Creative Global Investments

Friday, November 20, 2015

Steven Gluckstein
Global Strategist
sgluckstein@cg-inv.com
Tel: 732 768-8843

Creative Global Investments LLC
115 East 57th Street
11th Floor
New York, NY 10022
Tel: 212 939 7256

Creative Global Investments/Europe
5, op der Heed
L-1709 Senningerberg
Tel: (352) 2625 8640
Mob: (352) 691 106 969

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Volatility Hasn't Left the Oil Patch—New Lows Are Likely Before Yearend

We do not share the viewpoint that oil could hit $20 per barrel, as the Saudis not long ago would have us believe. Yet quite a few high profile commodity strategists would also have us believe that the price of oil has nowhere to go but down. There's some irony in that statement since we've written since May that oil prices were headed lower in the near term and would make new yearly lows by October, which they did in August before rallying to, but failing to hold, the $50 level last month. But in our view volatility is likely to remain pervasive as prices head for an eventual unsuccessful retest of the August low of $38. **However, longer term we believe that the bigger surprise is that oil prices could recover more strongly than indicated by industry executives or the futures market in 2016 as demand and supply fundamentals could rebalance more rapidly than currently anticipated by market participants. In the interim, oil prices will likely continue to frustrate bulls and bears alike.**

In a war of attrition, the Saudis remain fixated on pumping U.S. oil producers into submission. OPEC members are producing approximately 31.5 million barrels per day, which is far higher than the cartel's stated 30-million-barrel quota. Output likely rises to well in excess of 32 million barrels once Iranian sanctions are lifted. **After a year of Saudi Arabia's all-out assault on the oil market, it finally appears that a [modest] downshift is materializing in U.S. oil production rates.**

A year ago all we heard was that the high production costs of $80 to $90 per barrel for U.S. shale deposits (particularly in the Bakken shale formation) would quickly shutter production. The sharp drop in the domestic rig count initially was thought to confirm that conventional wisdom. (The latest rig count figures from Baker Hughes show just 574 operating rigs versus 1,578 a year ago.) However, too many observers focused on the headline "all in" costs of production. They missed the rapid technological advancements in horizontal drilling and hydraulic fracking applied to domestic shale deposits that have enabled costs to tumble. **Most importantly, it is the sharp drop in cash operating costs that have materially affected profitability for drillers and which have allowed even those highly leveraged producers to remain in business.**

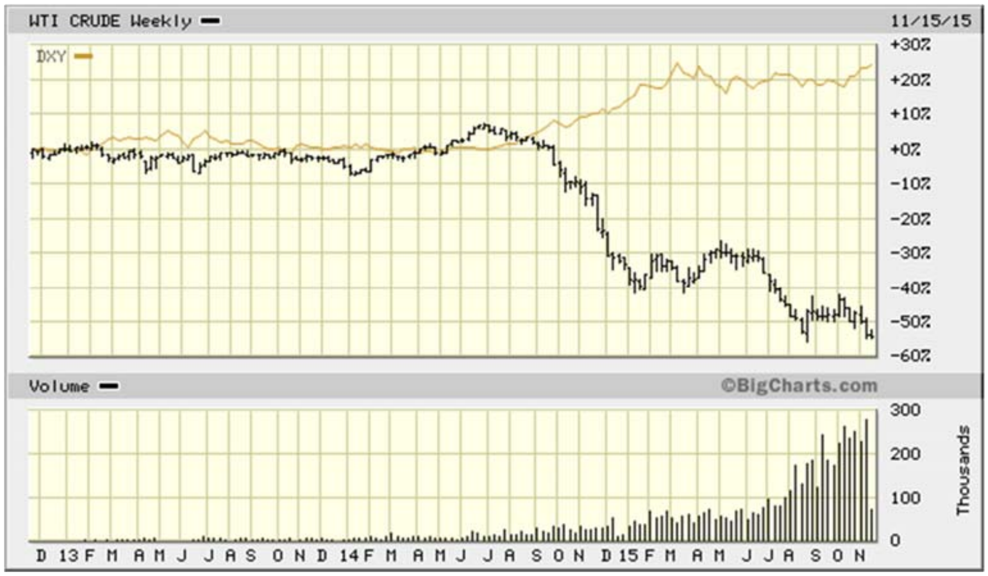
Those highly leveraged drillers have no choice but to keep pumping oil to generate cashflow for debt servicing. So long as the price of oil exceeds cash production costs they can keep creditors at bay for a while longer. And cash production costs have fallen well below $30 per barrel for many more drillers than generally recognized. Eventually many of the highly leveraged drillers will fold (as KKR Samson's bankruptcy filing demonstrates) when operating cash flow proves insufficient to sustain long-term financial viability. Most industry participants…and especially OPEC failed to recognize that these financially weaker players can remain in their death throes to negatively impact oil prices far longer than commonly believed. **However, now that contracts for delivery signed at higher prices are expiring, production should finally begin to fall.**

