

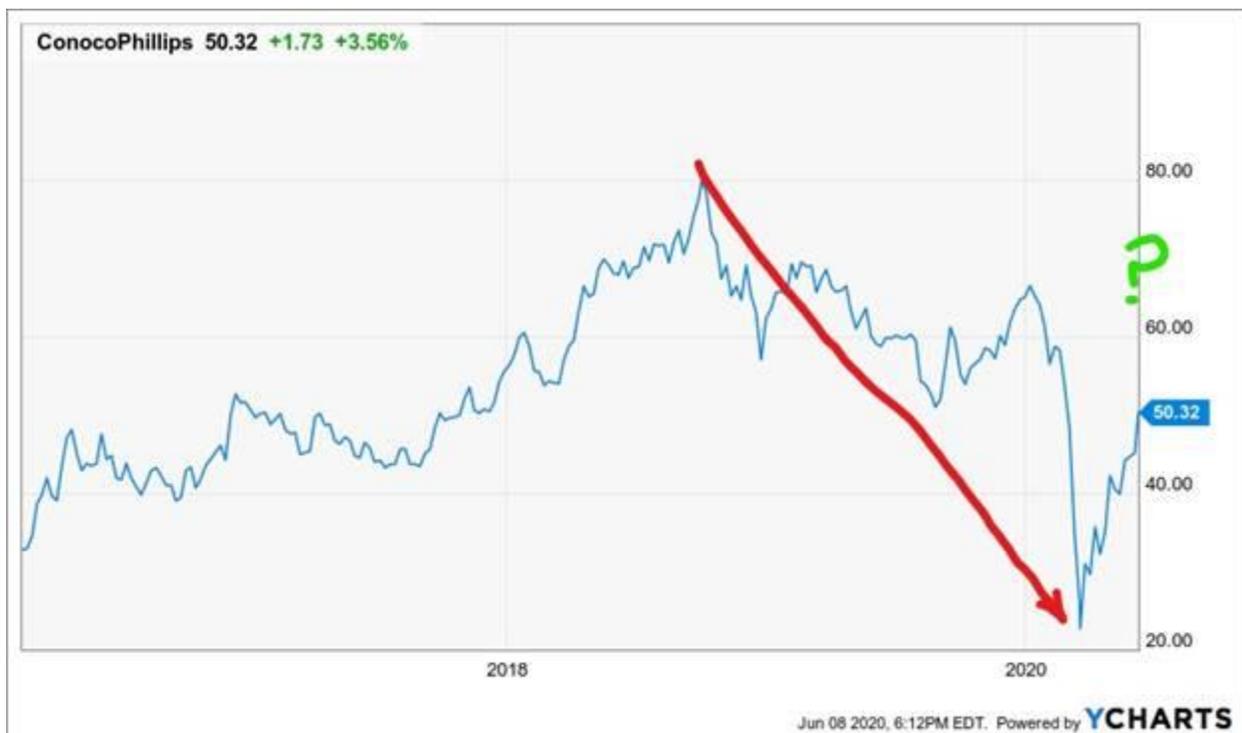
The Outlook: June 8, 2020

The oil business: old sayings, great values and tailwinds.

“A stock isn’t a great value until everyone hates it. But it isn’t really a great value until you hate it yourself.”

The investment world overflows with “old sayings.” Most of them are fun; many are useful; and quite a few are downright profound. Outlook ran across the saying above a few weeks ago, and it got all 3 stars: fun, useful and profound. It does get to the heart of how it often feels to be a “value investor.” Our long-suffering patience is sometimes tested to the limit; but it’s also rewarded, almost always, with remarkable returns . . . eventually.

That describes Conoco and our long-term position in the oil business. Here’s how Conoco has looked since the last bottom in the price of oil, in early 2016.

