

DIVIDEND CAFÉ PODCAST TRANSCRIPTION – AN UPDATED OUTLOOK ON ENERGY

Well, hello and welcome to another Dividend Cafe. I am sitting in the California studio today. I've just gotten back from New York city and have created a kind of special program today about the United States energy sector. It's a subject that we have addressed plenty in, in Dividend Cafe, this year, and really for many years, for those of you who have been following for a long time. And there's sometimes a tendency for me to think, if I've covered a topic a few times already, then, you know, just find a different topic, but this isn't a matter of beating a dead horse. This is an ongoing work influx of a very pertinent subject to investors. You, we have a certain special place in why we focus on energy because it's a large overweight in our portfolio management. When you look at the energy holdings in our core dividend portfolio, it amounts to, about three, times the weighting that the S&P 500 has an energy.

And prior to this big shift in sector allocation this year where energy's done real well, and technology's done very poorly, we were about four times, overweight in energy relative to the S&P. And so I can't recall a time in my career where I haven't been substantially overweight in energy, and yet since November of 2020, right around the time of the election and the latter portion of Q4, all of a sudden, the energy sector began initially, it was just a recovery out of what had been obviously an awful year in 2020 in the COVID year. But, has been the top performing sector in the stock market in 2021 and has been, not only the top performer in 2022, but basically one of the only positive performers in what has been a very negative year S&P's back to down about 20% NASDAQ down 30, or even more than 30%.

And yet you have energy, which is really performed quite well. So, it is one of those areas where it's worth continuing to revisit, like, okay, that's great. There's been this nice run it's been about, 20 months. Let's say year to date's been good. Almost two years have been good, but is the opportunity extracted now has energy had its run. Now we need to kind of rotate into something different and I wanna make the argument. That's not the case at all. So, first a couple anecdotal comments, and then I'm into no pun intended. how we view energy investment energy is, largely associated with fossil fuels. one of the big reasons for that is cause fossil fuels are what provide, the lion share of the energy, the powers of the world. but specifically even within the fossil fuel conversation, we look at oil prices as heavily correlated to the energy sector.

And I think it is very interesting to note that oil prices reached about \$125 a barrel back in March post the initial rush Ukraine invasion. They came way down and then, came back up to not quite 125, but 122, 123, in the summer. And then it began a steady decline. And as we're talking here today, there's somewhere around \$85 in WTI crude oil. And yet the first time that oil had its big surge up and, but then came down earlier in the year, the energy sector did have a bit of a correction stocks. Upstream, midstream came down with it, then oil rebounded, a lot of the energy sector rebounded. And yet now as oil has come back down again to kind of low levels of the year energy sector has not. And I think that behooves us to question why, and I want to give you an answer, I guess I'm willing out of humility to call it a theory, but I, I don't, I think it's beyond just a plausible theory.

I think it is the actual case. You have had a significant amount of barrels of oil extracted from the United States, strategic petroleum reserves. This has been a governmental policy that has brought down our reserves from about oh 700 million to 450 million barrels. The

lowest levels we've seen since the early 1980s. And you're talking about around 40% extraction from our total emergency reserves, that's allowed a significant amount of new supply to come on at a time in which demand has been high. And other supply has been inadequate to meet that demand based on less output globally, less output from OPEC plus less output from Russia, less people buying from Russia in this sanctioned moment around the Ukraine invasion. And then also the United States is still even with the demand resurgence post lockdowns and post reopening. we're still producing a million barrels a day less than we were pre COVID.

And we were producing two or 3 million barrels per day, per day, less than we were. And so you have demand that is either equal or higher supply that is not even equal, but in fact, lower. And the SPR extraction has been intended to try to meet some of that. So, then based on that dynamic, which has enabled prices to kind of come lower, why would the energy sector, this last time around not be reacting to potentially lower profit margins, a different pricing equilibrium. The United States government is not only extracted from strategic petroleum reserves. They have also committed to refilling those reserves and they have not provided the exact timing and pricing details, but the market is well bid because the market knows the, whether it's in three months or three years, or most likely somewhere in between these producers are going to be getting the order to refill those reserves at favorable price levels, to where things are.

So, you effectively have some knowledge in the market that is not with full clarity of detail, but with the awareness that there is going to be a resurgence of that production to get inventory levels back to where they were pre this extraction. In the meantime, we don't even know when the extraction from strategic reserves is gonna end. we do not see any waning demand and we continue to see supply challenges in various other elements around the world. OPEC plus is not looking to flood the world. They're loving the higher, margins. there continues to be all sorts of geopolitical entanglements around Russia, what they're able to get online and what who's going to buy from them, what currency they're going to pay China and Russia, maybe cutting their own side deals. the Iran oil is offline. There's, been concern of Iran coming back online.

And I say concern, not cause we don't want more oil supply, but because a lot of us don't want a rogue nation state actor, that is rooted in terror and hatred to the United States and Western democratic values to be, economic force. And that's certainly what oil enables the Iranian, jihadist regime to do. So, there's plenty of reasons geo politically to not want Iranian oil back online, but right now it isn't. So, not only do I think that's a good geopolitical thing, but it puts another bid into oil prices. Okay. So, all of this discussion around crude oil has first the isolated dynamic of what it means to us producers we're under producing relative to demand and there's more demand coming when the government has to reload its significantly hollowed out emergency reserves, but then you say, okay, what could go wrong here?

