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Crude Oil

Longer-Term History (Oil drops 37% from $100 to $63)

Several years ago, many of the discussions in SEIA's Investment Committee (IC) centered on whether the commodity "*Super Cycle*" of the last decade had finally come to a close. Long-term investors will recall that the period of the 2000s was marked by outperformance from commodities due in part to strong Emerging Market economies. China's rapid ascension gave a boost to any commodity needed to urbanize a vast and populous country (copper and iron ore to build, coal to run the power plants that provide electricity, and crude oil to fuel a new car-buying nation). The influx of capital into these economies strengthened their currencies at the expense of a weaker U.S. Dollar. These stronger currencies could then be used to buy more commodities to build more things, and the "super cycle" was on.

But by 2013, it was clear that the era of China's hyper "urban" growth was over, not only dampening the now 2nd largest economy on earth but also adversely affecting those that exported commodities to the country—namely South America and Australia. Meanwhile, Developed Markets in Europe and Japan, not yet fully healed from the depths of the Great Recession, were as yet unable to carry forward the global growth baton. As a result, many commodities were well off their post-recession highs and the fundamental catalysts were nowhere to be found. Moreover in separate but related conversations, the IC determined that the economic landscape moving into 2014 would clearly favor the U.S. over most capital markets around the globe. A comparatively strong U.S. economy would likely induce the Federal Reserve to not only end Quantitative Easing but also lift interest rates off of zero. Being one of the first countries to remove monetary stimulus and raise interest rates would be in stark contrast to three of the larger economies (Europe, China and Japan), which were increasing monetary or fiscal stimulus—or both! The IC thus believed that this economic setup would set the stage for a stronger U.S. Dollar versus the Euro and the Yen.

The combined backdrop of changing leadership in the global economy in conjunction with an appreciating U.S. Dollar morphed the commodity tailwinds of yesteryear into a stiff headwind. Gold was already off $700 from its 2011 high over $1900. Copper and Agriculture ETFs needed to gain 50% to reach their old highs as well. But Energy was the lone standout. In mid-to-late 2013, Crude Oil stood between $100-$112 (only a couple of dollars off its 2011 high).

So, with potential losses for energy commodities looming on the horizon, the IC undertook a concerted effort to reduce our commodity exposure by selling both actual commodities as well as commodity stocks (Materials, Energy, etc.). In December 2013 we liquidated our commodity funds in our discretionary accounts. Two months later, we eliminated our Energy sector overweight and rotated to the sector that would primarily benefit from lower oil costs—Consumer Discretionary. Later in the year with Crude Oil down to $82/barrel, we further reduced our energy and materials exposure. In an era where hundreds of billions of dollars can trade across the globe in a fraction of a second, the long-term vision of lower crude oil prices instead came to fruition in a mere three months, as frenetic trading took the commodity down to levels near $43—a price last seen during the depths of the Great Recession. The 56% Price drop in just seven months (from $106.83 on 6/19/14 to $46.47 on 1/19/15) has been nothing short of historical.

But the 2014/15-time period is very different from prior oil bear markets. Six years ago, world "demand" for energy (and anything really) came to a screeching halt. Today, demand is holding steady and actually projected to increase over the next couple of years. The problem today is not a demand problem but rather a "supply" problem, which was something unimaginable just two summer Olympics ago when oil hit a high of $147 just prior to the Chinese Summer Games on 08/08/08. Today, the game has changed due to the U.S. Shale Oil revolution. In short, the world is awash in too much oil.

A brief review of U.S. oil production is essential to understanding the magnitude of the recent shale boom. According to Bradford & Marzec, between 1970 and 2008, the depleting nature of oil reserves caused U.S. crude oil production to decline from 9.6 million barrels per day (b/d) to 5.0 million b/d, significantly increasing the country's reliance on foreign oil. However shortly thereafter, drillers began to use new technologies to develop oil reserves previously considered inaccessible and/or uneconomical. Hydraulic Fracturing (or "fracking") started a revolution and unleashed an abundance of new oil. The Energy Information Administration (EIA) now projects total U.S. crude oil production will grow over 1.2 million b/d each year. To put that amount in perspective, 1.2 million b/d is the size of a small OPEC country's total production. Thus, the U.S. is creating a virtual new OPEC country every year! If realized, the U.S. will average 9.4 million barrels per day in 2015. That would represent the highest annual U.S. crude oil production since 1972.

