

The Outlook: Jan. 20, 2018

Oil's "raging debate:" Schlumberger takes sides.

When the subject is politics, of course, it's not possible to have a "raging debate" about anything without people getting mad. We may have noticed that, these past couple of years, or days. But one of the just plain fun things about the investment world is that "raging debates" go on all the time, with great crowds of investors intensely focused on them, but far more interested in getting it *right*, than in getting mad. The only catch, when it comes to having all this fun, is that we have to think topics like the future of global oil demand and supply are interesting enough to be intense about. (It does help to have money riding on the outcome.)

Schlumberger's Paal Kibsgaard talked about his company's 4th-Quarter earnings yesterday. We aren't going to look at them, beyond noting that they were solid and accelerating—like Usain Bolt coming out of the blocks. We're more interested in the raging debate about global oil supply and demand, because Mr. Kibsgaard often has interesting things to say.

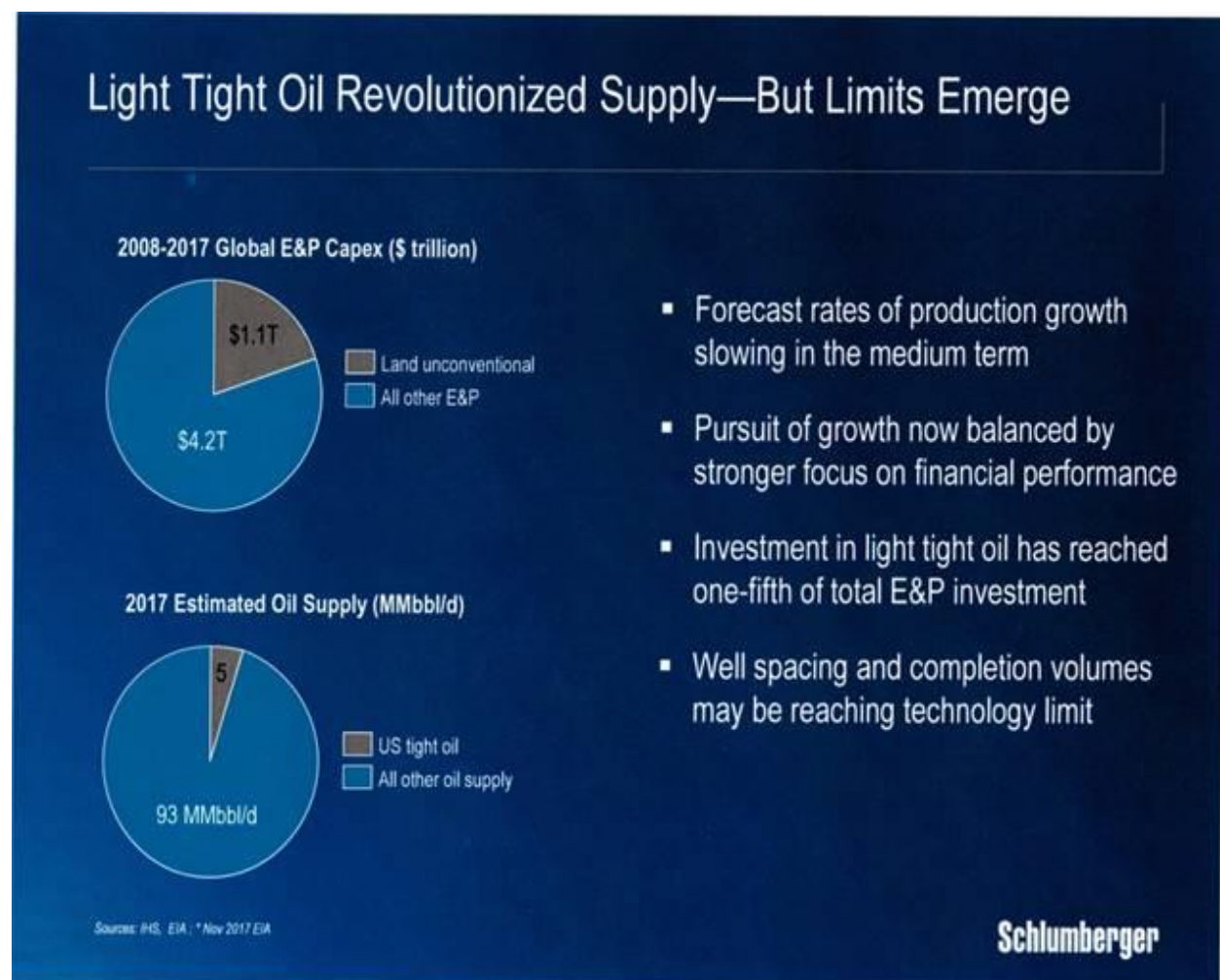


The yellow line is global oil production (supply), and the blue bars are annual capital spending by the "E&P" (Exploration and Production) companies. There's the sickening plunge in such "capex" after oil peaked in 2014 . . . but, oddly, there is that rising yellow supply line. Remembering that we're

