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Financial Markets Perspective

Energy Independence?

July, 2012

The second quarter of 2012 witnessed another test of European Union (EU) survival. The good news is that there seems to be resolution of the financial experiment—the European Central Bank (ECB) has taken on the role of the U.S. Federal Reserve by stepping up and buying individual country debt when interest rates on those securities rise to disconcerting levels. As the issuer of the Euro, the ECB has the power to write as many “checks” as necessary to keep the EU solvent. As a result, the ECB can buy as much country debt as necessary to avoid a country bankruptcy.

The bad news is that the commitment by many countries to implement measures of austerity is causing problems rather than helping the situation. The strategy of imposing higher tax rates and lowering government spending cannot, by any stretch of the imagination, return economic growth to the EU. The risk is that the “maintain the welfare state” policies of many European nations have gone beyond the level where even correct economic policies can help.

The risk to the United States is that Europe will enter a long-term malaise characterized by economic activity that is below a reasonable growth rate that will also undermine exports from the U.S. The weakening of the Euro will make European goods more attractive and U.S.-produced goods less attractive. Concerns about the outlook for the EU will also keep downward pressure on U.S. interest rates as the Federal Reserve continues to maintain a safety net under the U.S. economic recovery.

Over the past few weeks the term “fiscal cliff” has gained traction in the media as economists and politicians have highlighted the fact that the upcoming expiration of the Bush tax cuts will push tax rates substantially higher. For example, the tax on dividends will rise from a current 15% to the maximum tax rate for individuals that could end up being as high as 39%. On top of that increase, the health care bill will impose another 3½% bringing the tax to nearly 43%-- or about a 200% increase! Nearly one in five fund managers view this fiscal cliff as a greater cause for alarm than the Eurozone crisis, underpinning fears that debt gridlock could slow the world’s biggest economy.

This fiscal cliff that is a certainty for January 1, 2013 gets closer every day and greater attention is being paid to the downside risks of a massive tax increase. President Obama opened the gates to extending the Bush tax cuts for another year but not for individuals earning more than

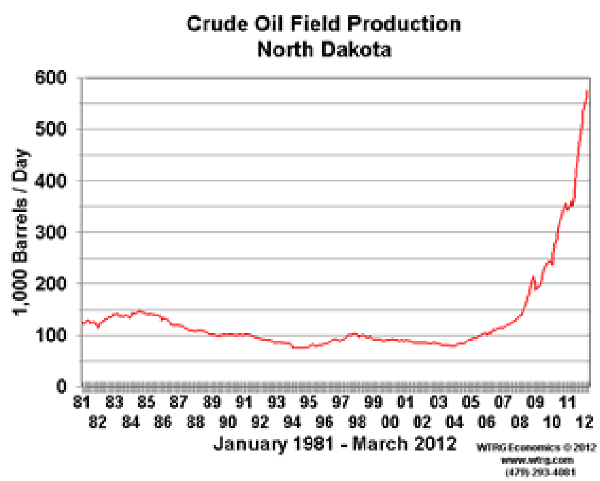
$250,000. On the other hand, the problem must be solved earlier rather than later as the economy cannot take another surge in uncertainty surrounding tax rates. Unless we get resolution before the election, our expectation is that late November will be very active in the Capitol.

The financial markets have been taking divergent paths in recent years. The bond market has been rewarding for many investors who benefited from falling interest rates. While fixed income portfolios produced double digit returns, they were due to one-time increases in principal driven by falling yields. Such gains are no longer viable given that interest rates are at record lows. We would be surprised if fixed income markets returned one-half of their returns in recent years. In 2000, the ten-year Treasury note yielded close to 7%. The current yield on that security is 1.5%.

On the other hand, stocks as measured by the general averages have been flat for twelve years even though corporate wealth and earnings are at record levels. The technology meltdown in 2000 and the financial crisis of 2008 undermined investor confidence in equity markets. An explosion in derivative securities and market volatility engendered in the day traders' market participation kept many investors heading for the bond market or on the sidelines. The massive frauds perpetrated on investors by Bernie Madoff and Alan Stanford (and others) further undermined consumer confidence in professional investors. As a result, billions of dollars are stored in low or no-yielding securities that have no hope of producing gains after inflation. In some cases bonds have negative yields due to investors' fears!