Well look, \$85 oil is an incredibly profitable spot. Could oil come even lower? I, I think it could under one particular scenario that I don't see as one of the more likely scenarios, but what gets you to 60 or \$65 oil in the near term would be, a significant global recession that obviously erodes demand at a, a massive scale. So, if you had that kind of demand erosion combined with the maintenance of current level of supply, then that could very well put downward pricing pressure. But of course you would very likely see further decreases in

diminishment of production if you had that kind of demand erosion. So, I'm not I'm most certainly not sure we're gonna have a severe global depression and I'm most certainly not sure that if we did, we would have enough production, demand, erosion and production maintenance to allow prices to come that far down.

I think more than likely you'd see, correlated production cuts that might maintain pricing power, but I don't want my thesis for energy investment to depend on a projection of oil prices. The only thing that I see professional investors do worse than predict bond yields is predict oil prices, most commodity prices for that matter. But when it comes to crude oil prices, our thesis about owning some large integrated production companies with a global footprint that are integral to where we go with renewables and integral with how we continue to provide the world with enough fossil fuel. my, my thesis for owning the midstream energy sector, which we're gonna talk more about in the MI in a moment, it cannot be correlated to a, specific thesis on oil prices, but there is an asymmetrical reality here. And this is what I'm trying to say.

The lowest probability event, I believe fundamentally is massive global demand erosion with equal level of supply that allows oil prices to come down into the sixties. I think that's the least likely event and still not that bad. It brings oil stocks down, but they're not losing money. They're not missing out bond payments. They're not over levered. They're not cutting dividends. It's just kind of what that, that worst case scenario could be right now in this profit environment. But are there potential \$130 oil prices? Goldman Sachs came out this week with a target price of oil at one 30 I've joked before that, that Goldman's, you know, track record has been almost can contain indicator. They haven't nailed Royal prices have gone neither as has anyone else. But my point is what would economically be at the root of their belief that you're gonna see \$130 oil?

Well, could the Russia bottleneck get worse? Could they cut off even further, could OPEC plus flex their muscle even more could, knowing that there is downward pressure on incentive for us production, politically environmentally, social cultural factors that, for OPEC plus to say, we're gonna benefit from \$130 oil more than the us is ergo. This is a way for them to establish middle Eastern supremacy over Permian basin supremacy. I do not believe it will happen. I believe it could happen. And, and so there is a scenario of upside extreme that is really enhancing of oil production. Now, by the way, at 130, you will get demand erosion. Okay. You cannot have people buying the same level of oil at that price that you can at lower. So, I see a very low scenario at the \$60 range for the reasons we talked about.

The higher range creates incredible margins, but eventually leads to demand erosion, but it's on the table as a possibility around some of these geopolitical and macroeconomic circumstances. But then what's the kind of mid-level baseline expectation that is sort of in the middle of those two scenarios. It is where there is still supply challenges and still elevated demand even at moderate normal demand. But because of the factors around Russia, OPEC plus, and you us production that you maintain something in the range between 80 and a hundred, and that is not demand erosive. People are not going to buy less oil at 90. Now they will at one 30, but I don't think 90 produces a substantive demand erosion, and it produces a significant margin, a profit margin. Ergo, you have a most likely scenario that is quite good for oil. You have a upside possibility of the tail that is huge.

And then you have a downside tail that is not that bad. There is therefore an asymmetrical risk reward that I think needs to be understood now that the downside tale can affect sentiment. It could affect, expectations and, and certainly produce a volatility in the pricing, but it isn't a substantive fundamental issue that causes us to say, this is a reason to be, significantly scaling back exposure. Now let's take away this entire dialogue about crude oil for a moment. I hope at the most simple of levels possible, I've at least walked you through the scenarios we see and why we maintain a bullishness in the present macroeconomic in the present geopolitical reality for the supply demand fundamentals of oil exposure. However, I think you have to look at natural gas to really understand the us energy investment opportunity. I mentioned that we are a million barrels a day under producing for crude oil relative to pre COVID natural gases.

Now back to pre-COVID highs yet instead of at a one 50 or \$2 or \$3 it's at seven 50 or \$8, eight 50 BTU. So, you have massive margins with massive volumes in natural gas production. Well, could that come down? Of course, it could, but the supply fundamentals remain under supplied relative to demand and demand is now not merely US-centric, but global. We are exporting more than we ever have. Now from 2016, 2022, our exports of natural gas are up 500%. We're five times the exporter of Naty gas that we were that's massive. And yet we're barely exporting any barely it's our all-time high and it's 500% what it was, but it is in early endings relative to what it could be. Our, pipeline exports used to be almost all of our exports. Now liquified natural gas represents about half of the exports of Naty gas.

