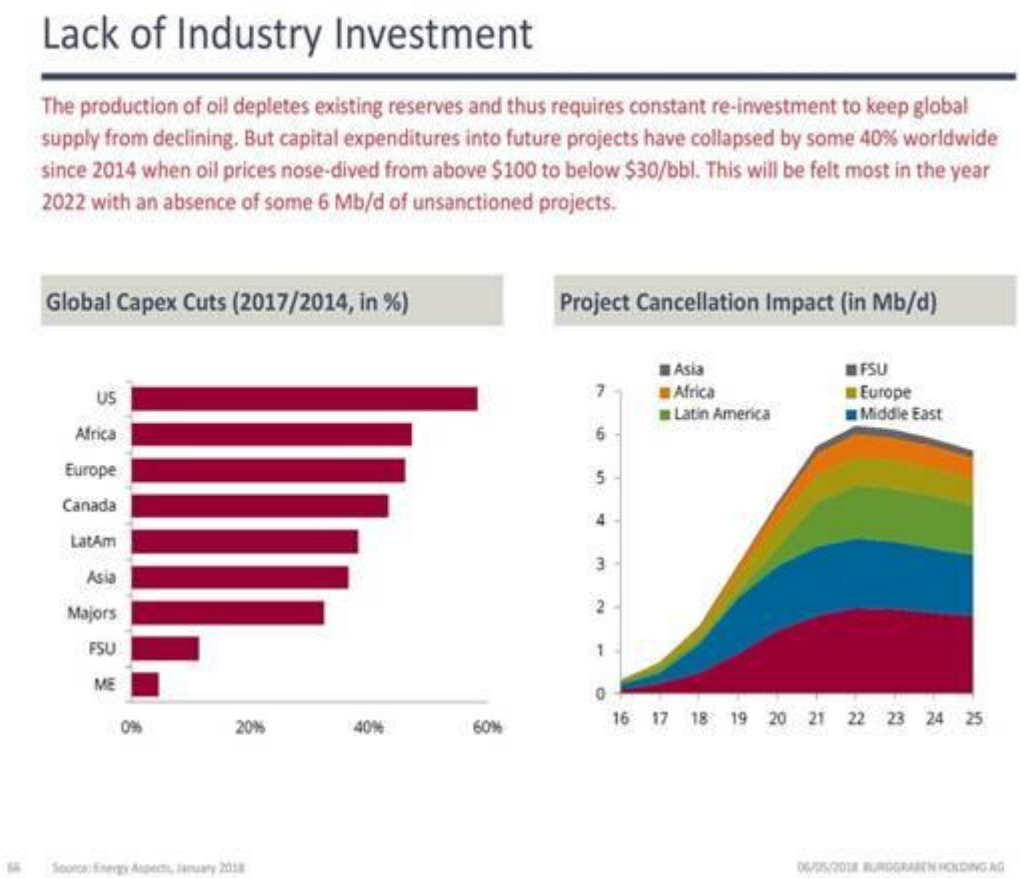
<u>The Outlook: May 8, 2018</u>

Oil in the Iranian spotlight.

Oil took the spotlight again this afternoon, as the President cancelled the Iran nuclear agreement. (That will lead to renewed sanctions in the near future, which will make it somewhat harder for Iran to keep growing its oil production.) Instead of rising, the global price of oil plunged on the news—normal market behavior, since speculators had pushed up the price for a couple of weeks, expecting the President's decision.

Last year Outlook placed a very significant chunk of its clients' money (and its own) into 4 strong oil-industry companies. They were financially strong; they had shown admirable speed and determination in fixing the problems which came with plunging oil prices from 2014 – 2016; global supply and demand for oil would eventually respond to that plunge in prices as they always do, hence reversing it; and finally, the market valued the 4 companies as if it didn't intend to believe any of those points until the facts made it impossible to disbelieve them . . . as the market always does. As Outlook has noted a few times, that is the way to make a great deal of money in the safest possible way. It's safe, because of outstanding financial strength and low, doubting valuations; and it's "a great deal of money" because the investment world almost never grasps the power and speed of rebounding commodity markets being "cured" by supply and demand, nor does it grasp the tremendous scale of the earnings flowing back to strong companies when they've been through what we call "The Valley of Death," and come out fighting.

