December 8, 2014

Finger on the "Buy" Button

All are aware of the recent oil price decline, exacerbated by OPEC's decision last week to maintain current production levels. The day that decision was announced, oil prices declined 10% to close at roughly $66 per barrel. OPEC's decision was a direct frontal assault on U.S. (and other areas) oil production, which has been ramping upward for the last 5 years. Indeed, since 2009, U.S. oil field production has risen from a low of around 5 million barrels per day to 9.5 million barrels per day. This increase in production has allowed U.S. oil imports (OPEC exports) to fall, as the U.S. has become more energy "independent." OPEC is fighting back to regain their "market share" loss – in the only way they can – by promoting actions that will drive global oil prices lower.

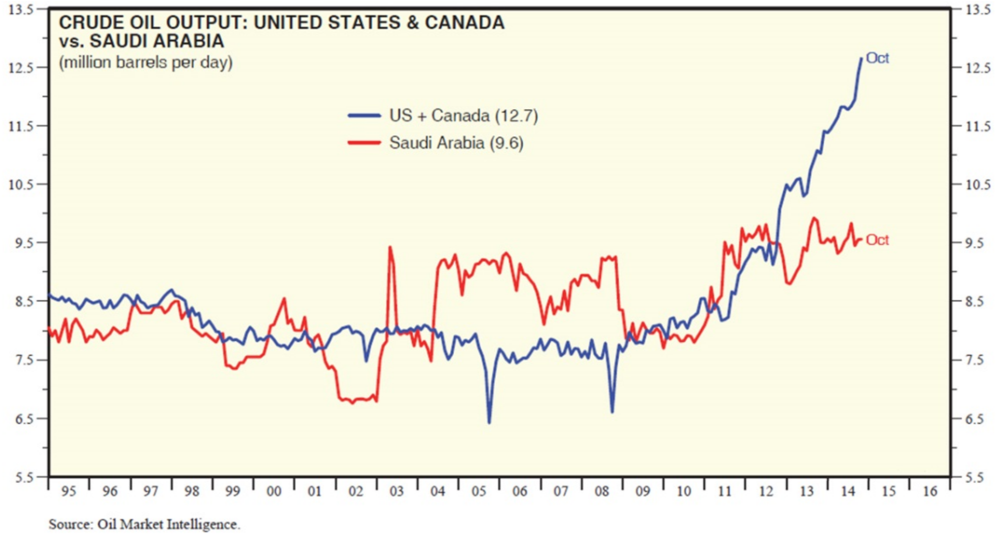
We have taken the position the downward shift in prices, which started last June, was a function of increasing oil supply, rather than a function of decreasing oil demand. We have speculated that the primary evidence of a supply-driven price decline is the fact that other industrial commodities (metals, etc.) prices have remained firm during this period of declining oil prices. If falling demand was the culprit behind the oil price decline, most other industrial commodities would also be falling in price. This hasn't been occurring (see chart below).

* Times 2 and divided by 10. Includes copper scrap, lead scrap, steel scrap, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, and tallow.
Source: The Commodity Research Bureau and Haver Analytics.

In the past, most oil price declines of this magnitude (down 38% from the June 13th high price) have been associated with demand contractions – usually surrounded by economic recessions. For example, from June 2008 to January 2009 oil prices declined by 70%. Again, from November 2000 to November 2001 oil prices declined by 42%. The only other major decline during the last 15-year period occurred from April 2011 to September 2011 (during the European currency crisis) when crude declined by 30% in value. Again, this was a downward move driven by a weak macro-economic environment.

So, this decline is truly "different" in that it is being driven by an increase in supply, rather than a contraction in demand. If you would like further proof, consider the following. On November 30th, the *Wall Street Journal* posted an editorial penned by the famed oil expert Daniel Yergin. The editorial was entitled **"The Global Shakeout from Plunging Oil."** Within that editorial he writes:

"The decision by members of the Organization of the Petroleum Exporting Countries on Thursday not to cut production reflects a profound shift in the world oil market. The demand for oil – by China and other emerging economies – is no longer the dominant factor. Instead, the surge in U.S. oil production, bolstered by additional new supply from Canada, is decisive. The surge is on a scale that most oil exporters had not anticipated. The turmoil in prices, with spasmodic plunges over the past few days, will likely continue."



So, as compared to past oil price declines, this decline is being driven by rising supply, rather than falling demand. The difference in economic ramifications and investment reactions is stunning. In his piece today, Ed Yardeni states:

"We are witnessing the Clash of the titans in the global oil industry. Saudi Arabia has abdicated its role as the Federal Reserve of the oil market. The Saudis are no longer willing to conduct "open market operations" in the oil market to stabilize the price on behalf of OPEC's oil cartel. They've decided to let the market determine the price. They clearly hope that it will fall low enough to shut down lots of U.S. oil production, and then bounce back. How do you say "Good luck with that" in Arabic?

Why does Ed make that statement? Consider the chart above which shows oil output from Saudi

Arabia as compared to North American oil output. Additionally, it is important to understand that only 4% of U.S. shale output needs $80 per barrel to remain profitable. Most production in the Bakken field, for example, remains commercially viable at or below $42 per barrel. So, if OPEC is wanting to strangle U.S. oil production, prices will need to fall much more than has been the case so far. **As oil prices decline, many oil producers who aren't as politically stable as Saudi Arabia will be fighting to cut production to stabilize pricing. In other words, the Saudi's will more than likely receive significant pressure from other OPEC members to take action if prices fall much further.**

