The Outlook: Oct. 21, 2016

People acting normally: oil supply falling, demand growing.

"Simplicity has a way of improving investment performance, by letting us actually understand what we are doing."
(Charlie Munger, 40-year business partner with Warren Buffett.)

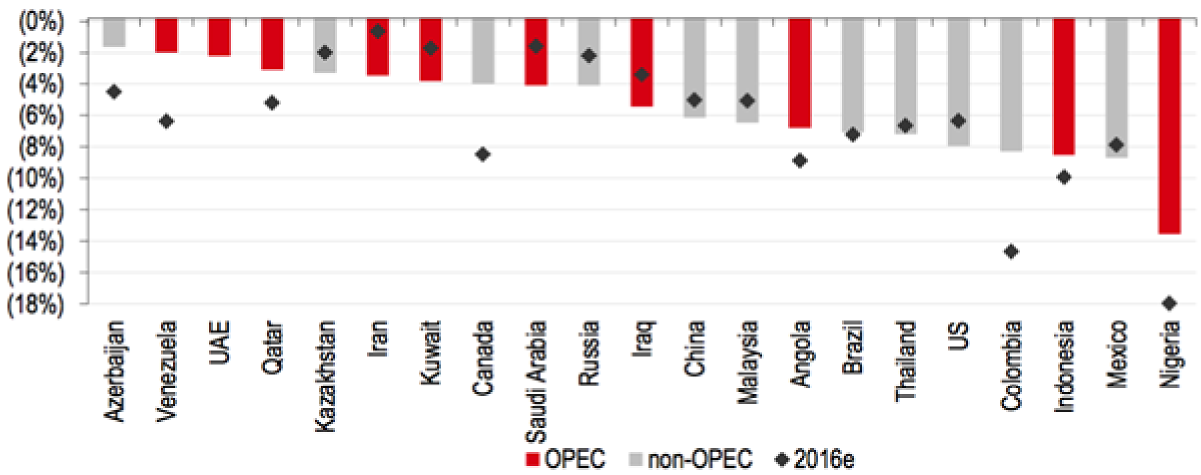
At Outlook we may disagree with most of Mr. Buffett's and Mr. Munger's political opinions, but they know a lot about how to invest—and they often say it very well. An article today applied Mr. Munger's quote to Harvard University's zillion-dollar endowment fund, which (like many others) always chases fads in the investment management field, and often buys high and sells low, as fad-chasers tend to do. Having enough experience with "institutional" investing, Outlook's own contribution to the quotation library would be to note that committeesalmost always make the decisions within institutions, and "Committees don't think straight, and never stand against the crowd." And if an investment manager isn't going to do either of those things, she is not in the right career.

One of the simple foundations to Outlook's investment strategy is the absolute belief that "Free markets cure themselves." They do so because markets are people, and people who are engaged in supplying or demanding anything always react normally and predictably to higher prices, and to lower prices. At lower prices, they demand more and supply less; at higher prices, they demand less and supply more . . . and that utterly dependable behavior eventually makes prices change direction.

The trouble is, it takes uncertain, highly-variable amounts of time for those behaviors to have that dependable effect. The stock market does not like uncertain, highly-variable things. The stock market, being a vast crowd of people whose money is at stake, always lets falling prices scare it into feeling they'll keep falling indefinitely; and often lets rising prices cheer it into complacency and suspension of doubts. And that, in turn, means the market hands remarkable bargains to us investors, if we insist on staying patient, thinking straight, and standing against the crowd.

