

Contrarian Time In Natural Gas?

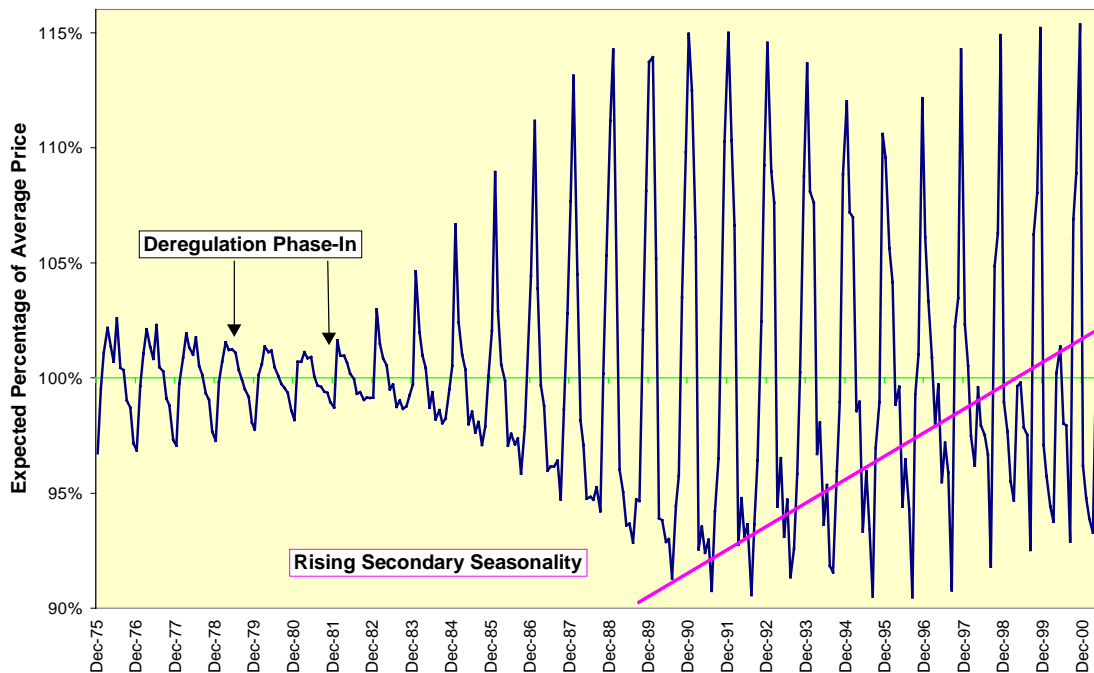
Even as our beloved Federal Reserve stays ever vigilant against the threat of inflation, 2000 has been another weak year for commodity prices, with the sole and significant exception of energy prices. The most spectacular performer, either as hero or villain, has been natural gas. Cash market prices at Henry Hub, the principal U.S. pricing center, have nearly tripled so far this year.

Is it too late to make investment decisions based on this surge? No, but not in the direction expected.

Unlike other assets capable of such exuberance – and we all have had several tattooed upon our foreheads during this year of our discontent – the natural gas market will have some staying power. The fuel has become the preferred source of new electrical generating stations, and given the environmental restrictions on both coal and oil-fired facilities and the death of nuclear power, the demand for gas is going to remain high. At some point in the not too distant future, however, new supplies will come into the market, as is always the case for physical commodities, and a new down cycle will begin.

The growth of natural gas as a utility fuel has had a profound impact on the market's seasonal structure and its ability to build inventories for winter heating use. Natural gas prices, unsurprisingly, have tended to peak during the middle of winter and to be soft in the late spring and early autumn, the so-called "shoulder" months of energy demand. But, we can see below the natural gas seasonal cycle has been anything but stable over the past quarter-century. After price deregulation was phased in, prices rose rapidly in the winter and fell in the summer. Once natural gas futures trading began in 1991, the seasonal peaks and troughs began to narrow as predicted by futures market theory. A second and smaller seasonal peak began to emerge, corresponding to demand from electric utilities. By 1999, this peak was above the annual average.

