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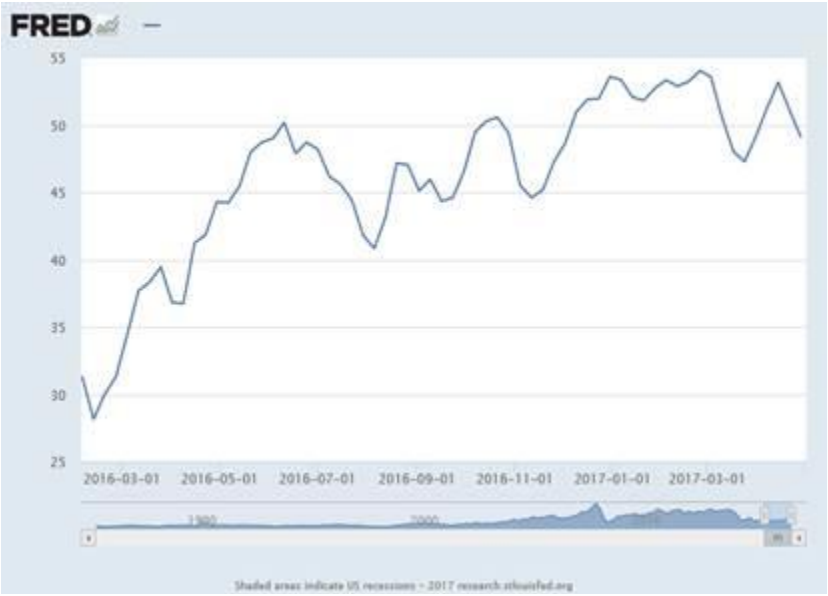
Conoco and Geospace: free markets, the laws of physics, making money

Oil Spot Price, One Year



Conoco and Geospace: Price Swings, One Year

"Here's how the laws of physics make all natural systems work: they grow and get better, then they peak and decline. We've got 150 years of history of producing oil and gas wells and fields around the world. So far, I have not seen the laws of physics give U.S. shale-oil fields a pass on how natural systems work."

Art Berman, Consulting Geologist

Mr. Berman was talking about his opinion that the eventual direction of oil prices is "up" . . . a lot. We believe the same thing, at Outlook. We also believe that a good way to make money, in the investment world, is to make as nearly-certain a judgment as possible about the broad future direction of something fundamental; then buy very strong, well-run companies which depend on that "something," when their value is doubted by a market which rarely has the patience to trust the "broad future direction" of anything.

Mr. Berman was specifically talking about the market's widespread impression, right now, that the "Shale Miracle" in the U.S. (in which better drilling technology triggered a vast boom in U.S. oil production these past 10 years) will prevent global oil prices from anything significant in that "up" direction for a very long time, if not forever. American shale production (and exploration) plunged after oil prices began plunging in mid-2014. But oil began climbing out of its shocking $27 hole early in 2016, and over the past few months there has been something like a "rush through the door" back to the shale fields, with hundreds of drilling rigs back to work. That rush to work here in the U.S., plus anxiety over whether OPEC would stick with its modest production cuts, has created the oil price behavior we see above, in the top chart: a year of waffling between $45 and $55 per barrel, with a spike down lately.

And (bottom chart) that recent down-spike in oil triggered similar plunges in the two Outlook core companies which depend most heavily on oil prices: ConocoPhillips and Geospace Technologies.

Such hills and valleys are a constant fact of life for investors. But we own Conoco and Geospace because we're nearly certain the oil-price line in that top chart is going to go up—quite far up—sometime between 2017 and 2020; and our rewards from Conoco and Geospace, when that happens, will make the wait seem trivial. Here's why Mr. Berman (and Outlook) are so sure of that:

- Global demand for oil will simply keep rising, year by year. The urbanization and general economic progress of really vast areas of the world (especially India and China, but elsewhere in Asia, Africa and Latin America too) is as nearly-certain a future trend as can be; and oil is the only energy source large and cheap enough to meet most of the needs arising from that trend.

- Global oil supply is a lot more difficult—regardless of the U.S. "shale miracle."

  1. U.S. shale gives us about 5% of global oil supply. "Conventional" fields are the other 95%. Mr. Berman observes two things about conventional fields: the giant ones were found long ago (Saudi, North Sea, Prudhoe Bay, etc.) and none have been found recently; and it takes a very long time (10 years or more) to get from "discovery" of any new field to "volume production" from that field. It also takes a great deal of money, spent regularly year after year. The 3 years from 2014 – 2016, Mr. Berman observed, showed the lowest exploration-and-production spending in decades, because all the major oil firms were forced to cut such spending to the bone if they wished to remain on their feet after oil plunged. And there are certain, unavoidable consequences to "not spending" on future oil production: namely, future oil production will shrink.

  2. The "Shale Miracle" was so startling, and so impressive, that once the investment world grasped it, it did exactly what people are always inclined to do: it swung from "too much doubt" to "too much enthusiasm." Hence Mr. Berman's remarks, above, calmly observing that shale oil fields are not remotely close to being infinite pools of oil, easily tapped by opening the spigots wider and wider. (The "spigots" being those hundreds of

drilling rigs.) Shale fields grow, peak and decline . . . and it costs sharply higher amounts of money and effort to keep squeezing oil and gas out of them, as they peak and decline. (And when they decline, they decline fast compared to conventional fields.) The technology behind America's shale miracle is wonderful, Mr. Berman thinks; but it's not so wonderful that cheap oil from shale can possibly offset the future crunch in oil supply arising from the dramatic plunge in spending on conventional fields, these past 3 years.

Another way of saying all this, of course, is that very old truth about free markets: they fix themselves . . . eventually. Sharply lower prices make sharp changes in how people act: hence the brakes slammed on conventional oil spending, and the bump up in the growth of oil demand. Markets are simply big crowds of people, acting like people—whose sharp changes in behavior inevitably cause prices to rise again. At Outlook we very much like to bet on that kind of truth.

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