The Outlook: July 21, 2017

"Recognizing hard facts eventually" . . . and buying oil.

Some of this week's headlines shouted about "All-Time Record Highs!" for the Dow, S&P 500 and Nasdaq—and, naturally, there were many "Look Out Below!" analyses ending the same advice, namely, "After an 8-year bull market and all-time records, why haven't you already sold everything and buried your money in the back yard?"

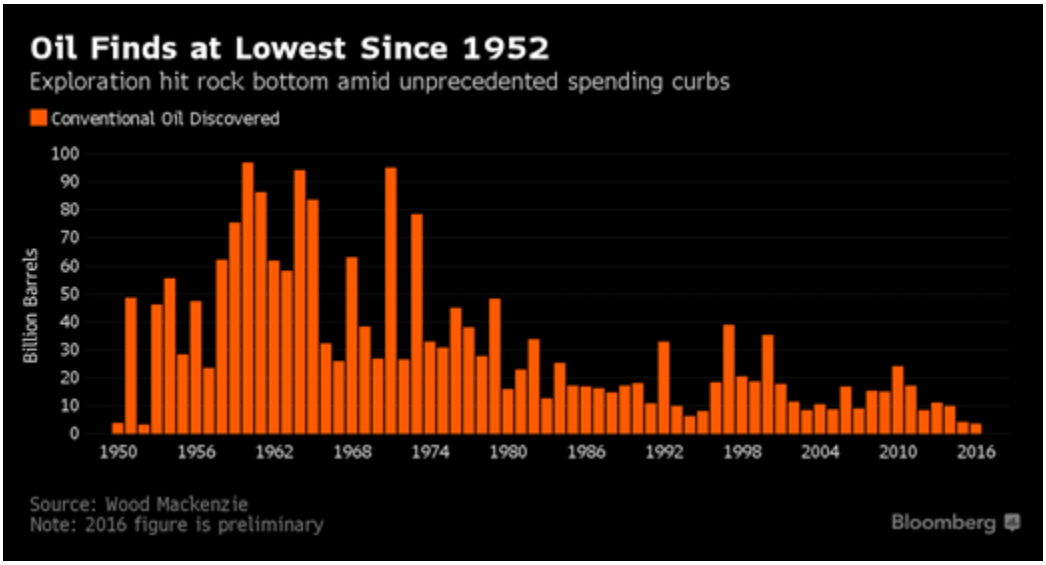
Here's Outlook's answer: "If our only investment choices were Facebook, Amazon, Netflix and Google (and a few other rockets up there in the ionosphere, like Tesla), we'd have sold, dug our underground money bin and stocked canned food. But there are a lot of strong companies today, whose stocks the market regards with something between boredom, contempt and outright loathing. When the market does that, we do not sell . . . we buy."

The oil companies are smack in the middle of that group, and at Outlook we are very interested indeed. We own Conoco, and a bit of Geospace Technologies . . . and we don't believe that's enough. As we continued to ponder quite a few attractive choices, this week, along came Mr. Paal Kibsgaard, CEO of Schlumberger (global oil drilling equipment king), who is one of those business leaders who's always worth hearing.

