

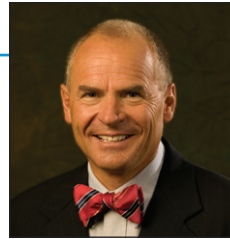


ABOUT THIS SERIES: This newsletter is the first in a series about macro-economic topics that may affect investors in the coming decade. It is written by Fritz Meyer, Senior Investment Officer, A I M Advisors, Inc.

Meyer Report

on Energy

Fritz Meyer



Back to the '70s? 'Star Wars' hit movie theaters. A foreign war dominated the news. Oil prices reached new heights. Are you feeling a sense of déjà vu? While these events apply to 2005, they all happened in the 1970s as well. Of course, in the '70s, high oil prices helped trigger a recession. Does this mean a recession replay is headed our way?

That was then, this is now

As the old saying goes, those who refuse to learn from the past are doomed to repeat it. In this case, it looks as if the U.S. may have learned some important lessons from the '70s.

In the past, high energy costs have led to surging inflation, which in turn led to sharp rises in interest rates—and then recession. This was the course that followed the energy price shocks of 1973–74 and the late '70s/early '80s. However, the U.S. economy today looks much different than it did in the 1970s—which indicates that the economic reaction to high energy prices should be very different as well.

Bottom line: I believe the U.S. economy should be able to handle relatively high energy prices without going into recession—and investors could find opportunities in this sector.

A more resilient economy

Most economists believe the economy can still post respectable, if not healthy, gross domestic product (GDP) growth in the face of moderately higher trending oil prices. The jump in oil prices from \$32 to \$43 per barrel in 2004 probably slowed the GDP growth rate by 0.75%. Yet, GDP still grew at a healthy, above average rate of 4.4%.

Of course, the braking effects of higher energy prices and interest rate hikes work with a lag, so I believe last year's hikes will continue to slow the economy in 2005—but not by too much. The general feeling among economists has been that with oil prices at today's levels in the high \$50s, the economy might grow 3.5%—in line with the long-term trend rate. Those economists proved to be close to the mark in late July, when the Commerce Department reported a second-quarter GDP growth rate of 3.4%.

Energy efficiency

Why is the economy more resilient now? Over the last 30 years, the U.S. economy has gotten substantially more energy efficient so that energy use per dollar of GDP today is less than half what it was 30 years ago. Hence, a rise in the price of oil here in 2005 has less than half the effect on GDP growth than it did 30 years ago.

In the early '80s, households spent an average of 8% of their income on energy bills, according to *The New York Times*. Back then, energy costs accounted for 14% of the American economy.

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Sticker Shock

In late March, U.S. retail gasoline prices hit a record average of \$2.15 a gallon. The price certainly came as a shock to many motorists, especially those planning summer vacation road trips. However, compared with the per gallon price of many other liquids consumers use every day, \$2.15 almost seems like a bargain.

Prices by the Gallon

Regular gasoline (U.S. average)

Price per gallon: \$2.15

Starbucks Chantico (6 oz.)

Price: \$2.65

Price per gallon: \$56.53

Coca-Cola (2 liters)

Price: \$1.69

Price per gallon: \$3.20

Pepto-Bismol (12 oz)

Price: \$4.99

Price per gallon: \$53.23

Castelas Olive Oil (16.8 oz.)

Price: \$29.99

Price per gallon: \$228.50

San Pellegrino bottled water (25.3 oz.)

Price: \$1.50

Price per gallon: \$7.59

French's yellow mustard (14 oz.)

Price: \$1.25

Price per gallon: \$11.43

Visine eye drops (1 oz.)

Price: \$7.39

Price per gallon: \$945.92

OFF! mosquito spray (6 oz.)

Price: \$5.49

Price per gallon: \$117.12

Windex glass cleaner (24 oz.)

Price: \$3.19

Price per gallon: \$17.01

1 gallon = 128 fluid ounces

1 liter = 33.8 fluid ounces

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Today those numbers are much lower, according to the *Times*, thanks to energy-saving measures prompted by the oil shocks of the '70s and '80s. Households now spend about 5% of their income on energy bills, and energy costs account for 7% of the American economy.

What does this mean? Consumers have a substantially greater ability to absorb energy price hikes today than they did in previous decades.

Emerging inflation

None of this means, however, that the economy is completely insulated from the effects of higher energy prices. Inflation pressures began to emerge earlier this year, keeping market-watchers on their toes. For example, in March the Labor Department's Consumer Price Index reported that consumer prices rose 0.6%, the biggest inflation surge in five months.

But I believe we're probably seeing the maximum effect of last year's energy price hikes flowing through the inflation statistics right now, and that inflationary pressures will ease as the rate of economic growth cools in the quarters ahead. Plus, the biggest driver of inflation is wage gains—and there's still ample slack in the labor markets.

Overall, I think inflation will remain contained. And probably the most important reason for having conviction in that view is that, unlike in the '70s, today's Federal Reserve avows that its principal job is to *make sure* that inflation remains in check.

The story behind high prices

Another big difference between the '70s and today has to do with the reasons behind rising oil prices. In the '70s, prices soared due to Middle East embargoes, which suddenly turned off the tap to important sources of supply. But today, oil prices are increasing due to growing worldwide demand—a result of strengthening economies, especially in developing countries such as China and India.

The U.S. is by far the No. 1 oil-consuming country in the world, currently using more than 20 million barrels per day, according to the Energy Information Administration (EIA). And high oil prices have not yet dampened that demand. Last year, oil demand in the U.S. rose 2.4%, the highest growth in five years, thanks to a strong domestic economy.

