



Creative Global Investments

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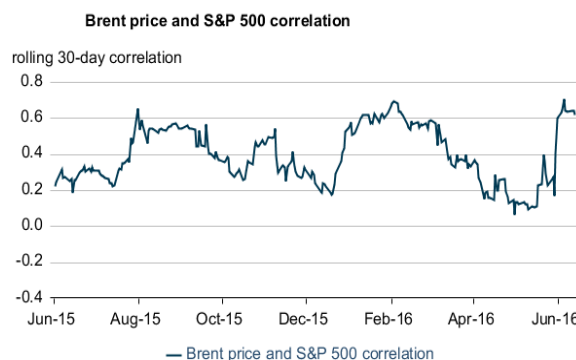
Objectivity
Integrity
Creativity

Going Once, Going Twice, Sold!

Oil Breaks Support at \$45

On May 25th with oil approaching \$50, we wrote that “This may be as good as it gets for the oil bulls near-term fundamentals do not support further upward price movement in the near-to-intermediate term beyond a technically-driven rise of another \$1 to \$2. Once those fundamentals reassert themselves, oil is likely to roll over. In our view, WTI crude will trade back down through \$40 before one can [or should] say with reasonable certainty that a bottom is in.” **Near-term drivers for higher oil prices have diminished.**

Crude oil and equity prices are often highly correlated. The rolling 30-day correlation between Brent crude oil prices and the S&P 500 index reached 0.70 at the end of June, its highest level since 2012 and surpassing the high correlation that occurred in February as crude prices traded down into the \$20's. Crude oil prices tend to correlate most closely with equity prices when the major price drivers are demand-side factors, such as expectations on global economic growth. Concerns over global growth increased in June after the UK referendum vote to exit the European Union. Uncertainty over how disruptive the British exit might be, whether other European countries will also vote to leave, and whether global trade and investment will slow all contribute to significant volatility in risk assets like commodities and equities.



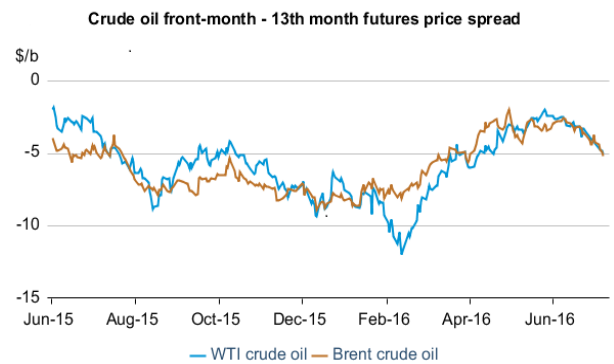
U.S. EIA, Bloomberg L.P.

The price correlation is also affected by market participants' demand for risk assets and while the market's fast recovery after the initial Brexit selloff has many pundits saying “I told you so” over the rapid fade of Brexit fears, we believe that there are many more shoes to drop as Brexit lingers on. British Prime Minister May stated that the UK may not even invoke Article 50 before the end of the year. Investor confidence readings in Europe are plummeting. Tensions between the UK and its European trading partners will rise. In an increasingly familiar pattern, the IMF downgraded its global growth forecast yet again, this time by 0.1% to 3.1% for this year and 3.4% for 2017—blaming uncertainty over Brexit. The resurgent safe-haven US Dollar rally has further upside on the charts and will weigh on commodity prices. **In the meantime, the UK Purchasing Managers Index fell sharply from 52.4 to 47.7k—can you spell recession? The Chancellor of the Exchequer can. A rate cut by the Bank of England is not far off.**



Risks of contagion should not be ignored.

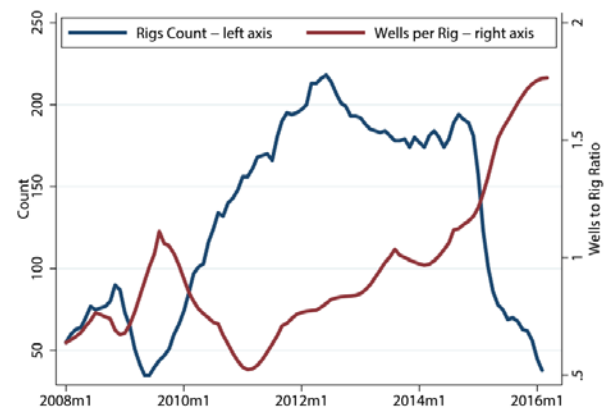
Oil futures have been rolling over and closed yesterday at their lowest level in three months. Brent and WTI crude appear equally under pressure. Although the oil market remains in contango, futures premiums have steadily declined. We've posited that this is more a function of increased forward selling by producers rather than increased demand. We believe that producers are simply saddled with too much crude and are struggling to find places to store it while continuing to pump— unrestrained by any sense of market discipline. As future premiums decline, the normal market response should be a liquidation of inventory as the incentive to hold oil declines yet oil inventories have risen. **Futures are telling us that something is still very wrong in the oil market.**



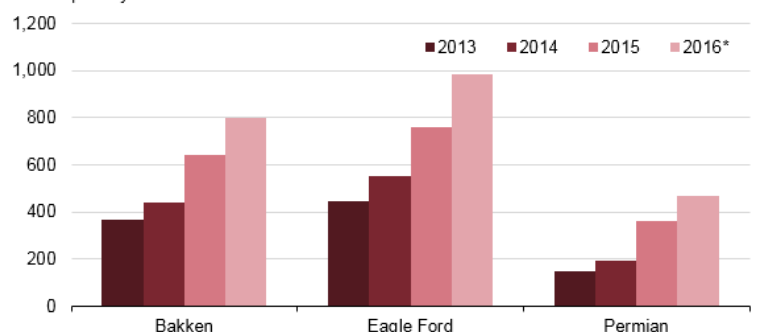
eia Bloomberg L.P.

