The Outlook: May 19, 2022

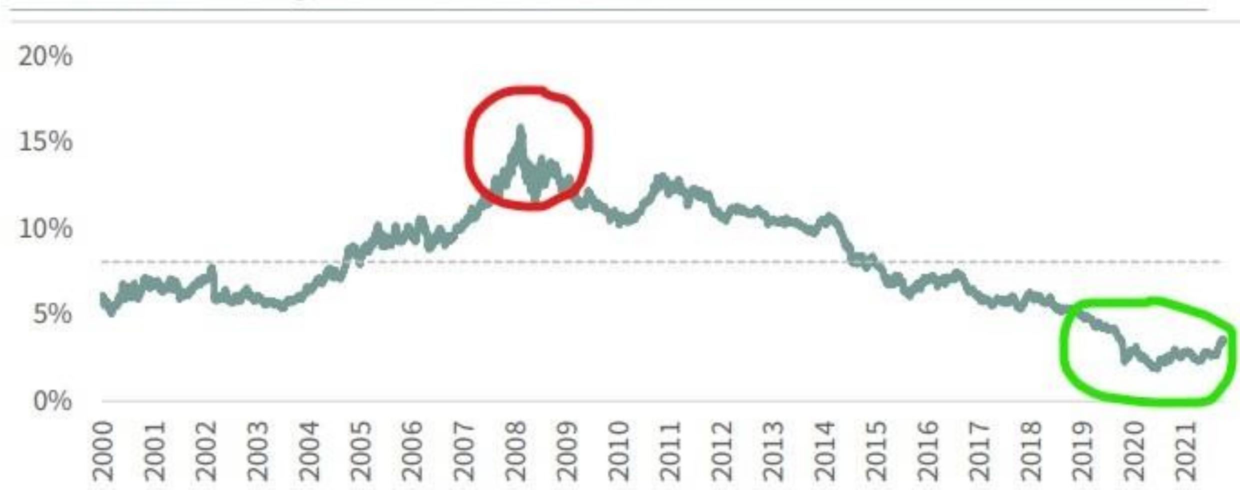
Conoco, Oil and "How the World Works" Again.

A couple of days ago we mentioned one of those "beliefs about how the world works" which a great many people embrace, in the investment world; and about which they never change their minds (being normal humans.) That belief is: "Government—mainly the Federal Reserve and other central banks—call the tune for the economy and the markets." At Outlook we think that is one of the sillier beliefs in history. But there's another one, even sillier: the scholarly "efficient market theory" which basically says, "The market knows all, sees all, tells all—and no mere individual has enough information or talent to outguess it." The Efficient Market Theory, for decades, has informed us that if we are so arrogant as to think we're right and the market is wrong about anything—from an individual company and stock to the whole market—we'd best dunk our heads in cold water and decide to be humble.

If the "Government runs everything" idea is silly, there are no words to describe the "Market knows everything!" belief. It's so galactically wrong that, as the old saying goes, "Only a professor could believe such a thing."

Oil stocks are the latest proof. Let's glance at a few pictures.

FIGURE 7 Energy as Percent of S&P 500



Source: Bloomberg..

The red circle around 2008 marks the peak of the market's love for energy stocks. Their value made up about 16% of the whole market's value. And what a long-suffering decline happened next! It was 12 years in which the market first merely distrusted energy stocks; then disliked them; and finally hated them with a passion, year after year. In 2020 – 2021 energy stocks hit about 2% of the market's value. That's the market saying, "Go away. Seeing you makes our eyeballs hurt."

Of course that's when serious investors ought to be looking as hard as they can, with a hand on their wallets ready to buy. That is what Outlook was doing in 2016 or so . . . as the market showed it could despise the industry even more with each passing year. And the questions we investors asked ourselves, back then, weren't the least bit complex or mysterious:

- What is obviously happening to long-term oil-and-gas supply?
- What is obviously happening to long-term oil-and-gas demand?

The answers were not mysteries. Supply was falling pretty sharply: that is, the tremendous spending needed to create future supply was falling sharply. It fell by as much as 80% between 2014, a peak year, and 2020. When prices fall sharply, that's what companies do. They have to meet payrolls and pay the rent, and when incoming cash gets choked off they must cut exploration-and-production spending if they want to survive.