in the middle of a raging debate, that seeming oddity (spending slashed, supply unaffected) explains one of the basic, eyeball-to-eyeball differences of opinion.

The Oil Bears say, “See? No problem from the spending shutdown, supply keeps rising—surely because of the lightning reflexes and technological advances in the U.S. shale sector, which can grow so fast it hardly matters what the rest of the world’s producers do.” The Oil Bulls, never blinking (which has been a strain, these past 3 years), reply “Nope! That yellow line is still rising because the money bins of cash spent on “E&P” from 2010 to 2014 paid off, finding or producing more oil from conventional (non-shale) wells . . . with a lag. That’s normal behavior: the benefit comes a few years after the spending . . . but it has a sharply limited life. The geophysical fact of life which rules us all, in the oil business, is “decline rate,” which means, “First a gusher, then a petering-out to a light sprinkle . . . unless the owner of the oil field keeps spending!” And the last 3 blue bars above are the very definition of “Stopped Spending.”

To Outlook the Oil Bulls have it right, on this point. They say “decline rates are not debatable, they are geophysics,” and we agree. Outside the realm of science, and inside the realm of psychological mumbo-jumbo, we also note that market participants have a history of being fooled by almost every possible kind of “lagged effect,” because most of them are passionately interested in what might happen in a few weeks, and much less interested in what might happen in a few years.



Here's Mr. Kibsgaard's second observation. By "Light Tight Oil," he means "U.S. Shale." There are 2 points here. First, the pie charts show (top one) that the "shale revolution" attracted \$1 trillion out of \$4 trillion in E&P spending, in 10 years. The result is in the bottom chart: shale contributes 5 out of 98 million barrels/day of worldwide oil supply. 25% of the spending . . . 5% of the production. "Hmm" is the thoughtful response both sides of the eyeball-to-eyeball raging debate ought to give this fact. It's not a slam-dunk, argument's-over, debate clincher. Like every chart or statistic in history, there are "if's, and's and but's" worth arguing about in this one. But underlying the stark "25% spending = 5% production" statistic are another couple of those "geophysical facts." Mr. Kibsgaard refers to them in the text, up there and elsewhere, but his lingo needs translating. In essence:

- Shale's "decline rates" are the steepest and fastest in the oil world, requiring constantly accelerating E&P spending to keep shale supply growing, or even stable;
- In the shale oil "calamity" of 2014 – 2016, as oil prices plunged and shale companies went bankrupt, everybody in the business behaved normally: they slashed spending, and focused their best remaining efforts on the easiest, most productive fields . . . which naturally drained those fields faster than planned. That's what people do when they desperately need cash, and suddenly have half the money needed to earn it: pick the low-hanging fruit.

"Why on earth are our shale companies selling their best long-term assets (from their oil in the ground) at the lowest prices?" was a question heard last year from a few big and "sophisticated" investors. It was a "rhetorical" question (which usually means the answer is obvious to everyone except the clever.) It was, "Because we need cash and that's the only way we can get it." Normal people behave in normal ways, which is why supply and demand always behave in normal ways . . . with lags, eventually.

The heart of Mr. Kibsgaard's observations is also the heart of the Oil Bulls' understanding of the forward path of world oil supply. It boils down to, "Growing supply will be a lot harder than it has looked, the last few years." And, further, "Global demand is growing at a very steady rate, or maybe even "strongly." That means a crunch must occur, and in fact will show up in its earliest stages, in 2018. The oil market, despite all the eyeball-to-eyeball debates, mostly suspects the truth of the Bulls' point of view, hence the startling upswing in oil prices last year and early this year. Schlumberger thinks that upswing is here to stay (for a good while), and is reflected in its customer orders, which were strong across the board as 2017 ended. Outlook agrees. We're holding our oil and commodity companies, and buying more.

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