Analysis of futures trading via the Commitment of Traders (COT) Reports show that oil producers are still unconvinced that oil prices are heading higher in contrast to positioning by financial speculators. Since our May 25th report, commercials (who should be in the best position to understand the true state of the market) continue to be overwhelmingly short as they increasingly hedge out their production at current price levels. On the other hand, large speculators (i.e., managed money) have begun to exit long positions over the past two months but are still skewed heavily to the long side. **If oil is headed higher over the next twelve months, why are producers so willing to hedge their output after passing up the opportunity to do so last year at higher prices?**

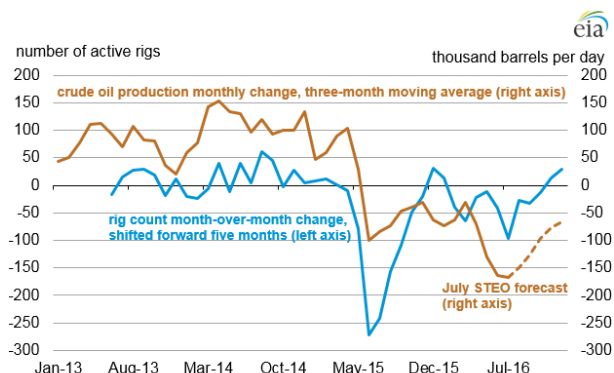
The US rig count has bottomed and it's likely that a return to domestic production growth is at hand. We received some pushback in May when we noted that increasingly aggressive hedging would enable many domestic E&P companies to stay afloat with lenders agreeing to maintain credit lines secured by those forward revenue streams. Additionally, drilled but uncompleted wells (DUCs) constituted a significant source of incremental shale oil production volume and since these wells were drilled utilizing the latest technology they should be better performing wells than most of those already online. The adjacent chart on wells per rig that we've used previously translates into the higher productivity in the second chart to clearly show why domestic oil production has been sustained despite the sharp drop in the rig count. We stated that many of the DUC wells could be completed in 2016 if oil were to stay above \$40 per barrel, which could significantly alter the consensus view for materially lower shale oil production in 2016.



New-well oil production per rig
barrels per day in first full month



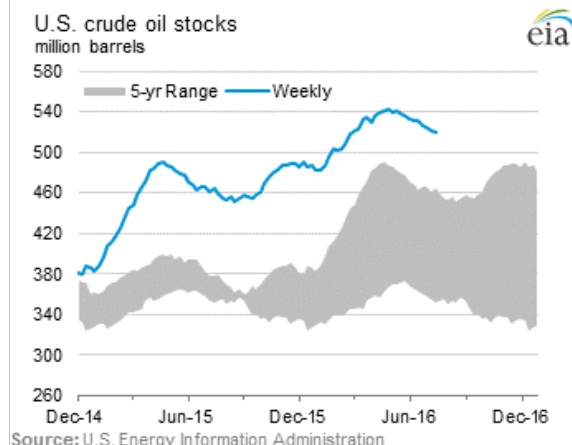
The rising rig count bodes ill for further production cuts since much of the bullish case for the recovery in oil prices, particularly for WTI crude, was predicated on forced production curtailment—a view apparently shared by Halliburton management on their second quarter conference call. US production actually rose the past two weeks, albeit at a pace of just 33 mbbl/day. **Domestic production is on the cusp of an inflection point.**



Sources: Baker Hughes; U.S. Energy Information Administration, *Short-Term Energy Outlook*, July 2016.

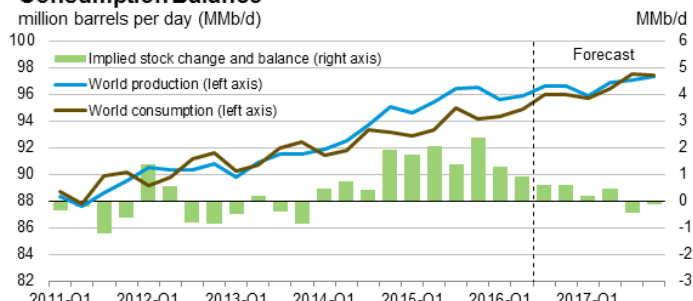
The supply glut shows few signs of dissipating as the major supply disruptions last spring are resolved. Last month, Canada recovered almost half of its lost output from the prior month due to the Alberta wildfires outage. A renewed security effort by Nigerian forces has slowed terrorist-related sabotage of Nigerian oil facilities, allowing production to come back online. **Meanwhile, every production cut in US crude oil output has been offset by a rise in OPEC production as Iran ramps output while the Saudis pump with abandon.**

