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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

What should be music to an investor's ears? A collapse in prices; especially if it is something that everybody consumes. It is always amazing to watch when something happens that no one predicts, and yet everyone is an expert on what will happen next. This is the case with oil currently. Of course it is going to $30. The decline from $100 a barrel just six months ago to $50 took everyone by surprise. The effects on the economy are debatable because though it is a tax cut for everyone, it has also been the largest job creator of the economy recently. It is too early to say which will have a larger impact on the economy. If the average consumer drives 1000 miles per month, and gets 20 mpg, they are saving about $75 per month. That is money you can spend somewhere else. The real question is what are the investment implications for the recent decline of oil prices?

It has been widely publicized that a big contributor to oil's price decline has been too much production, mostly resulting from new technology that allows oil to be produced from shale. In 1983 the world's proven reserves were .66 trillion barrels of oil. Today, proven reserves stand at about 1.65 trillion barrels. So much for peak oil theory suggesting that we should have already been running on empty with oil supply. Technology completely changed the game. The U.S. consumes about 92 million barrels per day, and it is estimated that current production is about 1.5 million bpd more than we use. For the 1st quarter of 2012, consumption was around 89 million bpd. So even at the present trend, it will only take a few years to soak up the extra oil being produced. Of course nothing stays the same and lower prices just speed up the process.

The last major spike in oil prices was in the 1970's. The number of rigs that where drilling for oil reached 4530 in 1981, but then the price of oil started to decline. By 1983 the rig count had declined to 1670. However, it took several years before oil really started to move higher again. Will it take years for oil to turn higher this time? Rig counts have already started to decline. In February of last year they were at 2403 rigs drilling for oil, now we are down to 1670. This is the beginning of a self-correcting process. There is one major difference that may affect how long prices stay down, which is the very thing that created the problem; shale. Because of the high pressure that is used in the drilling process to get oil out of shale, the production of a newly drilled well declines rapidly. If a new well starts producing 100 barrels per day, however, by the 12th month it is on average down to 30 bpd. Traditional wells have a slower decline in production. With the current decline in drilling and much of it being in shale, supply will probably come down faster than in the past. Especially since oil from shale represents about 1/3 of our U.S. daily production.

The economics of oil are complicated, because it is just not about consumption and supply. Independent oil producers have been the biggest sector of the high yield debt market (otherwise known as junk). Even though they may be selling oil at a loss, they need cash to service their debt. To complicate matters even more, many of these independent producers hedged (sold oil at higher prices months ago) much of their production at higher prices, however, most of these hedges expire before the end of 2015. This implies that they we may not feel the full effect of lower prices until the second half of this year. If oil prices stay down, the fireworks really start to occur during the second half of this year with the likely event of more bankruptcies in the oil sector.

From an investment stand point, it is quite easy to see that there are some real catalysts that exist in the relatively near future. A few are lower drilling budgets resulting in a continued decline in rigs drilling for oil, and independent oil companies starting to go bankrupt in the second half of this year. Finally, on the demand side, people are starting to buy bigger cars and trucks again (nobody said they are smart). Geopolitical events are always lurking in the background and can change everything in a day. In the short-term it is impossible to tell where the bottom is for oil, or how long it will take for the story to change. Most estimates suggesting that many producers cannot make money at current prices, so it becomes economics 101. Buy oil companies with strong balance sheets as prices decline, because the best cure for low prices is low prices.