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Our Thoughts Regarding Oil Prices, the Stock Market, and the New Tax Bill

Why We Think Oil Prices Are In the “Sweet Spot”

You may think we are crazy as you fume over skyrocketing gasoline prices!

Adjusted for 2005 dollars, oil prices are still a bargain, and have yet to match the levels reached in 1981 when it was $86 per barrel, or in 1864 when it was $102 per barrel. This means we are still paying less than we should be for oil if we adjust for inflation. Yet, at the current $60 to $70 per barrel price level, it now may make economic sense to develop alternative sources of energy, which is the real long-term solution for our economy and our security as a nation.

One example of alternative energy sources that may now be economically viable is oil shale.

There’s a new (Actually, it is VERY old) source of oil in the American West. Today, this gigantic oil deposit sits idle — untapped — inside more than 16,000 square miles of a special kind of rock under Wyoming, Colorado, and Utah.

There’s an interesting story about this rock. It’s about a cowboy who spent all summer building a cabin for the winter. He chinked the cracks with mud and built a big fireplace out of local stone. The first cold night, he built a roaring fire, and the stones of his fireplace burned down the cabin!

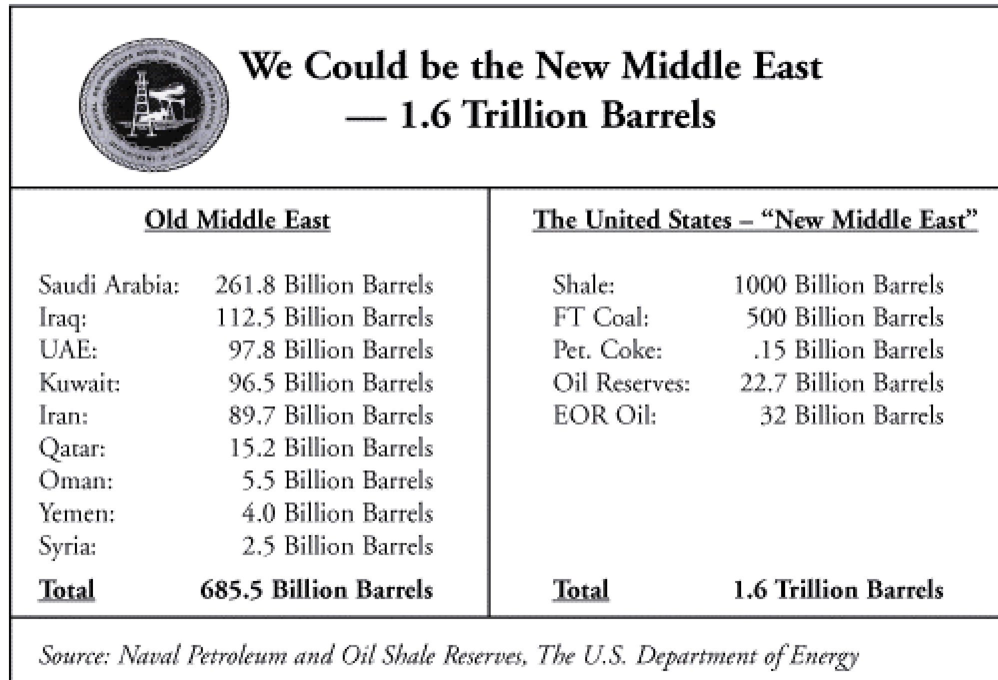
The cowboy built his fireplace out of oil shale… Oil shale is full of kerogen, which is like immature oil. You can’t blame the old cowboy… at first glance, oil shale looks like an ordinary black rock. It feels grainy to the touch and… greasy. But as he found out the hard way, oil shale is full of crude oil…

And although you don’t hear much about oil shale, this form of “unconventional oil” has the potential to be one of America’s major sources of petroleum for the next few generations.
The first recorded use of oil shale in America is by the Ute Indians, as they described it as “a rock that burns.”

In the U.S., oil shale begins to look attractive every time conventional oil gets expensive. In the 1850’s, early oil shale entrepreneurs were upstaged by the first oil well in Titusville, Pennsylvania. After all, why mess with squeezing oil from rocks if the stuff will gush from a hole in the ground?

In the 1940s, renewed interest in oil shale was crushed by the unlimited potential of nuclear energy and the discovery of huge oil fields in the Middle East…
As a result of the price spikes of the 70s, oil shale became a serious business among the major oil companies… modern-day boomtowns sprung up as a result of renewed oil shale interest.

