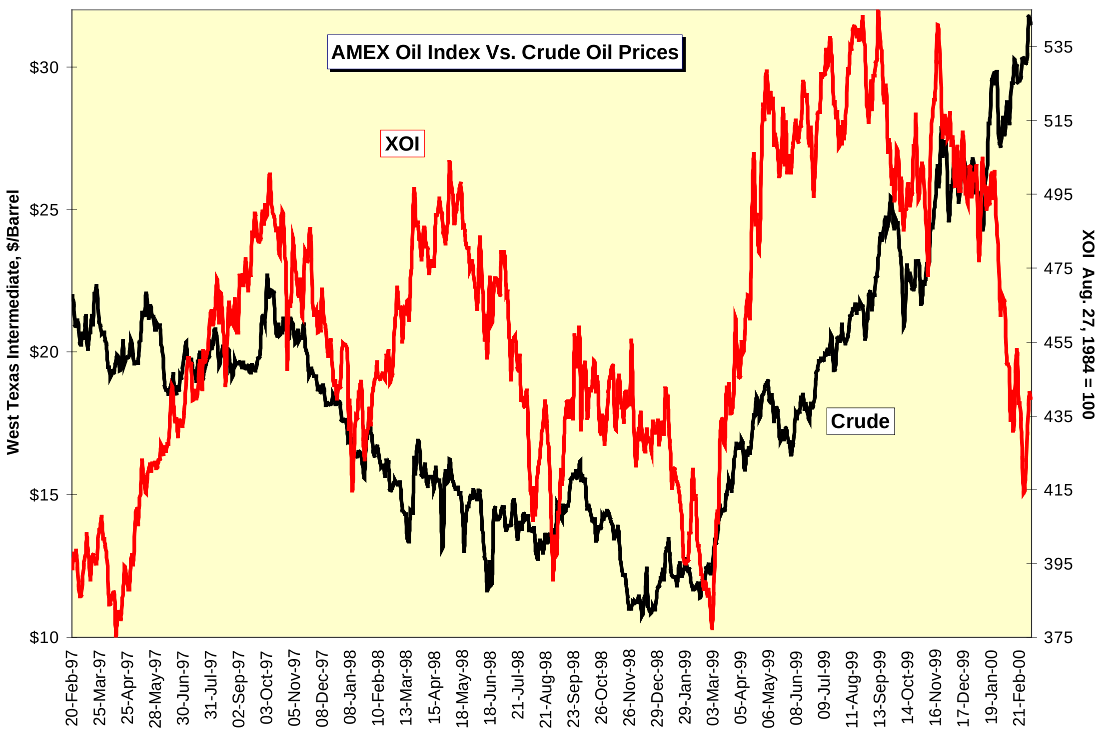
Black Gold, Texas Tea?

"Oil partnerships are greasy" -- Calouste Gulbenkian

The notion of resource-linked equities following the price of their underlying commodity higher and lower is an appealing one. In fact, stock prices in these groups frequently move well in advance of the commodity. For years, gold mining stocks led the price of gold, and no one would bat an eye at correlation between forest product prices and stocks such as Weyerhauser or Georgia Pacific. Inverse correlation is a useful indicator, too: The Dow Jones Transportation Index, consisting mostly of companies who use a lot of petroleum products in the course of moving goods from Point A to Point B, is down a whopping 35.6% since its peak of 3783.5 on May 12, 1999. That's not a correction, that's a slaughter.

