet_sum_snd_c_nus_epc0_mbbbl_m.htm. GDP data is from the Bureau of Economic Analysis, an agency of the U.S. Department of Commerce, and can be downloaded here: <http://www.bea.gov/bea/dn/home/gdp.htm>. Information in this Commentary has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed.

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Crude inventories in terms of months of supply

The slow-moving trends shown above may give false confidence in US crude oil inventory management. A more important measure of inventories is how long inventories would last during a supply disruption. Inventories would provide about two months' supply at the current pace of consumption. This two-month period is up only slightly since September 11, 2001.

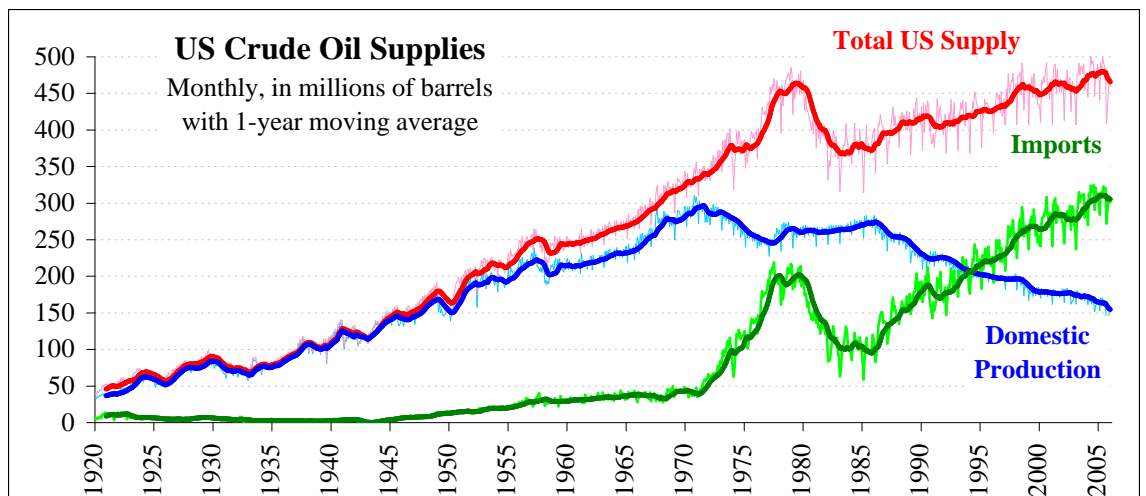
Current crude oil inventories would provide about 2 months supply at our current pace of consumption



The US is increasingly dependent on foreign sources of oil

US oil production peaked in 1971. Since that time, growing demand for crude oil in the US has been satisfied by rapidly increasing imports. In 1991, imports surpassed domestic production, and since that time imports have grown to two-thirds of the total US crude oil supply.

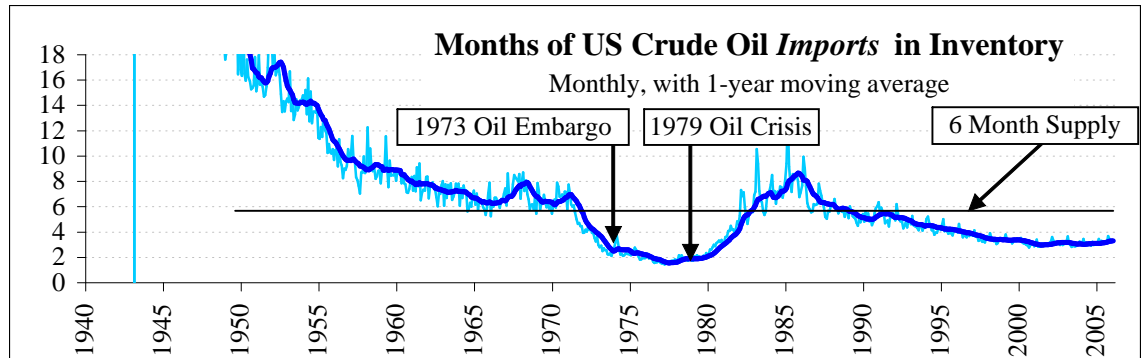
Domestic production is falling and imports are rising fast



In today's world, the disruption of imports is a distinct risk. In the event of a war, embargo, or terrorist act, imports could be interrupted while domestic production might continue. Current US crude oil inventories would replace about 100 days of imports. This 100-day period has essentially remained the same since September 11, 2001.

