



## BALTIMORE CAPITAL MANAGEMENT

575 South Charles Street  
Suite 506

Baltimore, Maryland 21201

Phone: 410-727-4480

Fax: 410-783-7917

Email: [agraham@baltimorecapital.com](mailto:agraham@baltimorecapital.com)

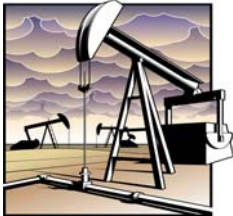
[www.baltimorecapital.com](http://www.baltimorecapital.com)

### "OIL !"

June, 2008  
Issue: 48

The extraordinary increase in the price of oil this year and last is defying logic and economics. While I agree that oil is an increasingly scarce commodity and that demand from India and China has grown to compete with demand from the rest of the world, the increase in oil prices does not match these changes in supply and demand. In fact, as the price of gasoline has increased in the US, the demand for oil has fallen off.

It's hard to believe when we fill up at the pump, but the price of gasoline has not increased nearly as much as the price of oil. To match the recent oil price increases, gasoline would have to be well over \$5 a gallon. Until now oil refineries have absorbed the difference between crude oil and gasoline, losing money in the process. Gas stations have also seen tight margins with little to show for high oil prices. No business will maintain low prices while losing money, so if the price of oil does not drop we can anticipate that refineries will raise the price of gasoline, and we will see gasoline at over \$5 a gallon. Given that consumption is dropping at \$4 a gallon, it should really plunge at \$5 a gallon.



Other than decreased demand or control of speculation, it is hard to see what will reduce the price of oil. There are very few new large oil discoveries, with the exception of a recent find in Brazil. The lack of a comprehensive and effective energy policy in the USA is also a huge problem, and has led to some rather unhelpful governmental actions. For example, in the past few years we have been subsidizing ethanol production, which has helped cause the price of food to go through the roof. Ethanol production using corn is inefficient and expensive, does not make economic sense, and without government subsidies would disappear. Currently the government is subsidizing farmers and ethanol producers at taxpayers' expense. In contrast, ethanol produced from sugar cane does make economic sense, at least in Brazil where sugar cane is plentiful. Rather than pursue this reasonable alternative fuel source, we have chosen to tax Brazilian ethanol with a .50 cent per gallon tax. Moreover, the state of Florida just paid \$1.8 billion to buy and close a sugar refinery. And this is while the federal government subsidizes ethanol from corn!

Other alternatives to oil are facing hurdles of their own. Nuclear power is considered by many to be an environmentally-correct energy source, but there has not been a nuclear power plant built in the United States in 30 years. Wind and solar power are potentially effective sources, but an attitude of "not in my back yard" is keeping wind power from taking off even in offshore locations that are not visible from land.

Nor are we allowing exploration for additional sources of oil itself. Additional drilling has been prohibited off of Florida and the east and west coasts. There have not been any seismic oil studies in these areas for years. The Chinese are now drilling for and finding oil off Cuba, yet the state of Florida will not allow exploration in its offshore waters.

Some of the blame for our current situation must also fall on the US auto industry, which kept manufacturing gas-guzzling SUVs and trucks. SUVs have avoided the low efficient mileage requirements for automobiles, due to the failure of regulations that allows SUVs to be treated as trucks. Manufacturers are now feeling the self-inflicted pain, as US auto producers are in danger of bankruptcy due to poor sales.

All these factors have been compounded by speculative trading in oil by hedge funds and others. Five years ago 40% of oil trading was done by speculators; today it is 70%! While I am a strong believer in free markets, I have to draw the line when speculators are damaging the world economy for their own benefit.

Given all of the above, why should there be any expectation that the price of oil will drop? First of all, I do not expect a big drop. We may even have higher prices in the short term due to fears of Israel possibly attacking Iran's nuclear facilities. On the other hand, at \$140 a barrel worldwide demand for oil will drop and economies will slow, thus further reducing demand. A more negative view would simply be that the world economy cannot function with prices as high as they currently stand. While this is a difficult and complicated subject and debate, my guess is that all this will play out over the next few months.