MORNING NOTES
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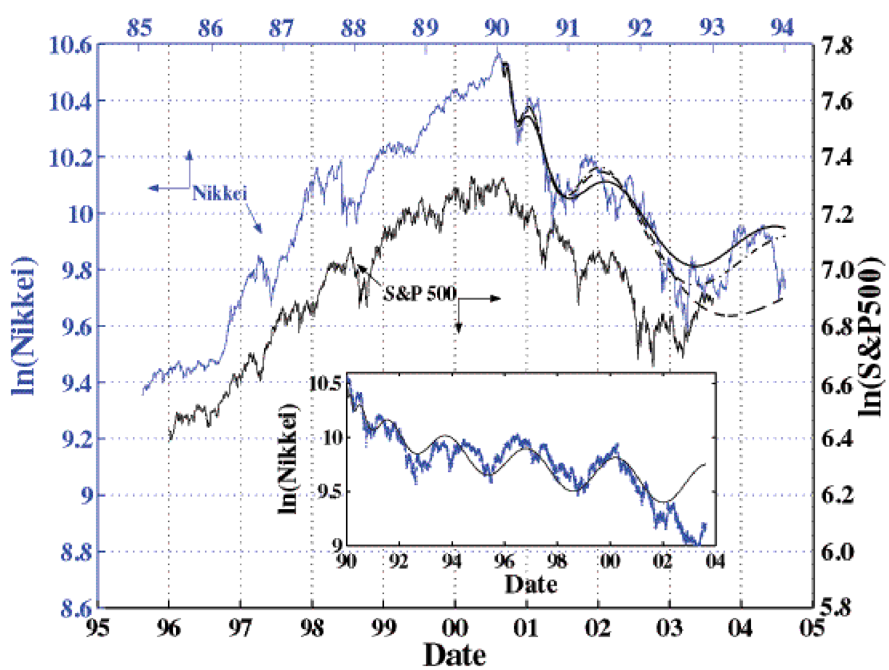
Today's Notes:

1. Don't Cover Up
2. Oil: a 10 to 15 year deficit

1. DON'T COVER UP

In my last year as a Professor of Business Administration at the Darden Graduate School at The University of Virginia, I invited a Japanese expert of the day, Paul Aron of Daiwa Securities, to visit my second year investments class and speak on the Japanese economy and stock market. It was the Fall of 1989. One of the largest bubbles of the day was brewing in Japan. The Japanese economy and assets were boiling. Real estate share prices and other hard asset prices ballooned. Prices were highest in Tokyo's Ginza district in 1989, with choice properties fetching over 100 million yen ($1 million US dollars) per square meter ($93,000 per square foot). Prices were only marginally less in other large business districts of Tokyo. By 2004, prime "A" property in Tokyo's financial districts had slumped to less than 1 % of its peak, and Tokyo's residential homes were less than a tenth of their peak, but still managed to be listed as the most expensive in the world. The Nikkei stock index touched the rarified level of 40,000 that fall. Mr. Aron, now deceased, gave a sparkling lecture enjoyed by all. In his talk Paul suggested that Japanese stocks were not really overvalued. He disassembled Japanese P/E multiples and rebuilt them for the class based on US principles. The conclusion was that Japanese stocks trading at 60 times trailing earnings once adjusted for cultural differences were actually cheap – good values! I won't go into Paul's reasoning – yet it made good sense at the time. Within months the Nikkei peaked and began its 18 year decent into obscurity, as the following graph, comparing the S&P500 from 1996 forward, shows. The similarity is glaring.

