## Peak Oil Mini-Me Part 2

**William Smead**
Chief Executive Officer
Chief Investment Officer

Dear Clients and Prospective Clients:

We at Smead Capital Management (SCM) wrote a piece a few months ago called "Peak Oil Mini-Me" in which we argued that the rally in oil from $32 per barrel in March to $73 in late June had characteristics very similar to the mania which took oil up to $147 per barrel in July of 2008. In that piece, we dealt mainly with investment psychology and the idea that we had never seen a bubble burst in the investment markets get put back together in anything less than about five to seven years. Here we are at $72 per barrel today with the U.S. economy appearing to be on the mend and the same army of energy bulls still out there promoting huge upside in the commodity oil and the energy-related stocks.

My professors in college always criticized me for not providing enough evidence in my writing to back my arguments. Fortunately for me, Michael Lynch, the former director for Asian energy and security at the Center for International Studies at MIT, provided all the evidence we need in an August 25 op-ed in the New York Times. In a piece called "Peak Oil Is a Waste of Energy", Lynch backs our argument from an energy consultant's fundamental viewpoint.

Peak Oil is a Malthusian argument which states that geological scarcity will at some point make it impossible for global petroleum production to avoid falling. To the Malthusians this could spell economic disaster.

> *Like many Malthusian beliefs, peak oil theory has been promoted by a motivated group of scientists and laymen who base their conclusions on poor analyses of data and misinterpretations of technical material. But because the news media and prominent figures like James Schlesinger, a former secretary of energy, and the oilman T. Boone Pickens have taken peak oil seriously, the public is understandably alarmed.*

Lynch explained that most arguments about Peak Oil are based on anecdotal information, vague references and ignorance of how the oil industry goes about finding fields and extracting petroleum. As an example, he showed how using pumped water in the Ghawar Field in Saudi Arabia scared Malthusians because the field registered 35% water. However, they failed to mention that the average field is estimated at as high as 75% water!

> *But those are just the latest arguments — for the most part the peak-oil crowd rests its case on three major claims: that the world is discovering only one barrel for every three or four produced; that political instability in oil-producing countries puts us at an unprecedented risk of having the*

*spigots turned off; and that we have already used half of the two trillion barrels of oil that the earth contained.*

He debunks the discovery argument quickly. He describes the fact that at the beginning of a discovery the energy industry chooses to make a conservative estimate of what is in the field. It is almost always revised upward, because of new pockets or improved technology. Those raised estimates are never counted as new discoveries. He says that you hear that all the easy oil is gone. Read Daniel Yergin's The Prize, which is a history of the oil business from 1855 to today and you'll realize that there never has been any easy oil.

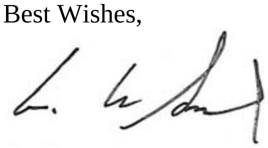
Once you conclude that the geological claims don't stand up, Peak Oil folks jump right into the political instability arguments. We all remember the two oil embargoes in the 1970's and Jimmy Carter's wool sweater. The major oil producing companies have diversified themselves around the world and have very much moved away from the Middle East dependence. In the U.S., we currently import more oil and gas from Canada than any other country.

Lynch believes that the most misleading claim of the Peak Oil advocates is that the earth is endowed with two trillion barrels of recoverable oil and we've used half of it already. The consensus among geologists is that there are some Ten trillion barrels out there and based on technological improvements that as much as 35% may be recoverable. Here is Lynch's conclusion:

> *Oil remains abundant, and the price will likely come down closer to the historical level of $30 a barrel as new supplies come forward in the deep waters off West Africa and Latin America, in East Africa, and perhaps in the Bakken oil shale fields of Montana and North Dakota. But that may not keep the Chicken Littles from convincing policymakers in Washington and elsewhere that oil, being finite, must increase in price.*

We at SCM argue that the constant enthusiasm displayed for the reflation trade and buying energy based on emerging market economic growth rates is a crowded trade. In our experiences, when investors ignore the law of supply and demand it is at their own peril. Lynch argues that supply is abundant and car buyers are reducing their demand with higher mileage cars. More supply and less demand could spell lower prices and would be very positive for the U.S. consumer, the U.S. economy, corporate profits and owners of quality companies.

Best Wishes,



William Smead

**The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. The securities identified and described in this missive do not represent all of the securities purchased or recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.**

This Missive and others are available at www.smeadblog.com.