The Outlook: Aug. 9, 2017

Authoritative figures: pretty from a distance, "big old mess" up close.

"She's like a Monet . . . pretty from a distance, but up close it's a big old mess."
(Alicia Silverstone, courtesy of a nameless scriptwriter for the movie Clueless.)

It has to be a cold day in Hell, pretty much, before Outlook is inclined to admire anything coming out of Hollywood, but there are always exceptions. Whoever wrote that line for Ms. Silverstone not only said something fun about Impressionist Art, but gave the investment firm Open Square Capital (writing on Seeking Alpha) a wonderful analogy for its excellent analysis of global oil statistics. (We're talking about oil a great deal these days, because it looks to Outlook as if that's where some remarkable bargains sit waiting to be picked up.) Here was Open Square's main idea:

> *Remember, oil data isn't always pretty. It's replete with inaccurate or missing information, half-truths and at times non-truths. The market wants to read the tea leaves (scrutinizing oil data) but you're often left staring at a blotchy painting (that Monet.) The 35 OECD member countries (e.g., Canada, Japan, US, UK, etc.) maintain open, reliable and timely data on their oil inventories. OPEC and Non-OPEC producers, which include countries such as Nigeria, Libya, Iran, Iraq and Kazakhstan? Not so much. Many countries protect their production and inventory data for strategic reasons, and what is disclosed is often questionable. The picture becomes even more convoluted when you add floating storage, for which there's some data, but incomplete. When oil sloshes around in the early stages of rebalancing, the speed of the inventory changes, how inventory changes are accounted for, and the weak data integrity can all skew the picture.*
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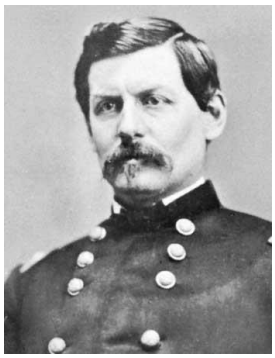
> *Since demand is hard to measure, the market guesstimates by calculating supplies and comparing it against inventories (usually OECD inventories). It stands to reason that the difference equals "implied demand." Many use supply and production interchangeably, but they are in fact very different. Supply includes production and inventory changes. Production is sustainable, whereas inventory changes may not be once inventories deplete. Additionally, inventory transfers can inflate visible stocks; so failing to delineate between the two can lead you to believe that demand is falling off when inventories are merely moving.*

Open Square went on to point out the numerous and significant revisions in official estimates of global supply and demand . . . and concluded that the market's consensus opinion—essentially that future U.S. shale oil supplies will swamp the market, overcoming global demand and any feeble OPEC attempts to cut supply—are wrong, being based on highly detailed and authoritative sources which happen to be all muddled up.

Let's jump back 150 years, and remember a lesson from the Civil War.

