FRIDAY, FEBRUARY 17, 2023

Well, hello and welcome to the Dividend Cafe. I am excited for a Friday discussion on energy and we have covered a number of topics this year that I think are prominent economic considerations in the current state of markets. We, we've looked at the recession scenarios, we've obviously talked about the inflation deflation debate. There's plenty of Fed and interest rate stuff out there. In the last week was a broader discussion of where dividend growth investing fits into the kind of current paradigm as well as the ongoing paradigm that we expect and believe in macroeconomically. And yet in the weeds of this, in the both short term and longer term scenarios, we have an ongoing interest in the subject of energy.

First of all, we care about the concept of US energy independence. We recognize that energy has profound impacts to other aspects of the market, both in the sense that higher energy cost represent a higher input to much of the entire economy, both for producers and consumers. We recognize that lower energy costs could be reflective of weakening demand conditions. There are of course supply issues with energy that may be relevant to geopolitics. So energy touches a lot of things and a lot of things touch energy. And then from an investor standpoint, we care because of our own exposures that we both have and want to have that are both real and that are theoretical or hypothetical for the future.

So when we talk about the current state of energy, let me give you a little context. Everyone I believe is aware that it was the highest performing sector in the market last year. And by

highest performing, I mean everything else was down and energy was up and it was up a ton about maybe seven years worth of returns in one year. Then in 2021 energy was the highest performing sector, but that was in a year where almost everything else was up to, but energy was just up more. So we're a whopping six weeks into 2023. And I'm not sounding any alarm bells on what's happening in the energy sector. Oil prices are about flat on the year. They've hovered a little bit above and a little bit below the flat line ever since the year started. And the energy sector from an equity standpoint is basically up about 1% on the year. And so it's it that's up nicely in a six week period. But there's other things up more as we've had a kind of risk on environment. So it's been pretty benign and yet I'm bringing up the subject to talk about where we're going from here because I think you have some people that could be considered really wildly bullish on the energy sector and others that would be quite bearish. And we have a view that I want to unpack more intelligently.

So first and foremost, let me just explain something about oil prices last year. I think most of you know that, the Biden administration announced in March of last year that they were going to release 180 million barrels from the strategic petroleum reserve. And this was being done as a protective measure because of the impact on oil markets from Russia's invasion of Ukraine. And you can reasonably argue that by the end of the year it had served its purpose if the purpose was political, but it also served purpose if it was to hold prices either lower or leased in check and oil prices very likely would've been

a lot higher. Have they not done that? Now initially there was a good 90 days, 75 days of a million barrels of oil per day being released from the spr and oil prices re-hit their high in July of what they had seen back in March about $120 a barrel. So I think that it was a bit nuanced at first, but what the five points that I kind of make about strategic petroleum reserve is that it did bring oils, oil prices down last year. It was probably politically beneficial. OPEC's production in the second half of the year helped contain oil prices too. Now, they did not cut excuse me, they did not increase production near the level the Biden administration wanted them to, but from where their cuts had been previously they picked up and that was impactful to global supply. Number four, let's not forget that China was essentially locked down all of last year. And so there was substantial impact to global demand that was also holding prices in check. And then number five, that all government interventions, there's a diminishing return over time. So the impact of this release of supply from Strategic Petroleum Reserve did what it did in '22, but it just from a diminishing return of the law, marginal utility cannot have the same catalytic effect going forward. And in fact, they're actually looking now to start the replenishment of the reserves not to continue releasing from them.

