Energising America

Henry Molloy examines a recent increase in the US of insider buys in energy and natural gas.

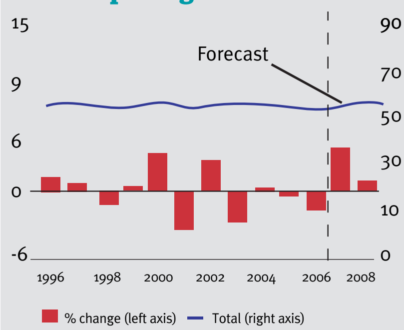
We have been picking through the pieces of the recent market turmoil and have found that interesting energy infrastructure and natural gas both show significant insider buys. It appears that after decades of under investment, commodities are finally having their moment in the sun. Could this be a rerun of the commodity bull run of the '70s or has there been a fundamental change in the supply demand dynamics of these resources?

China and India, to name but two emerging economies, are rapidly developing a thirst as big as the US for these precious ingredients and perhaps there is truth behind Hubert's peak production theory. That being the case, there remains many years of out performance for this sector.

The housing market is unravelling in front of our eyes and looks very similar to the internet bubble – except this time investors are losing their houses. Of course this cannot auger well for consumer confidence, yet it appears to be holding up quite well, with Bernanke, Paulson and Wall Street Titans like Citibank and JP Morgan trying to avoid a complete crisis. We are confident that like the last asset bubble that popped, we will overcome this one and, indeed, come back stronger than ever before.

With the recent market intervention by the Fed, it was made very clear that while its primary role is to contain inflation, it is in fact more concerned about maintaining continued economic strength. With interest rates at 4.75%, it gives the Fed plenty of room to stimulate the economy, given that they ignore two real key components: food and energy.

Total US natural gas consumption growth



Social security is linked to the rate of inflation, and if they told the truth about the real rise in the cost of living without conveniently padding the numbers, they would bankrupt the country. How long this falsehood can last is anyone's guess, but it has been working for sometime and we don't see any immediate change in policy on the horizon.

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Natural gas has become extremely popular as a major source of energy in the US, both for consumers and industry, in part because it burns cleaner and has a minimal impact on the environment. With the Democrats coming into power, we believe that there will be a shift away from oil and that emphasis will be placed on this clean burning fuel. Thus the forecast for trend growth is positive (see chart).

This year gas supplies are unusually high due to a relatively cool summer, mild winter and lack of any significant hurricane activity. As in the past, insiders like Aubrey McClendon, CEO of Chesapeake Energy (CHK), and Charles Goodson, chairman of PetroQuest (PQ), have taken advantage of this weakness to add to their positions. Bear in mind that valuations of these companies are still quite depressed relative to their five-year averages. Also with oil above $80, natural gas is looking very cheap indeed. As a rule of thumb, oil and gas trade at about a 7:1 ratio, which puts natural gas at about $11.40 – a far cry from its recent close just above $7.

For anyone that feels that the US economy – or in fact the world economy – is part of a more significant and prolonged slow down than anticipated, then we suggest buying into energy infrastructure companies. Insiders demonstrated their confidence by buying huge amounts of stocks in industry bell weathers like Enterprise Product Partners (EPD). As an asset class, they tend to do very well, especially during times of economic uncertainty and falling interest rates. According to Raymond James research, their total annualizes returns were 32.69% from January 2000 through to the end of June 2005, while the S&P 500 index returned 2.07%.

Bear in mind that some of these MLPs pay as much as 6.5% dividend – about 300% more than the S&P – and dividends play a very significant role in total return especially for long term investors.

Homebuilders continue to get hammered, and deservedly so as many continue to build, while inventories are continuing to grow. We expect to see headline bankruptcies as some very fragile balance sheets crumble and, like the technology implosion, we will wait for insiders to start buying and buying in size before we step in. Patience is a virtue. ◆

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