The third quarter earnings season provided only a temporary respite from the selloff in energy shares. Although the rate of earnings decline was a slight improvement from the second quarter (Energy sector earnings declined by 56.8%.), in our view, it still failed to encourage a sufficient volume of fresh buying to sustain upward momentum due to the subdued outlook from managements on their quarterly conference calls. **Nonetheless, investor sentiment still doesn't appear to have washed out as there are still too many analysts and investors calling a bottom. We doubt that they know something that management doesn't.**

Can oil prices go even lower? Yes. In an oversupplied market, spot prices will be determined by the marginal producers and [in this instance] the variable cash cost of production for the most efficient producers. Aggregate U.S. production still shows no sign of peaking with certainty. Iraq is pumping a record amount of oil with the stated intent of increasing output. Iran will ramp production as rapidly as possible once sanctions are lifted. We suspect that it's probably three to five months before oil prices have any hope of stabilizing. Near term, any rally is likely to be short lived. However, when the market turns, as it did in August, it usually does so quickly and sometimes violently. **Short oil has become a very crowded trade, which usually ends badly.**

Recent price action points to lower oil prices. When President Obama killed the Keystone pipeline two weeks ago it should have been construed as positive for oil prices. Yet instead of rallying, oil traded down on the day by almost one dollar and has continued to trade lower. **When prices decline on what should be bullish news it's a bearish sign that should concern market participants.**

There are other reasons to believe that oil prices are headed lower near term. The U.S. dollar has rallied on expectations of a Fed rate hike and higher U.S economic growth versus other developed economies along with the more recent flight to safety trade as the fallout from the attacks in Paris and fear of broadening terrorist activity unnerve investors. Although we expect the dollar to achieve new highs, we hardly believe that it is about to go vertical but rather for its recent gains to prove sticky for the next several months and weigh on commodity prices. The chart on the following page shows a set up for new lows for oil if the dollar breaks out to new highs, which the second chart indicates looks increasingly likely. Lower oil prices are not stimulating "real" demand to outpace supply while global economic growth forecasts continue to be dialed back. We attribute any increase in "demand" not to rising consumption but to countries such as China capitalizing on current low prices to add to their strategic reserves. If these countries were to cease topping off their reserves, oil prices would quickly fall to new lows in our view**. Futures spreads have returned to higher levels. Despite lower spot prices, contango is back near the highs where oil prices previously failed.**



Those bulls hoping that the December 4th meeting of OPEC oil ministers will be a catalyst for higher oil prices are destined for disappointment. Ignore all the noise around the meeting—the Saudis certainly will. Non-OPEC producing countries will continue to plead for production discipline within OPEC, which is aimed at Saudi Arabia and its gulf allies. The weaker OPEC members (the loudest being Venezuela) will echo the call for cutbacks that would be borne predominantly by the Saudis. But without any bargaining leverage whatsoever, the weaker members will have no choice but to be patient and acquiesce to the Saudis. **A break-up of the cartel as some observers have suggested is not in the cards.**

There are political overtones to the Saudis' actions. The Saudis declare that the cornerstone of their strategy to sustain market share is to stop the flow of higher-cost U.S. shale oil to the market by increasing their own output to force prices down to uneconomic levels for U.S. drillers. While true, we believe that the Saudis' more immediate concern may be the rapidly growing regional threat represented by the Iranian Shiites and their surrogates. **Causing financial pain and distress for Iran through reduced oil revenues serves Saudi interests (and by extension those of the United States) well.**

