Trust Company of Vermont

Quarterly Update

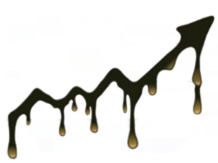
July 2008

Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans ◆ Stowe

Oil: There Will Be?

Christopher Cassidy, Trust Investment Committee

With the price of a barrel of oil eclipsing $145 recently, and the national average price for gasoline rising to $4.07 per gallon, the so-called energy crisis has quickly become the most important issue to Americans in the 2008 presidential campaign. Oil's tremendous advance, the price of a barrel doubling in one year, has sparked debate among economists and energy analysts as to whether the price of oil will continue to rise, or whether the price is due for a dramatic pull back.



In 2005, Goldman Sachs energy analyst Arjun Murti predicted that oil would breach $100 a barrel. Murti is now saying that the likelihood of $150-$200 oil is increasing and other analysts are now making similar predictions. The belief that oil prices will continue to rise stems from several developments including emerging markets growth, supply constraints and geopolitical instability.

The Gross Domestic Product (GDP) of many emerging economies, such as China and India, continue to grow at significantly faster rates than that of the United States. With this burgeoning economic growth comes an increasing demand for energy. The United States per-capita oil consumption is 25 barrels per year compared to just two barrels in China and less than one in India. Many analysts believe that as China, India and other emerging economies continue down the road of industrialization their per-capita oil consumption will only increase.

In addition to the growth of emerging economies, many analysts believe that supply constraints could lead to higher oil prices in the future. Much of the world's oil production comes from giant wells discovered decades ago, such as the Cantarell Field in Mexico (1976 discovery) and the Ghawar Field in Saudi Arabia (1948 discovery). As Byron Wien, Chief Investment Strategist for Pequot Capital Management, put it, "the world isn't finding oil fast enough to replace the 3% to 4% that gets pumped every year." Fears over diminishing oil supplies have forced lawmakers to revisit the possibility of drilling in off-shore Florida and in the Arctic National Wildlife Refuge.

Geopolitical instability could also send oil prices sharply higher. The Organization of the Petroleum Exporting Countries (OPEC) supplies more than one-third of world oil supply, and other large oil wells are located in areas known for political instability, or are run by government-controlled monopolies. Just this past week, the attack on the Royal Dutch Shell facility halted close to 10% of Nigeria's oil production.

Despite oil's rapid run up and evidence that further price spikes are likely, many economists believe that oil is overpriced. According to Carl Weinberg, Chief Economist at High Frequency Economics, crude prices should fall to around $80 over the next year. Many analysts believe that a combination of declining consumption, a strengthening in the dollar and action from Saudi Arabia will significantly lower the price of oil.

Despite growth in emerging markets, oil consumption has decreased from a year ago among the member nations of the Organization for Economic Cooperation and Development (OECD), which includes the United States, Great Britain and Japan. The

thirty nations that make up the OECD account for 57% of global oil demand. In the United States, for example, Americans drove 11 billion fewer miles in March 2008 than in the year before, which is the first drop since 1979. A declining rate of oil consumption in the developed world coupled with the potential for a global economic slowdown could lead to lower oil prices.

Many analysts believe that the price of oil is artificially high due to a weak dollar and the growth in commodity trading. Oil is priced in dollars on the world market and with the Federal Reserve lowering interest rates, the dollar has continued to depreciate against foreign currencies. A weak dollar makes oil less expensive to investors in other countries. If the Federal Reserve begins to raise rates, in an attempt to fight inflation, the dollar may strengthen, which could in turn lead to lower oil prices.

In addition, many investors buy commodities like oil as a hedge against inflation when the dollar falls. With commodities outperforming the S&P 500 over the past five years, large endowments, such as Harvard and Yale, and pension funds, such as the California Public Employees Retirement System, have been rapidly increasing the commodity exposure in their investment portfolios. According to Michael Masters, Head of Masters Capital Management, the commodity indexing strategies used by these endowments and pension funds have pushed oil prices upward over the past year. These investments totaled more than $250 billion through March of this year, which is up from just $13 million at the end of 2003. If investors begin taking gains and selling commodity related investments, the price of oil could fall.

Several recent developments could also serve to lower oil prices. Saudi Arabia, the biggest oil exporter in the world, intends to produce 9.7 million barrels a day, which is up from the current level of 9.5. In addition, China raised prices on retail gasoline and diesel fuel by 18%. If this price hike leads to a decrease in demand the price of oil may fall.

At the Trust Company of Vermont, we do not make short term bets on commodity prices, and will not increase exposure to an area based solely on momentum and recent performance. We are using the dramatic rise in oil prices as an opportunity to review the underlying valuations and fundamentals of the energy companies that we own in clients' equity portfolios to determine whether our current weighting is warranted.

Mr. Cassidy thanks our summer interns, Luke Morse & Jacqueline Stevens, for their research assistance.

Wondering what to do about fuel oil for the upcoming heating season?

Pre-buy? Wait and take your chances?

We polled all of our ten investment managers and here's what they are planning to do:

I'll pre-buy all of it:
No votes - 0%

I'll hedge - pre-buy some and go with market price during heating season for the balance:
3 votes - 30%

I believe the market price will adjust downward so I'll buy during heating season:
7 votes - 70%