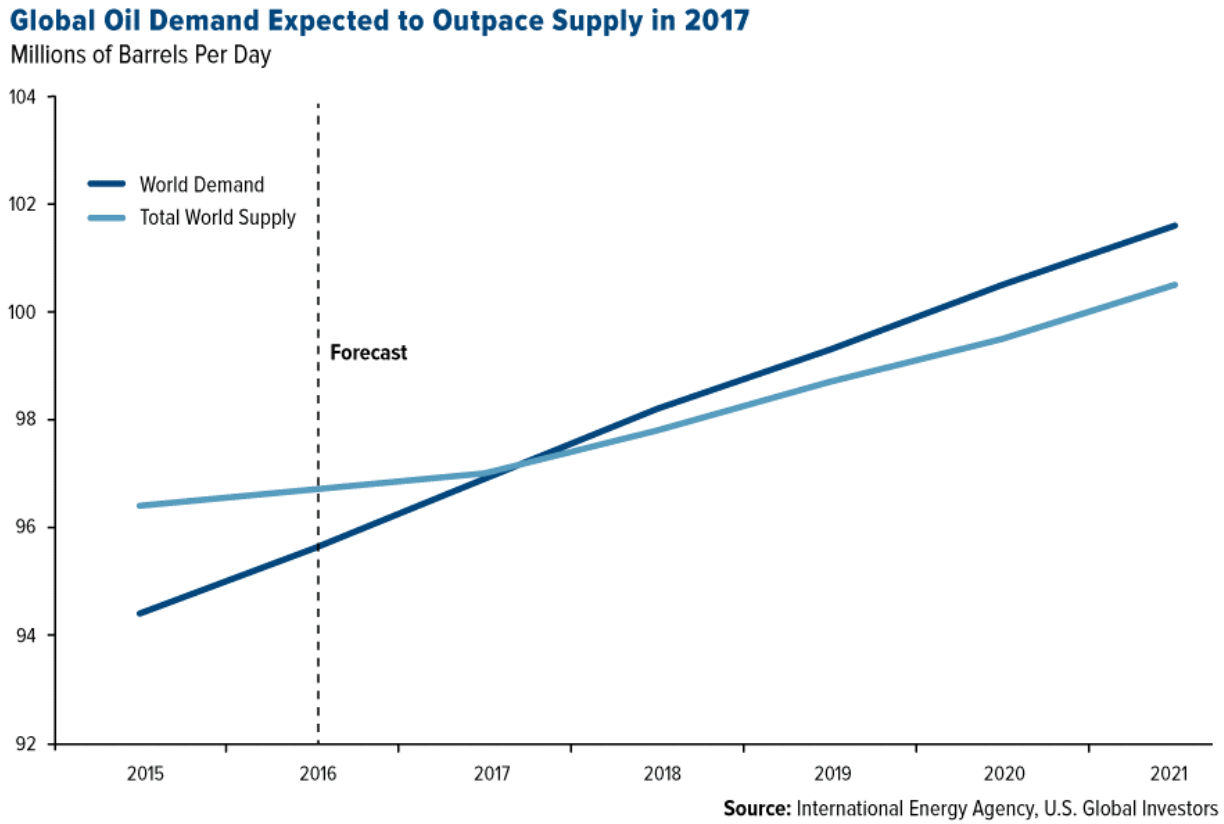
The Outlook: March 20, 2017

People behave normally . . . so oil will keep pointing up.



At Outlook we've made a significant long-term "bet" on behalf of our clients, since 2015 or so. Our bet is that the commodity and energy markets will behave in the future as they've behaved in the past: rising strongly for a good many years, having fallen sharply for a few years. We are "betting" on a principle—a profound principle, in Outlook's opinion. That principle is that free markets always cure themselves—eventually—because markets are nothing but crowds of normal people who behave normally and sensibly—eventually—in response to big changes in market prices.

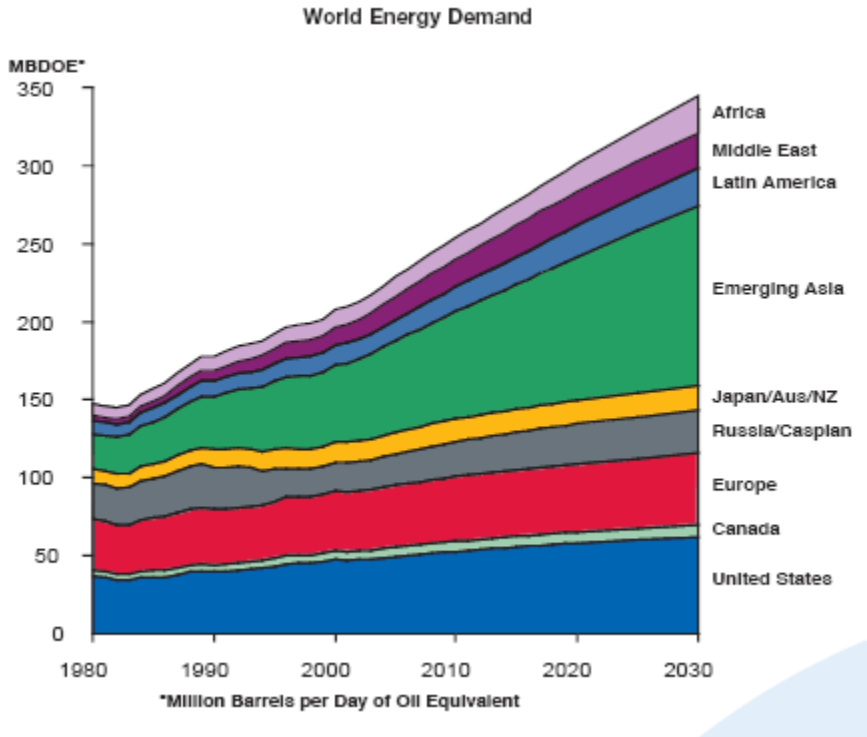
The stock market hands us extraordinary investment opportunities because normal people find it very hard to trust that word, "eventually," when their own money is at stake. When we are anxious or downright fearful about something, we're mostly pretty awful at enforcing a code of "calm patience" upon our thoughts and emotions. So we "miss the forest for the trees," and find that "a watched pot never boils" again and again during our lives. It's too bad, and frustrating indeed to relearn the same lessons over the decades . . . but it absolutely gives us investors the chance to do very well, when we can remember the lesson ahead of time.