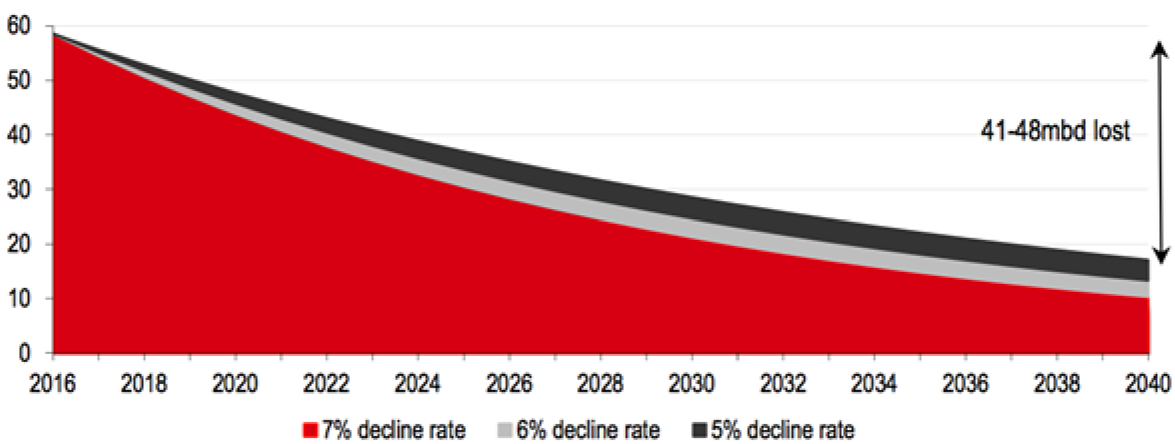
For the last 2 to 5 years, many commodity markets have been falling, and taking their sweet time to do their dependable thing: change direction. Oil has been a wonderful example since its plunge began at $110 in 2014, hitting $27 earlier this year. Now it's near $50 . . . and every single day of the week, there's a pitched battle between intelligent analysts convinced oil is doomed to fall again; and intelligent analysts who think it won't (much.) There are still very few analysts who think oil will rise, strongly, back toward those $100/barrel days. Outlook is one of them. So is a very good writer from HFI Investments. Here are a couple of pictures he showed us, today:

Compound-average underlying decline rate by country, last 20 years



Source: HSBC estimates, Wood Mackenzie. NB: Excludes NGLs and unconventional shale production in the US and Canada.

Post-peak production (benign definition) – sensitivity to 5-7% decline rate to 2040



Source: HSBC estimates

Now, right off the bat these grossly violate our “keep it simple” rule, don’t they? But let’s give them a quick chance to say something. At the top are the world’s oil-producing countries, ranked by the speed at which oil production has naturally declined in their existing oil fields, year by year. (All oil fields act the same: spurt a big geyser at first, then dramatically weaken, year by year.) We can see those decline rates average around 6% per year. Don’t study the next chart—it’s too obscure. But if we look only at the year 2020, straight up, we can see global non-U.S. production falls to 48 million barrels per day (mbd) from today’s 60 mbd. Hang on a moment longer. Total world supply and demand, today, stand around 96 mbd. The natural decline rate will drop 12 million barrels daily from production, unless the world oil industry invests aggressively to replace the declining flows.

The point, of course, is that since early 2015 the oil industry has slammed the brakes on exactly that kind of investment. It had to, since when your product price falls from $110 to $27, it is certainly a “life or death" emergency. HFI estimates that $1 trillion of oil capital spending has been cut. That stark fact is borne out by our own oil bargain, ConocoPhillips, whose capital spending was $17.1 billion in 2014 . . . and $5.5 billion in 2016.

These things are not trivial. They are the polar opposite of "trivial." That $1 trillion of canceled exploration-and-production spending is not a fuzzy theory in an economist's mind . . . it is real money and hard work which had to be suspended, and which will strike a hammer blow at global oil supply. That hammer blow will be felt more and more heavily in 2018, 2019 and 2020, as the benefits of heavy oil spending before 2014 begin to fade and decline.

Markets, and the people in them, behave normally. When prices fall, they do things which must be done to avoid business destruction. On the demand side, when prices fall, an infinite variety of buyers and users of oil find ways to use more of it—because it saves them money—their own money—versus the alternatives. These "dependable behaviors" are as simple and certain as they sound . . . but the often-clever but always-impatient people in the stock market cannot stand the uncertain wait for them to happen. We can, which is why we own Conoco, plus several other companies related to the oil market to lesser degrees. We're waiting, not for 10% to 20% returns, but for 50% to 100% returns. That kind of wait is worth our patience.

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