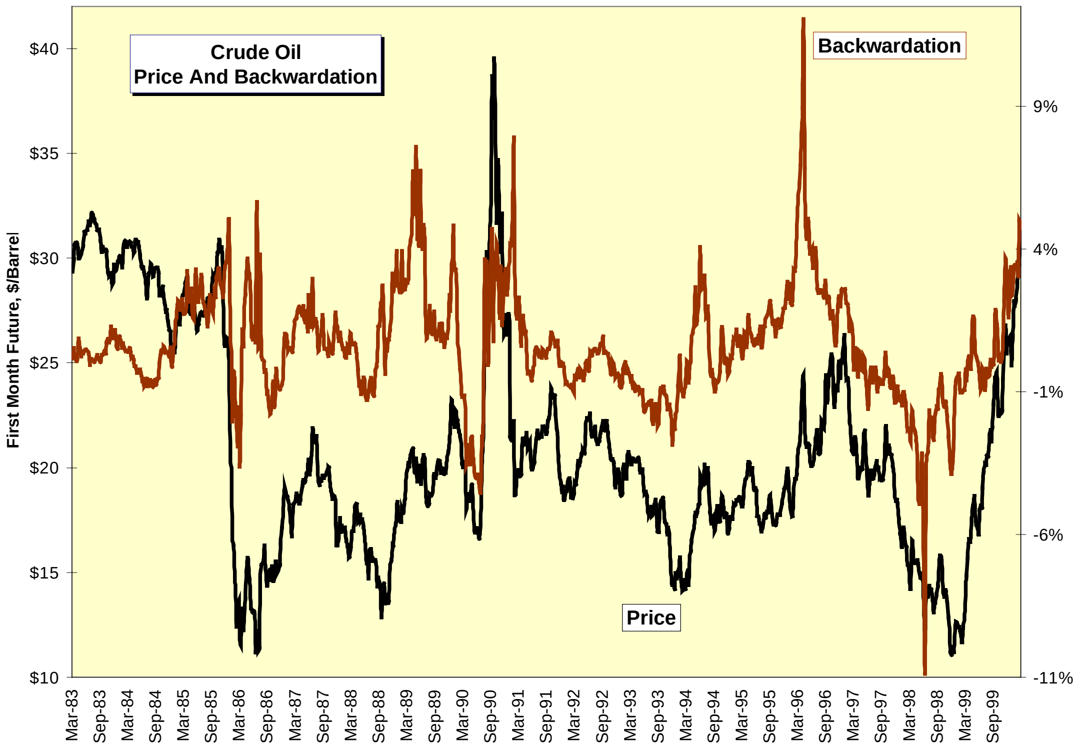


So, why have oil stocks, here represented by the 16-member AMEX XOI index, languished in the face of surging prices for crude oil and refined products? Over the past three years, the index rose in the face of declining crude oil prices during 1997, fell from mid-1998 through early 1999 as crude oil prices moved to a twelve-year low, and then rocketed higher in the spring of 1999. After churning at high levels in 1999, the XOI has broken support in 2000, even as petroleum prices continue higher. At a P/E of 32.06, and a dividend yield of 2.98%, and with tens of billions of dollars in earnings and hundreds of billions of dollars in productive assets, shouldn't investors be a little more forgiving?

No. This is Wall Street, not your local horticulture society. The market is looking ahead to the end of good times in the Oil Patch. While direct comparisons are difficult due to radical changes in both energy markets and in the composition and structure of the energy industry itself over the past quarter-century, this current malaise is reminiscent of the 1981 downturn in oil stocks. The stock market then foresaw, correctly, the connection between higher oil prices and lower growth in energy demand. Oil stocks have underperformed, with only short-lived exceptions, the overall market since that time.

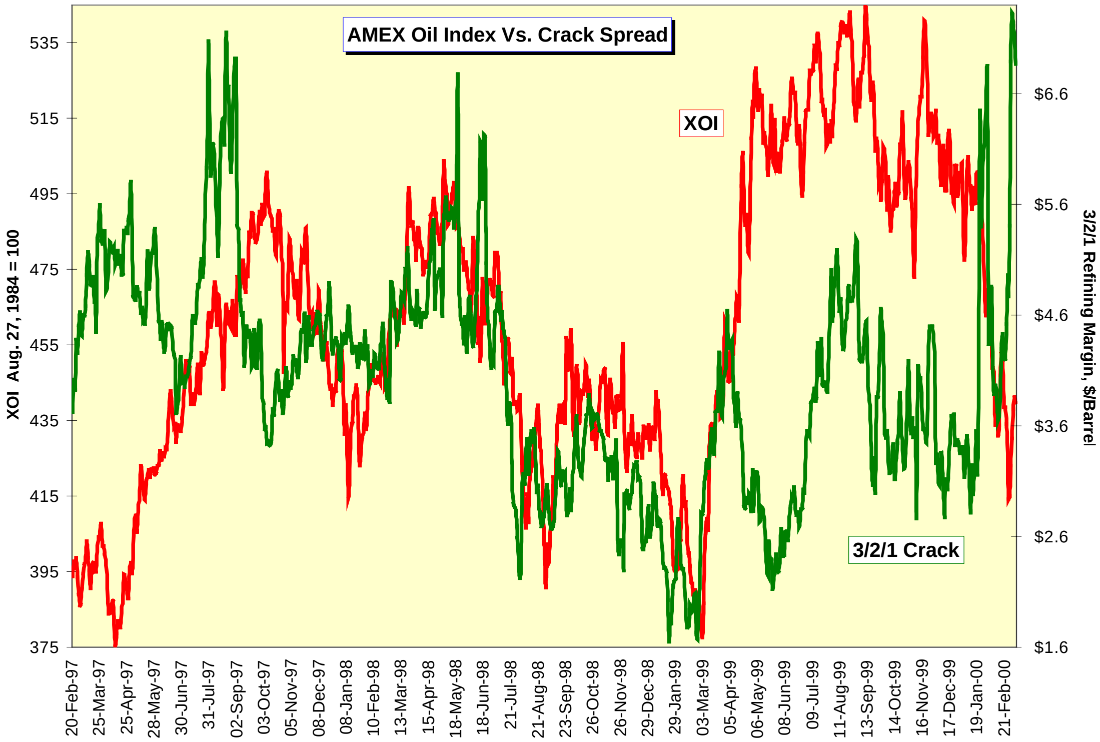
Backwardation As Far As The Eye Can See

One of the dimensions in which commodity markets trade, in addition to current supply/demand balancing and price insurance, is forward price expectation. When prices rise so rapidly both buyer and seller agree the current state of affairs is unsustainable, forward prices will begin trading below current prices; this condition is known as a backwardated or inverted market. Over a long period of time, high levels of backwardation appear to call peaks in crude oil prices with about 6-9 months in advance. The same forecasting ability occurs in reverse when the front month of crude oil falls to an extreme discount; the June 1998 spread led the bottom in crude oil prices, which formed between December 1998 and February 1999.



