The Outlook: June 22, 2018

First understand; then act: OPEC and trade war frights.

We all hear, quite often, that we ought to be very afraid of something. We also hear—less often—that we ought to be very happy or excited about something. Here is today's $64,000 Question, courtesy of Outlook Capital Management: "How often do we *understand* whatever we're supposed to be terrified or ecstatic about?"

If our first reaction to that Question is to figuratively shuffle our feet and look sheepish . . . we may congratulate ourselves, as far as Outlook is concerned, because we've walked a fair way along the hard road toward wisdom. On the other hand, if our first reaction is to feel offended that anyone might suppose we're not sharp-eyed, well-informed analysts of every major issue . . . then Outlook's only remark would be, "Be careful about dabbling in the investment world."

This past week or two have seen the market taking a drubbing nearly every day, until today; and they've given us two things we're supposed to be frightened about: the "Global Trade War" (touched upon just Wednesday, and back for another look today) and OPEC's meeting, upon which the future of oil (and our oil companies) supposedly rests. Both of these frightening "things" are perfect examples of why so many investors (and speculators) fail. They are both like icebergs, as far as genuinely understanding them is concerned: a small part is perfectly visible, and shouted about very loudly by many people; but actually understanding them requires looking very deeply beneath their surface. Most of us have nothing close to the time and background needed to take that long, deep look . . . which makes it extra tempting to feel that surely there must be big fires beneath all that smoke, since everyone else seems to think so.

Let's take a first look beneath the surface.

- **OPEC Meeting and Oil Price Collapse.**

  The "frightening thing" here has been the idea that global oil prices (hence our companies' futures) are at the mercy of OPEC and friends; that Russia and, mainly, Saudi Arabia can, with a mere twist of the wrist, loosen a spigot and flood the world with oil, more or less, driving down oil prices or freezing them in place, whichever they prefer. So the market battered oil and oil stocks in the days running up to today, because those countries had been clear that the only item under debate was "how much" to loosen the spigot, and not "whether to loosen at all."

  Finally came today's announcement, which was not worth quoting in detail, but which amounted to: "We all (OPEC and friends) plan to pump somewhat more oil, because we'd like to stabilize the price for a while. We're not going to talk about which of us will pump more, because we couldn't agree on that; and we won't talk about the hideously complicated facts about whose pumps are broken, whose are getting there, and whose may or may not be capable of any sustained increase . . . because we'd rather you all thought we had no such problems. Can't you all just keep staring at the tip of the iceberg, and trust that we can stabilize oil's price if we want to?"

  The market, acting normally, sent the price of oil and oil stocks on a rocket ride. It did not do this because its experts in scuba gear have analyzed every ice crystal beneath the surface of that frightening berg, and its vast mob of speculators burnt the midnight oil poring over the scuba

divers' voluminous reports. No: it simply "sold the rumor and bought the news," hammering prices down to unrealistic levels on fear of the upcoming event; and rocketing them up on the event itself, figuring that some time after the dust is clear we'll all eventually see just what OPEC could and could not do.

Those long-term investors who did their scuba diving a long time ago just didn't care very much about this latest "OPEC Fright." If Saudi and Russian whims were, in fact, in charge of the global oil market, it would have been distinctly unwise for us to take any positions at all in the oil business, far less the emphatic positions taken by Outlook in 2016 – 2017. They are not in charge. What is in charge is:

1. Inevitable steady growth in world energy (hence oil) demand, due mainly to the enormous, continuing trend toward urbanization and modernization in about 2/3 of the global population;

2. The near-collapse, for an unprecedented 3 years, in spending to discover new oil fields and maintain production in old ones.

3. The geologic fact of sharply declining output which happens naturally in all fields, from shale to coastal to deep-water—unless great effort and funds are spent to keep them going—and which is clearly already happening within most of OPEC—and very likely within Saudi Arabia itself, so that the Saudi's ability to "loosen the spigot" is nowhere near as powerful as the Saudi's and the frightened market would have us believe.

4. The inevitable eventual slow-down in oil supply from the U.S. "shale miracle:" already perfectly evident in the original shale fields scattered across America.

5. Finally, the simple impossibility that "renewable" and "alternative energy" sources can grow nearly fast enough to take oil's place in meeting global energy demand: for the next ten or twenty years, anyway.

- **Global Trade War: China vs. USA.**

We touched upon this two days ago, so much less today. But today an analyst named Avery Goodman did something, finally, which "all the King's horses and all the King's men," so to speak, hadn't bothered to do whilst running and shouting in alarm about the "Global Trade War's" threat to the world's economic health. He looked at the trade facts about China and the U.S., namely the facts about who exports exactly what to whom, and what exactly happens when China, for example, says, "We'll see every Trump tariff on our exports and match it, if not raise it, with our own tariffs on U.S. exports to us."

Mr. Goodman's conclusion: China loses. It only hurts itself, and hardly bothers the U.S. Why? The U.S. exports a fraction of the goods to China which China sells America; and a Chinese notion that its 25% tariffs will price those U.S. goods out of its market, hurting all those U.S. companies and farmers, looks silly when we reflect upon how markets actually work. <u>They work by finding ways around blockages:</u> very fast ways, mostly.

China must buy those U.S. goods from somebody else; and "somebody else's" previous customers will buy the goods from the U.S. which China tried to block from its own borders. So in the end, American producers will simply sell to non-Chinese customers, while non-American producers are selling to the Chinese. In the process, the non-American producers newly selling to China will have every reason in the world to raise prices toward the 25% higher tariff prices—because China will have damaged its own ability to make its suppliers compete toward the lowest price. American producers will end up generally selling the same volumes at somewhat higher prices; and Chinese companies will end up simply paying more for everything they must import, from America or anywhere else.

Like most topics in economics, that made us blink a bit, didn't it? The heart of it is this: a giant engine of China's economic growth has been exports to the U.S. But the opposite is not true. Chinese purchases of U.S. goods have been helpful; but not critical for the American economy as a whole. America's President is determined to make China play "more fair" when it comes to both trade itself, and the use of trade barriers and threats to acquire American technology which is not for sale. No previous President has pressed that battle to the point of seeing who blinks. This one looks like he means to do so. And Mr. Goodman's remarks pointed quite clearly to the great mismatch in the strength of the two "battlers."

A "Golden Rule" for investors from all this might be: "Never Believe the Headlines." In Outlook's experience, for every one headline which captures the heart of some frightening thing, ninety-nine others seriously distort the heart of the matter, and in fact point us toward the wrong thing to do, rather than the right thing. The only cure is to dig hard and deep for the truth, then act (or, most often, don't act.) We do not aim to let vague threats from OPEC frighten us out of our long-term oil industry positions; nor confusing alarms about "Global Trade Wars" frighten us out of stocks in general.

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