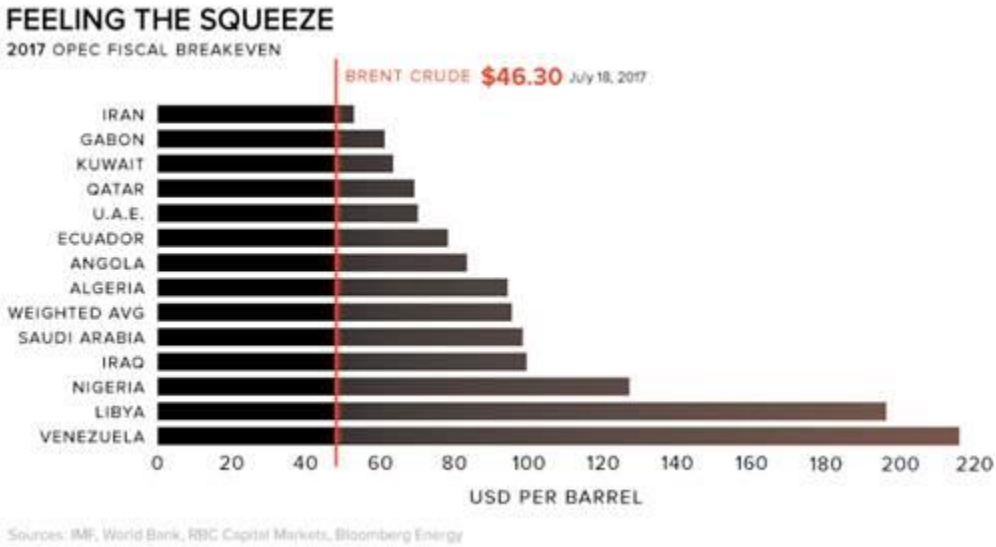
> *What we are currently witnessing is that the U.S. equity investors and E&P companies have spooked the oil market into believing that the fast barrels from U.S. shale will flood the markets, and leave oil supply levels elevated for the foreseeable future. Still it remains clear to us that the current underinvestment in the rest of the world's oil fields will with increasing certainty create a mounting supply challenge over the coming years. Needless to say, the longer the current under investment carries on, the more severe the cliff like decline trend will likely be when the producers run out of short term options to maintain production. And given the size of the production base, it would be difficult for the rest of the global producers to compensate for this pending supply challenge.*

Even the best business leaders speak in jargon, of course. Let's make Mr. Kibsgaard's points even simpler.

Oil prices fell off that cliff in 2014, and after a while the world's biggest oil producers slammed the brakes on exploration spending. As the picture shows, "slamming the brakes" was not exaggeration—it has been a shutdown of global efforts to find and develop new oil beyond anything seen in modern history.



This picture shows non-shale discoveries of oil, each year. (Non-shale oil is around 93% of the world's total.) The message comes down to: "We stopped looking for oil . . . and we stopped finding it."



This picture shows that every single member of OPEC is hemorrhaging cash at today's oil price: meaning their governments feel the urgent need to spend far more money than their treasuries (funded by oil) bring in. So are Russia and many non-OPEC big producers. And here's another key point from Mr. Kibsgaard:

(Regarding the market finally noticing, recently, that most U.S. shale producers are losing quite a lot of money:) *"Well, I think we talked about this before: the U.S. shale business hasn't been positive cash flow or positive free cash flow for the last six, seven years. Now whether the shale people can continue or not, I think it's going to come down to whether they can keep borrowing money, going into 2018."*

A long time ago an old banker made a comment to a young banker, in "Problem Loan Committee" (where bankers sit in pain, trying to figure out how to get back money they wish they hadn't lent.) "Give them money, and they will build." He was talking about real-estate developers, who are indeed a crowd of risk-takers, generally, who seldom see the train coming down the tunnel until they've been run over. The same thing has always been true of oil drillers, generally, going back to the first Rockefeller gusher in Pennsylvania . . . and it's been emphatically true of most of the U.S. shale drillers since that boom began. Mr. Kibsgaard was talking about the phenomenon of high-risk equity investors and lenders being endlessly willing to give so many smaller, weaker shale drillers more money, despite the fact that most of their financial statements show that most of them proceed to lose it.

So the picture above might just as well be labeled: "U.S. Shale Drillers," and it would show how much money most of them are losing at today's prices.

"The market can stay irrational longer than you can stay solvent," is a favorite old saying at Outlook Capital Management. But it does not stay irrational forever. It changes, recognizing hard facts eventually, as all of us do in many sides of our lives. Regarding our chance to make quite a considerable amount of money with the right oil companies, here are those hard facts:

- Global oil demand will keep growing steadily, probably faster than recent years. The world has a massive amount of urbanization and industrialization left to do, and the lower oil prices of 2014 – 2017 <u>will</u> trigger higher demand. That's what low prices do.

- Global oil supply <u>will</u> be squeezed in the years ahead. The shocking cut in oil exploration since 2014 will significantly cut the growth in oil supply, with the 3 to 5-year lag which is historically normal. And the U.S. shale sector, as genuinely admirable as it is for invention and aggressive risk-taking, cannot live beyond its means forever—hence it has no chance to create enough new global supply to offset that coming squeeze.

That was Mr. Kibsgaard's basic message, this week. Outlook Capital Management thinks he's right, and we plan to invest that way.

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