But as booms and busts go, the price of oil dropped soon after, and by 1991, the last major company pulled out, with no return to show for the massive amount of capital spent.
There's a good reason people keep returning to the oil shale deposits… The reason?
This area - the Green River Formation - contains 2 trillion barrels of oil.
It can be difficult to imagine such massive amounts of oil. Below, I've included a page of the Energy Department's report that puts those reserves in perspective.



We Could be the New Middle East — 1.6 Trillion Barrels

Old Middle East		The United States – "New Middle East"	
Saudi Arabia:	261.8 Billion Barrels	Shale:	1000 Billion Barrels
Iraq:	112.5 Billion Barrels	FT Coal:	500 Billion Barrels
UAE:	97.8 Billion Barrels	Pet. Coke:	.15 Billion Barrels
Kuwait:	96.5 Billion Barrels	Oil Reserves:	22.7 Billion Barrels
Iran:	89.7 Billion Barrels	EOR Oil:	32 Billion Barrels
Qatar:	15.2 Billion Barrels		
Oman:	5.5 Billion Barrels		
Yemen:	4.0 Billion Barrels		
Syria:	2.5 Billion Barrels		
Total	**685.5 Billion Barrels**	**Total**	**1.6 Trillion Barrels**

Source: Naval Petroleum and Oil Shale Reserves, The U.S. Department of Energy

As you can see from the table, you could even add together all the oil in the Middle East — and our reserves would still come out on top — 3-TIMES LARGER.

When asked about America's least-publicized oil supply, Utah Senator Orrin Hatch said:

> *"The amounts of oil are staggering. Who would have guessed that in just Colorado and Utah, there is more recoverable oil than in the Middle East?"*

This past January, the government proceeded with the next step in the process. Three companies were each given 160 acres of the government's oil-rich land. The company with the cheapest, most environmentally sound drilling method will be granted full access to the government's oil mother load.

We have a name for people who complain about high fuel prices, then turn around and hinder the production of American oil and gasoline… We call them Congress.

We'll stay out of the debate of drilling in northern Alaska and the coast of Florida… but we'll point out that America's ridiculous NIMBY (Not In My BackYard) policies have prevented a new oil refinery from being built on US soil for thirty years. Thanks to those policies, America has less refining capacity than it did 25 years ago. Combine that lack of capacity with strong oil prices and you get expensive gasoline.

All of the potential alternative face many technological and logistical problems and are not cheap. A recent Forbes expose delineating the complexity of converting to ethanol, concluded we would need gasoline prices of $4.50 per gallon to justify replacing oil. Maybe ethanol will help, but for now, it's high oil prices, high gasoline prices.

What's Up with the Mini Stock Market Correction?
For the last five years, we have been lulled into a false sense of relative benign volatility. The S&P 500 has gone 810 trading days without a 10% correction -- well above the average of 222 days between such pullbacks. Major stock benchmarks have been relatively stable even as other markets, such as commodities and currencies, gyrate, but the risks of a decline increase with the age of the bull run. Just how staid has the stock market been? In the past year, annualized volatility of the S&P 500 was 9.6%, near the bottom of its 16-year range.

The U.S. market has been supported by exceptionally strong earnings and a very healthy economy. Even when we experience a correction (Not IF), remember, this is not 2000, when the go-go stocks had business plans but little in the way of earnings.

Meanwhile, economic reports are showing a nice mix of growth with low inflation. We think the Federal Reserve is close to the end of its rate hikes. First-quarter gross domestic product was revised up to 5.3%, slightly lower than expected but higher than the initial reading of 4.8%.

Don't forget that investments in businesses through the stock markets are long-term investments. We always advise a minimum five year time horizon. Because our clients are broadly invested in globally diversified portfolios, the risks of any single business experiencing problems are greatly minimized. The biggest risk in the near term is panicking due to market volatility caused by emotional investors. The advice you always hear from us…"Just like you don't look at the value of your home in the newspaper daily, the same should hold true for your investments in businesses through the stock market." The daily ups and downs in the stock market should be treated as a sport. Investing in the stock market is like a marathon. Each day in the stock market is akin to a quarter mile in a 26.2 mile marathon. Acting on daily volatility is, in our opinion and history, speculation!

How the New Tax Act Affects You
The Tax Increase Prevention and Reconciliation Act of 2005 has a number of planning implications if you need to fund college and retirement, small-business owners investing in their businesses, and affluent taxpayers hit by the AMT. After months of back-and-forth negotiations, we have a new tax act. The Tax Increase Prevention and Reconciliation Act of 2005 (I love these titles!), signed into law in mid-May but dated 2005 because it is part of a 2005 revenue package (Go figure), offers a couple of tax breaks. Some take effect immediately; others have a built-in delay (try four years!!??).

