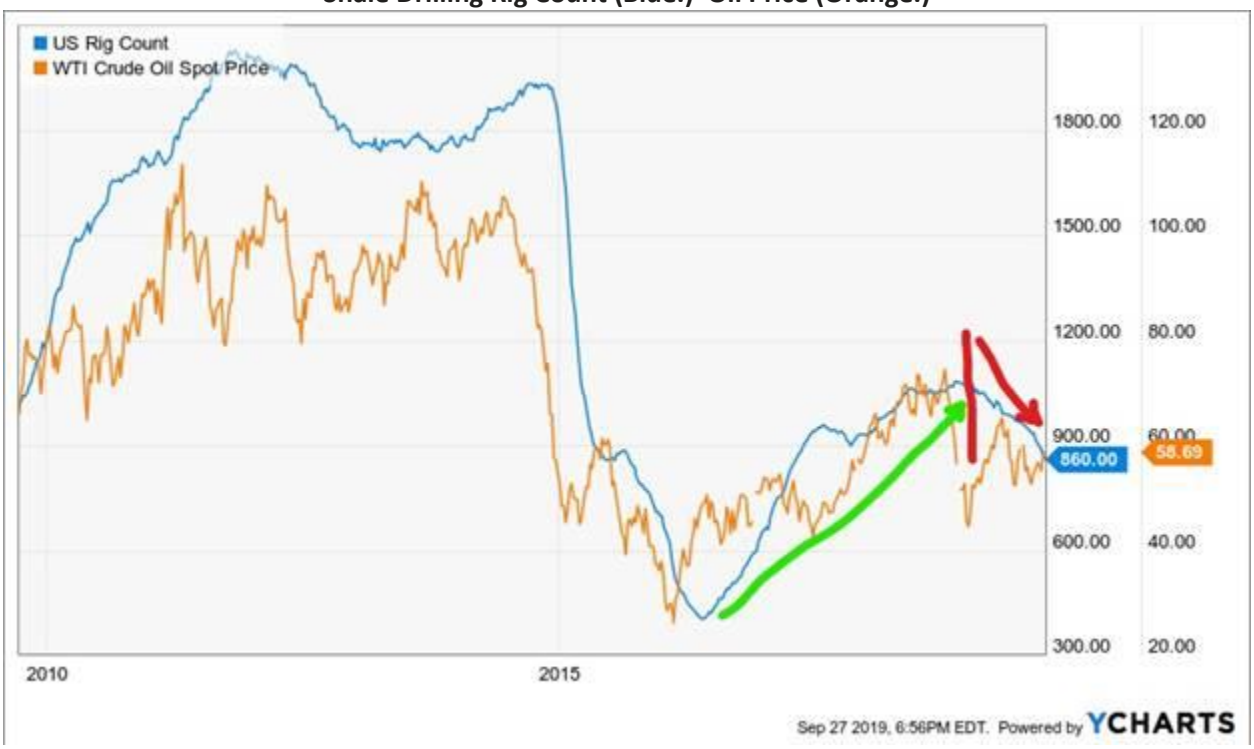
The Outlook: Sept. 27, 2019

Oil supply and demand: the 2-by-4 effect.

For any Outlook clients and friends who might be glad to read about anything other than politics, lately, here's something a lot more dull . . . unless we happen to own and like oil companies, and wonder if the price of oil is ever going to go up, and stay up.

Shale Drilling Rig Count (Blue.) Oil Price (Orange.)



Among the sayings Outlook clients have heard many times is, "The cure for low prices is low prices, and vice versa." It's just a short way of saying that when a price plunges in a free market, both supply and demand make big changes, eventually—which eventually cause prices to rise again (and vice versa.) The big changes happen because the people who either make or buy a product are normal human beings, and they react in perfectly sensible ways when the product's price gets a lot lower: making and selling a lot less; or trying to buy a lot more.