That means we can ship it to Asiaified, natural gas can be shipped to Europe. We need more terminals to export and they need more terminals to import. So, the infrastructure's not in place to fully meet that demand and totally disintermediate Russia, but at other authoritarian regimes. But the fact of the matter is that we theoretically have huge upside in what we need on both supply and demand side of natural gas makes an incredibly attractive place to invest. And then you look within our own economy. P the number one factor people say puts downward pressure on the opportunity for us oil and gas assets is the ESG movement, the environmental movement, the move to convert, to renewables, to get to net zero emissions by 2050, all of these things. Here's what I'm saying, whether you put the birth of ESG is seven years ago, 10 years ago, 15 years ago, the percentage of world power and us power coming from fossils, not come down, not anything it's where it has come down.

It's negligible, carbon emissions have come quite a bit down. Natural gas is a far cleaner emitter of carbon men. Coal was around 50% of electricity generation, 15 years ago. It's now 20% natural gas was around 15% of electricity power. It's now 40%. So, Naty gas has become more important to electricity production in a world, desperately needing electricity. We have more opportunity for export more countries that need to import from us versus either middle Eastern or Russian opportunities or options. And we're doing so at more volumes being produced and more, margins, as pricing has stayed very, very heavy. You combine all of that along with an investment along with, by the way, a realization that natural gas is not merely what is heating homes, which lastly checked is very important and not merely a power source for electricity generation. Also completely integral to, fertilizer, livestock, cosmetics, plastics, the petrochemical space that natural gas and natural gas liquids is so involved in all elements of society that you have a really well bid demand characteristic, and now ample supply and very little appetite to hurt supply and producers all

doing so with a free cashflow generation context.

Previously, when we had a big increase in our capacity for production for post fracking, there was negative cashflow dynamics with so much cap capital expenditures required. You're now in robust, positive, free cashflow generation. All of these things I'm sharing by the way, have charts at dividendcafe.com today that I've provided for you to just visually see what I'm talking about. So, you have ample opportunity for free cashflow generation that is both happening in the quarters behind in the current quarters quarters ahead with volumes, with margins, with global dynamics, all speaking to a continuation of this thesis. So, then this brings me down to the midstream element where whether we're talking about crude or natural gas, whether we're talking about transporting the needs for oil and gas within our own country, or prepping from the well to the storage, to distribution, to a terminal, to export the infrastructure needs that the midstream energy sector monetizes in our country are massive.

Our thesis is that there is incredible opportunity for patient energy investors for the years to come while we've had massive outperformance over the last 20 months, there are net outflows in the space. There's just simply not the sentiment that speaks to, excessive bullishness and, and, getting frothy in terms valuations. The, the space is not as ignored and left for dead as it was 20 months ago, but we still see great opportunity. We wanna be selective along the way. We wanna maintain a balanced allocation, but there is great free cash flow generation, a natural gas story, underpinning it, a global realization that there is nowhere near the ability to disintermediate fossil fuels from world energy needs, position, a strength for some of the great energy companies to be investing in renewables for a continued diversification of energy sources myself as a fossil fuel investor have never bought into the idea that I'm anti renewable.

I've merely said the most realistic statement, a grown up can say, which is that renewables are not ready to replace fossil, but I love the idea of renewables coming up alongside fossil for an all of the above energy policy, both not only on the policy landscape, but also for investors as well, where there could be profitable cashflow generative, all of the above energy investing that leaves you to the final argument against my thesis, which is well, yeah, that was all well and good until capital has been starved off from oil, gas and so forth. You're talking about the need to get more terminals, to get more pipelines, to get more production. And unfortunately now from ESG and Pension funds and, and other social or cultural dynamics, there's no capital available for the growth necessary for what is a CapEx heavy, a CapEx intensive sector like us energy.

And this is where I have to then come back to the glorious reality of us capital markets, where yes, a significant pressure has gone against public companies and large commercial banks and investment banks, capitalizing the debt and equity needs of the us fossil fuel industry. However, 1.1 trillion has come into the, oil and gas sector via the private equity industry over the last 10 years. So, once again, a incredible American innovation us energy production and independence is facilitated by another incredible American innovation, private equity that represents a financial or capital markets innovation that is in this case, able to, basically move the cheese, as, as to how the sector is capitalized and, and invested in which leads to greater productivity and greater growth. So, I don't think this is gonna be a straight line for years to come. I don't think it's gonna be easy, but I believe in this story and I hope this is somehow around oil fundamentals, natural gas, the capitalization of how all

this is, is going to be fed.

I hope you see the basic species we have around being a us energy investor. Energy is not destroyed. Now that's a scientific statement. That's a grade school level fact that energy is only transformed, never destroyed, but I believe the same is true of our financial energy investing dynamic as well that we can transform some of the different opportunities, the vehicles, some of the companies and there's evolution in the capital markets element, but you can't destroy it. You only transform it. We wanna be there for that transformation. I hope you've appreciated the lesson here today in today's Dividend Cafe, please reach out with questions, questions at thebonnongroup.com. Thank you for listening to thank you for watching and thank you for reading Dividend Cafe. There are a lot of charts at dividendcafe.com. I'd love for you to go to and check out and thank you for reviewing us, rating us, subscribing to us and sharing us and have a wonderful weekend go USC.