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OIL'S WEEKEND AT BERNIE'S

ASK FORSTRONG: ARE OIL STOCKS "DEAD MONEY" OR SHOULD I BUY?

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Speed Read:

- Many investors continue to bet on an oil revival.
- Despite a high probability of a short-term counter-trend rally and stabilizing prices as coronavirus concerns ebb, we are not convinced of oil's longer term fundamentals.
- Looking ahead, investment leadership out of this crisis is unlikely to come from oil stocks. Better opportunities exist elsewhere.

Despite receiving mixed reviews, the 1980s comedy, *Weekend At Bernie's*, became a cult classic. That's surprising for a film where the central joke is that its main character is a corpse. Moviegoers were forced to drag themselves through nearly two painful hours of making Bernie look alive for the weekend.

Investors in oil markets have undergone a similar experience over the last few months. Coronavirus concerns have crushed oil stocks and those carrying substantive exposure feel like their portfolios are on serious life support … if alive at all.

The carnage has been breathtaking. Some oil stocks have collapsed by more than 80%. Chronic oversupply has completely overwhelmed crude storage facilities and supertankers. Apparently, nobody needs oil and there are fewer and fewer places to put it.

Market prices have spoken. On Monday, the world's most important commodity thrust global markets into yet another post-crisis parallel universe — negative oil prices. Traders were willing to pay nearly $40 per barrel for somebody to take crude off their hands.

Yet market action still shows a perceptible pulse amongst oil enthusiasts. In the week ending April 17th, investors plowed $1.6 billion into a popular retail energy ETF (the United States Oil Fund LP) — setting a new weekly record.

Clearly, many investors continue to bet on a revival. But should you too? After all, asset classes can become interesting contrarian propositions when they are left for dead.

We have had lively debates about this during recent investment committee meetings. Some scene setting is helpful here. Since as far back as 2014, our investment team has maintained a "lower for longer" outlook on oil prices. Back then, contrary to the rampant "peak oil" thesis pushed on the masses, we observed that commodity prices tend to be long-trending markets. What we meant by that is cycles of rising or falling prices tend to last several years. Large capital spending responses in boom times tend to keep a ceiling on prices for years, as supply persistently overwhelms demand.

Prices went through a very typical secular phase from 2002 – 2014. Rising demand amidst constrained supply in the early 2000s was met with a prodigious surge in capital spending. Enormous amounts of capital spilled into oil and gas exploration. In 2013 alone, Shell's capital expenditures hit a record $40 billion. Globally, the oil and gas industry's annual capital budget skyrocketed, from just over $100 billion in 1999 to an all-time record $1 trillion in 2012.

But clearly COVID-19 has changed the calculus. The world economy is now in the ICU, with a staggering loss of global GDP projected at anywhere from USD $7-10 trillion. Oil consumption has collapsed by more than 25 million barrels/day (b/d). And even though OPEC+ has agreed to historic cut of some 10 million b/d, a huge supply glut still exists.

But the world will eventually heal. It doesn't seem this way today, but many things will return to normal (see "Investing In The Time Of Coronavirus"). And, oil prices will move higher. The important question then is what has changed — and what will not change — as a result of the pandemic?

Let's start with what will not change. Before the coronavirus hit, several headwinds were working against higher oil prices. First, vehicle efficiency improvements have been evident for years. The highest level of US oil demand was recorded all the way back in 2005 at 20.5 million b/d. Despite the US population growing by some 20 million over 2005 – 2019 and vehicle miles travelled increasing by 10%, US oil consumption in 2019 was still below 2005.[1]

Second, the arrival of electric vehicles will radically lower oil consumption. Yes, cheap oil will likely slow this trend in the very short-term. But whether you agree with climate change or not, there is broad policy support almost right across the world. Countries like China and India are competing with Europe for electric vehicle penetration. For automakers, the further optimization of the internal combustion engine is becoming increasingly expensive. By contrast, electric vehicles are set to become more profitable as regulatory targets for carbon emissions bite deeper and the cost of batteries continue to fall. These trends have deep roots and are unlikely to reverse course.

What about changes? Here, investors should focus on behavioral shifts prompted by the pandemic. Millions of daily commutes have been eliminated by the global lockdown. And millions of people have suddenly realized they can be productive at home (despite some being six feet too close to the fridge).

Global air travel, one of the fastest growing sources of demand over the last decade, has also collapsed. Face-to-face business meetings and conferences have been substituted with videoconferencing services. In many cases, businesses have already learned they can be more efficient while reducing travel costs. How much of this demand destruction is permanent? No one knows for sure at this point. However, it will surely be significant.

Now a final troubling aspect of all of this is government interference in markets. Heavy-handed intervention in the oil market is almost certain in the future … more regulation, more subsidies and more bailouts. Oil could even be subject to regulated production or price controls at some point (hey, it has happened before!).

Bailouts are most likely in the short-term. This is most probable in the US which has been hit with the twin headwinds of the Saudi-Russian fight for market share and the drop in demand driven by lockdowns. The Trump administration is now planning some type of bailout. But the business model for many exploration and production companies was broken well before oil prices plummeted. Fueled by the low cost of credit, US shale producers borrowed heavily to invest in drilling. The focus was on producing quantity to conquer market share. As it happened, debts rose along with oil supplies. The US energy bond market tripled over the last decade. And yet the increase in oil capacity yielded low returns for equity investors, as frackers reinvested windfalls and raised executive pay. A shakeout was inevitable at some point.

And so, a bailout would throw good money after bad. This would only prop up an industry that should instead be pursuing efficiency gains, consolidation and a needed wave of bankruptcies. The result? Zombie companies (courtesy of the US taxpayer) that will surely provide lower returns to shareholders.

Investment Implications

We are still in the early stages of an ongoing oil crisis. Even in a post-virus world, global demand is unlikely to recover for some time. That means a wave of bankruptcies, consolidation and government intervention is yet to come.

The oil price collapse will also re-draw the global map of power. Petrostates like Russia and Saudi Arabia (where the oil sector accounts for nearly 90% of its exports) will see diminishing influence. Canada, Brazil and others also have a tough slog ahead, as production will fall dramatically. The US will have to deal with the hangover of its shale oil spending boom, as the energy sector has been a key driver of the US growth story over the past decade. And yet there will be winners. These will be found in the oil importing regions of Asia and Europe, and will become more apparent as the positive impact on consumption, investment and liquidity materializes over time.

Looking at the period ahead, oil stocks could certainly stage an impressive counter-trend rally from here. Unlike Bernie, they are not dead yet. Headwinds will play out over several years. But don't be fooled if they give a lively performance.

[1] Figures from the US Energy Information Administration.