West Oak Capital, LLC

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Iraq has taken a turn for the worse in recent weeks, prompting diplomatic, humanitarian and, potentially, economic concerns for the industrialized world. The combination of civil unrest in a prominent OPEC country and a surprisingly weak GDP growth report here at home raises the menacing specter of stagflation. We do not believe conditions will get that bad. However, these events do rattle nerves as the Federal Reserve is gingerly working to return monetary policy to a more neutral position. Reviewing the importance of oil and Iraq in global energy markets, we arrive at three main observations:

1. Even with progress in alternative energy sources, fossil fuels remain a crucial part of meeting U.S. energy needs, and a contributor to clients' investment portfolios.

2. Canada and the Bakken oil fields of North Dakota are large and growing resources, while Iraq actually provides remarkably little oil to the U.S.

3. China has a huge appetite for imported oil, and Iraq may be more important to China than to the U.S., at least as a supplier of fuel.

The good news, according to the U.S. Energy Information Administration, is that the U.S. produces enough energy from its own sources to satisfy 84 percent of its energy demand. However, more than 80 percent of our total energy production is based on fossil fuels (including coal, natural gas and petroleum), with natural gas our largest domestically produced resource. Alternatives are making headway, although renewables and nuclear energy provide only 10 percent and eight percent of our total energy needs, respectively. Roughly 27 percent of our nation's energy demand is for transportation. While electric cars are now spotted regularly on our roads, it is still the case that 99 percent of vehicle miles traveled in the U.S. are powered by petroleum-based fuels. Even the most optimistic energy forecasts show that we will still need plenty of oil and natural gas for the foreseeable future. Big oil remains a pillar in our energy holdings.

Total U.S. demand for oil is 18.9 million barrels of crude per day. We import 7.7 million barrels per day, roughly 40 percent. One-third of the imported oil comes from Canada, a politically stable and friendly source that has been growing in recent years, and which now delivers nearly twice as much as our number two source of imported oil, Saudi Arabia. Way down the list at number six is Iraq, which provides a mere 340,000 barrels per day, representing less than two percent of the total needed to keep our economy humming. Canada is critically important to the U.S., while Iraq is a relatively small contributor. The U.S. is also benefitting from a new oil development in an area that straddles North Dakota and Canada, called the Bakken formation. In April 2013, the U.S. Geological Survey estimated the Bakken formation has 7.4 ***billion*** barrels of recoverable oil, meaning that current technology should be able to pull that much crude from the region. The total amount of oil, including the portion that is currently considered non-recoverable, amounts to a whopping 24 ***billion*** barrels. Advances in recovering that oil could make Bakken our most important petroleum resource. Already, the North American "shale-oil boom" has ramped up production to roughly three million barrels per day, bringing a lot of high-paying jobs and welcome tax revenues to North Dakota and surrounding states.

> *"Baghdad to Beijing is the new Silk Road of the global oil trade."*
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> --- Fatih Birol, chief economist at the International Energy Agency in Paris, as told to Bloomberg Businessweek in January 2013

China has become the world's largest importer of oil, relying on foreign sources for 60 percent of its current needs. With demand on the rise, securing oil has become a national priority. Iraq has the fifth-largest proven oil reserves in the world, which tantalizes the optimist in every oil-importing nation, even though political turmoil in Iraq has chronically disrupted attempts to tap those oil reserves. China's current top producers are Saudi Arabia, Angola, Oman and Russia, which are regions that may be difficult to squeeze for more oil. So, state-owned China National Petroleum has rapidly expanded its presence in Iraq in recent years. They plan to dramatically expand Iraq's output, from roughly three million barrels per day to eight million barrels, with 80 percent of that Iraqi oil production earmarked for China.

Islamic militants are back in the headlines. Unless the rebellion in Iraq spreads to other oil-producing regions, this appears to present only a short-term problem for the energy markets. However, temperamental oil prices could complicate efforts by the Federal Reserve to maintain a gradual path for monetary policy. The most recent report of our nation's economic activity was surprisingly off track, and it is difficult for the Fed to ward off an inflationary threat while the recovery is showing signs of weakness. Oil reserves in troubled regions of the world are a politically sensitive topic, although we believe investments in the energy sector, including multi-national oil and natural gas companies, play an important role in an investor's portfolio. Recent events in Iraq are a reminder that our nation's energy policy should favor self-sufficiency, supplemented by imports from countries that are friendly to U.S. interests.

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