

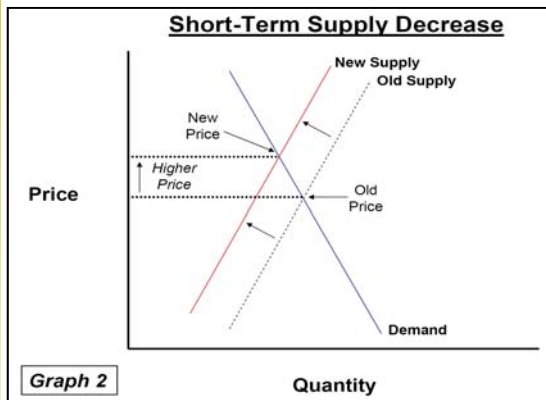
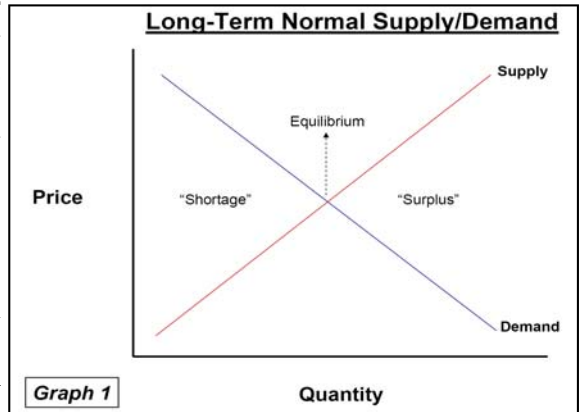
Goodman Financial Corporation: Special Research Report

July 2008

Oil: Supply, Demand & Speculation

With the price of a gallon of gasoline rising to around \$4.00 per gallon, the topic of crude oil and its price has been a headline story for media outlets around the world. This calls for a brief discussion on the principles of supply and demand for oil worldwide and other factors that are influencing prices.

Recent news headlines have been pointing the finger at investment speculation (placing bets via futures contracts that the price of oil will rise) as the cause for historic high prices of crude oil. According to the Energy Hedge Fund Center, investments in commodity index funds have grown from \$13 billion to \$260 billion over the past five years, due both to a combination of an increase in commodity investing as well as, to a lesser degree, an increase in the market value of those investments. The prices for oil have skyrocketed, yet the basic principles of supply and demand would suggest that demand should then sharply fall in response, which has not happened. As a result, the demand for oil can be currently labeled 'inelastic,' meaning that changes in price do not severely affect consumer demand in the short-term. A normal supply and demand curve resembles Graph 1 to the right.



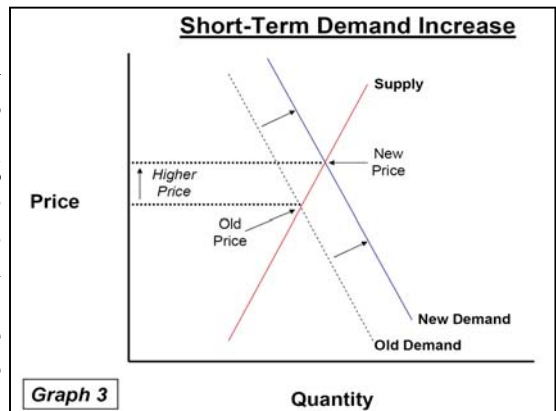
In the normal scenario, as prices increase, demand decreases and supply eventually increases causing a surplus. Alternatively, when prices decrease, demand increases and supply decreases causing a shortage. Oil prices are not presently behaving in this way as there are minimal substitutes for oil currently available. Even with gasoline prices at their current levels, the majority of consumers cannot immediately sell their cars and purchase a hybrid vehicle or reduce their daily commute to their jobs. **Thus, the supply and demand curves for oil in the short-term are steeper.** This means that small changes to the supply or demand curve cause large changes to the equilibrium price. For example, after Hurricane Katrina destroyed wells in the Gulf of Mexico and reduced production, this shifted the sup-

ply curve to the left, resulting in a rise in prices for the quantity produced (See Graph 2).

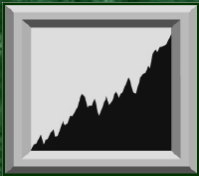
The same applies to an increase in demand, in which the demand curve would shift to the right, thereby increasing prices in the short-term (See Graph 3).

