

Natural Gas: Last Tango In Houston

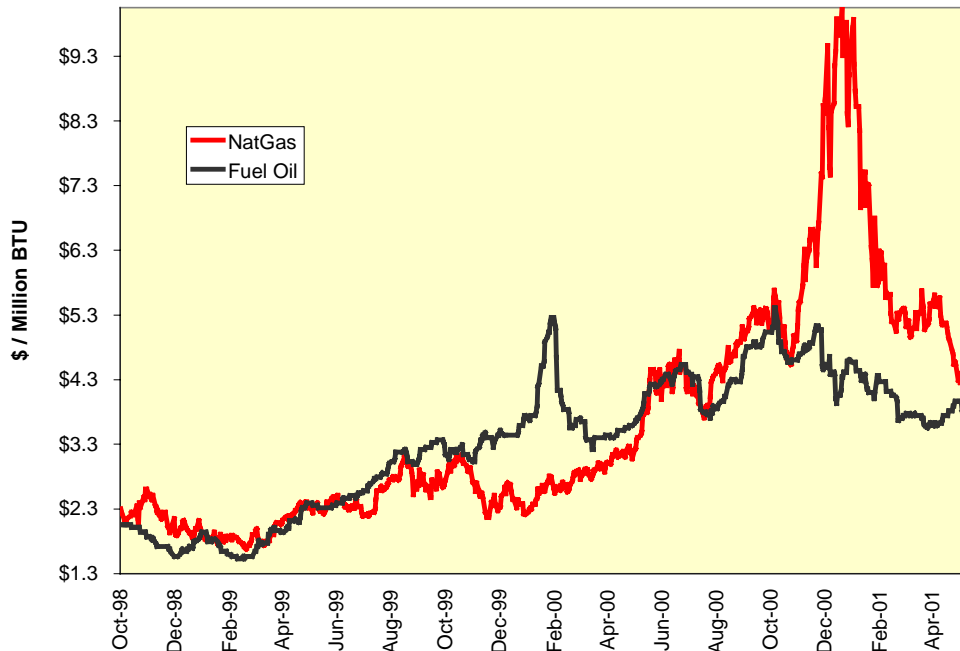
If you want to pay less for something in the future, pay the full price today. This enduring principle of resource economics is behind the very long-term secular decline in the real prices of physical commodities, and has held so true for so long that consumers should welcome the present price spikes in energy as insurance for future price stability. This sentiment may seem rather odd for a Chicagoan who recently suffered through \$300+ monthly home heating bills this past winter and who is presently subject to gasoline prices well over \$2.00 per gallon.

However, higher prices have a way of stimulating over-investment on the part of commodity primary producers and both conservation and substitution on the part of consumers, and there's no reason for things to be different this time. Before these processes kick into full gear, there will be some additional bumps and bruises along the way. Let's update last winter's correct call of an imminent top in the natural gas market, (see "Contrarian Time in Natural Gas?" November 29, 2000) and see what implications any change in market outlook may have for selected industries.

The Current Market

Natural gas has just completed a NASDAQ-like ascent and descent over the past year; its price quadrupled between January and December of 2000, but it has fallen in half since. Forecasting energy prices as we head into the summer air conditioning season is a dicey business, but that's our job. The downside price target, generated by Fibonacci retracement analysis, is \$3.60 per million BTU, a level considered quite high during the 1990s. If and when such a level is approached, the downside should be limited by the re-convergence of natural gas prices to those of residual fuel oil.