For More Refined Tastes…

We have one more statistical paradox in the oil industry. Most American oil companies today are refiners more than producers; their refining margins should be helped by both lower crude oil prices and a lower level of crude oil backwardation. Right now, however, the 3/2/1 refining margin, or "crack spread", produced by taking the price of two barrels of gasoline and one of heating oil and subtracting the cost of three barrels of crude oil therefrom, is very high by historical standards.

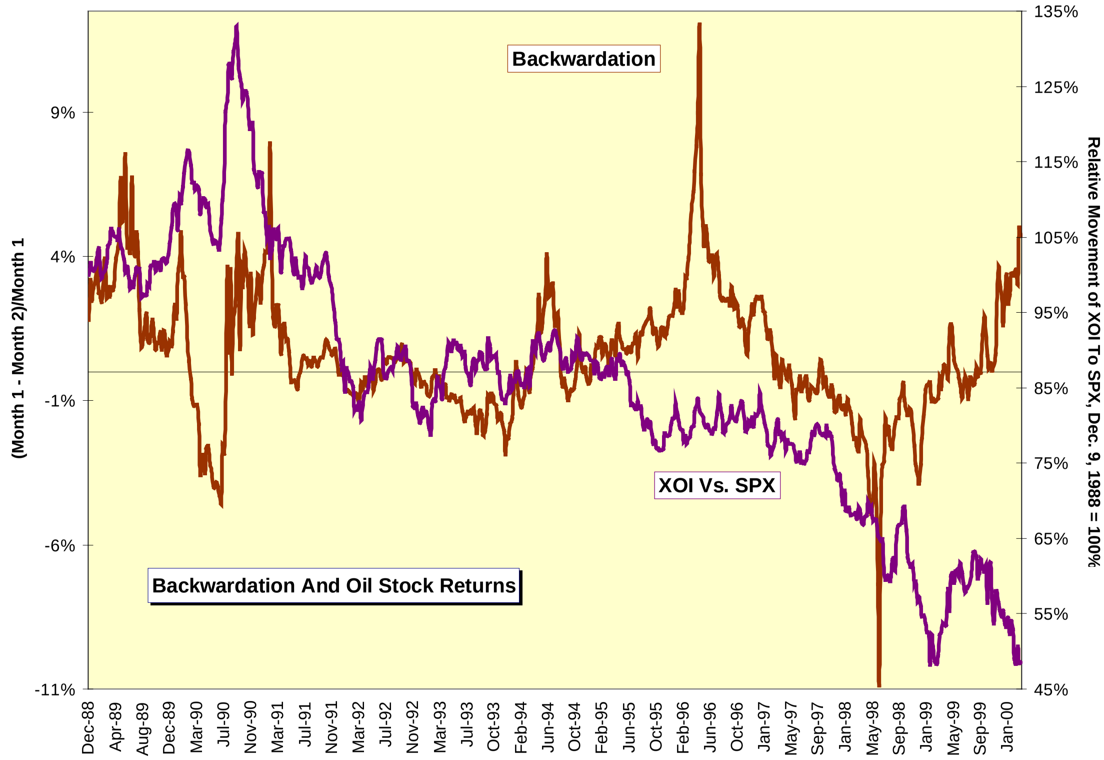


High refining margins tend to precede declines in the XOI. Conversely, the historically low margins of early 1999, which oddly enough occurred at a time of very low crude oil prices as well, preceded an explosive rally in the XOI.

Rewards For Patience

The conclusion from the data is an interesting one indeed. We should wait for a period of lower prices and lower operating margins to jump back into the oil sector. In a market crazed with the "buy high, sell higher" syndrome, the oil stocks stand out for their "buy low, sell high" behavior. The market already has sold high, so when will we know when to buy low?

The key appears to lie in waiting for real weakness in oil prices. The few periods when the XOI enjoyed strong performance relative to the S&P 500 all came after periods of deep discounts in the intermonth spread, including the most recent minor rallies in late 1998 and mid-1999. You can follow this spread easily yourself; right now, just watch [April crude - May crude], and keep rolling the months forward. Wait for the front month to fall to a discount, which will be accompanied by low crude oil prices. That will be your buy signal. With value stocks in general and oil stocks in particular unloved, longer-term and patient investors should fare rather well.



Backwardation And Oil Stock Returns
Backwardation
XOI Vs. SPX
(Month 1 - Month 2)/Month 1
Relative Movement of XOI To SPX, Dec. 9, 1988 = 100%
9%
4%
-1%
-6%
-11%
135%
125%
115%
105%
95%
85%
75%
65%
55%
45%
Dec-88
Apr-89
Aug-89
Dec-89
Mar-90
Jul-90
Nov-90
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