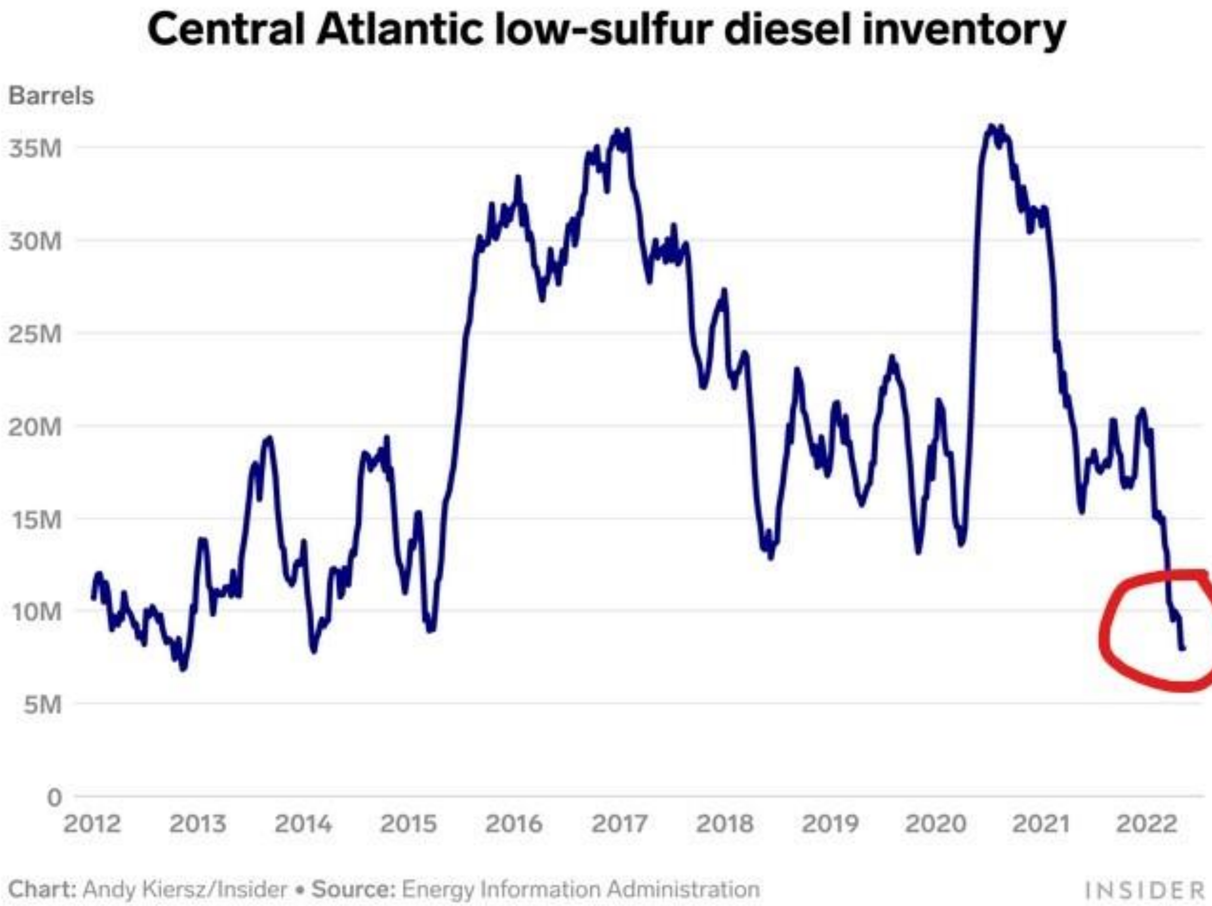
And demand, until the Virus and Lockdown Calamity's short but sharp interruption, was steadily rising . . . because billions of the world's population were climbing from poverty to the threshold of something like "middle class." When they cross that threshold, people consume more energy. They can afford to, and it makes their lives better in countless ways.

There has been one more factor in the answer to both of those questions: the Green Energy Movement. That political movement has swept a good deal of the world over the last 5 to 10 years. It has certainly helped choke off spending on future oil-and-gas supply, especially in Europe but really all over the place. The political idea has been that it would also choke off carbon demand, as governments threw up roadblocks to the use of "dirty" energy and forced their citizens into use of green energy. For our purpose, though, all that really matters about Green Energy and carbon demand is: "Does Green Energy have the power to stifle that long, steady growth in oil-and-gas consumption around the world?"

