

Big Wave Commentary

Mexico and Oil...A Double Whammy for the US Economy?

With the sub prime mortgage mess grabbing all the headlines, it is easy to take your eye off the ball and miss some other important investment themes lurking underneath the surface. One of these themes could provide investors with a great opportunity while at the same time, add to US economic woes for 2008. The theme is Mexico and specifically Mexican crude oil production.

Even though oil prices have had a great upside run since 2002, the general consensus while bullish, has continually underestimated the long term price of oil. Most focus their bullishness on the demand side of the equation while I tend to be bullish because of the supply side. I think oil prices will continue to stay high because we have peaked out in terms of production. Let's look at the word out of Mexico as a prime example of this supply side problem.

With the recent release of production figures from the Mexican government, it appears that we are now witnessing a potential collapse in Mexican oil production in the Cantarell oil fields. The Cantarell field complex is the largest oil field in Mexico and one of the largest in the world. Discovered in 1976, Cantarell has produced almost 11,500 billion barrels (b/d) of oil during its lifetime.

Earlier this year, PENMEX, Mexico's state owned and nationalized oil company announced that production from Cantarell fell from 1.99 million barrels a day to 1.44 million b/d. a 27% drop. They also announced that production from all of their fields combined dropped under 3 million b/d for the first time in 6 years. Despite their efforts to repressurize the wells, production is estimated to fall in 2007 another 600,000 b/d. Leading US drilling rig executives are confirming that Mexican government officials are "very concerned" or in a "panic" over these numbers. Oil experts now think that Mexican oil production peaked in 2004 and production could lessen by 1 million b/d by 2010.

This sudden shortfall of oil has serious implications for the US and Mexican economies. Mexico derives almost 40% of its federal budget from PENMEX's profits. Last year revenue from Mexico's crude exports reached an all time high 34.7 billion. A significant drop in revenues to the Mexican economy is concerning since their subsidies and welfare programs are very expensive. Any cuts or threat of cuts in these programs will not only negatively affect their economic and political landscape, but currency as well. The Peso should fall hard, as it always has, in past Mexican economic crises.

The US economy relies heavily on Mexican oil. In 2005 Mexico exported 1.82 million b/d and most of it was to the US. By December 2006, oil exports dropped to 1.53 million b/d. With a growing Mexican economy continuing to demand more domestic fuel, Mexico has already warned US crude importers that it will be unable to fulfill some existing US contracts. It is estimated that US imports could drop by 1 million b/d by the end of this year. A loss of that magnitude will be hard and expensive for the US to make up thru spot contracts on the international market.

Mexico's dwindling production is one example but on a world view it is just as alarming. A recent study by ExxonMobil came to the conclusion that the peak in oil discovery was in the late 1960's. After 40 years of the most advanced technological applications, no new major fields have been discovered to reverse the declining trend of discovery. The odds are increasing that many of the biggest, oldest fields are at or near their peak production levels. If ExxonMobil's assessment is right, the era of cheap oil is over. Despite what demand does, oil production supply, is in the process of peaking.

Should this idea of peaking oil production become a consensus view, the negative implications to financial markets or the economy are obvious. But, oil prices

should rise, therein lies a profit opportunity. Oil ETFs should be researched and prices watched for any weakness.

As the sub prime woes continue to grab the headlines, look below the surface, below to where oil lies. Rethink your views and look to the supply side of this commodity. It still may surprise on the upside.

OF NOTE: The next shoe could drop on the stock market as we get near Sept 30th. This is the date when distressed hedge funds will be forced to sell securities in order to raise cash to meet redemptions by quarter end. How much selling there is and what effect it will have on the markets remains to be seen. But be aware of this before buying stocks or bonds.

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