Economic Differences Between Supply/Demand Disruptions

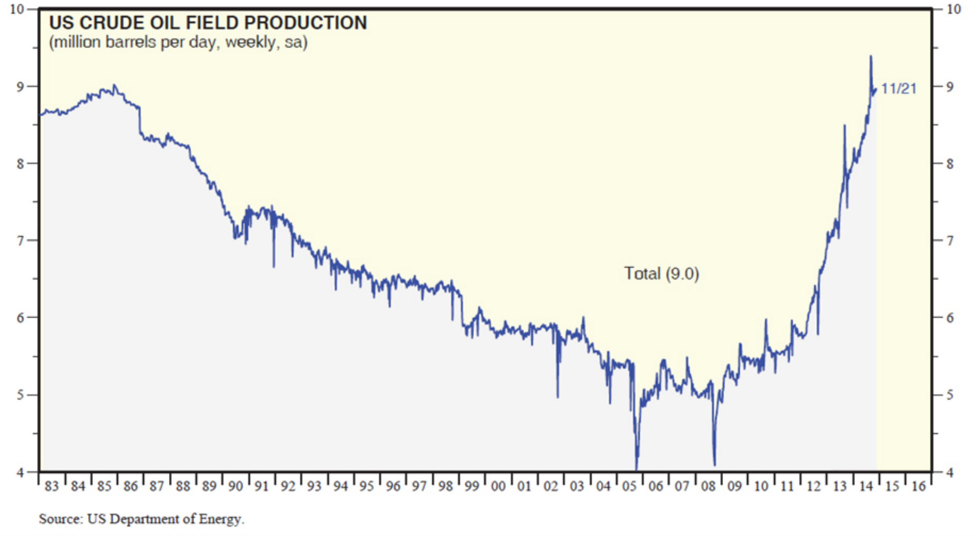
Much of my view on the differences between supply/demand disruptions is speculative. As noted above, **all** major oil price declines which have occurred over the last 15 years have been demand-driven. Those periods of price weakness had been associated with weak equity markets. The table below highlights market returns from the S&P 500 during each of the demand-driven oil price declines mentioned above:

	S&P 500 Price Change	Oil Price Change
Nov. 2000 – Nov. 2001	-13%	-42%
June 2008 – Jan. 2009	-36%	-42%
Apr. 2011 – Sept. 2011	-17%	-30%
June 2014 – Nov. 2014	**+6%**	**-38%**

While the oil price decline very well may continue (we probably haven't seen the bottom in prices) the S&P 500 is certainly acting much differently so far than during the previous three major oil price declines.

From a macro-economic standpoint, the vast majority of the world's economy is a net benefactor of falling energy prices. From corporations that burn energy for various reasons to consumers who spend an average of 4% of their family budget on gasoline, as energy prices fall, discretionary income rises. If oil prices remain at the current level, our calculations show that consumer discretionary income effectively rises by $152 billion on an annualized basis due specifically to falling gasoline prices. This equates to a boost in GDP of about 0.9% over the next 12 month period.

Capital spending by producers in the oil patch will be cut (this is currently occurring) due to a fall in



oil prices. Indeed, from production peak levels, U.S. oil production has already fallen by 400,000 barrels per day since September (see chart below).

On a global scale, Yardeni Research notes that the oil price decline means a $1.5 trillion economic windfall for global oil users. Global GDP is running around $69 trillion, so $1.5 trillion in economic benefit is very meaningful for global economic activity. That number may provide the same stimulus to global economic activity as the 2008 Chinese stimulus package, which had positive knock-on effects to the rest of the world's economy.

Enter MLPs

So, if oil prices remain low for a meaningful period of time, the world's overall economic picture will show improvement. What about something a little closer to home – MLP activity? While I'm not a MLP expert (our friends at Tortoise Capital Advisors fill that role), I have some overall thoughts as to how all of this may play out for the MLP space.

First, it is important to understand that MLP's own positions in pipelines and other assets which facilitate the gathering and transportation of various energy commodities. The commodity's price is not a major factor to pipeline's revenue. Pipelines are like toll roads – they charge a "fee" for transporting fluids/gasses. The actual spot price of that commodity is not a major factor of their revenue stream. What is disturbing the MLP space with the current fall in oil prices is the view that the amount of oil transported over the pipelines will fall due to a lowering in exploration, which is driven by lower oil prices.

It is also important to understand that the MLP space is more than oil pipelines. The Alerian MLP ETF (an index-based MLP ETF) exposure to various segments of the energy space is as follows (as of 9/30/14):

Natural Gas Transportation:	27%
Gathering and Processing:	31%
Petroleum Transportation:	41%

So, as can be seen, petroleum transportation (oil pipelines) represent less than 50% of the MLP index noted. This fact is important to the investor. Why? Natural gas prices have NOT declined in-line with oil prices since last June. Indeed, natural gas prices have declined by 5% since the first of June, while oil prices have declined by 38%. Consequently OPEC's decision to not cut production does not directly impact pricing on the entire MLP space – just a portion of that space.

Summary

OPEC has declared "war" on the rest of the world's oil producing organizations. Their apparent main target is the North American oil producing complex, which is now one of the world's largest oil producing regions. We believe (as others now do) that the oil price decline is due specifically to excess supplies rather than the typical demand-driven oil price decline. From a macro-economic standpoint, it appears the world in general could show higher economic growth due to the oil price decline than would otherwise be the case.

The overall impact on the U.S. may be more of a mixed bag, as our oil production appears to be the target at which OPEC actions are directed. I suspect, we will see eventual lower oil production in the U.S. than some had been expecting. With this in mind, it appears oil prices may have more downside potential as we move forward. That being said, we firmly believe oil domestic oil production will stabilize following the supply-driven oil price disruption.

Is now the time to push the “buy” button and purchase MLP funds’ shares? In my opinion, it depends on the fund you are observing. I do expect to see further price volatility within the MLP space (and the entire energy space as far as that goes) which will provide an excellent entry spot for new capital.

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