The simplest answer, today, is: "Nope. Not when energy costs rocket up 500 – 1000%, and there isn't enough to go around even at those prices." Then the question for ordinary citizens becomes, "Do we want Green so much we're willing to pay through the nose for (or do without) some pretty important things, like affordable transportation, groceries and heating-and-cooling?" People with enough wealth may answer "Yes!" to that question; but several billion people in Asia, Africa and Latin America will not answer the same way.

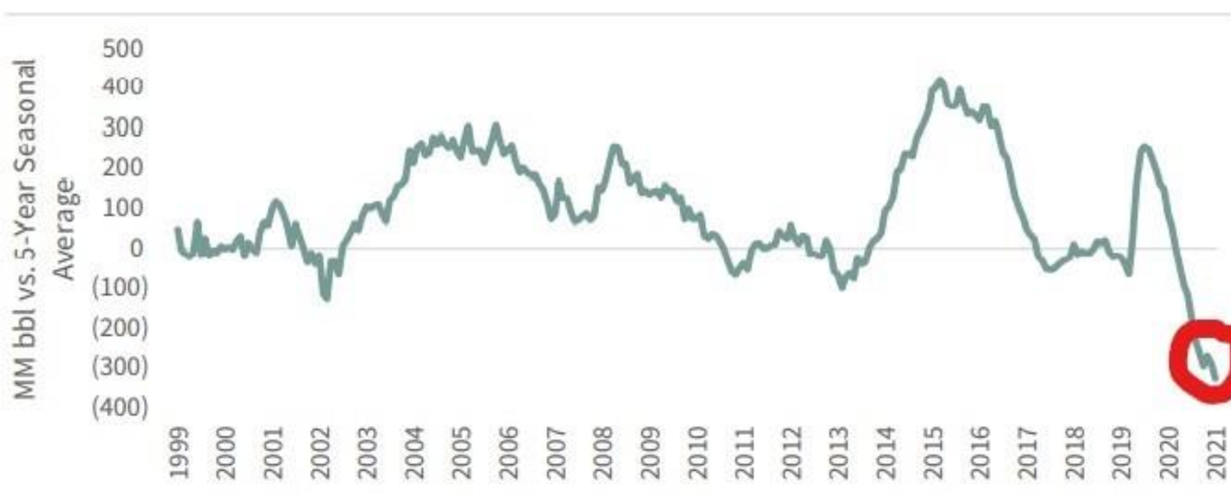
- So what's obviously happened to long-term oil-and-gas supply is: "Sharp cutback."
- And what's obviously happening to long-term oil-and-gas demand is: "Continuing slow-but-steady growth . . . because we need it too much."

That's the picture Outlook saw in 2016. It's the same picture today. The difference is this:



And this:

FIGURE 6 OECD Oil Inventory vs. Five Year Seasonal Average



Source: IEA.

And finally this:

Those first 2 pictures are about supply. Low, isn't it? That did not happen overnight; it got there in the usual roller-coaster way, as almost everything priced in free markets does, over time. And the last picture, above, is a stand-in for demand. It's Conoco, from 2016's great pain to today's rocket ride toward the moon. (Theresa's Inside Report, this afternoon, made that clear.) Conoco is on that rocket because oil demand is strong and supply has been choked; so oil's price is way up and Conoco's profits are over the moon.

It's the nature of the market to say, "We've made a killing. Sell, before it's too late!" It will keep that up, about Conoco, from today past the horizon. But the market does not "know all, see all, tell all." It makes jittery guesses and bets every day, based on fleeting impressions about what the rest of the betting crowd is probably feeling, at the moment. None of that matters for Conoco, nor for our long-term investment position. Big decisions and decisive past actions are what matter: especially those which have choked off global oil supply. Those actions and decisions can't be reversed in a hurry. If the world wishes to reverse them, it will be like turning the Queen Mary, as the old saying goes: "very slowly." That's why we think our Conoco and Exxon positions have a long runway ahead . . . yes, stretching out past the horizon. They'll ride the never-ending roller coaster . . . but it's pointing up over time.

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