In the meantime, according to Goldman Sachs, the U.S. over the last seven years has morphed from a country that imported a net 13 million b/d to one that imports around 5 million b/d. The 8 million b/d swing is comprised of a 2 million b/d efficiency-driven demand reduction along with a 6 million b/d supply increase from shale. Taken together, it appears that shale oil has created a global surplus of roughly 1 million b/d according to Pimco. For the markets to rebalance, this surplus must be stored for future use, demand must increase, or production needs to decline. In the past, OPEC would dictate the results but remember—we called it a revolution.

Shorter-Term History (Oil drops another 32% from $63 to $43)

Oil has always had booms and busts. But in the past, OPEC (namely Saudi Arabia) wanted price stability and possessed the ability to balance global oil supply and demand with production cuts. This assumption quickly changed on November 27, 2014 when OPEC announced its decision to hold production steady, despite an oversupplied market and deteriorating oil prices. Why the change of heart? History may provide some clues. Earlier, when OPEC/Saudi Arabia reduced production to sustain high prices, investment in alternatives increased (North Sea, Alaska, Gulf of Mexico, Solar, Wind, Tesla, etc.). The long-term result was reduced demand for traditional oil in the developed world. This time however, by allowing prices to fall earlier in the business cycle, many believe that OPEC appears to be trying to avoid a repeat of past mistakes, in essence taking short-term pain of lower prices for long-term stability of higher demand. Also, Saudi Arabia may be deliberately trying to hurt competitors—namely Iran, Russia, and the fracking revolution here in the United States. Whether for economic or political reasons, the shock of the "regime change" pushed oil prices down on a second leg south.

Near-Term Outlook: It's all about Supply and Demand.

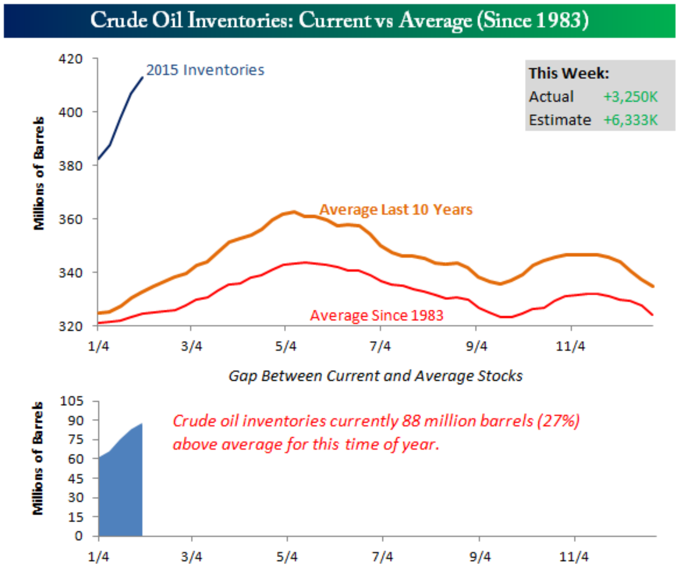
In the long-run, supply needs to match up with demand, and lower prices should allow for supply and demand to realign by year-end. But how? Either supply will be reduced via a decline in the growth rate of U.S. production (job cuts, idle rigs, etc.) or global demand could increase due in part to lower oil prices. Most likely some combination of the two will come to pass. Once investors start to anticipate this realignment, the downward price pressure on crude oil should cease. The following data points should provide investors with clues on the future of pricing.