The markets and the whole investment world, of course, have been just as focused as Outlook, upon the energy and commodity markets. From 2014 to 2016, oil fell from $107 to $26, which qualifies as a "big

change" in a market if there ever was one. Oil is back in the $50 neighborhood now, and the sheer intensity of the market crowd's day-by-day scrutiny of oil's future is something to behold. So also is the hard work and extreme detail wrapped into most of the bear-versus-bull arguments about oil's future. Yet, as always, the forest is missed for the trees, and a great many pessimistic analysts find many detailed reasons to doubt the profound principle about market and human behavior: "markets cure themselves."

Let's look straight at that principle and apply it to this oil market.

When the price of anything falls sharply, and stays down for a while, people who use it eventually buy more . . . and people who make it eventually produce and sell less. The first people are the "demand" side of the chart. Here's what they'll be doing in the decade ahead.



The green section ("Emerging Asia") includes China and India. The many tree-scrutinizers wandering through the forest these days are uniformly doubtful about China's economic future . . . and uniformly blasé about India's future. Outlook suspects the doubts are overdone about China . . . and is sure the collective shrug about India is a big mistake. India has vast potential for economic growth, and for the first time in history, its own government is gradually unlocking the political shackles which have blocked that potential for decades. There will be an extraordinary jump in cars on the road, electricity in homes and every other energy-consuming aspect of modern life in India, in the decade ahead.

World oil demand must keep rising strongly for the next 10 to 20 years, no matter how wishful we might be about solar, wind and battery power.

And oil supply? Here are just a few numbers for 2017:

OPEC oil supply: 32 million barrels/day
Non-OPEC supply: 64 million barrels/day (Only 4.5 million of which is U.S. shale production)
Total: 96 million barrels/day

And here is what's happened to global "oil capex" spending since 2014: down 41%. If 2017's global oil capex spending falls, which is very likely, it will be the first time in 50 years, or so, that such spending has dropped for 3 straight years.

Now it's time to return to that word: "eventually." The last time oil capex spending fell, in 1998 – 1999, the shockwave effect of that drop showed up several years later, in 2003 – 2008: oil production from non-OPEC nations dropped in 4 of those 6 years. Why the lag? Because people behave normally. When oil first fell, companies which badly needed to stop their incoming cash flow from dropping too sharply reacted by slamming the brakes on exploration-and-production spending (capex) and also by accelerating production wherever that was possible at the least added cost. They did exactly the same thing this time, in 2015 – 2016. In effect, they took more money from their bank accounts, and stopped putting money into them. We can all do that for a while. We all must stop cold . . . eventually.

Existing oil fields need to keep spending to keep producing—really, to keep their outflow of oil from declining as sharply as they decline without efforts to squeeze out more oil. New oil fields, waiting to be discovered, need truly massive spending to be discovered in the first place, then built up for production. (That process can easily take 5 to 10 years.) The tremendous drop in both kinds of spending which began in 2015 will shrink future oil supply . . . yup, "eventually." That oncoming shrinkage is already perfectly visible in the volumes of oil coming from existing fields all over the world (shown with wonderful clarity recently by Seeking Alpha analyst Nawaralsaadi, writing under the heading of "Long Term Energy.")

That brings us to "the Shale Miracle," and its role in global oil supply. It really was a miracle of invention, turning around America's emphatic oil-production decline of decades. But glance at those "few numbers for 2017." About 5% of world oil production comes from U.S. shale. As another analyst put it this week, "That 5% is getting around 95% of the experts' scrutiny these days." The Shale Miracle was just that . . . but miracle or not, its power to drive global long-term oil supply has distinct limitations, particularly when we recall the shockingly steep rate at which production declines from newly-producing shale fields—reaching 70% in 2 or 3 years.

Hence Outlook's liking for the chart at the top. Global demand will grow. Global supply will grow more slowly, because of the normal behavior of suppliers as oil fell off its cliff in 2014. This market has already begun to "cure itself," and its uptrend looks likely to go on for a long while, carrying our assets like ConocoPhillips and Geospace Technologies (and others) along for the ride.

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