Now, there is a sense in which any form of price controls, and in this case I'm referring to two things, the sort of implicit attempt at controlling price through manipulating supply by releasing from emergency reserves. So it's a kind of less direct, but nevertheless, obviously intended price control mechanism

and also just a literal price controls. In terms of the caps with Russia, there's a couple of interventions that I think we historically understand work until they don't. If you're talking about holding prices in check price controls by definition control price for a time, and then even the price control itself, at some point the distortion unleash unwinds the very benefit you're trying to get because you create a shortage and therefore with the diminished production as a result of the price control, especially if you're controlling the price, it's something less than market clearing level. Then you disincentivize production, you end up with a shortage, which you're not talking about just freezing prices, but you actually end up reversing, the analogy I use is teeter-totter. It doesn't stay there in the middle. You're either pushing something higher or the other side, and that's really the way price controls work. They force prices down for a bit, but then of course set a normalization. You have diminished capacity diminished inventories and you see prices go much higher. Even more than that though the strategic petroleum reserves themselves not only losing their impact of putting downward pressure on prices and that diminishing return you get and then the fact that perhaps it is being used to incentivize further under production, which at some point the chickens come home to roost, but you also have to replenish. And so markets are well aware the administration's already had to cancel some of their planned purchases. But there's a chart I want to put up right now showing you the stock of crude oil in the strategic petroleum reserve. And when you look at that diminishment of our access to emergency reserves back down to basically 40 year ago levels the markets are well

aware that has to be replenished and the administration is very confident they can replenish it without an issue. But I don't know, and I don't know anyone else who knows how they can do so. There's also another fact that as you see that chart and how many reserves have been depleted, they have enough cash on hand in the fund to buy back 84 million barrels of oil but that's 140 million less than it was when they began these purchases. And so there is a significant challenge that I think creates some form of upward pressure and prices going forward. The admittedly though the timing being quite uncertain there.

Anecdotally, I want to mention that the US dollar has historically been inverted with oil prices and the, there's a pretty logical reason oil on the global market is denominated as it transacts in dollars. So therefore a stronger dollar is generally going to mean a weaker oil price and a weaker dollar is a stronger oil price. That's tonologically true, all other things being equal and generally all other things are not totally equal, but they're kind of close. And so that inverse inverse relationship holds, but it hasn't held at all for a while. And the simple reason is that all other things are not equal at all. There's a variety of issues around the Chinese Yuan issues happening with the US dollar in a Fed tightening period, a substantial Fed tightening period we've obviously had over the last nine months. So between other currency complexities stuff in the economic cycle that correlation is not there. Do I believe that in theory we'll see a point in time at which a weaker dollar could be pushing oil prices higher? I do, but I would not place

our worldview on where oil prices go on, where we see the dollar going right now just simply because of the various non correlative circumstances that exist between the dollar and oil. But it's at least on the table that some reversion of the mean in that relationship were to come back.

Now, what else is worthy of our discussion when we think about oil prices right now? I want to talk about something that is an old principle. It's a new principle, it's an unchanging principle. It's all the above is geopolitics and there's an asymmetrical reality when you think about oil prices with geopolitics. Now, it doesn't have to be pretty symmetrical if you said world peace is breaking out everywhere, China and the US are hugging it out, Russia is not getting favors from China. All of those things could symmetrically produce downside forces on oil. And yet because the geopolitics are probably not looking at circumstances like that, but more either bad things happening or just sort of status quo, not an actual threat of world peace breaking out. Therefore it becomes very asymmetrical for the very reason that the geopolitics is mostly asymmetrical. We have some bizarre things happening in the relationship between China and Russia. We see China getting cozier with Saudi Arabia. We see Russia getting much cozier with Iran. You have Iran talking about its ability to go online now with nuclear weapon production and you have Israel saying they're not going to let it happen. I could go on and on and I'm tempted to do so. I may do a special podcast unpacking a deeper level of some of these foreign policy considerations. But for our purposes today, the very simple

