Oil and Water

If you are like most people, the phrase connotes two things that can never mix well or properly. Insofar as that is true, it is a worthy starting point for a review of the month's events that saw long warring nations rise against one another. It can be, however, applied more broadly to other scenarios we will discuss in both an investment and geopolitical context. For all we know, we may even steer into a brief discussion of the actual resources themselves, as well, because there is some sense that we may look back at this period in amazement for reasons I will describe.

The obvious starting point is with Iran and Israel and the 12 Day War which we will hope will not later be described as the 12+ Day War. These things have a mind of their own. Certainly, there are lot of competing interests and such. I will set aside a lot of philosophizing over whether it should have happened; what the result will be; or, whether the US should have engaged. Having served, as we have, in Afghanistan and Iraq, it is easy to empathize with the 100 million people on both sides of the conflict who have largely had nothing to do with it. As is the case with Americans, most are simply people trying to make a living, raise their children and enjoy their free time as they may have it. I have related to a couple of clients and readers over the years how I met two tiny Iraqi boys alone in the middle of a bombed out, smoldering war-scape of a desert who forever imprinted on me that people are the same all over and our first goal should be to simply protect humanity. Perhaps, this can be a turning point. I had an old soldier tell me recently that this feels different than past conflicts. Let's hope. Without a doubt, both Israeli and Iranians will read this commentary, and we can know with certainty that they would sincerely hope that there can be an enduring peace.

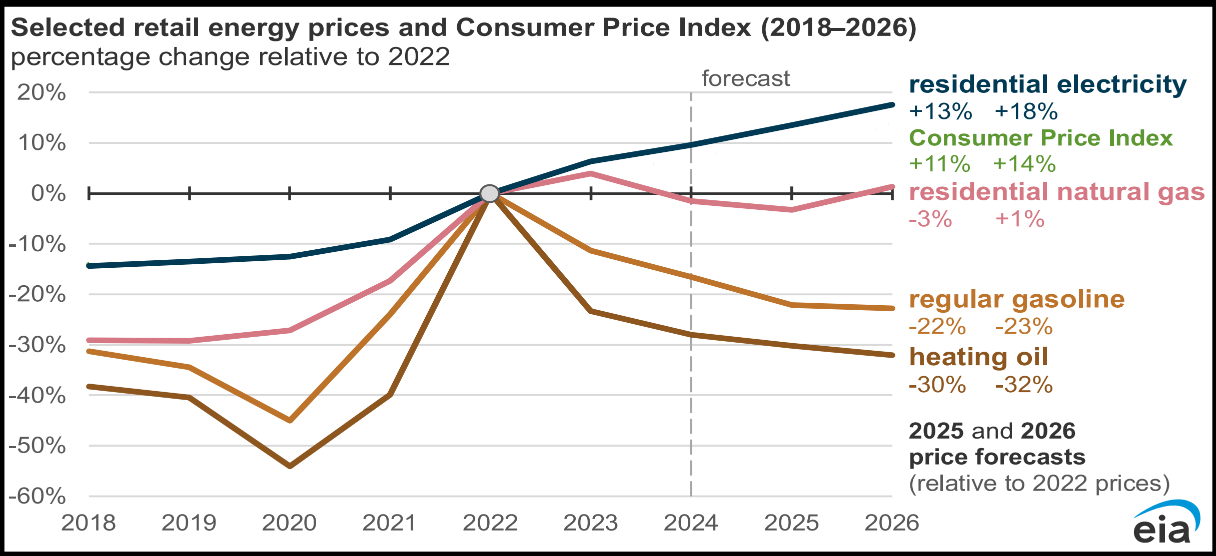
Returning to oil and water, we can relate how the market interacted with oil and oil prices leading up to and during the hot period of the conflict, as well as the narrative in recent months. Somewhere, in my mind, a big disconnect has taken place leading me to believe that oil is too low or everything else is too high. As we lay out the basic fundamentals behind prices and relative prices what is likely to stand out the reader is that two opposite things cannot exist simultaneously. Into that reasoning we will bake the notion that there are traders who are short-term focused and government and energy industry analysts who, for professional reasons, are unlikely to stretch their forecasts.