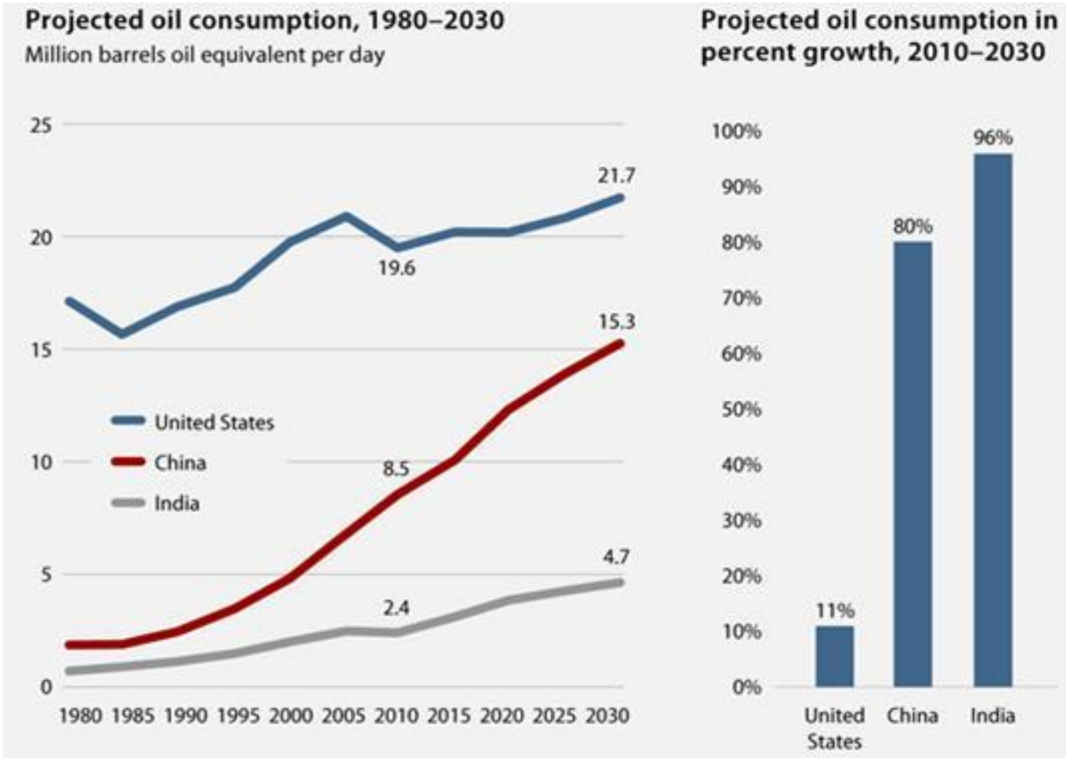
Though many headlines naturally suggest otherwise, the Iran cancelation is a fairly minor piece of this long-term picture. Let's remind ourselves exactly why we handed a chunk of our hard-earned savings to Conoco, Shell, Schlumberger and Transocean, with just a couple of the much bigger pieces of that picture. Here's a big part of the oil supply picture:



This chart shows the truly remarkable cuts in the world's investment in future oil supply, as oil plunged to its 2016 bottom, and continuing right up through today. This wasn't bad planning or poor management, but necessity. The price of oil fell 75%, plunging the oil industry into that Valley of Death. Many firms disappeared. Our strong companies were in no danger of that, but profits vanished and they absolutely had to do something about it, fast. They all acted the same way: slashing spending on their long-term futures. The right-hand part of this chart is even more interesting. It shows how the oil-exploration business works: no great pain (in lost oil production) the first few years, because the vast spending <u>until</u> 2014 was paying off with more production, with the normal time lag. But then the pain mounts and mounts, with this particular chart expecting lost oil production to peak all the way out in 2022.

That's a big part of the long-term oil-supply picture. It's not the only part by a long shot . . . but it actually reflects the same forces acting on other parts of the supply picture. In the U.S. shale-oil part of global supply, for example, even sharper rates of decline govern oil production from existing fields, requiring massive, accelerating spending to offset the natural declines. Shale spending paused briefly, down in that Valley, but nothing like as dramatically as in the rest of the world—so shale-oil production recovered faster. U.S. shale gives us about 6% of global oil supply: notable, but just not powerful enough to offset the problem pictured above, even if shale's production doesn't begin to weaken in the years ahead (as Outlook thinks it will.)

