



VIEWPOINT

June 2008

What about Oil?

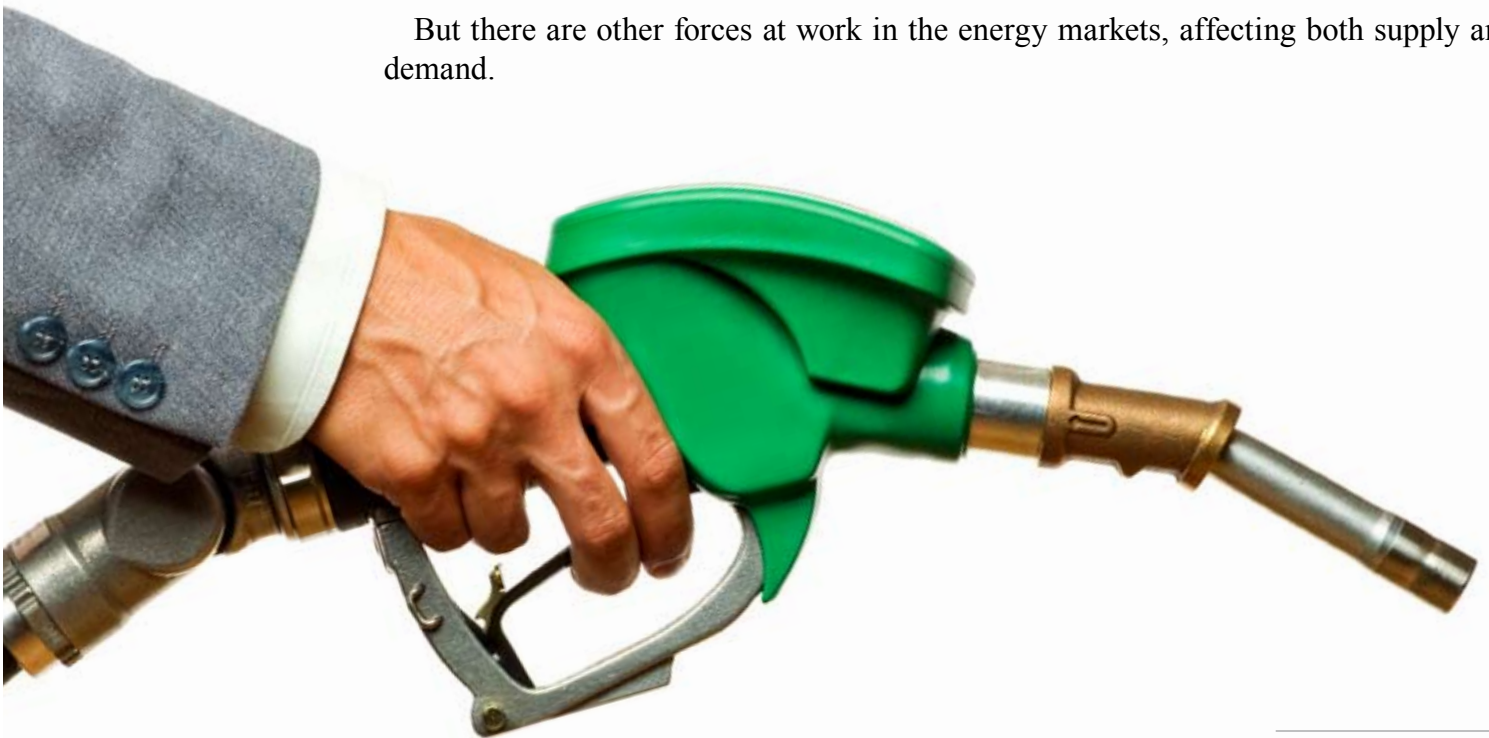
What does the rocketing price of oil mean for your investment portfolio? That's a question we've been asked often as the benchmark price has gone past \$135 per barrel.

Consumers certainly can be expected to tighten spending. The downturn in housing and a weaker economy had already made people cautious shoppers; higher fuel costs are making them even more so. We've been cautious in turn on the stocks of companies that depend on discretionary spending, such as home improvement stores, restaurants and apparel retailers.

Companies with more stable demand should do relatively better, though they will feel some effects, too. Our portfolios are well represented in this area, with companies like Abbott Labs, Becton Dickinson, Anheuser-Busch and Walgreen. The best such companies are able to pass along their own higher energy costs.

Higher and higher oil prices are not inevitable, even though it may seem that way at the moment. Two arguments for higher prices are that: 1) there is a finite supply of oil in the world, and 2) demand will only go up as developing countries consume more.

But there are other forces at work in the energy markets, affecting both supply and demand.



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Higher fuel costs have already cut demand. Oil consumption among the 30 developed countries of the Organization for Economic Cooperation and Development (OECD) has actually fallen over the past two and a half years. In February, Americans drove fewer miles year over year – the first time this has happened in 26 years. Developing countries may post a slower rate of demand growth, too, now that many governments are slashing the fuel subsidies that had kept consumers from feeling the worst of higher global oil prices. Slower economic growth around the world may also weaken oil demand.

The supply of oil – or more broadly, the supply of energy – is growing. Oil reserves and alternative energy sources that could not be profitably developed at much lower prices can now be brought to market. The tar sands in Canada, for instance, are thought to hold nearly as much oil as Saudi Arabia, and now can be processed economically.

There is already a glut of heavy crude oil, according to *The Economist*, and price discounting is expected to make it profitable for refiners to process this into the lighter grades that are now most expensive. The same magazine notes that diesel prices are higher in part because the Chinese government has temporarily ramped up demand for the fuel in advance of the Olympics. The government intends to run some power plants on diesel instead of coal in order to reduce air pollution. When the Games are over, this supply may be available to the market again.

Many forecasters seem certain that oil prices will rise. We saw a similar conviction a year ago about the all but inevitable rise of the Chinese stock market. (See “Pork Stir-Fry” in the June ’07 *Viewpoint*.) The Shanghai Stock Exchange is now off about 46% from its peak. Energy prices could follow, which would be a boon to stretched consumers and businesses.

—Barry

Curious about a financial topic?

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