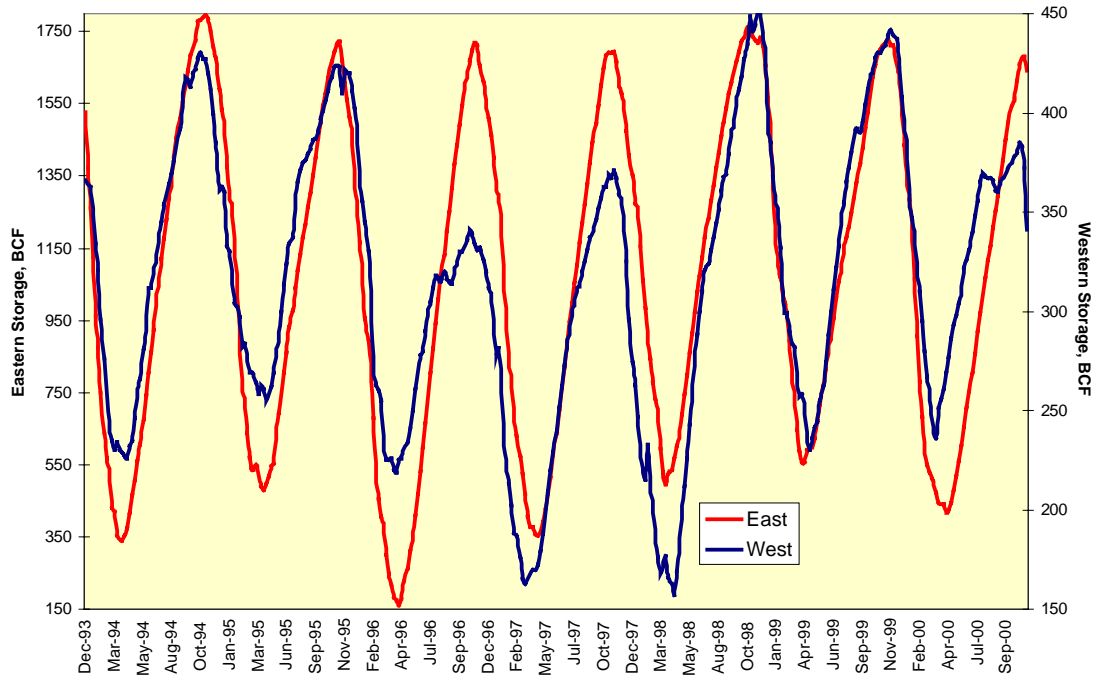
Natural Gas Seasonal Adjustment Factors



A series of warmer than normal winters, from 1996-1997 onwards, took some of the pressure off the market. This can be seen in American Gas Association storage data; the seasonal inventory reductions in

the eastern consuming region were far less in these winters than in previous winters, most notably 1995-1996. Another feature visible in the AGA data is the aborted build of normal inventories in the western consuming region this year: Too much gas is being consumed immediately to generate electricity for California.

