Are Inflation Fears Driving Oil and Gas Investments?

Inflation so ravaged investors in the 1970s that they feared it for most of the 1980s and many sought oil investments for refuge. Such concerns drained away during the 1990s until recent outright fear of deflation sparked nostalgia for some good old rising prices.

Those buying medical care, housing, an education—gasoline—might say emphatically that inflation has returned with a vengeance. Yet the Consumer Price Index (CPI) remains curiously low. This begs a pair of interesting questions. First, which comes first, inflation or rising prices? And second, are investors hedging against inflation by allocating capital to private oil and gas investments?

COSCO Capital Management LLC, a New York-based oil and gas investment advisory firm, surveyed investors regarding these issues. The punch line: inflation comes first, but its threat has not triggered a stampede into private oil and gas.

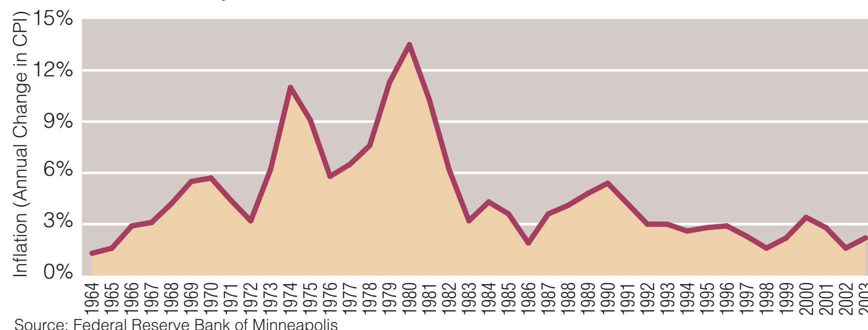
Inflation is classically defined as growth in the quantity of money that exceeds the rate of growth in demand for money. It follows, therefore, that inflation must exist before it appears in a rising CPI. A hedge-fund manager recently told *The Wall Street Journal*, "If you need the government telling you what inflation is running at, you have no business in financial markets."

While deflation fears gripped the markets recently, a growing chorus of contrarians howled that great events, including three enumerated here, were paving the way for a significant new inflation.

- Asian economies are growing dramatically and supplying the rest of the world with a variety of goods. Increasingly, the producers of these goods spend their prodigious cash flows on commodities, oil among them, thereby driving up commodity prices.
- Some argue the significant deterioration of the U.S. fiscal position is tantamount to a stealth tax increase that may become reality after the 2004 elections, and that may be inflationary.
- By far most important is the precarious cycle of U.S. purchases of Asian goods at exchange rates that are fixed or influenced by the printing of local currency to purchase dollars, which are often reinvested in U.S. Treasury and agency securities. Oilmen call this vendor-financing. In monetary circles, it's called excessive money-printing. And excessive money-printing is inflation.

Long memories recall that during the great inflation of the 1970s, direct oil and gas investments, and to a much lesser degree, oil and gas public equities, were among the few asset classes that delivered attractive rates of return.

Rate of Inflation, 1964-2003



Source: Federal Reserve Bank of Minneapolis

The seeds for the 1970s inflation were sown in the late 1960s, when CPI inflation remained low during a period of excessive liquidity and war financing. Many have argued, in fact, that the 1973 oil-price shock was nothing more than OPEC's effort to corner an inflation that had been unleashed years earlier.

By the end of the 1970s, fixed-income investors flocked to oil and gas investments as an ideal hedge against inflation-ravaged bond portfolios. One might theorize that, while their timing was less than perfect last time, such investors might take preemptive action against the renewed threat of inflation today.

We decided to test that theory. COSCO surveyed more than a dozen oil and gas money-management firms, pension-consulting firms and institutional investors by posing the question: Are investors increasing their capital allocations to private oil and gas investments to hedge against inflation? The answer was a resounding "no."

Recent oil and gas fund offerings have been oversubscribed and some repeat limited partners have complained their fund allotments were reduced to accommodate new investors. **First Reserve**, **Quantum Energy Partners** and **Natural Gas Partners** have each raised more money quicker, and others among their peers are diligently following suit. A sampling of reasons given for this money flow follows, but inflation is simply not among them.

Commodities are a growth area. More than one pension consultant referred to global demographics, especially long-term economic growth in China and India. These are powerful drivers of commodity prices, from which owners of oil and gas reserves will benefit.

Poor relative outlook for equities. Another theme heard from pension consultants and money managers was that public equities performed so well during the last two decades that little likelihood exists that equities can or will continue to do well during the next decade. Therefore, any asset class negatively correlated to equities provides a potentially attractive alternative, and private oil and gas is among these alternatives.

Superior returns. Money managers reported their investors increased capital allocations to oil and gas simply because oil and gas private equity funds have been delivering substantially better rates of return than other private equity funds or alternative investment strategies. In fact, one money manager cited a prominent venture capitalist as saying he expects venture returns to remain mired in the single digits for several years, so this has sparked his interest in unique alternatives such as oil and gas.

Historically low allocation. Several investors who recently increased their oil and gas allocations did so because they had plenty of cash and had been underweight in energy for years. This reasoning was cited by fund investors and direct investors alike.

Better inflation hedges. Oil was generally not considered an ideal inflation hedge. Instead, respondents said, real estate, timber, Treasury inflation-protected securities (TIPS) and precious metals were superior inflation hedges. One money manager cited timber funds, in particular, as having experienced significant new capital flows for this reason.

Although the lack of focus on inflation was a surprise in this survey, it also suggests there is plenty of room for this focus to emerge in the future. If past is prologue, then rising interest rates or dollar depreciation will join this list of factors driving private oil and gas investment demand. The absence of these factors on this list today just might indicate there is still more oil and gas investment demand coming.

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