But the demand growth in the U.S. pales in comparison to that of the No. 2 oil-consuming country, China. The International Energy Agency (IEA) estimates that China's oil demand grew a whopping 16.36% last year—from 5.5 million barrels per day in 2003 to 6.4 million in 2004. And the EIA projects China's oil demand will reach 12.8 million barrels per day by 2025.

Worldwide, oil production is struggling to keep up with growing demand. World oil demand this year is expected to average 84.3 million barrels per day. But production capacity is only 85.5 million barrels per day; this is the tightest level of capacity utilization since the '70s, according to my colleague John Segner, senior portfolio manager of AIM Energy Fund.

Looking beyond oil, the supply and demand situation for natural gas is tight as well. According to the EIA, U.S. natural gas production is forecasted to be 7.06% higher in 2006 than it was in 1992. But gas demand is expected to grow at more than double that rate—15.18%.

Gasoline price source: Energy Information Administration, March 28, 2005.

Product price source: Houston Chronicle, March 27, 2005.

Opportunities for Investors

Oil prices may not ease from today's levels unless the world economy contracts, which would shrink demand, or production capacity grows through increased drilling. In fact, Segner doesn't believe that oil prices will fall significantly below \$40 a barrel any time soon—barring an economic meltdown of some sort.

What does this mean for investors? Opportunities. Despite the fact that oil prices soared in the first quarter, the stock valuations of many energy companies are still attractive. In fact, even if oil prices fell back into the \$40s, Segner doesn't believe that decline would result in long-term weakness in stock prices, because today's oil price doesn't seem to be factored into the stock prices of energy companies.

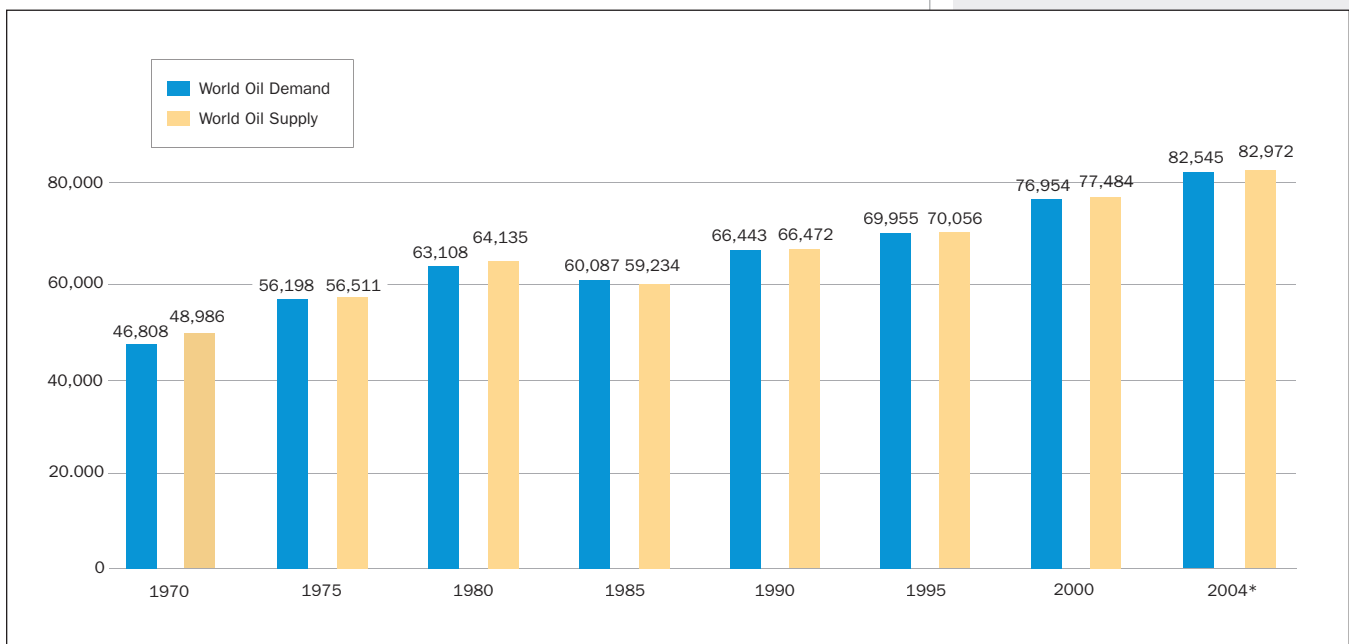
If the market finally accepts a long-term view of high oil prices, today's stock prices could seem like bargains.

Fritz Meyer is a Senior Investment Officer with AIM Advisors, Inc. He regularly provides both economic and general market commentary for internal audiences and external broadcast and print media. He began his investment career in 1976. Mr. Meyer received his master's in business from the Amos Tuck School at Dartmouth College. He received his B.A. from Dartmouth College with a distinction in economics.

The opinions expressed by Fritz Meyer are subject to change at any time based on market and other conditions and offer no guarantee of future performance.

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World Oil Supply and Demand, 1970-2004 (Thousand Barrels per Day)



Source: Energy Information Administration.
 Note: Oil supply includes crude oil, natural gas plant liquids, other liquids and refinery processing gain.
 *Supply data is preliminary.

Your goals. Our solutions.®

Mutual Funds	Retirement Products	Annuities	College Savings Plans	Separately Managed Accounts	Offshore Products	Cash Management
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