Consuming Region Inventories

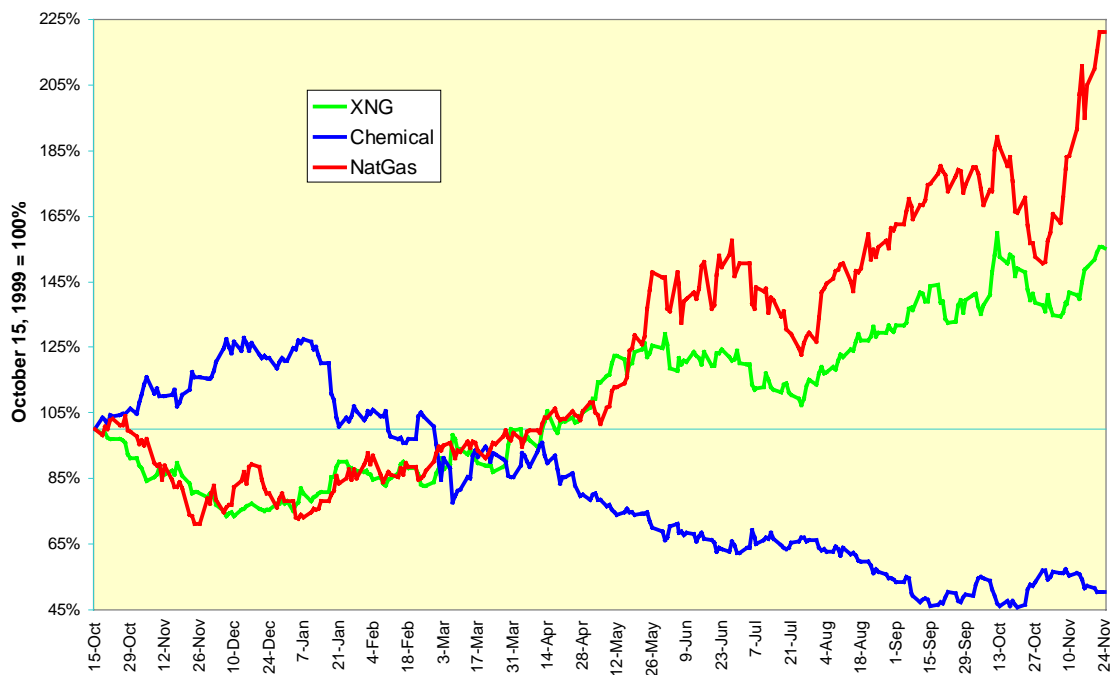


Interestingly, the level of backwardation, or premium of the spot month to the nearby month is very tame given the unprecedented surge in price. Prior to this year, the previous high for natural gas prices was \$4.573 set on December 20, 1996. This was accompanied by a backwardation premium of 14.28%. The present price is near \$6.60, yet the spot month is actually .10% below the nearby price. This indicates a surprising degree of comfort with present price trends; few buyers have adopted a just-in-time inventory policy, and few producers are hedging their production forward out of fear of a price collapse.

Winners And Losers

Let's take a look at two indices relative to the S&P 500, the AMEX Natural Gas Index (XNG) of natural gas producers, and the S&P Chemicals Composite Index (CHEM) from the market low of October 1999 to the present. The paths of these two indices, and of natural gas prices themselves, are shown below.

Natural Gas Sensitive Indices Performance Relative To S&P 500



Since heavy natural gas consumers such as Du Pont, with a 45.2% weight, and Dow Chemical, with a 22.2% weight, dominate the CHEM, the inverse relationship between the CHEM and natural gas prices should not surprise us. Both of these stocks represent cyclical multinationals with exposure to a large number of factors. However, their declines so far in 2000 of 37.8% for Du Pont and 30.5% for Dow, NASDAQ-like plunges for stocks with P/E's of 14.6 and 13.1, respectively, are attributable in some part to the unrelenting rise in natural gas feedstock costs.

Moreover, the chemical industry cannot escape the negative earnings consequences of a slowing economy and a strong dollar in the short-term. However, if U.S. interest rates start to fall and the euro firms as a result, the CHEM index may turn into a great value play.

The opposite appears to be true for the XNG. Since October 1999, this group has tracked the price of natural gas reasonably closely, but not completely. As natural gas prices rise, the producers will find themselves bidding their own production costs higher and reducing their profit margins. This was the downfall of crude oil producers during the great drilling boom of the late 1970s and early 1980s.

While natural gas prices may have significant room to the upside – the forecast here is for \$8.00 sometime this winter – it's never too early to plan a countertrend trade of buying the petrochemical issues and selling such natural gas-linked issues as Ocean Energy, Apache Corp., or Burlington Resources. Not yet: We still have to see the whites of their eyes.