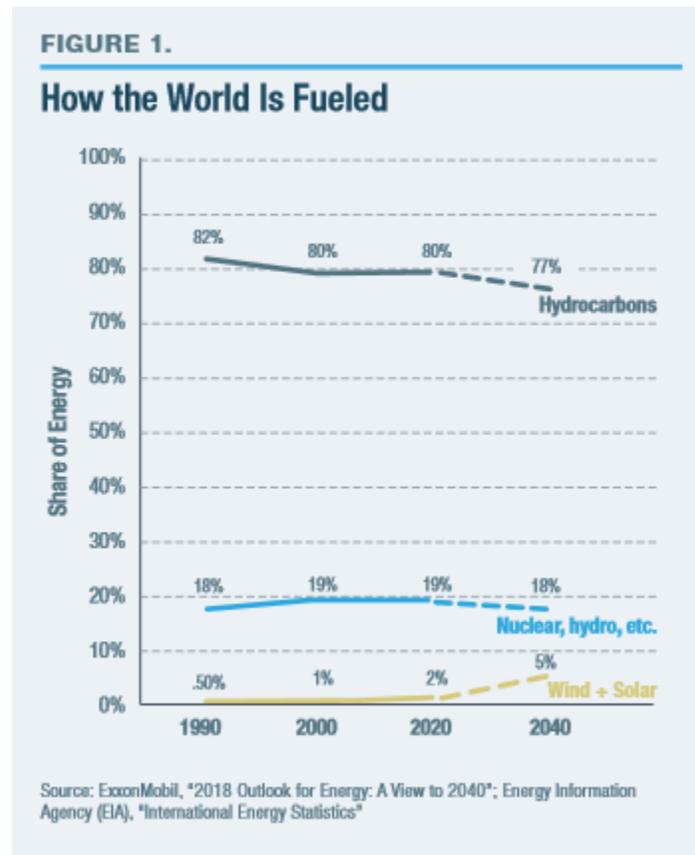


Conoco rose 150% from that terrible bottom until it’s \$80 peak in 2018. Then we see the “red arrow of death” taking it down to \$22 near the bottom of the Shutdown Bear Market in March . . . followed by a rocket to today’s \$50. That green question mark asks the obvious: “Where next, and where eventually?”

The heart of value investing comes down to understanding some enduring, powerful tailwind which is sure to do a company a lot of good in the long run—and which the market’s speculating crowd lacks the patience to wait for, hence values our company as if the tailwind doesn’t exist. For Conoco, that tailwind is simple: oil demand will keep rising—not fast but steadily—for a very long time; and oil supply will be squeezed and slowed by 5 years of terribly low spending on new supply. The price of oil will always be a roller coaster, but those facts about long-term supply and demand mean its general direction will be “up.”

There isn't so much argument, these days, about the squeeze on global supply. The U.S. shale business used to be the ace in the hole, so to speak, for oil bears who doubted the supply squeeze . . . but not anymore. In less than one year, believers in "endless shale oil supply" have almost disappeared. No . . . today the argument centers on whether or not long-term oil demand really does have "legs," or whether "alternative energy" has developed the legs, itself, to make oil's future look limited.

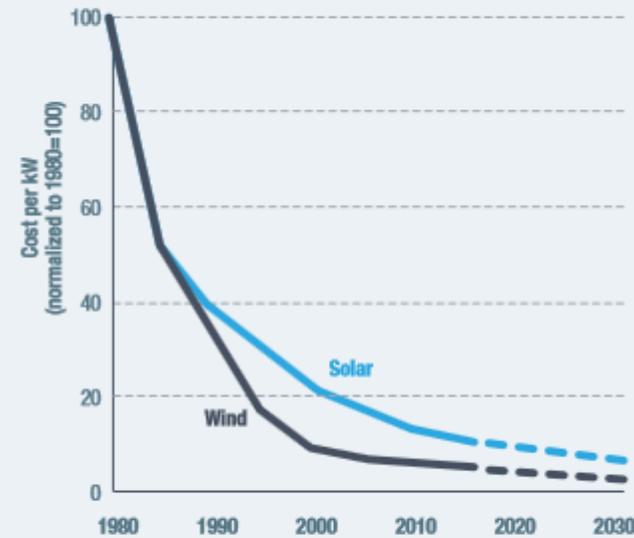
Physicist and Engineering Professor Mark Mills, of Northwestern University, took a deep look at exactly that question last year. He had a lot to say about it in 24 pages of analysis . . . but here's Outlook's idea of the heart of his story:



That's a 50-year chart, above: 30 years of history plus 20 years of forecasts, out to 2040. On top we see oil and its cousins falling as sources of global energy; and at the bottom we see wind and solar rising . . . but both things are happening so very slowly, aren't they? And the slowly-dipping "hydrocarbon" curve does not mean slowly-dipping demand—because the world's total energy needs are emphatically rising.

FIGURE 4.

