November 12, 2014

Flooded in Oil

October was an eventful month in global markets. At the midpoint of the month, the S&P hit a low 7.7% below that of the month's start and just shy of 10% from 52-week highs. This October was well on its way to competing with other miserable Octobers of lore before markets magically rebounded to close at new all-time highs; with the S&P 2.4% above where it began the month. Some attributed the selloff to Ebola fears, passing around a chart that highlighted the correlation of Ebola mentions in the press with fear in the stock market.

In our estimation, the most consequential move this month was in the commodity complex, specifically crude oil. Oil has been a hot button topic of socioeconomic and political relevance for longer than any of us can remember. Not long ago, the conversation centered around "Peak Oil" before pivoting to the massive surge in domestic U.S. shale production. Today we think a new narrative begins honing in on a global supply glut and irrational state actors. In our March commentary, we spoke about feedback loops and the impact they can have on market prices[1]. Over the past decade, oil benefited from a tremendous feedback loop of soaring emerging market demand, tightening supply in older production fields and from geopolitical tensions, and the creation of vehicles whereby oil became an investable asset class. This last point is critical, for through ETFs the average American could own oil in their retirement account instead of simply treating it as a consumable commodity. Moreover, funds could bet on oil in increasingly exotic ways. The positive feedback loop here is important, as George Soros explains:

> … positive feedback process is self-reinforcing. It cannot go on forever because eventually the participants' views would become so far removed from objective reality that the participants would have to recognize them as unrealistic. Nor can the iterative process occur without any change in the actual state of affairs, because it is in the nature of positive feedback that it reinforces whatever tendency prevails in the real world. Instead of equilibrium, we are faced with a dynamic disequilibrium or what may be described as far-from-equilibrium conditions. Usually in far-from-equilibrium situations the divergence between perceptions and reality leads to a climax which sets in motion a positive feedback process in the opposite direction. [2]

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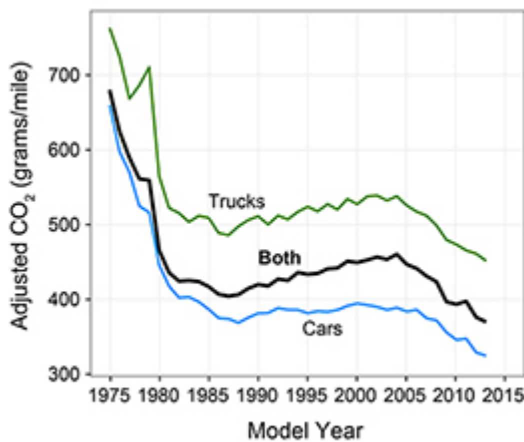
[1] http://www.rgaia.com/flushing-out-momentum/

[2] http://www.ft.com/intl/cms/s/2/0ca06172-bfe9-11de-aed2-00144feab49a.html#axzz2kMJs54ti

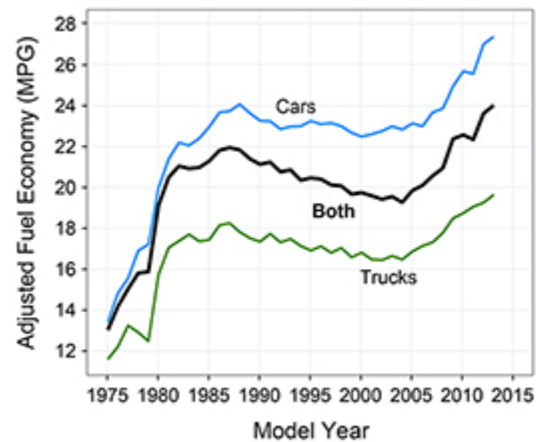
When prices of a commodity good rise, consumers and suppliers each adapt to the new price. Consumers pull back consumption, while suppliers increase production.

Consumers did this by buying more efficient cars:[3]

Adjusted CO_2 Emissions for MY 1975-2013[1]



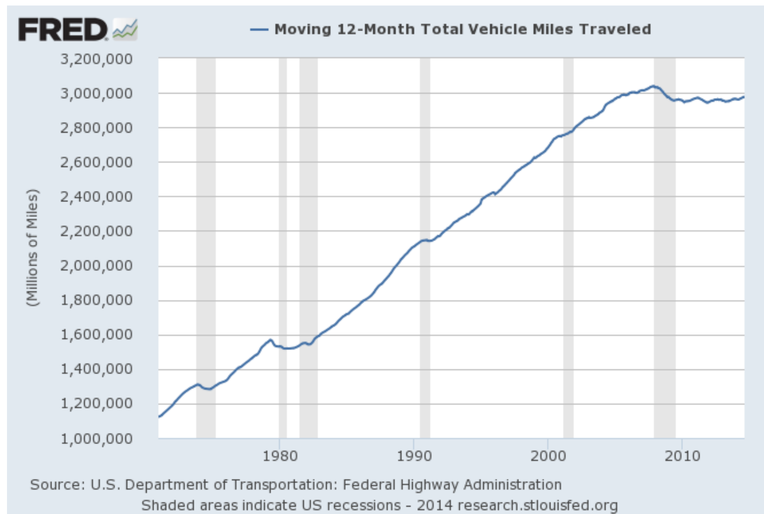
Adjusted Fuel Economy for MY 1975-2013[1]



