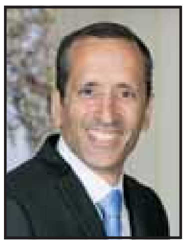
How to Avoid Another Energy Crisis



By Jonathan Caplan

Let's face it—filling up your tank these days is not as much fun as it used to be. The Russian attack on Ukraine is certainly one of the causes of the recent price surge at the gas pumps. Moreover, since the war broke out, energy prices, grain prices and select metals prices have skyrocketed and are now hovering at levels not seen in some time. A portion of this price inflation can be attributed to market speculation by professional commodity traders, which has abated somewhat in recent days.

But the longer-term prospects for a reversion back to lower prices has become increasingly doubtful. I believe that this is at least partly due to poor decision-making by our elected officials. And the consequences of policy missteps could have severe consequences. Economists and commodity market forecasters are raising the possibility that consumers will feel the financial pinch of heating their homes and feeding their families in the coming months and possibly longer. It may soon become clear that poor public policy can hurt your pocketbook—and your investment portfolio.

A Focus on Energy

Some may ask: "Why are we once again being held hostage to higher gasoline prices? That is so 1970s!?" Let us first explore the economic history of that era.

In the 1970s, the United States was a major importer of OPEC oil. Following the 1973 Yom Kippur war, major Middle Eastern oil producers wanted to "punish" the United States for its support of Israel during the war. Energy prices began to soar. Shortages of fuel led to long lines at gas stations. This forced the government to intervene by rationing consumer purchases of gasoline. Suddenly, Americans learned that our economy and way of life was vulnerable to economic warfare.

Over the next few decades, through technological breakthroughs and more prudent government policy, the United States gradually transformed itself into the world's largest producer of oil and natural gas. And a few years ago we finally achieved energy independence.

So Why Is the War in Ukraine Causing Prices to Soar in the US?

If the United States is now "energy independent," then why are the prices at the pump soaring? The main answer is that the oil markets (as well as many other commodity markets) are indeed global markets. If there are shortages in Europe, it will eventually impact the prices in all regions across the world to bring the global market in balance.

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Now you will hear politicians claim that the "greedy" big oil companies are once again taking advantage of the U.S. consumer. Newsflash: That is a completely false narrative. The blame for global energy shortages lies mainly with short-sighted energy policy, not only in the United States but across the globe.

If our politicians desire stability in oil prices, they need to allow energy producers to do their job of investing in production growth. Disincentivizing energy producers from investing will ensure that the supply/demand imbalance will get worse. Technological breakthroughs such as hydraulic fracking have made it easier and cheaper for energy producers to grow production. But Washington and many EU countries have been taking actions that make it increasingly more difficult for producers to increase investment in new production.

Clean energy is a lofty, if not necessary, goal to sustain our environment. But the transition to clean energy will take many years. We will need to continue to produce fossil fuels even while we aspire to a more-sustainable environment.

What I am suggesting is not just some talking points from the oil industry lobby. Last week I attended a webcast that featured Larry Summers, former treasury secretary under Bill Clinton and a respected economist. This is what he said regarding soaring energy prices:

"Policymakers have made a substantial error on energy policy over many years. Natural gas is 75% of the way toward the transformation from coal to clean energy. Policymakers should complain less about corporate greed and pay more attention to regulatory obstacles, which will help reduce energy costs in a meaningful way. Policymakers need to focus more on energy security."

Many European Union countries are hurting much more than we are, also due to short-sighted policies. Germany has become hostage to Russian oil and gas supplies as policymakers have abandoned nuclear power. The upshot in Germany and across Europe is that utilities are facing severe shortages of natural gas this winter. Aside from the severe economic bite due to higher prices, there have been credible concerns that supplies could run out before the end of the winter heating season. Let us hope that our policymakers do not let those dynamics reach our shores!

Investment Implications

Our firm has been advancing the idea for some time that energy prices were likely poised for a steep climb. When oil prices collapsed and briefly traded below zero in the wake of the COVID-19 economic shutdown, we penned a blog that laid out a case for higher prices for fossil fuels longer term. And while the many breathless talking heads on CNBC were calling the energy sector "uninvestable" at that time, we laid out an opposing investment thesis:

"The long-term outlook for the price of oil is not as bleak as the short-term outlook. We expect supply to fall sharply in coming months as bankruptcies of poorly financed oil production companies mount. Moreover, we expect the larger and financially stronger companies to benefit longer term from the decline in supply. Interestingly, the large oil stocks declined yesterday, but not as sharply as one may have expected. So, we believe we may be closer to a bottom in the price of energy stocks than most pundits believe."

Several months later oil and gas stocks bottomed and began rising steadily over the next 18 months. Many of the stocks that we bought around that time have risen as much as fivefold since the low. This proves once again that successful investing can be the result of taking the opposing view to the conventional wisdom, even if it means going against the opinions of the "consensus." This is a case in point when a well-reasoned investment strategy can make a huge contribution to one's long-term portfolio performance.

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