Cost Reductions for Wind and Solar Power, 1980–2030



Source: Data drawn from Massachusetts Institute of Technology, Energy Initiative, "The Future of Solar Energy: An Interdisciplinary MIT Study," 2015; Johannes N. Mayer, "Current and Future Cost of Photovoltaics," Agora Energiewende, February 2015; David Feldman et al., "NREL Photovoltaic Pricing Trends: Historical, Recent, and Near-Term Projections," National Renewable Energy Laboratory (NREL), Aug. 25, 2015; Ryan Wiser et al., "Forecasting Wind Energy Costs and Cost Drivers," Lawrence Berkeley National Laboratory, June 2016; Ran Fu, David Feldman, and Robert Margolis, "U.S. Solar Photovoltaic System Cost Benchmark: Q1 2018," NREL, November 2018

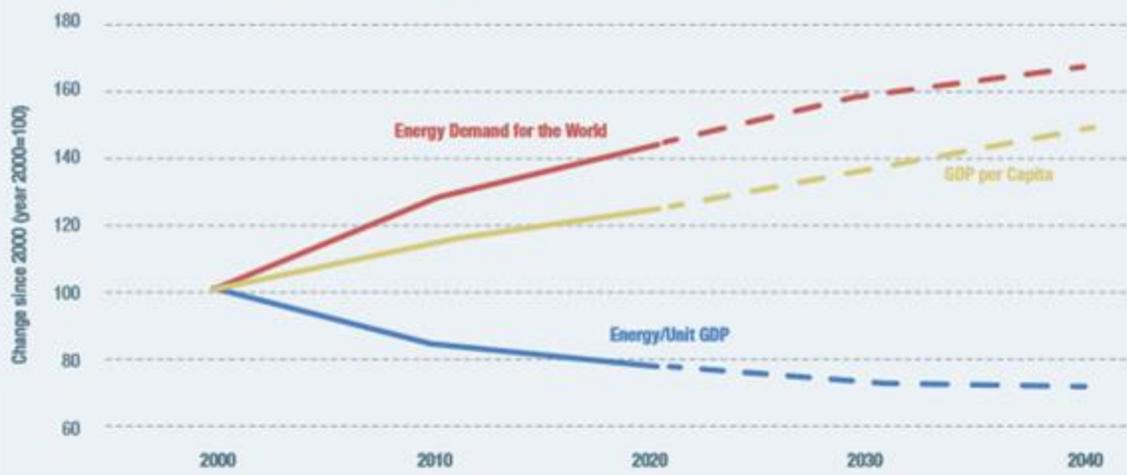
There's an impressive picture. The plunging costs of wind and solar power, since 1980, have been amazing. But notice the shape of those curves: no longer plunging, but emphatically flattening in the last 20 years. Why? Here is Professor Mills:

In the world of people, cars, planes, and factories, increases in consumption, speed, or carrying capacity cause hardware to expand, not shrink. The energy needed to move a ton of people, heat a ton of steel or silicon, or grow a ton of food is determined by properties of nature whose boundaries are set by laws of gravity, inertia, friction, mass, and thermodynamics—not clever software.

Mr. Mills' "clever software" remark came in response to the widespread feeling, among optimists about alternative energy, that the kind of technological miracles which created smartphones can be applied to the production of alternative energies. Over the course of 20 pages of analysis, Mr. Mills' reply comes down to: "Sorry, those are different kinds of science. Digital science still offers explosive gains in what it can do; but energy science does not. Energy science offers only gradual, slogging gains as we look ahead."

FIGURE 8.

As Global Efficiency Improves, Energy Demand Rises



Source: ExxonMobil, "2018 Outlook for Energy: A View to 2040", PWC Global, "The World in 2050," 2019

Here is Mr. Mills' grand summing-up. The blue line at the bottom shows how clever the world has been, these past 20 years, at producing more goods and services per unit of energy. (So energy-per-unit of GDP is on a long, gradual decline.) But the story is in the red line: global energy demand. It has risen strongly, and it looks a lot like it will keep rising strongly for a long time.

Why?

Because the more clever we get at producing things with less energy . . . the more things we find we want to produce. That sentence deserves its bold print. Here is one of Mr. Mills' explanations:

When the world's four billion poor people increase their energy use to just one-third of Europe's per capita level, global demand for energy will rise by an amount equal to twice America's total consumption.

When it gets easier and cheaper to make things people want—especially the things the world's poorer people want and need—they understandably want more of them. Hence the long, rising trend of global energy demand—of which oil is still the cheapest and most productive source by a long shot.

That's Conoco's long-term tailwind. Of course, as its chart shows, the market roller coaster ignores tailwinds when it chooses to—but like all real-world facts, it can't ignore them forever. Conoco's people have handled their business roller coaster with really admirable skill, since 2016. That tailwind won't go away, and it means Conoco's direction is "up," roller-coaster or not.

© Dave Raub
Outlook Capital Management, LLC
125 S. Wilke Road, Suite 200E
Arlington Heights, IL 60005

847-797-0600

The remarks above aren't a general recommendation to buy or sell particular securities. Such decisions should only be made in the context of an investor's own circumstances. Stocks and bonds carry the risk of loss.