

# PRIVATE WEALTH MANAGEMENT

# CLIENT UPDATE

August 2008

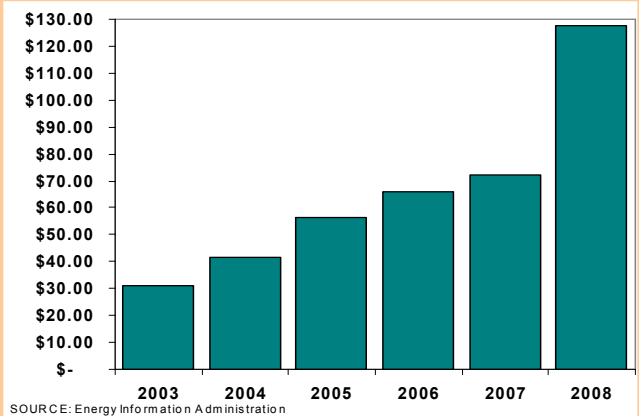
*We periodically provide our clients and friends with updates on various investment, economic, and planning-related topics. Our hope is to give you a concise analysis of issues that impact your portfolio, and help you better understand our investing approach and strategy. As always, we welcome your feedback, questions, and suggestions.*

August 2008 – By now everyone knows the story – nearly insatiable demand from emerging markets like China and India has pushed oil prices to nosebleed levels. And with no let up in sight, the world appears on the precipice of a natural resource disaster.

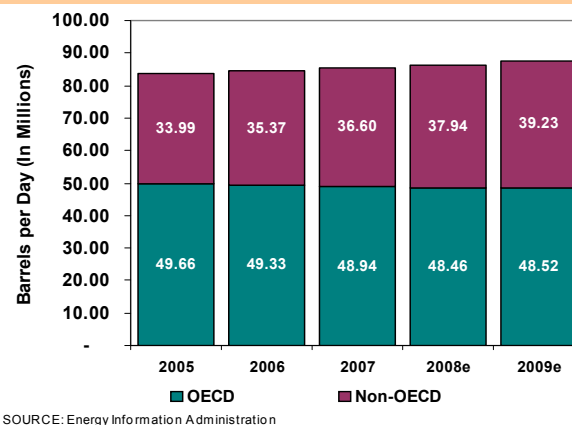
But is this really true? After all, according to the Energy Information Administration (EIA) total worldwide oil consumption has only increased 3.3 percent since 2005 – hardly enough to justify current prices.

Moreover, domestic demand is actually waning. For example, in March we saw the largest ever year-over-year drop in vehicle miles driven and we are headed for the first annual decline in gasoline consumption in almost two decades.

West Texas Intermediate Spot Price (Average)



Total Worldwide Oil Consumption



The tide also seems to be slowly shifting overseas. While half the world's population is insulated from oil price increases by government subsidies, countries such as Taiwan, India, and Malaysia have recently announced plans to curb price controls. And passing along higher prices to consumers should at least theoretically temper oil demand in these countries.

So, if increasing demand alone can't explain the recent parabolic rise in oil prices, what other factors may be adding fuel to the fire, so to speak?

"The key to making money in stocks is not to get scared out of them."

- Peter Lynch  
Fidelity Investments

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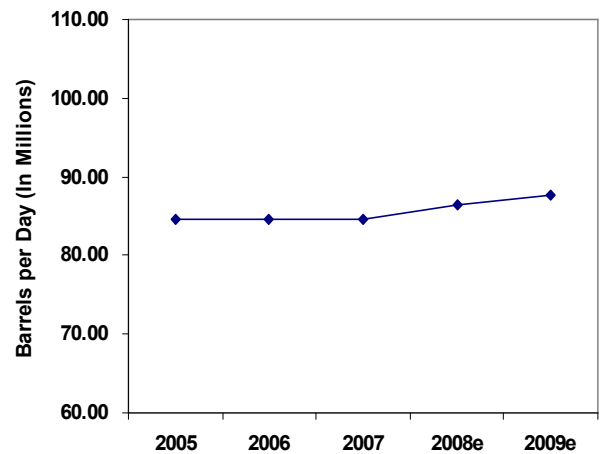
## Stagnant Worldwide Production

Worldwide oil production has remained relatively flat since 2005. In fact, many major oil producing regions – including Mexico and the North Sea – have actually seen production fall recently.

These regional production shortfalls, when coupled with the lack of new supply coming online, has put significant pressure on global excess production capacity. For example, OPEC currently has only 1.5 million barrels per day (mbl/d) of excess capacity, down from almost 6 mbl/d in 2002.