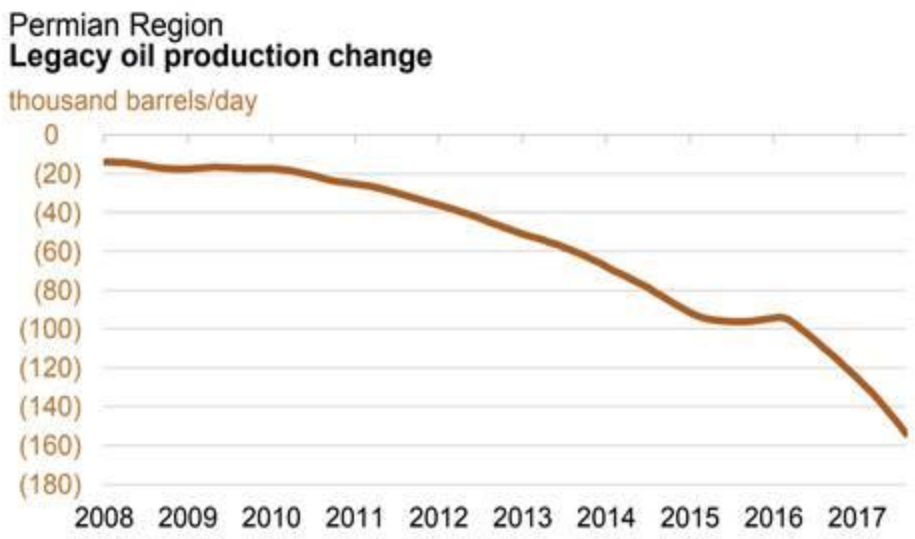


That's Union General George McLellan, and his intelligence chief, Allan Pinkerton. Mr. Pinkerton founded the nation's first wartime intelligence organization, and offered to provide the North with information about the size and strength of the Southern army. He was eagerly accepted, and proceeded to supply the North—and especially Gen. McLellalan—with reports of Confederate military size, strength and capabilities which were just plain astonishing, in their volume, detail and air of authenticity. Mr. Pinkerton's spies appeared to be everywhere—ears at keyholes at Robert E. Lee's headquarters, sampling the food served to the troops, noticing the levels of marksmanship and general training in Confederate army units right down to company and platoon size, practically, and much more. Mr. Pinkerton's written reports to McLellan were models of sharp, concise, fact-based analysis . . . and they arrived as often as weekly.

We know, of course, where we're heading. The only trouble with Mr. Pinkerton's brilliant work was that it was completely, totally and absolutely wrong. Until General Grant finally took over, and told Pinkerton to get lost or words to that effect, Mr. Pinkerton's "intelligence" always reported the Confederates as 3 to 5 times larger and stronger than they actually were. They supposedly outnumbered poor McLellan's forces by 2 or 3-to-1 . . . when the truth was nearly the opposite, with tiny, malnourished, underarmed Rebels always far smaller and weaker than their Union opponents.

Since the one military virtue General McLellan did <u>not</u> have was the willingness to fight, Mr. Pinkerton's "intelligence" rang with authenticity, to him. And that, finally, brings us back to the investment world and the oil market, today. There are a great many pessimists out there who don't think oil prices can show any kind of sustained strength (<u>because</u> they haven't, for the past few years, though the pessimists would deny that.) All those pessimists look at the voluminous, authoritative data on the global oil supply/demand picture, standing off at a distance, and they reach the conclusion they're inclined to reach. They don't walk up close and see the "big old mess," and they certainly don't pause and think for a moment about the eternal behavior of free markets, always "curing" either cyclically high or cyclically low prices eventually.

Let's close with one more chart, which captures in a nutshell the future problems for that supposedly giant U.S. shale supply:



The Texas Permian region is shale's Shangri-La, so to speak: the absolute "sweet spot" for shale production among all the big U.S. shale fields. That curve shows how fast oil production drops—"plunges" is a fair word—from existing shale wells. All oil fields do this, but shale fields do it fastest. The fracking revolution has been a technological marvel . . . but shale production is still a hamster in a cage, running very fast on his wheel just to stay in place. The only way to offset that "Legacy Decline" is with new wells, and more new wells. And that's exactly what happened before the 2014 Oil Bust, and then began to happen again last year, as oil prices rose somewhat. But the hamster has to keep running faster, no matter what . . . and at OPEC and everywhere else in the world, at the conventional oil fields which supply 92% of the world's needs, they shot the hamster back in 2015 and recycled his wheel and cage for scrap, being desperate for cash.

As Outlook noted last week, that piper will be paid . . . period. It is not "if" but "when" the oil market will rise strongly again. The number of today's experts who think we'll see $100 oil again, in our lifetimes, can probably be counted on the fingers of one hand—just as back in 2014, after 3 years of $100 oil, the number who thought oil could ever drop much, from triple digits, was also a one-hand affair. It's never really helpful to predict exact prices . . . but Outlook thinks oil will end up "high enough, in fact more than high enough" to accomplish 2 things: remarkable investment returns on our energy positions; and the humbling of a great many eminent people who are predicting that this time the market won't fix itself.

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