Lower Supply Data Point #1 (Job Cuts): Economists were taken by surprise in January when jobless claims shot above 300,000. Whereas increased layoffs normally portend a weakening economy—this time we believe they were in large part attributable to the recent plunge in oil prices. Energy companies such as Halliburton, Schlumberger, Baker Hughes, and Suncor have all announced plans to cut jobs and reduce the number of active oil wells. Unfortunately, we are in the very early innings of what appears to be a long game, and additional future job cuts are likely. But in an odd way, this is a good sign for the future stability of the oil industry. This is capitalism at its best—dictating how many jobs are needed and ultimately where the price of oil is headed.

Lower Supply Data Point #2 (Fewer Oil Rigs): As energy companies scale back on employees, they'll also need to reduce the number of active oil rigs/wells/drills in operation. Baker Hughes has issued a "Rig Count" since 1944 when the Hughes Tool Company began weekly counts of U.S. and Canadian drilling activity (the North American rig count is released weekly at noon central time on the last day of the work week). The Rig Count is an important business barometer for the drilling industry as it acts as a leading indicator of demand for products used in drilling, completing, producing and processing hydrocarbons. As of January 30th, the North American Rig Count stood at 1937—a drop of 456 rigs from a year ago and back to levels last seen in 2010. Fewer rigs equal less oil.

Lower Supply Data Point #3 (Reduced Capital Expenditures): In order to produce oil, energy companies must spend money. But in a period where they're driven to reduce output, these "capital expenditures" (CapEx) must also be reduced. According to Goldman Sachs, the overall capex in the U.S. Exploration & Production (E&P) sector is already down 25%. Why? Many E&P companies are small, with highly-leveraged balance sheets that rely on the High Yield bond market to access debt financing. Strict capital structure mandates require these companies to aggressively reduce capex to ensure continued access to the high yield marketplace and avoid potential high yield bond defaults. As of January, the more credit-intensive companies are already in maintenance mode, allocating all their available cash for maintaining fields with nothing left over for new projects. In essence, the capex shutdown has already translated into the fastest decline in drilling due to lower prices that the industry has ever experienced. This also suggests that the market is very likely close to achieving a sufficient slowdown in U.S. production growth to effectively balance the global oil market by 2016.

Lower Supply vs. Increased Demand (Watch Inventory): As of late January, however, there are no signs that supply is slowing down. Further analysis from Goldman Sachs reveals that U.S. crude oil production recently hit a new multi-decade high above 9.21 million barrels per day. And on a four-week rolling basis, output was up 1.1 million barrels per day (13.3%) from last year. With production still robust and demand not keeping up, all of the excess oil must be stored somewhere, thus inventories keep piling up. As an example and according to Bespoke Investment Group, every week this year inventories have far exceeded the consensus forecast. In fact, over the past four weeks, total crude oil stockpiles have grown by 30.667 million barrels, the largest monthly increase since 1983.



While the industry is starting to respond to falling prices by taking rigs offline, reducing capital expenditures and cutting jobs—it is not yet being reflected in the inventory numbers. This data will be watched closely to determine when and at what price crude oil will bottom. Why? The investment ramifications extend far beyond commodities and energy stocks.

Investment Implications: "It's all connected."

Investment implications (Stocks): Winners and losers are spread across all capital markets, but the short answer for stocks is that at the expense of oil producers, the winners should be those industries that are high consumers of energy. Airlines and cruise lines should benefit as their costs go down. Traditional auto makers, retailers, restaurants, lodging, entertainment and other consumer discretionary stocks should also all benefit as consumers will likely have more money in their collective pockets. Within society at large, lower socio-economic classes (who spend a higher percentage of their after-tax incomes directly at the gas station) should have more discretionary cash, which is likely to translate into increased earnings for discount stores and mass retailers. Regionally, countries that consume and import oil (Europe, Japan, China, India, etc.) are clear winners versus countries that produce and export oil (Russia, Brazil, OPEC, etc.). And this regional theme can be carried across asset classes into currencies well—the investment ramifications are not limited to stocks.