An example of this is the industrialization of emerging markets such as China and India. Due to their large populations, as they require more oil for their advancing economies and emerging middle class, a shift (increase) in demand will occur. This has happened over a relatively short time period.

However, the industrialization of China and India are not the only factors that have been causing increases in crude oil prices. As discussed earlier, recent news headlines and politicians are blaming speculation as a major role player in



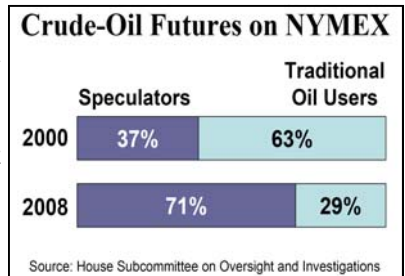
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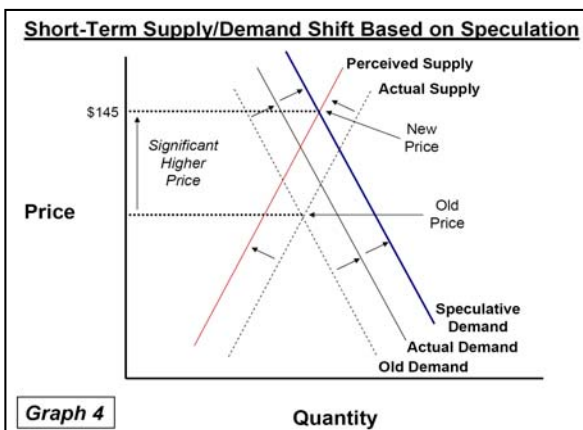
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the historic run-up in oil prices. In a June 23rd, 2008 Wall Street Journal article, these speculators are identified as “pension funds and investment banks that never take physical custody of oil, but instead invest in oil futures contracts as a way to hedge against inflation and diversify their portfolios.” **Recent figures released by the House Subcommittee on Oversight and Investigations state that speculative traders now account for 71% of all oil futures contracts on the New York Mercantile Exchange, up from 37% in 2000.** Traditional oil users now only hold 29% of the contracts as opposed to 63% in 2000.



To put the magnitude of these speculators' role in the commodity market into perspective, we can look at our previous example of the industrialization of emerging markets. Masters Capital Management LLC noted that annual demand for petroleum in China has increased by 920 million barrels over the last five years. In addition to actual Chinese demand, speculative traders have raised their demand for petroleum futures contracts by 848 million barrels over the same period. These speculators nearly match the increase in oil demand of a country with a population of 1.3 billion; that impact cannot be ignored.

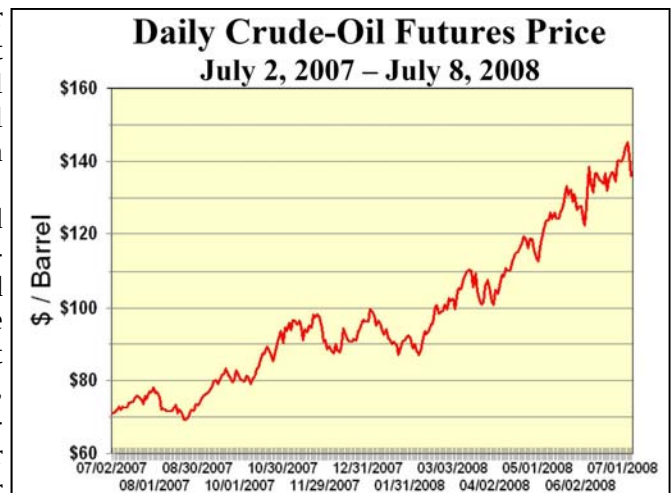
Pension funds and institutional investors are able to take such large positions in futures contracts be-



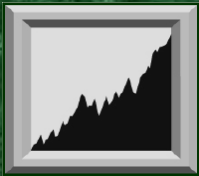
cause of the ‘Enron loophole’ that does not regulate speculative trading by these institutions. For example, the University of Texas Investment Management Co. has around \$500 million invested in commodities while the Teacher Retirement System of Texas now has a market value of \$4.4 billion invested in commodity indexes. The result of large in-flows of dollars from these and other institutions' speculative investments is believed to have affected crude oil prices greatly. In effect, this has created a perception of a significant increase in demand. Also, disruptions such as political instability have generated a perception of future decreases in supply for oil that shifts prices up in the short-term. The supply and demand curve in Graph 4 to the left illustrates this.