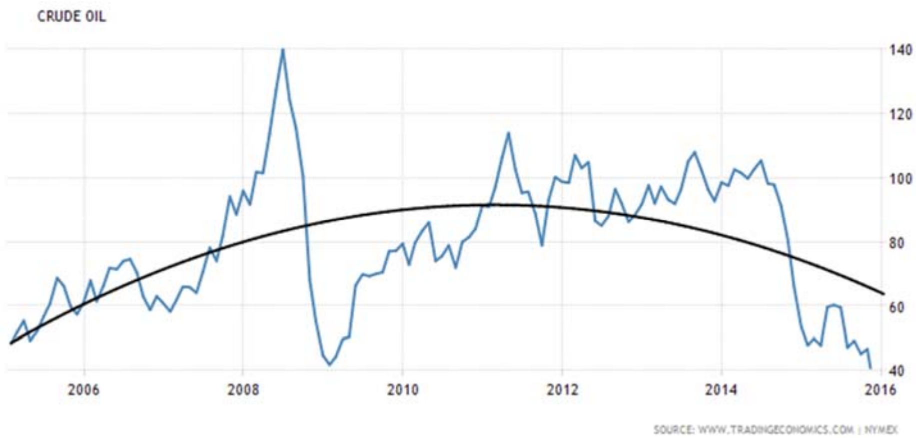
Saudi interests are also causing pain for Russia in its export markets. Many observers have been saying for more than a year that Russian crude production would fall, perhaps abruptly so, although we've seen no sign of it. To the contrary, Russia is pumping oil at a record pace as it seeks to tap export markets to offset its weak domestic economy. Oil exports account for more than half of total revenues received by the Russian government. These revenues have obviously suffered from the precipitous drop in oil prices but the problem has been recently compounded by the Saudis' push into traditional Russian export markets in their effort to expand market share. This has caused Russia to increase the discount for its Ural-blended crude. Russia can't let its production output fall, especially as it ramps military spending. **Reading between the lines, we wouldn't be surprised if the Saudis are creating leverage for future political maneuvering given Russia's current push in the middle east.**

OPEC estimates that there is a global 210-million-barrel inventory glut while the International Energy Agency (IEA) estimates total OECD stockpiles have swollen to three billion barrels. Both claim that the excess supply will be worked down in 2016. The IEA reckons that next year supplies outside OPEC will decline the most since 1992 although it cites forecast cutbacks in U.S. shale oil production that equate to the entire forecast global decline of 0.6 million barrels per day (mb/d). Meanwhile, they forecast demand in 2016 to rise at twice the pace as this year for an increase of 1.2 mb/d compared to 0.6 mb/d in 2015. This seems rather optimistic when global growth forecasts by the International Monetary Fund and others continue to be reduced in real time. Also, last Friday's tragic events in Paris seem destined to put downward pressure on Europe's economy next year**. However, if they are correct, even under the best of circumstances as currently envisioned, it would take better than six months to bring inventories into equilibrium.**

The outlook for higher oil prices ahead of the upcoming December 4th OPEC meeting now espoused by the Saudis is nothing more than condescension (and political cover) to appease the weaker OPEC member nations. After all, wasn't it less than two weeks ago when they were saying that oil could hit $20 per barrel? Not coincidently, that is the Saudi cash cost of production. **The Saudis are essentially just buying time.**

However, even the Saudis acknowledge that producers require an adequate return on capital. Although the Saudis have a competitive production cost advantage, they nonetheless have been raiding their huge cash reserves and tapping the credit market to sustain the country's vast entitlements and avoid unrest (which is an even greater concern for OPEC's weaker regional member states) as their oil revenues have declined. At a minimum, $65-$70 oil is needed globally to support self-sustaining capital expenditures [and not coincidently reduce the drain on the Saudi Treasury]. **Ultimately, there is no alternative solution other than higher oil prices.**

Long speculation has risen over the last few weeks. Some believe that oil has put in a bottom (perhaps in anticipation of positive news out of the OPEC meeting) with some analysis pointing to $48 by year end (see chart on the following page) but we see nothing fundamentally or technically to support such a view. To our point, the most recent EIA forecasts do not show a material drop in U.S. crude production from September. **Commercial traders, who should be in the best position to know, are short.**