It is first worthwhile to share a little near-term history. We had Covid which drove oil prices literally negative in WTI because oil had nowhere to go in a global, simultaneous economic quarantine. With all freedom of movement and most all production shuttered, the demand for oil was non-existent. So, it just overflowed. As I have pointed out before, there are few things never before seen on Earth, but the global lockdowns were, in fact, unprecedented. So, we acknowledge that period and beyond. Covid is also important in that it ushered in the fastest money supply growth we had ever seen. It also ushered in prolific government spending that drove our deficit to $35T. Along the way, inflation took root, as we had forecasts long before it bled through. Gold prices soared. Frankly, prices soared across the board for the most part. Prices are up about 55% since 2007 with a substantial part of that happening in just the last three years or so.

Notably and conveniently, oil has historically been priced in dollars. Given that the value of the dollar has been cut in half since 2007 resulting in an attendant price increase on virtually everything that we buy, what would you expect would be the price of oil? If you guessed much, much higher than the 2007 price, you are not going to be the next Jeopardy champion. Oil is exactly where it was in 2007. So, after eighteen years, oil has not budged. The likely response that would follow from those who will rationalize this is that fracking has changed the game and the world is awash in oil. In fact, the world consumption and production numbers are almost at equilibrium now with just over 100MM barrels produced and consumed. Further, the great fracking boom has happened on the back of an industry that has somewhere in the vicinity of $63-65/bbl breakeven on new wells. With the current WTI (West Texas Intermediate Crude) price being about $64, the industry is not likely to bring on a lot of new rigs at this price. And, in fact, they are not. We imagine CFOs throughout the entire, capital intensive industry revising project pro forma's with $64 oil and a cost of capital that is quite a bit higher than it was just a few short years ago. So, for all the 'drill, baby, drill' mantra, executives in the Permian basin will drill when they are going to be paid and not before. Another question is whether or not there is endless oil in the world that can easily and efficiently be extracted. We can game that out either way. If that is true and said oil can be pumped immediately at $35/bbl, US fracking will collapse entirely and a lot of aggregate US supply (some 13%+ of global) would be shut-in and not available in the world market. The likelihood of anything approximating this case is remote, of course. If the US producers, on the other hand, have radically evolved technologically, using newer technology, as some suggest, they would not have breakeven new wells at $60+ or existing operating breakeven well into the $40s or higher. And, if the prospect of much cheaper oil is on the horizon, it has to be discovered and produced which is not a 2025 or 2029 event, of course. So, in some very real sense, global oil, including that which is produced in the US and Canada, has a relative floor under it below which production would collapse and create a supply crisis, of course. That floor is not too far below current pricing. It is relatively easy math to consider that bringing on new rigs and creating a supply glut at current prices is probably not in the equation.

So, we can assume that there is no new normal in oil as it relates to exploration and production. The next rationale offered for oil prices is the softening economy. This is, perhaps, the most confounding. It was originally hinged to tariffs slowing the global economy. So, let's game out the notion that tariffs, in fact, slow the economy. Let's further assume that oil is equal to or higher than the appropriate price given the expected slowing. Then, equities running at 25X trailing earnings are clearly mispriced. We would even conjecture that real estate is mispriced globally. If on the other hand, tariffs don't impact the economy such that it slows, we have another conundrum. Oil is lower now that it was pre-tariffs and fairly close to where it was when the tariff scare was reaching a crescendo. Oil is also much lower than the 2022, 2011-2016 and 2008 highs which were over $100/bbl. The current price at $67 is lower than the twenty-year average price of WTI, in fact.

If we flip the scenario and ask where oil could be (ignoring any Mideast conflict), we could price it against inflation, as well as gold. If our dollars were as weak against oil as against the general economy, we would be looking at oil well over $100/bbl. If we were to price oil in ounces of gold per barrel with gold now at approximately $3,340, we would end up with a, seemingly, absurd price north of $200/bbl. What if we looked at something like electricity rates which should also be hinged to technology enhancement, power generation, commodities, demand and economic activity? Interestingly, its cost has risen about 50% since 2007, as well. Again, assuming that there is or could be a connection, that would predict a price closer to $100 than to $67/bbl.