Lately, light, sweet crude futures have been trading as high as \$145 per barrel. However, a recent report by Exxon Mobil Senior Vice President J. Stephen Simon stated that the current price for crude oil should be around \$50 to \$55 per barrel based on historical supply levels. He also said that speculation, along with geopolitical instability and a weak U.S. dollar have created a “disconnect” between past and current prices. In the May economic letter from the Federal Reserve Bank of Dallas, it was noted that global oil consumption has only increased 1.21% per year from 2004 to 2007.

Up to this point, the concepts of supply and demand for oil have only been discussed in the short-term. That is the key to this analysis. With supply and demand being inelastic in the short-term for oil, these outside forces are inflating prices that do not reflect actual supply and demand levels. In the long-term, supply/demand dynamics tend to become elastic resulting in price levels having little or no speculation or perception influences. For example, as substitutes for



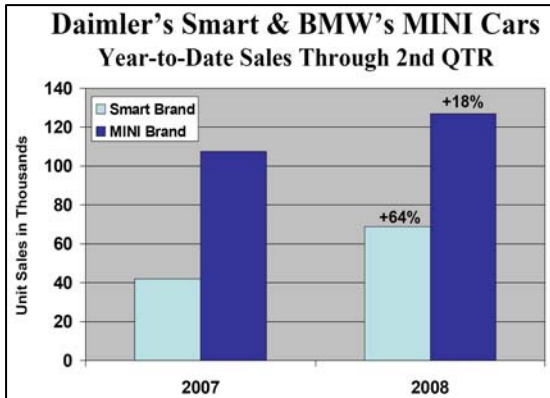
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oil continue to be researched, oil companies put more dollars into exploration, and alternative energy methods become more prominent, they will eventually be reflected in the supply and demand curves and, consequently, bring the price of crude oil down. Consumers are beginning to realize the financial burden of current energy



prices on their everyday lives, and with time, will take measures to address the problem. This can already be seen in the decrease in sales figures of large SUVs or trucks, along with the cutbacks on flights by airline companies. The chart to the right was published in the June 21st, 2008 Wall Street Journal and shows the slumping sales for some of Ford's most popular trucks and SUVs through May. Furthermore, GM's truck sales are down 22% for the year through May as consumers look for more fuel efficient options when purchasing a vehicle. Two examples of popular fuel efficient vehicles are the Smart brand by Daimler's Mercedes-Benz segment and the MINI brand by the BMW Group. The Smart ForTwo model has been a success throughout Europe, and was first introduced to the U.S. market in January of 2008. Year-to-date unit sales for the Smart car have risen 64% to 68,900 from 42,000 cars in the prior year period, while MINI sales have risen 18% to 126,810 vehicles in 2008.

It takes time for consumers to do their research and explore their options prior to taking action. Given that time, the demand for oil will slow and supplies will increase as exploration continues and alternative energy sources are developed. As a result, a price correction should occur (See Graph 5).

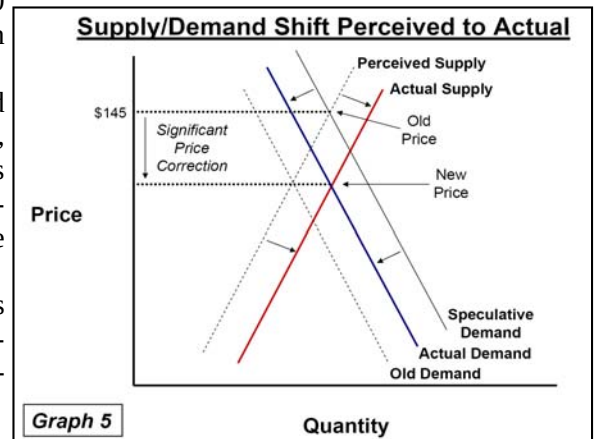
In the short-term, price relief should materialize as perceptions of supply and demand move closer to their reality. In the long-term, simply put, the price will be determined by the laws of supply and demand.

Tough Sell

Sales of some of Ford's top trucks and SUVs, through May

Model	2008 sales	Pct. change from '07
Expedition	28,686	-30.6%
Explorer	43,116	-28.7
F-Series	235,924	-18.7

Source: Autodata



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