These modest changes include the definition of a child for kiddie-tax purposes and the repeal of income limitations on conversions to Roth IRAs. Also included are a temporary fix to the alternative minimum tax (AMT), a two-year extension to today's lower tax rates on capital gains and dividends, and an extension of Section 179's small-business expensing thresholds. The kiddie tax, A simple change in the age at which the kiddie tax kicks in may undermine years of

family financial planning. Until now, investment income of children under the age of 14 exceeding specific inflation-adjusted limits ($1,700 in 2006) was taxed at their parents' highest marginal rate, while the investment income of older children was taxed at their own, typically lower rate. The new tax act changes the game. Now, starting with the 2006 tax year, the investment income of children up to the age of 18 is taxed at their parents' higher tax rate.

The change affects two aspects of family financial planning: the vehicles used for college savings and tax-saving strategies involving income shifting.

On the college savings front, the change is the final death knell for custodial accounts, the accounts established under the Uniform Transfers to Minors Acts. Parents may want to transfer existing UGMA/UTMA assets to a 529 College Savings Plan for the same child.

A couple of caveats: Although the money in a 529 Plan is free from current income tax, only cash can be transferred to a 529. So there may be a capital gains hit if stocks or other intangible assets must be sold before making the transfer. Also, since 529 assets can be transferred to another family member and an UGMA/UTMA account is the irrevocable property of the specific child, the account must be segregated.

On the positive side, however, UGMA/UTMA assets within a 529 plan are no longer counted as student-owned assets in the financial aid calculation.

In terms of family income shifting, high-bracket parents have had considerable incentive to transfer appreciating securities to children in a 10% or 15% tax bracket, where the capital gains rate is just 5%. But parents who had planned to sell a child's college stock portfolio after the child reached age 13 and before he or she entered college have no opportunity now—if the child is already past age 13—to accelerate that planning technique. In fact, where the capital gains tax on assets sold by a high school student might have been zero if parents waited until 2008 to sell, this is no longer the case.

But all is not lost. College students and young adults are still most often in lower tax brackets than their parents. If clients continue to gift appreciating property, it can be sold after the child turns 18.

Roth conversions.
Although it doesn't take effect until 2010 (Go figure), the biggest news is that income limits are being removed on conversions from traditional to Roth IRAs. Under present law, and through 2009, if you have more than $100,000 in adjusted gross income, you are ineligible for conversion.

Contributions to Roth IRAs are not deductible, but they have two super-attractive features for high-net-worth clients. First, withdrawals are completely tax-free. Second, because there are no required minimum distributions, accumulated Roth funds may be left in place for future generations.

Starting in 2010, conversions will be available to everyone. A conversion is treated as a taxable distribution, and wise taxpayers will pay the tax from outside funds rather than dipping into the IRA itself and thereby generating an early-withdrawal penalty (if under age 59½) and reducing tax-sheltered retirement savings. Our analysis following the 1997 tax act concluded that

converting to a ROTH made sense if your intention is to pass the assets on to your heirs. Otherwise, we find it difficult recommend paying taxes today for an uncertain future tax world.

Alternative minimum tax

As a demon that haunts more and more taxpayers each year, the alternative minimum tax (AMT) has been crying out for attention. The new tax act takes a baby step toward a temporary fix. Instead of real change, the act extends and increases the amount exempt from the AMT—but just for this year! That means if you were subject to the AMT last year, you will probably be subject to it again this year. Those who didn't have to pay the AMT in 2005 will probably not fall into it this year, although individual people in individual circumstances might or might not be affected.

The respite is brief.

In 2007 we go back to square one.

Dividends and capital gains

The 2003 reduction of the tax rate on dividends and capital gains, to a maximum of 15% with an even lower rate of 5% for taxpayers in the 10% and 15% tax brackets, was scheduled to expire at the end of 2008. The new tax act extends the cuts for two more years, through the end of 2010.

While the extension may appear to be good news for top-bracket taxpayers, clients need to remember the impact of the AMT. If you are subject to the AMT, you actually pay an effective rate of 21% to 22% on capital gains.

Section 179 small-business expenses

Small-business owners may have been considering stepping up purchases to beat the Section 179 sunsets that allow them to expense $100,000 in qualified property through 2006 and 2007. Congress has extended those thresholds (indexed for inflation) through 2009. For 2006, the amounts are $108,000. Without the extension, the expense limits would have fallen to $25,000 in 2008.

We hope our comments regarding energy prices and alternatives, the stock market and the new tax laws have been helpful.

Don't hesitate to call to discuss in further detail.

As always, we thank you for your trust and confidence.

Best regards,
Karen Lee, CFP, CLU, ChFC, MSFS, AEP

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