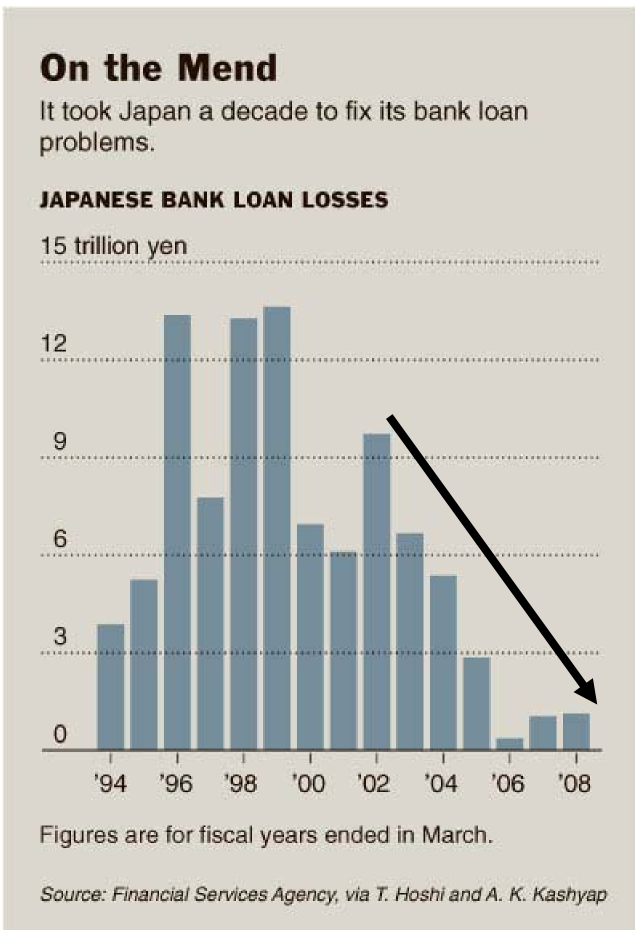


Japan lost the rest of that decade and most of the next to inaction. Within a few years as the Japanese asset bubbles burst their banking system was impacted in ways not dissimilar to the plight of the US, British and European banks today. The New York Times notes this AM,

"The Japanese crisis of the 1990s and early 2000s had roots similar to the American crisis: a real estate bubble that collapsed, leaving banks holding trillions of yen in loans that were virtually worthless."

Japan did not begin to solve its banking problems till 2002; 6 years after the banking crisis broke. Prime Minister Koizumi finally forced a hard analysis of the assets on the banking system's books and the write-off of these assets considered toxic. It was unfortunate that the powers in Japan refused to get the bad news (and bad assets) out. No one really wanted to admit the scope of the problem and it festered for two decades. "Zombie companies", those that had formerly boasted the 60 P/E multiples, layered bank balance sheets and dragged the Japanese economy down. The Nikkei index declined by 75% of its value.

It is readily apparent that the scope of the US and OECD banking problem is much larger. Neither the Paulson nor the Geithner Treasury seems to have a firm plan for rectifying the situation.



Heizo Takenaka, headed the Japanese government's financial reform efforts. These finally brought the full extent of bad loans to light. Mr. Takenaka's rallying cry, he said,

"Don't cover up. Don't distort principles. Follow the rules."

It took three years to erase the bad loans off the banks' books. One bank, which was found to have insufficient capital, was nationalized. From 1992 to 2005, Japanese banks wrote off about 96 trillion yen, or about **19 % of the country's annual G.D.P. *"That was a turning point in the banking crisis,"*** said Mr. Gomi of the Financial Services Agency, who worked with Mr. Takenaka on the audits. By then, other factors had fallen into place that aided economic recovery, including a boom in exports to the United States and China

The Japanese cannot understand why the US government, Republican and Democrat alike cannot see the result of Japan's lengthy cover up. It is clear some US banks must be nationalized and that assets for which we have no rational valuation procedure should be sought and written off – now. The Times suggests ***"The way things are going right now, the U.S. taxpayers' burden will keep going up and up."***

