

The Outlook: Aug. 28, 2017

Oil: pain and trouble . . . and big values.

At Outlook we might sum up our investment philosophy this way: “Where there’s pain and trouble, get interested. Where there’s pain, trouble and financially strong firms with good leadership, get very interested indeed.” Strong companies with good leaders almost always survive the pain and trouble, fix their problems and come back with astonishing strength . . . handing remarkable returns to patient investors.

In the “pain and trouble” rankings, the Energy and Commodity sectors have been at the top of the list for a good while. Oil, in particular, has the most gruesome bragging rights in that regard, with its engine—the price of oil—doing one of the screaming cliff-dives of all time from 2014 to 2016: from \$115/barrel to \$27/barrel in only 18 months. A 76% plunge in any company’s product price qualifies as “Pain and Trouble” on a galactic scale. Here’s the picture:



Coping with this problem has been the challenge of a lifetime for a good many CEO’s—and their people—throughout the oil industry. Many—especially Conoco’s Ryan Lance—have risen wonderfully to the challenge, strengthening their companies while lowering their break-even oil prices to levels which would have been unthinkable two years ago. Conoco and many of its colleagues in the oil business are creating positive cash flows today at \$45 to \$50 oil, or lower, and even the most sour of pessimists would probably admit that they are “out of the woods” with respect to serious further damage to their profitability and even their share prices. But the price of oil is still the engine driving the train, for Conoco and every other oil sector company. Hence the price of oil—when it will rise higher, and how much higher—is the single factor we investors must understand, and must feel very confident about, to justify hanging onto and adding to our oil positions.

We’ve talked a lot these past months about the foundation for our confidence. Outlook clients know it by heart: “Free markets fix themselves eventually, and the cure for low prices is low prices.” That’s a quick way of saying that supply and demand always adjust logically to sharp changes in prices, eventually

causing those prices to change directions. What makes it hard for most investors to believe in those inevitable turnarounds, though, are always the torturous ebbs and flows of progress along the path of the turnaround. And for the great crowd of speculators and investors who just cannot bring themselves to have faith in an ultimate turnaround, regardless of history's overwhelming list of examples, the details behind those ebbs and flows always make them feel "this time" will be different; "this time" the market won't fix itself, and prices will stay down approximately forever.

And so they pounce upon every remark from a Saudi prince or Russian politico, which might mean OPEC's ability to control supply is broken for good; and every study from shale enthusiasts which might mean we've only seen the beginning of the U.S. shale gusher, so global oil supply will wash over demand like, well, Hurricane Horace over Houston; or every press conference with Elon Musk, which might mean the internal combustion engine (and its oil-guzzling habit) will be vanishing next week, or anyway next year.

There are a good many excellent analysts digging carefully into those notions, and others; and more than a few of them have concluded "Nope, not for a good while," regarding all three of those notions. At Outlook we are persuaded by their reasoning, and we're not persuaded by the numerous oil bears, who are no slouches themselves when it comes to digging into the evidence. But if we had to state the most simple case for a serious, long-term stake in the oil sector, it would come out like this:

"We might be wrong about OPEC, shale or even Mr. Musk. But we won't be wrong about the powerful response of supply and demand to sharply lower oil prices. That response will play out just as we expect in some ways, and it'll play out very surprisingly in other ways. Turnarounds just work that way . . . as we've seen through 40 years of watching them. In other words, we'll never be 100% right about how it's going to happen; but we'll be exactly that right that it will happen."

And that's enough, at Outlook, to justify wading even deeper into the oil sector, both hands out, and picking up some long-term bargains.

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