If inventories do not grow in pace with demand, the period of protection against import disruptions will decline. As inventories shrink relative to imports, the US becomes increasingly vulnerable to import disruptions that could adversely affect the labor and lifestyles of Americans. By this measure, inventories have rarely been lower.

The US economy is vulnerable to import disruption



It is probably no coincidence that the 1973 oil embargo was triggered by OPEC when US inventories had fallen to less than three months of imports. A period of low inventories causes prices to respond dramatically to disruption. The oil crisis of 1979 resulted in long lines for scarce gasoline. Solar panels were actually installed on the roof of the White House.

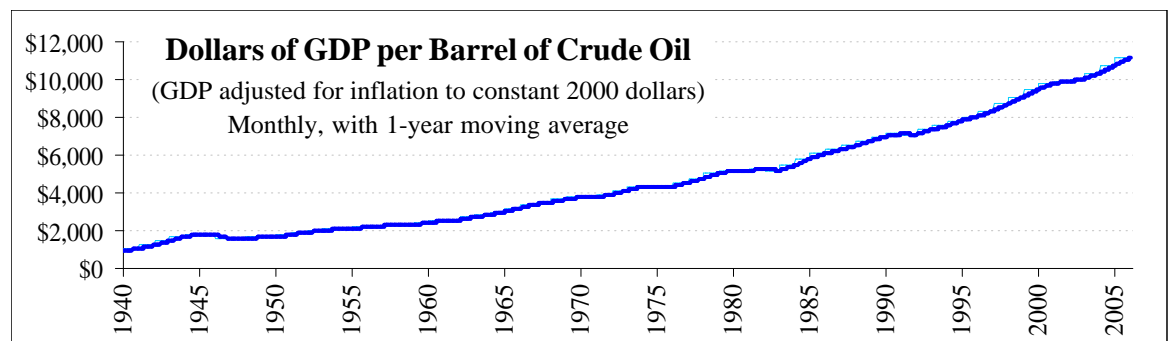
In order to provide for the equivalent of six months of imports, inventories would have to rise by 79% over their current level.

Almost every aspect of modern living is tied to consumption of crude oil, directly or indirectly. The economy relies on the oil industry for gasoline, diesel, jet fuel, heating oil, natural gas, propane, asphalt, lubricants, fertilizers, antifreeze, pesticides, synthetic rubber, pharmaceuticals, and plastics. It is hard to imagine a functioning economy without these products.

Even the most optimistic experts anticipate that world crude oil production can only grow for a few more decades. After that time, production would decline as remaining sources became more difficult to recover from depleting reserves. Most prominent experts anticipate that global production will peak sooner; some even believe it peaked in 2005.

Already, energy efficiency is on the rise. We are increasingly using crude oil for applications that are best served *specifically* by crude oil. Other sources of energy are being exploited whenever possible and whenever the cost can be justified. The US economy has been growing faster than its rate of consumption of oil, but it is still highly dependent on crude.

World oil production is expected to peak within a few decades



Efficiency and a changing economy are linked to slowing demand growth

In sum, America began coping with its dangerous dependency on oil after the Arab oil embargo of 1973. But management of this dependency is ongoing. War and terrorism, increasingly scarce supplies, and changing standards in the transportation industries are likely to lead to rising energy prices as America continues to struggle with its addiction to oil.