There is an additional, long-shot consideration that would ask what if Russia's conflict is resolved and sanctions are lifted. That is an interesting question that calls forward all kinds of other questions like how closely the sanctions are being followed in any case, how far the sanction price is from current market prices and where oil prices were both with and without sanctions. Assuming Russia produces somewhere in the vicinity of 10% of the world's oil and is selling, subject to sanction cap, somewhere in the vicinity of $60 (wink wink) anyway, the overall impact of an immediate lifting of the cap would not necessarily move the needle that much on global prices in any event.

One could conclude from the above that, while it is extremely difficult to predict near-term oil prices, it is difficult, also, to reconcile current oil prices with valuations in other asset classes, as well as the general consensus view on economic prospects. Said another way, either oil may well be too low or other asset classes and predictions of economic activity are too high. In a period where all eyes were on Mideast tension, oil was remarkably stable, owing in part to consensus that OPEC+ was in a weak position, US oil self-sufficiency and a consensus view that tariffs and economic malaise in places like China will dampen demand. Assuming that all those things are true and could account for more than twenty percent of the differential discussed above it still leads back to the conclusion that oil prices and the valuation and prices of everything are detached in a fairly unusual way.

For our part, we can focus on the longer term as well as indirect ways to consider these circumstances. As has been mentioned before, we like cash flow and we like strong repeatable earnings/financials. If there are companies who present these characteristics and also possess some exposure to upside oil, they could be very interesting over a longer horizon. To be sure, the consensus is that oil ought to be where it is or lower largely predicated upon the above concerns and the cessation of hostilities in the Mideast. Those considerations, however, do not eclipse the fact that oil is arguably not expensive in real terms relative to other assets, its own historic pricing or the supply/demand fundamentals in a longer-term view. Further, if rather than investing directly in oil per se, we are able to own cashflow producing assets with greater than 4% yields in some instances, we have the potential to acquire valuable assets at prices that could prove quite favorable over the long term even if in the near-term oil prices decline somewhat. In a risk management context, it is possible that, relative to global equities and real estate, the risk reward for some oil related assets could now be somewhat asymmetric, meaning that the downside from here might be well lower than the upside.

You may now be wondering where the water comes into the story. We may well revisit the water story in the future in more depth. Oil and water, however, are somewhat unique in terms of human dependence on both. Water, clean water, is scarce and, perhaps, getting much scarcer. It is, however, very difficult to assume an investing attack angle on water precisely because it is so closely hinged to human survival. As such, it will always be an area of government interest, concern and regulation. Thus, it is somewhat difficult for investors to define a way to consistently derive defensible excess profits in the space. Although in an era of self-sufficiency Americans are less sensitive to it, oil is, likewise, a cornerstone commodity on which modern human existence currently rests. Without oil things are either not moved or energized. Frankly, believe it or not, much of what grows would not grow, as nitrogen fertilizer is derived of natural gas. Plastics, of course, are also petroleum products. The list goes on. So, whether the world grows faster or slower, both sustaining and developing the world requires it and, to date, it is generally neither recoverable nor reuseable. Once it is consumed, it is gone. Ironically, global warming may take a poor second place in the list of reasons to find alternative energy sources over time. When we are in era of horizontal fracking and such, it is probably a reasonable opportunity to work hard on figuring out how the tech masters of the universe are going to fire their AI and crypto dreams.

In the meantime, we will continue to monitor and survey the broad investment landscape in executing plans designed foremost to realize client investment goals. Certainly, energy is but one small sliver of the investment landscape. In light of recent events and the market’s myopic focus on tariffs and war, we thought it worth both investigating and sharing a relevant, albeit slightly longer term, view of the relative value of a cornerstone commodity and an international currency of sorts. In our daily and weekly conversations, we will continue to keep clients informed of portfolio changes.

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