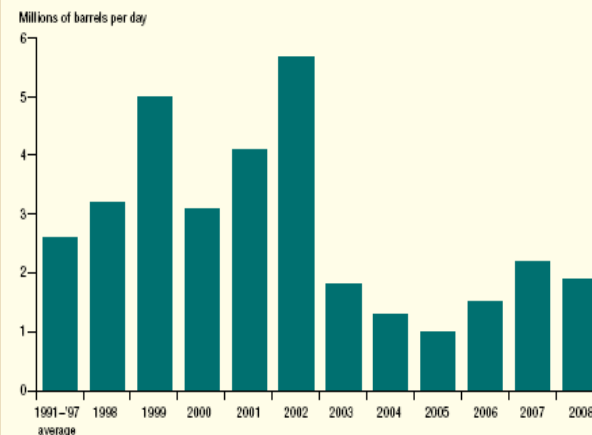
This highlights a real problem in the oil market – while there is enough oil to satisfy current demand, there is very little margin for error. In other words, it isn't a current supply/demand imbalance driving prices higher, but the fear supplies will fail to satisfy future demand, particularly if there is a sudden supply disruption.

## Total Worldwide Oil Production



Source: Energy Information Administration

## OPEC's Excess Capacity Dwindles



SOURCE: Energy Information Administration.

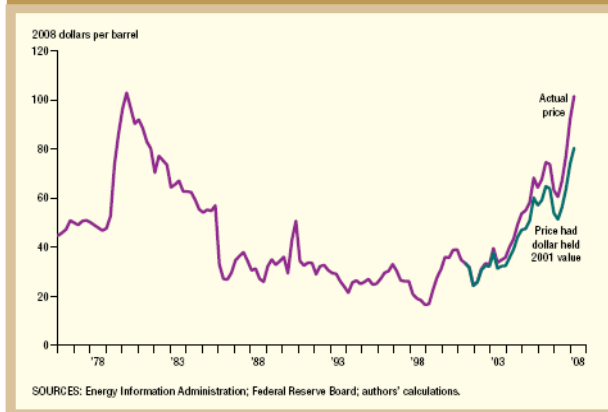
The good news is that while new production will likely remain relatively stagnant through the end of 2008, next year looks more promising. In fact, the EIA estimates worldwide production in 2009 should increase by between 1.5 and 2 million barrels per day. Not only will this new production keep pace with likely increased emerging market demand, it should also provide a sufficient cushion to alleviate some of the current supply related concerns in the market.

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## Weaker Dollar Drives Oil Prices Higher



## Falling US Dollar

Another important factor pushing oil prices higher is the declining US dollar, which has dropped almost 45 percent against the euro since peaking in mid-2001.

Because oil is traded globally and priced in US dollars, a depreciating currency makes oil more expensive to US consumers. For example, if oil was \$100 per barrel and the value of the US dollar fell by one percent, the same barrel would cost US buyers \$101 even though demand remained unchanged.

So how much of an impact has the declining dollar had on oil prices? According to a recent study by the Federal Reserve Bank of Dallas, the falling dollar accounted for roughly a third of the oil price increase from 2003 to 2007.

## Rising Speculation

A final factor driving oil prices higher is investor speculation. Today roughly \$260 billion is invested in long-only commodity indices and exchange-traded funds – 20 times the amount just five years ago. And while this increased investment interest does not translate directly into increased consumption – since few speculators actually want to take physical delivery – it does significantly increase market volatility and demand for oil futures contracts and other derivative instruments.

Interestingly, the futures market began signaling the likelihood of coming oil price declines in May, with delivery prices for December 2010 oil contracts sitting roughly 15 percent below the current market prices. This phenomenon – called backwardation – rarely occurs and is often a precursor to falling market prices down the road.

## Going Forward

We have seen a dramatic drop in oil prices over the past few weeks. While the magnitude of this decline is a testament to the amount of speculative froth that had built up in the oil markets recently, the fact prices are moving lower should not be a surprise. With the US and world economies teetering on the brink of recession, the US dollar strengthening, and Congress contemplating new legislation targeting oil speculators, the real question is why it took so long for prices to fall.

As with all markets, though, supply and demand will ultimately determine where oil prices go. And while things look fairly promising over the short run, unless the longer-term supply and demand issues are resolved through a combination of conservation and new production, prices may start heading higher again before long.