The global change in energy resources may be the link that is necessary to get Western economies back on their feet—at least for the U.S. We believe that there is a once in a lifetime change taking place in the energy industry. Similar to the change that ushered in the industrial revolution, or the replacement of whale oil with petroleum, the implementation of drilling techniques for oil and gas and the discoveries of huge reserves are reshaping the cost of doing business. The use of an old drilling technique—horizontal drilling—coupled with the ability to extract oil and gas using a technique called "fracking" is providing a renaissance for domestic oil and gas production. The process was first used in 1947 but has only recently come into vogue as shale oil discoveries rely on this technique to get oil and gas out of the shale. The advent of new techniques to find oil leads to drilling as companies increase the number of operating rigs. We have identified this theme as "New Era Energy" and have subsequently identified numerous opportunities for growth.

Additional support for this theme comes from the Energy Economist publication that recently penned the following: "North Dakota oil production increased from 192,000 barrels per day in January 2009 to 575,000 b/d in March due to the success of the Bakken shale play. Data just released by the state shows April production at 602,000 b/d. In the 12 months through March, U.S. production was up 625,000 b/d or 11.1%. Texas oil production was up 388,000 b/d (28.4%), while North Dakota came in second up 215,000 b/d (59.7%). North Dakota just passed Alaska and is now the second largest producing state in the U.S."



Rather than shipping money to the Mid-East via oil purchases to fund mega cities such as Dubai, Americans (and Canadians) will benefit from the sale of domestic oil and gas to domestic consumers. As supplies increase, the expectation will be for oil prices to fall as more discoveries are adding to our total reserves. On the other hand, low prices may penalize current domestic producers who were benefiting from the OPEC price umbrella. Given this tradeoff, consumers are likely to see their energy costs fall as well as their job opportunities increase as the domestic oil and gas industry continues to expand into the next decade.

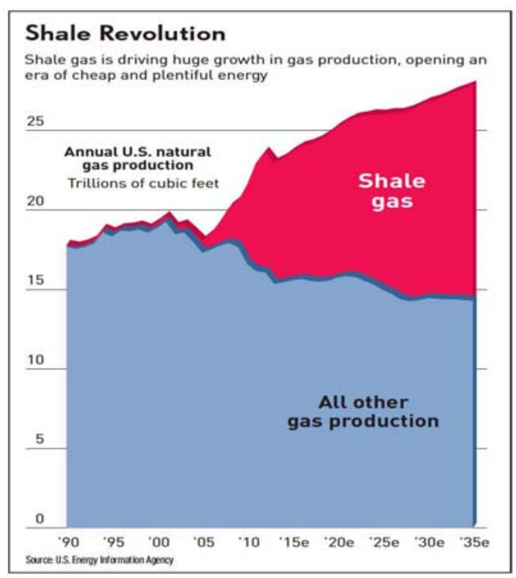
For investors these circumstances should provide a strong underpinning for companies that benefit from lower energy prices. Economic growth should accelerate as more workers in the oil and gas industry earn a living wage that puts them into the American workforce and not in the unemployment lines. As was with the impact of the industrial age, economic growth should accelerate and standards of living should rise as a result of the confluence of both energy availability and the utilization of tools that can extract that energy. The U.S. is not the only beneficiary of this theme. Venezuela supposedly has more oil reserves than Saudi Arabia. Brazil has embarked on a massive search for oil off of their coast. Reports of new oil and gas discoveries off the coast of Africa are also adding to world supply.

America is moving quickly to take advantage of lower oil and gas prices. Gas pipeline partnerships are rapidly expanding across the country to accelerate the shipment and delivery of natural gas. Trucking companies are retrofitting large vehicles to run on compressed natural gas or to have a dual fuel capability. We can buy a natural gas powered Honda Civic today.

The U.S. oil production boom is only outpaced by the natural gas boom. One major publication has intimated that this growth will lead to a new industrial revolution. The collapse in the price of natural gas (the price has tumbled 83% since their December 2005 peak) coupled with the use of fracking to find natural gas is encouraging industry to begin to convert vehicles to use natural gas as a fuel instead of gasoline or diesel fuel. Cheniere Energy is building a massive factory to convert natural gas to LNG and then to sell that LNG abroad. Imagine that the U.S. could not only be self-sufficient in energy production but could become a major exporter of the cleanest of fossil fuels!

Edward Yardeni, a well-known Wall Street economist, compared this revolution to the high tech revolution of the 1990s. His rationale is that energy plays such an important part in our lives and standards of living that any dramatic increase in supply at lower prices will make just about everybody better off.

An exhibit from the research department of Citigroup shows that the U.S. will be a huge exporter of oil and natural gas in the future. The bank projects that the surge in these sources of energy will add 2-3% per year to domestic growth. This advance could create somewhere between 2.7 million to 3.6 million new jobs -- just in time to get our unemployment problems under control. Cheap energy will be a world game-changer as companies can justify major investments if their cost of energy input falls dramatically. Is the forty-year U.S. dependency on the Mid-East oil cartel coming to an end? Only time will tell.



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