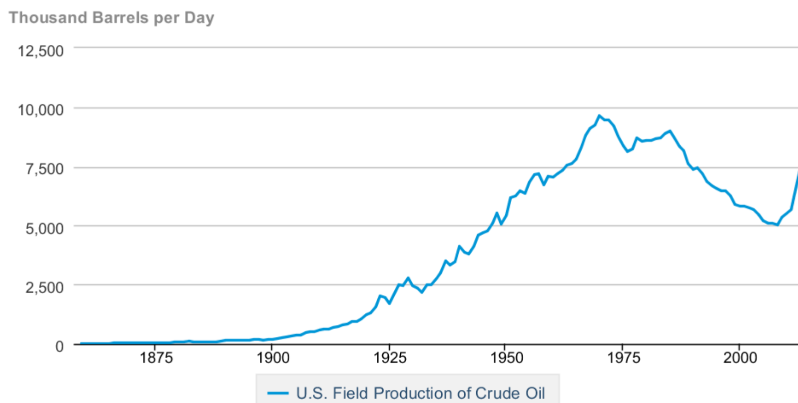
[1] Adjusted CO_2 and fuel economy values reflect real world estimates and are not comparable to automaker standards compliance levels. Adjusted CO_2 values are, on average, about 25% higher than the unadjusted laboratory CO_2 values that form the starting point for GHG standards compliance, and adjusted fuel economy values are about 20% lower, on average, than unadjusted fuel economy values.

[3] http://www.washingtonpost.com/blogs/wonkblog/wp/2013/12/13/cars-in-the-u-s-are-more-fuel-efficient-than-ever-heres-how-it-happened/

And driving fewer miles:[4]



Meanwhile suppliers, most notably in the U.S., ramped up production:[5]



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[4] http://research.stlouisfed.org/fred2/graph/fredgraph.png?g=P1H

[5] http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=MCRFPUS2&f=A

And this is where the supply story really gets interesting. The oil market is not your typical commodity market. In theory there is an oligopolistic price setter in the form of OPEC, and every other producer is a price-taker. This has given immense geopolitical power to the OPEC group, yet with non-OPEC production surging, their market power has come under threat. In microeconomic theory, suppliers of commodities are motivated by profit. Yet, with many of the largest suppliers actually state actors, what may be rational to protect the oligopoly economically speaking might be very irrational politically.

Take the example of Russia. Since 1998, Russia has been careful not to run budget deficits. Oil's rise this past decade has been a fortuitous source of funding for the state, as revenues from the country's production cover about half of their annual budget.[6] This year, Russia's budget called for a small deficit premised on $100 oil and pre-Ukraine-related sanctions. With oil prices collapsing, and sanctions limiting access to global capital markets, how will Russia finance its government? Bullish oil analysts have suggested huge producers like Russia and Saudi Arabia would merely cut production in order to protect price. If Russia were to cut its production by 10% at $85 per barrel, it would chop off 1.6% of its GDP in the middle of a recession no less. Economically, cutting production might be rational, but politically, increasing production might be a necessity.

A quote from Iran's oil minister is quite telling on the impact of political over economic objectives: "Under any circumstances we will reach 4 million bpd even if the price falls to $20 a barrel."[7]

This leaves us in a world awash in supply, while consumers are cutting back on demand and the reality is that the boom itself has led to what now looks like the early stages of a bust. Why is all this relevant now? For one, many portfolios globally were very long oil on the heels of its success over the prior decade. Alongside this current, many oil companies levered their capital structure premised on the expectation of consistent, if not higher oil prices. With oil prices now souring, many assumptions have to be revisited, leading to a de-risking, and forced selling in the space.

While after-the-fact rationalizations are dangerous and vulnerable to considerable biases, we think this is one of the most sensible explanations for what went wrong in markets in the first half of October, while also offering a built-in segue for what went right in the second half of the month. We are a consumer-driven economy and consumers have been constrained by a lack of wage growth and soaring commodity costs for the past decade. With oil reversing, consumers will benefit from one of the more stimulatory market-driven events we have seen in recent times. It's very challenging to quantify the

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[6] http://online.wsj.com/articles/russia-may-need-to-cut-budget-spending-finance-minister-says-1414158145

[7] http://www.reuters.com/article/2013/12/04/opec-agreement-idUSL5N0JJ2QF20131204

exact effects on consumer wallets, but "Economists at J.P. Morgan Chase estimate that a 10% decline in oil prices will, over time, add roughly 0.25 percentage points to U.S. GDP"[8]. At the end of October, oil was 21.8% off its high for the year, and down about 11.8% year-to-date. If this new lower level is only just beginning, and we believe that it is, then look for an increasingly favorable consumer environment into next year which will surely impact our portfolios going forward.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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[8] http://online.wsj.com/articles/americas-uneven-boost-from-cheaper-oil-heard-on-the-street-1415125113

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