The Outlook: Nov. 23, 2018

The oil market, and Royal Dutch Shell: looking beyond the corners at the big picture, as always.

"Oil: Drowning Under a Glut of Supply!" has been the headline lately, along with "Oil Enters Bear Market!" and many more like those. Since Outlook began investing in the oil business, back in 2015, then redoubled its clients' oil positions a mere 14 months ago, we're naturally interested in oil's nightmare stories. Being the day after Thanksgiving, the bullet-point summary seems like a good thing.

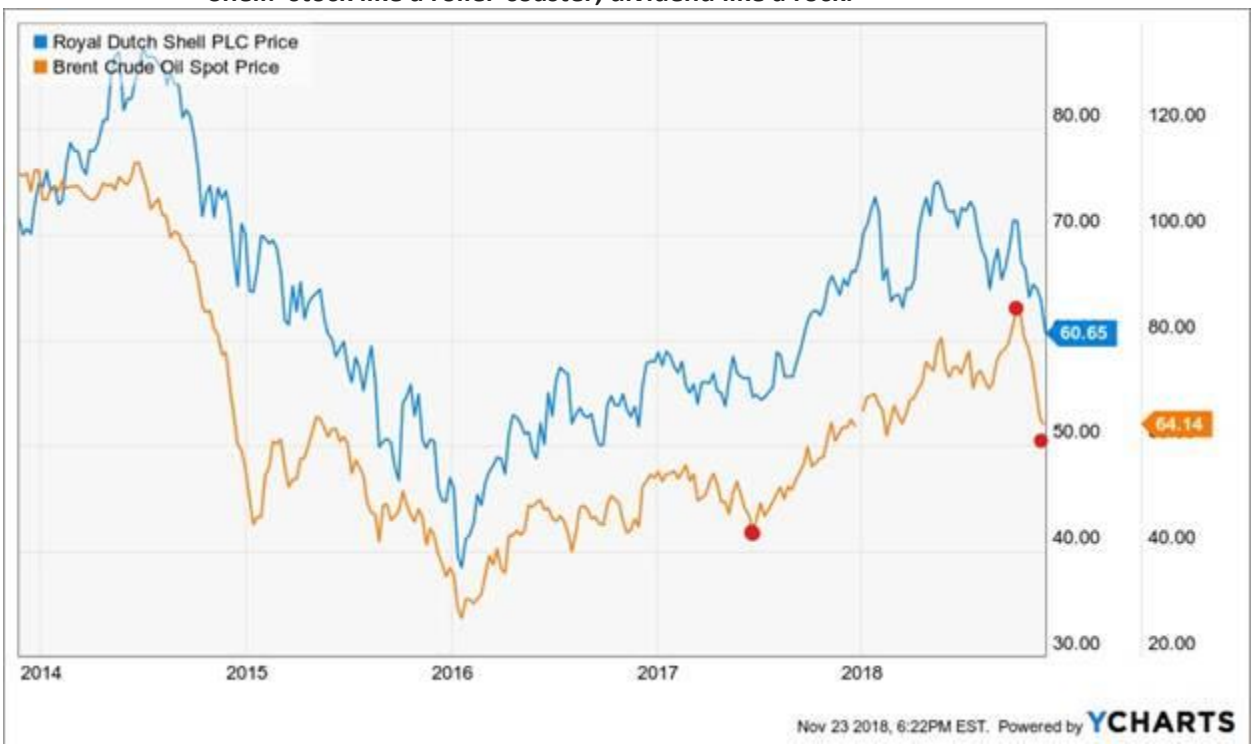
- Today, "oil is drowning under a glut of supply." About 6 weeks ago, it was "global supply looks hard-pressed to keep up with demand." Quite a turnaround, isn't it? We might think global supply and demand for oil are like Ferrari race cars, turning on a dime, accelerating to 60 from a standing start, then braking to a dead stop in a couple of seconds, and so on. They are not, though: they're like glaciers, moving down mountain valleys an inch a month or so, and very incapable of turning on a dime. What can turn on a dime, of course, are the opinions of speculators and journalists. Just as in the stock market, oil's speculators utterly dominate short-term price changes for oil, and detach them from reality all the time . . . for a while. And just as with every subject, journalists rush to offer breathtaking disaster stories to support whatever stampede the speculators have indulged themselves in lately.