2. OIL

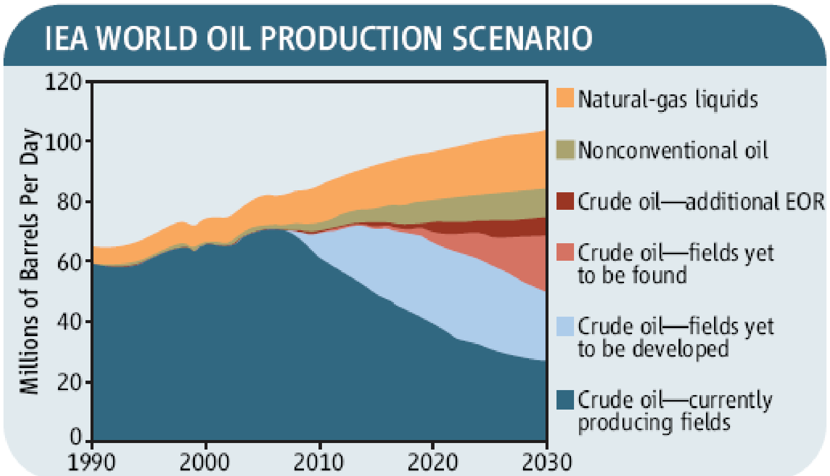
Many observers are quietly smiling at the plight of the OPEC producers and Russia. With WTI trading (**inexplicably**) at $34.70 this AM and Brent crude trading $10 higher at $45, most of those countries are in trouble. The reason is that while oil rose continually from 2004 to peak at $147 last July, OPEC's budgets expanded even more. Russia, for example has had to draw down 40% of her foreign exchange surplus to support her currency and banks. He has continually devalued her currency to address the problem. She recently declared that she would re budget the Russian economy based on $41 oil. Senior Chavez in Venezuela needs $90 oil and the Iranians needs north of $80 oil to support their spending plans. Obviously many of those spending plans will be put on hold.

But there are other side effects as well not so comfortable for the West. Companies that we have supported such as MegaWest and Derek Oil and Gas, both producing heavy oil, have had to pull back. Their share prices have been devastated. Derek is installing new boilers at its Lak Ranch field. The company is currently raising capital to support this new installation. MegaWest has ceased injecting steam into its US heavy oil fields. The story is the same across the oil sands. Even Suncor, a producer in the Canadian oil sands since 1968, announced two weeks ago that they would cut $3 billion from the capital budget for new projects. The OPEC producers are also pulling back on investments. All this pushes out increases in global oil production.

The current deflationary tendencies notwithstanding, most observers believe that $50 or $70 oil is in the near future. In fact, if one were to look across the entire commodity spectrum you would observe decade long supply destruction almost everywhere.

The International Energy Agency opines that ***"non-OPEC conventional oil is most definitely at a peak."*** This spike down in oil prices since July 2008 has taken any marginal non-conventional projects - including many in the Canadian oil sands off the table – for now. It will be expensive to restart them. Yesterday the ***Economist*** noted that corn-based ethanol producers were ceasing capital spending and many were attempting to sell their new facilities.

The Journal Science (Nov 18 2008) wrote, ***"The fall in oil prices will likely be short-lived, say those in the know. Although price spikes and drops may recur for years, says economist Fatih Birol, "we think the era of cheap oil is over." He and colleagues at the Paris-based International Energy Agency (IEA) just released their World Energy Outlook 2008. IEA analysts see enough oil still in the ground to satisfy ever-rising demand for decades to come—assuming the price continues to rise. But they aren't at all sure that the Middle Eastern government-owned oil companies sitting on most of the remaining oil will be pumping it fast enough a decade or two from now to meet the unbridled demands of the rest of world."***



It'll work, if ... In this scenario from IEA, the world's rising demand for fluid fuels will be met by growing unconventional oil and natural-gas liquids production, but only if OPEC expands its production of crude oil.

It is very clear that we need to bring on all the unconventional oil and gas production in the US and Canada – starting now. That is why I still think MegaWest, Valcent and Derek are very good discovery plays. The IEA notes that this delay in spending on both conventional and non-conventional oil resource discovery,

"Could precipitate a calamitous oil crunch as early as the middle of the next decade. There can be no guarantee that [oil resources] will be exploited quickly enough" to meet expected demand.

David Greene of Oak Ridge National Laboratory suggests the non-OPEC world will not be able to increase oil production much if at all,

"The United States can help itself but it's going to be tough. Insulating the economy from the worst oil price effects takes a long time, 10 to 15 years. You have to do just about everything you can think of, from further improving the efficiency of cars and light trucks to bringing on biofuels to producing more oil in the United States. You have to have a comprehensive structure and a measurable goal. We don't have that now. I just hope the Obama Administration doesn't look at the [current] price of oil and shove the problem to the back burner."

And so it seems we have 10 to 15 years of dwindling oil supplies in front of us, at a time in which we will not have fully deployed alternative energy strategies. One might hope that electric cars could be a reality in that timeframe but that seems quite a stretch given the past and current lack of focus on energy planning in this country. Both agencies suggest $100 to $200 oil is in the future. Stay tuned.

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