

Is \$4.00 Gasoline Here to Stay?

By Michael E. Chadwick, CFP®

A few years ago, this concept seemed outrageous, simply never an option, especially here in America. People across the globe regularly paid \$4 & \$5 a gallon for fuel at a time when we paying \$1 or \$2 and change. We Americans are a spoiled bunch - and a wasteful bunch. Unfortunately, in under two years the price of fuel has doubled. It's here now at \$4.00 a gallon for regular, \$4.59 for the good stuff, \$4.50 for home heating oil and \$5.00+ for a gallon of diesel. The price we pay still relatively cheap when you consider motorists in Turkey pay \$11+ per gallon. Germans pay \$10+ per gallon.

The big question is why on earth are gasoline and diesel suddenly so expensive? It's not an easy situation for people to deal with as our infrastructure is built to run on cars in most of this great country. With the current prices people have modified their habits whenever possible and changed the way they plan simple errand trips to big vacations. The catch word this year is "staycation" – staying at home and visiting your backyard for a vacation. Last year's catch phrase was sub-prime. We don't hear that word much anymore. There is nothing wrong with a staycation as more quality time for families to spend together talking, playing and enjoying one another is never a bad thing, regardless of where the time is spent together.

To watch our politicians grill oil company executives makes great TV but it is laughable, and our current situation is not Exxon's fault. The fact is our politicians and oil companies don't have the power to control crude oil prices: oil is bought and sold in our global marketplace. To be frank, our politicians have helped to cause our current crisis due to long-term failure to formulate national energy policy while also placing a lot of land and sea areas outside of national parks, where massive known stores of oil and natural gas sit, "off limits" to drilling for political (mainly 'environmental' reasons). This is artificially limiting the supply that oil companies can bring to market. By the way, gasoline, diesel fuel, home heating oil, natural gas, and lubricants are oil made from a barrel of crude oil.

Fuels are a commodity as are many other things we use daily – grains, orange juice, metals, etc. These commodities are traded on worldwide exchanges and the market sets the price based on supply and demand. When there is high demand coupled with limited supply the price of the commodity will go up, and that is what we see with oil today. When there is excess supply relative to demand, prices go down, which is what we are seeing now residential homes and real estate.

Commodities are considered a hedge against inflation – they usually go up in value when inflation is an issue and it's currently an issue so many people are putting their money to work in commodities as an alternative to stocks, bonds or real estate. We started buying commodities in our portfolios three years ago and have been handsomely rewarded. With prices where they are, we've eliminated the position as it seems excessive now and commodities may be ready for a crash. Since there have been so many buyers in this space, prices have gone up.

It's not just a supply and demand issue – it's also trading pressures that have driven oil prices to these levels. The trading activity in the oil markets worldwide is denominated in U.S. dollars, and with the dollar's current weakness against foreign currencies more upward pressure is placed on prices, making oil more expensive. The dollar's value fluctuates like a pendulum and it will at some point swing back to be strong relative to foreign currencies.

Other factors affecting price include the development of consumer societies such as India and China. Not only are these countries consuming oil and gas at record levels, the governments of those countries subsidize the retail price their consumers pay: this keeps the price artificially low and affordable, boosting demand. The Chinese people pay \$2.90 a gallon for oil – while the government spends more than that amount on the subsidy to make it affordable. This trend is slowly eroding as prices reach record levels and the country's economic booms slow down. Middle East countries have been slowly becoming substantial consumers of oil too– they certainly still export but they're now consuming many more times what they had in the past, leaving less for export to the U.S and elsewhere. These countries are racing to build infrastructures and other economies with all of their new-found oil money – which they know will not last forever. It may last another century or so but where will they be then economically? All they have is oil and sand – someday they'll just have sand.

Many small countries that were typically exporters of oil have become importers of oil as they can no longer sustain the current clip of usage and still have any surplus available for export. Electricity is causing many countries to rely more and more on oil as supplies of natural gas and coal supplies have dwindled – these fuels have historically provided electricity and all oil went to export. The USA is making a pile of money exporting coal around the world but since the average consumer doesn't use coal they don't know or care about that fact.

Another risk that commodities speculators fear is the arrival of the point in time known "peak oil" which means the world's future production of oil, a finite and non-renewable resource, is never going to be as high again and will steadily and predictably decline year after year. A few studies support this peak oil theory. Other studies support the 2017 – 2025 range when peak oil will hit. Others say peak oil will never happen because by the time it is expected to hit demand will be waning because of alternatives and government legislation to reduce greenhouse gas emissions. I tend to agree with the last argument.

Political instability in the world has also caused prices to soar. It seems that wherever there is a lot of oil in the ground there is a nutcase running the country, a war is raging on, or there is some type of issue that may disrupt oil production. None of this will last and more oil will eventually be pumped and sold. But global refining capacity is too low, especially in America, and investments in drilling and exploring has been too low.

All of this will change but it will take years to take hold and impact the markets. Potentially massive new deposits of oil have been found in Brazil, Russia, China, Canada and here in America. This is not discussed but will ultimately play into the supply equation, lowering prices.

There is plenty of oil for now and for at least the next 30 – 40 years. We have more oil on the ground and in ships today than ever before so the problem isn't today, it's what may happen in the future. No country can stop selling oil because it's too big a piece of their economy. I expect sharp declines in prices soon, but also

expect extreme volatility in the commodities system. Current record high prices have reduced demand sharply in some areas such as here in America, where usage is now at 1997 levels.

Alternative energy sources are now becoming a reality. Geothermal heat, solar and wind energy, and fuel cells are all here to stay and will slowly play a bigger and bigger role in our energy consumption as time unfolds. Europe has built an infrastructure where public transportation, walking and bicycles are the daily norms. The new “green” trend has caused a huge decline in oil consumption as people begin to live with more planet-conscious habits. These factors also will add more capacity to the supply side, further reducing prices. Foreign governments’ reduction of oil subsidies will do the same. Will this signal the comeback of the American downtown and the death of malls? I doubt it will kill the malls but it will change our habits and reinvigorate American downtowns. Will it change our love affair with the automobile? Not a chance – I still own 3 V8 engines and have no plans on downsizing for fuel savings. It’s a great time to buy any big vehicle with a V8 now that the little fuel sippers are the choice of the day. \$1,000 to put 200 gallons of oil in my tank at home is painful so I may go with a geothermal furnace and better insulation! 😊

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