So far we're on Day One of Economics 101. (That day, and probably a few days or weeks after that, is when the best and most useful principles of Economics are taught—and heaven help the poor soul who gets the idea that deeper enlightenment lies in the advanced thinking found in a Ph.D. program.) As simple as supply and demand sound (compared to algorithmic trading formulas in the hedge fund world) they will lead us to outstanding investment returns, if we've got the patience and nerve to wait for them to do their job. When a price plunges, in some markets supply and demand make their common-sense reactions pretty fast. But in other markets, it can take so long we're tempted to doubt they knew what they were talking about, back in class on Day One.

When it comes to supply and demand in the oil market (and our returns on oil company investments) we've been in the "slow response" category since 2016. When oil's price plunged 75% from 2014 – 2016 (orange line), the number of shale drilling rigs went right off the cliff as well, without much delay. But as oil regained part of its cliff-dive losses, over the next 2 years, the rig count went right up with it . . . until hitting that red vertical line late last year. Then the red arrow shows the very steady, steepening drop in shale rigs in use by oil suppliers through 2019.

Since oil's 2016 bottom at $27/barrel, it's spent the last 3 years roughly around $55/barrel (plus or minus $10.) The mystery, for oil investors waiting for shale oil supply to dry up (or at least ease off) has been why on earth it's taken so long for so many U.S. shale companies to cut spending (on rigs, etc.) in response to an oil price which, in that $55/barrel range, was making them lose money hand over fist. A new shale well's oil production drops 70% after a year or so—a number which is just as shocking as it sounds—so oil producers must keep drilling and drilling to replace the run-off, and have any hope of keeping their total production growing. It's a hamster on a treadmill. If he wants the treadmill to go faster, he must keep running faster.

Why didn't all those shale-producing hamsters give up sooner, or have heart attacks and die?

There are a host of technical, jargon-filled answers to that . . . but here's the bottom line: "Because they're people—stubborn Main Street people, with an appetite for risk and all the drive in the world—and stubborn people do sometimes have to be "hit upside the head with a 2-by-4" (like the legendary mule) before seeing that reality is telling them to change their behavior."

The Dallas Federal Reserve Bank recently did a survey of 142 oil-and-gas executives in the shale business in Texas and New Mexico. The Bank's measurements of <u>activity</u> by those shale suppliers was pretty grim, as we'd expect after looking at our rig-count chart. But after the survey collected "just the facts" about activity, it gave the executives a chance to vent, in a "Comments" section for anonymous remarks. Here's a sampling:

- *"The capital market has dried up for small E&P companies." (Meaning Wall Street finally got sick of losing its investments in shale companies.)*
- *"It seems no one has any money for oil and gas projects. Lack of Wall Street participation in oil is very apparent."*
- *"Many oil shale projects are failing to meet production projections… Further cost declines will not be forthcoming.*
- *"The industry is admitting what (some independent companies) early on figured out: <u>You cannot make money drilling at this price structure</u>. An ongoing drilling program consumes all your returns and continues to require new money."*
- *"Over $130 billion of junk status bonds are coming due after 2020 over a two-year period for those that got in the treadmill drilling business, with wells that decline 70 percent in the first year." (Meaning more losses for Wall Street.)*

- *"U.S. oil production is about to fall significantly. The rig count has declined dramatically from one year ago (down 170 rigs), and our customers are not completing wells in order to save cash flow. This all equals a big shift down."*
- *"Shale oil companies have pulled back on spending and continue to pressure service company prices. I expect there will be a number of insolvent companies looking for help in the next six months."*

There's plenty of jargon there, of course. It all comes down to: "You can stop using that 2-by-4, please. You've gotten our attention . . . and we're changing our behavior."

For our companies, like Shell and especially Conoco, this just helps. They're infinitely stronger than the companies moaning in that survey; they're mostly producing their oil in non-shale fields around the world, whose consistency is much friendlier to producers than those 70% decline rates in shale; and they'll turn most of every dollar of rising oil prices into pure profits and cash flow. (That's exactly what the shale industry can't do.)

The laws of supply and demand never change . . . they just take a painfully long time to show themselves, sometimes. The market always values companies doubtfully and cheaply, when those companies are waiting for supply and demand to finally do their thing. But the payoff for patient investors is always remarkable. We like Shell and Conoco a great deal, and we expect to own them for a good while.

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