The Outlook: Sept. 17, 2019

Oil: "You're going to get your head handed to you."

When we get one of those truly "Big!" stories like Sunday's Iranian missile strike on Saudi oil refineries (since we aren't politicians or the United Nations, we can say what is completely obvious to everyone else), a lot of people say interesting things. Here are three of the most interesting, from Outlook's point of view as a determined long-term optimist on the oil market:

"If you're a shale oil company in the U.S., and you use this event (skyrocketing oil prices) as an excuse to ramp up spending again . . . you're going to get your head handed to you."
Kevin Hold, Chief Investment Officer at Invesco (big shale investor)

"We have no intention of adding rigs over and above our original plan."
Scott Sheffield, CEO, Pioneer Natural Resources (big shale company)

"U.S. Shale Won't Spring into Action."
OilPrice.com (big oil market analyst)

In the oil market's short run (like the stock market and every financial market) real-world factors like supply and demand don't matter—only the collective bets of the speculating herd matter. In the long run, though, the facts of supply and demand are all that matter. Our position at Outlook is that global oil demand will grow steadily, with the kind of gentle ebbs and flows shown by demand for decades, for at least another 10 years—because over that time frame, oil-demand-killers like electric cars and wind/solar energy may very well grow, but they can't possibly derail global oil demand. The numbers just don't add up.

And when it comes to oil supply, our label is: "getting tougher, year by year." Supply will be pinched because almost all oil production except for U.S. shale took an ax to exploration and production spending in 2015, as oil plummeted in price . . . and hasn't yet restored much of that spending. That fact has consequences which are perfectly clear and unavoidable: a significant decline in future supply. The consequences were put off for a few years, after the 2015 cuts, because the heavy exploration spending of 2010 – 2014 was paying off in new oil production. "Delayed response" is how the oil business works.

That brings us to U.S. Shale—the rest of the supply story—which kept spending and producing more (with a minor pause) during and after the 2015 – 2016 oil price plunge. The shale story is one of those things the Europeans call "American cowboy capitalism." The companies and people who triggered America's "shale miracle" had the best of those cowboy traits (boundless optimism, an appetite for big risks, and well-funded investors with an equal appetite for risk) and the worst (boundless optimism and an appetite for big risks, overwhelming any inclination toward discipline and cool-headed analysis.) The result was a U.S. shale industry which lost an ocean of money, not just since 2015 but throughout its existence. The further result only showed up over the last year, or less: the well-funded investors got so tired of losing money they began firing the shale cowboys (those who weren't already bankrupt) and bringing in accountants who felt that "losing money" and "Boot Hill" were about the same thing.

"You're going to get your head handed to you, if you start spending again" said Invesco's Mr. Hold. That sounds more like Wyatt Earp holding a six-gun than a CPA wearing a green eyeshade—and it perfectly captured the change in mood inside America's "shale miracle." And from Mr. Sheffield at Pioneer, "We

have no intention of adding rigs!" sounds like one of the Clanton gang after the OK Corral . . . "Don't shoot, marshal! I'm a peaceable man, now."

Though the oil market's speculating crowd had ignored it so far this year, the results from U.S. shale have shown more signs almost every month that the cowboys have given way to the peaceable men: the drilling rig count has fallen, month after month; and shale oil production (which is remarkably hard to measure week by week, while it's happening, and is often highly deceptive) has shown clear signs of slowing overall growth and falling productivity-per-well when we look at the delayed, but more accurate figures which look backwards a month or two.

On the supply side of the oil story, that leaves OPEC, which still means Saudi Arabia first and foremost. $50 to $60 oil does not work for Saudi Arabia. It cannot pay for its government spending at those prices, and has had to drain its galactic level of savings to fund some vast welfare spending aimed at the Saudi people. Regardless of how quickly or slowly the Saudis fix Sunday's missile damage, $50 - $60 oil will stay the enemy, for Saudi Arabia . . . and its oil spigots will stay pretty tight for a long time ahead.

"Delayed response" is indeed how the oil business works. As usual, that means patient investors must endure the wait, and some pain. But companies like Conoco and Shell have not stood still through all their pain, as Theresa's Inside reports have made so clear. They are remarkably stronger and more profitable than they were 5 years ago. They are making as much money now, at $60 to $70 oil, as they did in 2014 at $110 oil. It won't take all that much of an oil upcycle to bring even more remarkable returns. That's why we weren't troubled by the oil market before last Sunday; and we're not troubled afterwards.

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