Record gasoline inventories will help swell domestic crude oil inventories into the fall. Gasoline inventories should be falling during peak driving season instead of rising. Crack spreads have collapsed over the past month. In another three weeks, refiners will enter the fall turnaround period, which will act as a further drag on crude oil demand. Note the lower slope for the seasonal drawdown in domestic crude oil stocks versus a year ago in the adjacent chart. Despite the well-publicized loss of shale oil production this year, crude oil inventories are still 55.6 million barrels more than a year ago. Storage capacity utilization has been hitting record highs. **Those oil bulls hoping for a quick V-shaped recovery in WTI crude oil prices are destined for disappointment as refiners dial back output, domestic drillers continue to pump, imports flow unimpeded into the US and the dollar continues to rally. Inventories will stay elevated.**



OPEC and the EIA have recently raised their demand forecasts for 2017. They forecast market equilibrium being achieved more rapidly than just three months ago (see adjacent chart). We view these forecasts as suspect along with the big non-OPEC supply cuts. Estimates for global economic growth were pared back by the IMF almost before the ink was dry on the reports while OPEC acknowledges that Brexit could reduce the outlook for demand. **The current fade in oil demand appears to contradict their more optimistic view.**

World Liquid Fuels Production and Consumption Balance



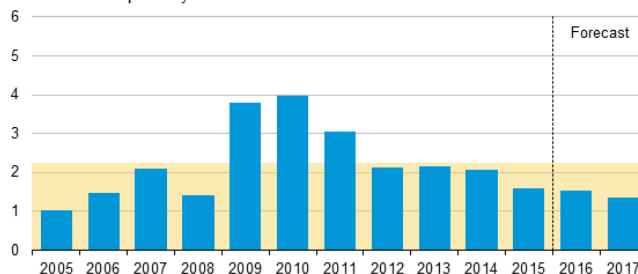
Source: Short-Term Energy Outlook, July 2016.

No sooner than fading demand throws cold water on the oil bulls, a new bull case for oil is being promulgated by those believing that an agreement to cut production will be reached at the next OPEC meeting on November 30th. The story is based upon the belief that the Russian energy minister will meet with Mohammed Sanusi Barkindo, the new Secretary General of OPEC from Nigeria, once he assumes his new role in August to lay the groundwork for mutual accommodation.

But for this to have any credibility, one must believe that the Saudis would cut output based upon trust that Russia and Iran, its two most bitter rivals for regional power, would do the same. Good luck with that; especially after Russia's energy minister just said the idea of such an agreement was "dead". Despite the rise in Saudi and Iranian output, OPEC (mostly Saudi) surplus production capacity appears little impaired from 2015 levels—the equivalent of a loaded gun cocked and ready to be fired at the first sign of assault on its market share. **We've always viewed the real impetus for Saudi action as political rather than economic.**

OPEC surplus crude oil production capacity

million barrels per day



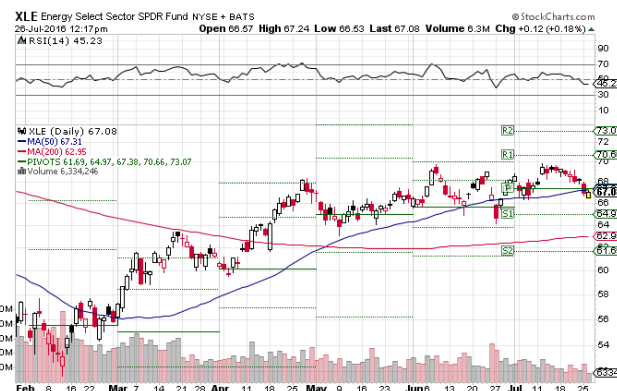
Note: Shaded area represents 2005-2015 average (2.3 million barrels per day).

Source: Short-Term Energy Outlook, July 2016.

WTI crude oil has failed to hold its pivot point (\$44.73) on the weekly chart. Support exists around \$41 on both the weekly and daily charts but if support fails to hold (and we believe that it won't), WTI crude oil is immediately vulnerable technically to the mid-\$30's.

Little has changed for oil stocks. Back on May 25th with XLE at \$66.32 we noted that although oil had broken out through trend line resistance, major overhead technical resistance on the price chart was not far off and we doubted that overhead resistance could be overcome in the near-term. Oil stocks would likely grind higher in the very short-term as WTI crude attempted to take out \$50 and work higher. We were correct to suggest that traders with a short-term orientation sell into any near-term resurgent strength in the sector as XLE subsequently failed to breach resistance at \$70 once oil prices rolled over. **We continue to believe that investors will be presented with a better entry point as bullish sentiment for the sector continues fading on the heels of resurgent supply and demand that falls short of recently raised forecasts.**

Falling oil prices also represent a genuine risk of contagion for the broader stock market as we exit earnings season with few near-term catalysts to drive shares prices higher.



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