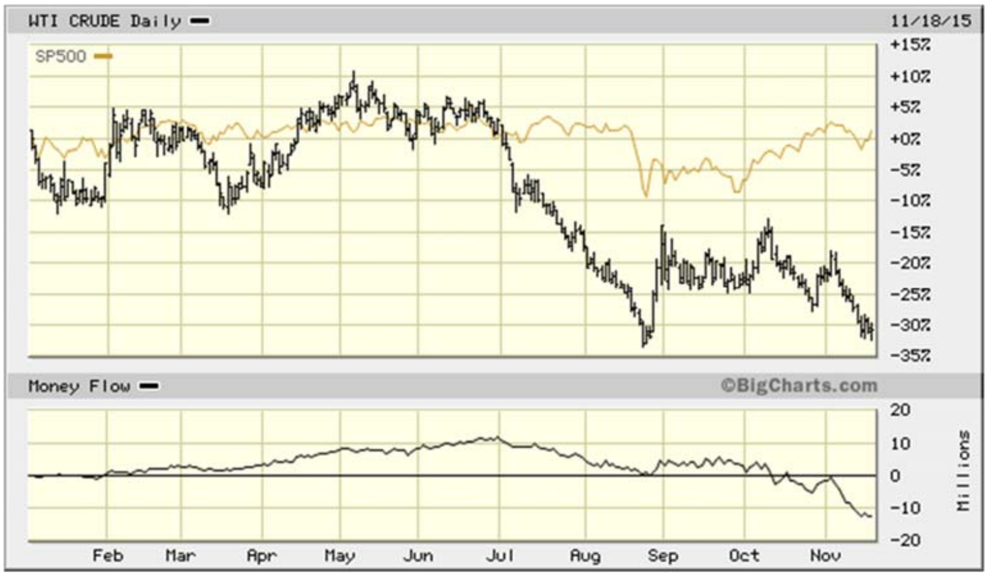


Forecast	Actual	Q4/15	Q1/16	Q2/16	Q3/16	2020	2030	2050	Unit
Crude Oil	40.4	48	46.7	45.5	44.3	54.1	73.8	98.4	USD/BBL

Given the wide disparity in financial conditions within the sector, buying individual high quality well-capitalized companies is likely to generate better returns than a broad-based approach such as exchange-traded funds like XLE. Since the price of oil may stay lower for longer than previously believed, many highly indebted producers will eventually succumb to the financial pressures of their balance sheets. Although this should stimulate an uptick in merger & acquisition activity, take-over valuations are likely to be compromised as the value of proven reserves is reduced. Beaten up unlevered (or under levered) domestic E&P companies and onshore service companies likely present the best upside while large-cap managers will want to focus on high quality major integrated producers that are also committed to maintaining their dividend such as Chevron (CVX) and Exxon Mobil (XOM) along with Total S.A. (TOT) and BP plc. (BP) for global portfolios. Of course one must remember that given declining earnings, the majors' ability to generate cash flow to fund dividend payouts can only be generated by severely reducing capital spending, which isn't sustainable in the long term or borrowing. **In our judgment, it is still too early for bottom fishing. We suggest remaining on the sidelines and continuing to underweight the sector. Investors with a short-term trading horizon that are currently long crude should consider selling into any resurgent strength while those so inclined to do so should fade the rally—too many participants still remain in denial.**

Notwithstanding our commentary to support the case for lower near-term oil prices, it is not the "seen" but the "unseen" that most impacts markets. When we read statements by "experts" made with certainty that "we'll never see $100 a barrel oil ever again" we are sure that is exactly what we'll see because no one knows with certainty. The probability of some unforeseen event impacting prices is skewed to the upside and eventually a catalyst will materialize. We are beginning to get the sense that many market participants and pundits are being lulled into complacency regarding the long-term prospects for the price of oil. There's danger in accepting unidirectional movement as fait accompli. **Prices tend to overshoot in both directions.**

The broad market is unlikely to mount a broad sustained breakout to the upside while the energy sector remains on its downhill slide. A reversal does not appear imminent.



Carlo R Besenius, CEO & Head of Global Strategy
cbesenius@cg-inv.com
office: +(352) 26 25 86 40
mobile: +(352) 691 106 969
Luxembourg/Europe

Sabine CJ Blümel, Head of Global Automotive Research
sblumel@cg-inv.com
office: +44 (7785) 301588
London, UK

Gary Schieneman, Managing Director,
Global Accounting and Finance
gschieneman@cg-inv.com
office: 917-868-6842
New York, NY, USA

Steve Gluckstein, Global Strategist
sgluckstein@cg-inv.com
office: 212 939 7256
mobile: 732 768 8843
New York, NY, USA

Marc Peters, Head of Global Industrial Strategy
mpeters@cg-inv.com
office: +(352) 26 25 86 40
mobile: +352 621 36 44 50
Luxembourg/Europe

Allison M Cimon, Director of Sales & Technology
amcimon@cg-inv.com
office: 646 228 4321
Boston, MA, USA

Jennifer Crisman, COO
jcrisman@cg-inv.com
office: +(352) 26 25 86 40
Luxembourg/Europe