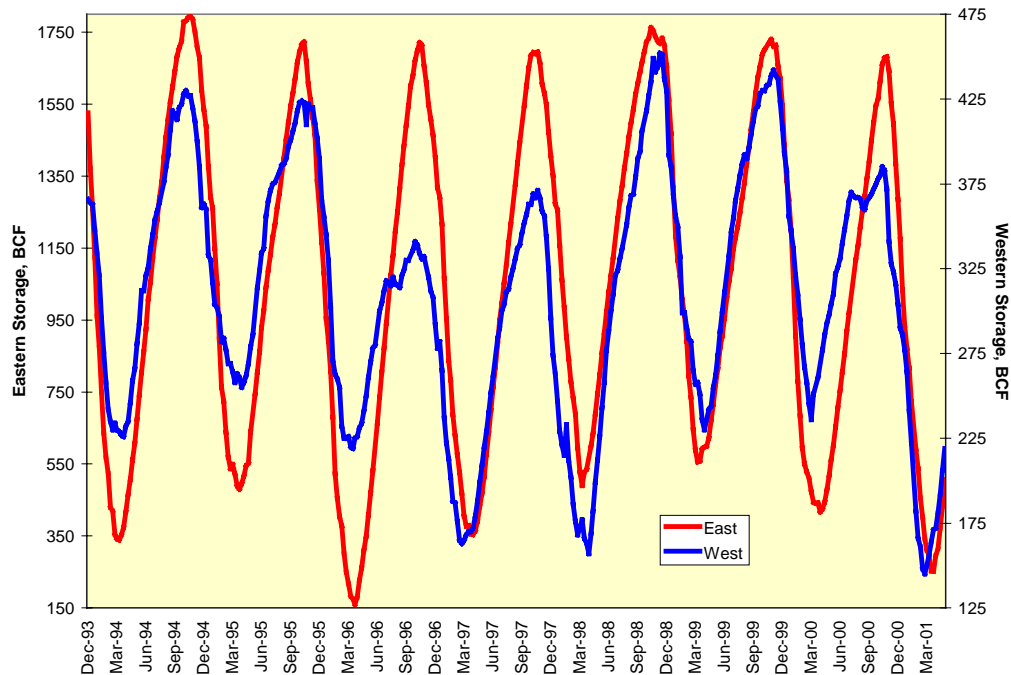
Relative Prices: Natural Gas And Fuel Oil



These two fuel sources are substitutes in many industrial and utility applications. Fuel oil prices were higher during the winter of 1999-2000, but the markets converged during the summer of 2000. The natural gas rally created an unprecedented gap between the markets – shades of the NASDAQ - S&P 500 gap during the 1999-2000 tech boom – but the two markets are nearly in parity once again. This suggests natural gas could begin another leg higher in price during the summer, especially if oil prices remain high.

Moreover, inventory levels of natural gas are still quite low by historic standards. Should anything go awry in the nation's baseload electrical generating capacity – unexpected shutdowns of nuclear plants, transmission grid problems, protracted hot weather – the supply cushion for natural gas-fired peaking plants, those brought on-line to satisfy extreme demand for electricity, will be absent. Experienced energy traders know never to bet against supply disruptions in periods of high demand.

Consuming Region Inventories



Equity Market Implications

The economic impact of erratic natural gas prices cannot be overstated. Each \$1.00 per million BTU change in natural gas prices equates to a wealth transfer of more than \$2.3 billion per month at current rates of consumption. The price increase during 2000, from \$2.30 to \$10.00 per million BTU, created a monthly distortion of more than \$16 billion within the economy concurrent with the bear market in stocks, the strong dollar, and the previous interest rate increases engineered by the Fed. The effect on natural gas-dependent industries such as petrochemicals and fertilizer (see "A Whiff of Ammonia," January 3, 2001) was considerable.

Has the drop in price from \$10.00 back to \$4.30 per million BTU inside of six months affected the stocks of natural gas producers and consumers? Since spot natural gas prices peaked on December 27, 2000, the seven-member S&P Chemicals index (CHEM, which is 43.3% DuPont and 29.2% Dow Chemical) has underperformed the S&P 500 slightly. Over the same period, the 15-member Amex Natural Gas index (XNG) has outperformed the S&P 500 slightly. This index is equal-weighted, not capitalization-weighted, and includes such stalwarts as Enron, El Paso, Dynergy, Apache, and Anadarko Petroleum.

Natural Gas Sensitive Indices Performance Relative To S&P 500



While neither index' relative performance in 2001 has been significantly different from the broad market, we can see two interesting trendlines: The XNG appears in danger of breaking down, while the CHEM appears ready to explode higher. The CHEM in particular appears to have anticipated the impending peak in natural gas rather well; it bottomed relative to the S&P 500 just as the recent bear market gathered strength in September 2000. The XNG on the other hand continued to rally as natural gas prices fell in early 2001; this may reflect a general enthusiasm for all energy-related stocks during this period.

Should the above analysis be correct, holders of XNG stocks may get one more strong, natural gas price-induced rally behind their issues this summer, and this rally should be viewed as a selling opportunity more than an entrance into a new era of profits in natural gas stocks. In addition, the economically sensitive stocks of the CHEM are likely to retain their strength if the present consensus toward a strengthening economy in late 2001 remains. Yes, this is the same relative trade suggested last November, and has the same underlying logic: Over time, commodity consumers can and do add far more value than commodity producers.