Now for a glance at one big piece of the oil demand picture.



Source: Energy Information Administration, Office of Energy Markets and End Use, "World Petroleum Consumption, Annual Estimates, 1980-2008," October 6, 2009, available at: http://www.eia.gov/emeu/international/RecentPetroleumConsumptionBarrelsperDay.xls (accessed February 26, 2010); EIA, International Energy Outlook 2009, Table A5, "World Liquids Consumption by Region, Reference Case, 1990-1930," May 2009, available at: http://www.eia.doe.gov/oiaf/ieo/excel/ieoreftab_5.xls (accessed February 26, 2010).

This chart is a forecast of long-term oil demand, made in 2010. We're in blue; China in red (naturally.) India is in gray, at the bottom: much smaller than America and China, but growing fastest on its smaller base. If we look at India's gray line, we'll see the forecast at 4.7 million barrels per day, which the world's foremost statistical authorities thought India might reach by 2030.

Today we're in 2018. India will reach that 4.7 million barrels by 2020—ten years ahead of schedule. The forecasters of 2010 simply couldn't imagine that India's economy might accelerate a great deal faster than the 96% oil-demand growth rate they'd predicted. That was also not bad analysis or poor forecasting—it was simply normal forecasting, meaning often very wrong, because grasping the scale of change is one of the hardest things for human beings to do. Few experts using their eyeballs on India, back in 2010, would have contradicted the forecast, because the vast country was then—and still is—appallingly poor and undeveloped. But the change accelerated anyway.

Here's one of the best pictures of all.

COUNTRY/REGION	VEHICLES PER 1,000 PEOPLE	
	2004	2014
Africa	23.1	35.1
Asia, Far East	46.6	90.4
Asia, Middle East	90.7	134.8
Brazil	119.7	206.0
Canada	580.8	655.9
Central & South America	115.1	186.5
China	21.4	104.9
Europe, East	222.5	346.8
Europe, West	569.5	590.9
India	10.7	30.8
Indonesia	28.8	82.3
Pacific	530.6	584.2
United States	829.9	816.4

No lines or bars here . . . but this chart is worth the closest look we can give it. There is India in 2004 and still in 2014: the lowest vehicle usage per person in the world, pretty much. It's under Africa, and way under Indonesia, for heaven's sake. It's vehicle usage tripled in those ten years . . . but China's quintupled. Here's the $64,000 Question: "Is India's auto usage going to stay down there at the bottom, or is it going to accelerate like Usain Bolt 30 meters out of the blocks—like China?" And the $128,000 Question that follows is: "And if it accelerates, how much oil will India buy from the world's suppliers?"

Not long ago an Indian politician—the Minister of Energy, or something close—said something like this: "We shall be passing laws which will require all vehicles to be electric vehicles, in India, by the year 2030." He gained the world's media spotlight at the time, which was surely the point (pardon the cynicism.) The media being what it is, there were no incredulous reactions along the lines of "But your electric grid is perhaps a tiny bit less developed than America's grid, for example, and 100% electric vehicles in the U.S. by 2030 is less likely to happen than 100% electric vehicles on Pluto." The point for us oil investors, though, is that China's explosion in car usage (and oil consumption) happened because her politicians got out of the way, more or less; and the only force in the world capable of stopping an accelerating pace of modernization in India's halfway-free economy is, yes, politicians determined to do their worst. India's politicians have done just that, pretty much, since Independence in 1947. But with the election of Mr. Modi a few years ago, India got its very first determined backer of the private sector and free markets. The economic benefits of that election have ebbed and flowed, as political changes always do, but most observers of India feel the trend has tilted dramatically toward faster growth, nevertheless. At Outlook, we're not first-hand observers of India . . . but we do believe completely in one thing: "When a significant enough chunk of any country's people have begun to feel the benefits of real economic growth and modernization, it always tends to accelerate." That's the heart of China's 20-year story, and we're very willing to bet India will follow roughly the same path.

This story has been about big pieces of the big picture, concerning the oil market and our heavy investment in four of the industry's outstanding companies. If Outlook is right about that picture, the return on our investment will be startling both in size and duration. We'll have to endure ebbs and flows along the way. That's the nature of investing. But the picture convinces us more strongly than ever that the payoff will be very much worth the wait.

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