Investment implications (Currencies): As mentioned above, it's logical to expect that some oil exporting Emerging Market (EM) countries such as Russia and Brazil could see their currency weaken. Besides the Russian Ruble, according to Goldman Sachs, investors may also expect near-term weakness in the Nigerian Naira, South African Rand and the Columbian Peso. Meanwhile, oil importers could benefit; specifically the Turkish Lira and the Indian Rupee. This collateral currency damage will not, however, be confined to Emerging Markets as falling oil prices are putting pressure on some commodity-export driven Developed Markets (DM).

Analysts expect further weakness in both the Australian and Canadian Dollars. How does this pertain to most U.S. investors? Quite simply—don't own assets based in a depreciating currency.

Investment implications (Bonds): In high-quality fixed income, lower oil prices are deflationary and low inflation should keep a lid on DM interest rates. However looking further out, oil will eventually stabilize and if it should move higher than $60 towards the end of 2015, it would then be inflationary. Therefore, look for interest rates to be stable near term, but move higher over an investor's 12-36 month investment horizon.

In lower-quality fixed income, the story is much different. The Credit and High Yield analysts over at Goldman Sachs remind us that "debt-fueled growth often ends in tears." The bonds in the High Yield E&P sector have sold off and now trade at spreads that reflect a historically familiar narrative–when rapid debt accumulation is fueled by optimistic growth expectations that subsequently prove disappointing, credit bond investors usually end up holding the bag (think 2009 subprime mortgage holders, or 1999 internet/telecom high yield corporate debt). With E&P high yield debt levels twice as high as they were just three years ago and oil prices half of what they were just six months ago, the danger is real. As energy makes up 20% of the High Yield index, look for subdued gains in the near term. Floating-rate Bank Loans look better positioned as energy exposure is minimal.

Investment implications (Contagion or U.S. Dominance?): The real danger for most investors is whether the troubles in High Yield Energy spread into the broader market and whether ultra-low oil prices lead to Sovereign instability in Russia and elsewhere. Liz Ann Sonders of Schwab recalls that the 1980s plunge in oil prices helped trigger the Savings and Loan crisis in Texas, and that the 1990s drop in oil promoted the Russian debt default which led to the Long-Term Capital Management (LTCM) debacle creating massive turbulence in the later months of 1998. But consider that current credit pricing implies an average default rate roughly equal to the most distressed period of the past 35 years (namely, the mid-1980s). E&P companies today are generally in better shape and according to Goldman Sachs, liquidity should not pose a problem as the vast majority of bond debt outstanding for E&Ps does not mature for 3-4 years. Goldman concludes that "for most E&Ps, total liquidity should be sufficient to weather three quarters of sub $50/barrel oil prices." Perhaps most importantly, the long-run economics for U.S. shale oil remain favorable. U.S. demand is continuing to increase and most U.S. producers have a lower cost versus other areas of the world (IHS Energy concludes that 80% of U.S. oil production in tight shale formations is economic at less than $70 per barrel and the IEA estimates that more than 80% of U.S. shale is economic at $60 per barrel or less). Also, American innovation and technology improvements seem to continue unabated, boosting recovery rates and lowering future costs. The cost advantage of most U.S. producers over other regions of the world appears to be both sustainable and growing—not to mention more attractive than ultra-deep water production or operations in politically unstable regions around the globe. Thus, U.S. producers can likely continue to generate strong production growth long-term. Others agree. Analysts at Bradford & Marzec are optimistic that oil production in the U.S. will continue to rise significantly in future years which should benefit domestic producers as well as mid-stream Master Limited Partnerships (MLPs). Finally, it is wise to keep a 30,000 foot perspective. The excess oil producing capacity is only a few million barrels per day in a world that is consuming 93 million barrels a day. The 3% supply/demand gap should easily be narrowed. Although a global rebalance may have large reverberations, the U.S. is well positioned to substantially grow production and gain market share at the expense of other higher cost producers, and for many years into the future.

As always, if there are any questions please do not hesitate to contact our office or your local Financial Advisor. Visit us online at seia.com.