- Outlook's investment in the oil industry was, and is, a long-term investment. We think we'll make a great deal of money with our oil firms, over the next 5 years or (quite possibly) much longer. Our opinion about demand and supply is pretty simple: global energy consumption <u>must</u> rest upon oil, for many years to come, and that global demand will do nothing but grow, steadily and sometimes strongly, as vast parts of the world urbanize and become better off. Global supply growth is difficult and slow everywhere in the world except Texas, more or less—and as impressive as the shale oil miracle has been, it's still only 5% of global supply . . . and cannot offset the clearly increasing difficulty of growth from the other 95% of world oil supply.

  There is a world of detail buried under those two sweeping statements about supply and demand. Some of the details sometimes look as if they can indeed spin on a dime, accelerate to 60 in no time, etc. The market and the media will never stop being fascinated by such details, and they'll never stop projecting vast, changing trends in global supply and demand from details which actually represent small corners of the picture: the Trump Administration's unexpected gift to Iran (and its buyers) by issuing 6-month waivers to let Iran keep pumping oil; the U.S. shale industry's surge in production over the past couple of months; Saudi Arabia's extra 500,000 daily barrels of supply, also over the past couple of months, which was aimed at offsetting the expected Iranian supply cutoff in early November, to avoid an abrupt hike in oil prices. When the media write headlines about such things, and the oil market "enters a Bear Market," it's very easy to think those items are in fact the Big Picture, rather than small corners of it. They aren't. Iran's continuing production will fade; the Saudi's will be cut; and Texas shale oil will decelerate, just as North Dakota and Pennsylvania shale did . . . in time. Then we'll see that they were corners rather than the whole picture—but the oil market will have turned around before that's perfectly obvious.

- Meanwhile, as always, the $64,000 Question is: "What kind of companies do we actually own? How will they behave, while the oil market's speculators and media do their things?" One example will do: Royal Dutch Shell.

Shell: stock like a roller-coaster; dividend like a rock.



The lower line, in orange, is the price of Brent crude oil. Shell's stock price is in blue. That first red dot is 18 months ago (June, 2017) when oil was at $44/barrel. The second red dot is 16 months later (October, 2018) with oil at $86. And the third red dot is today, showing oil's cliff-dive to $59. In about the same time, Shell rose from $54 to $75, then dropped to today's $60.

The market's vast crowd of speculators care about nothing beyond this picture . . . for a while. Brent up? Shell up. Brent down? Shell down. But we long-term investors are allowed to ask: "What's changed inside Shell, since June 2017?" As Theresa's "Inside" reports have made so clear, the answer is: "A lot. And all good." Shell's break-even oil price and its debt have been hacked down tremendously. Only a couple of weeks ago, making its Quarterly Earnings presentation, the company made the following points:

- Today, Shell is running at an annual rate of $17 billion in free cash flow. A year earlier, the rate was around $8 billion.
- By 2020, Shell will be running between $25 and $30 billion in annual free cash flow—at $60 oil, which is where we are today.
- By 2020, Shell will have repurchased $25 billion of its own stock—about 10% of the company.

At the current cliff-diving price of $60, Shell's dividend yield is 6.2%. Shell sustained its current 94-cent quarterly dividend through oil's own cliff-dive to $27/barrel in 2014. The company is tremendously stronger today, than it was then. We investors will collect that 6.2% return from dividends alone, while we wait for the oil and stock markets to look beyond their fascinating corners and see the big picture. They'll do that eventually, as they always do.

Outlook Capital Management, LLC
125 S. Wilke Road, Suite 200E
Arlington Heights, IL 60005
847-797-0600

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