point I want to make is that none of them represent an obvious downward pressure. Oil prices and all of them represent a potential and asymmetrical upward pressure on prices. Again, it could very well hang in there because everything just sort of behaves. But most of these things that are a little bit when you look at China's sort of tacit approval of Russia and we're a number of these different dynamics with Iran, Russia, China, I think Saudi Arabia fits in there as well. I don't think people have to be very imaginative to see those things putting upward pressure on oil prices and that risk of geopolitics taking oil from 80 to 110 seems much higher likelihood even if it doesn't happen then some circumstance in geopolitics bringing oil to 50. Now let's take the geopolitics out and look at other things that could push the supply and demand of oil. One of the things could be of course, the US coming to the rescue to produce more and then therefore create a better price dynamic where there's still profitability for the US oil industry between 50 and let's say 60, $65. And yet it's not coming from a total collapse of demand and yet it gets the lower input price is beneficial to both producers and consumers than let's say 80 or 90 or a hundred or what have you. The only thing I would say is that there is a significant political reason that's not very likely to happen. There's a significant cultural reason that that's not like it happen. And even if I wanted to take the so-called ESG anti fossil forces out if I wanted to take the president administration's hostility and even threats saying we won't need fossil in 10 years and that kind of stuff out, what you do have is still an oil industry that has learned, I believe from lessons of the past where they were over levered to a global

cyclicality that was not sustainable and that lack of capital discipline bit them and bit them hard. I don't think these things are mutually exclusive from some of those political and cultural forces we're talking about. You not only want to behave as a good steward of financial resources when you learn from the lessons of more recent history but also you hear the threats that in 10 years, 20 years, there are political and cultural forces calling for your extinction. And that has to be priced into some of your decision making and consideration.

So I don't see the US oil industry all of a sudden abandoning its newfound fondness for capital discipline and I don't see production getting up to the levels that would bring supply and demand in line just here from the US. The other side, and this is probably the most popular bearish view as to how oil prices could drop quite a bit and hurt the upstream energy sector significantly is a full-blown recession and not just a recession, but a rather severe one. And the thing I would say about that is that I've already said it over and over nobody knows that a recession's coming certainly a recession of a severity would erode demand that would impair volumes. It would impair margins around the oil prices and yet the supply curve if it were moving left, it wouldn't matter much if the demand curve was moving down, but without people knowing that that will happen and that having to happen potentially up against these geopolitical uncertainties I've talked about. And then finally, the ultimate hedge to the demand erosion thesis, it ends even if there is a recession, it ends. And on the other side of it, there's a normalization. And that's not necessarily something I'd bet

against or around in terms of that timing. And so you have a number of reasons to not allow that to drive a decision if anything, to maybe maintain some sort of agnostic humility in how you're viewing the sector based on the potential ramifications of a recession okay.

Now I'm putting another chart up on the screen now that I think is quite useful on this discussion about demand side because I think two can play at this game. Is there the potential of a big diminishment of demand if we were to have recession? Of course. But I would just simply point out that as you see on your screen at this chart, demand the daily consumption globally of oil has not even come close to coming back to trendline levels. That we are significantly below trendline levels out of the Covid moment. We recovered a lot, but there is still a big gap. So sure, let's think about demand erosion. Let's think about recession. Let's think about what demand destruction does to oil. But let's also think about the possibility of pent up demand of catch up demand of demand surge because that isn't necessarily something I'd bet on either, but it's not off the table just as the inverse is not. So let's go back to just this discussion of the industry itself. A couple data points I want to share and I'll have us, let's put up the chart of the week now that I think is pertinent to this portion of our discussion. You see the rig count, it's called the Baker Hughes rig count, the normal rigs that are online and that are responsible for extracting oil right now. And I just want you to note there were 244 rigs in operation in our country at the Covid low August of 2020, and we're up to 759 now. So we've gotten quite a bit more online.

And yet you can see from the chart that there were almost 2000 in the insanity of 2015, and there was still about 1100 online when oil prices were about 55 to $60 a year or so before Covid. So there is a kind of sweet spot here in the middle where we're well off at the ridiculously low levels when the world was shut down, but we're nowhere near back to where we were in 2018, let alone 2015. I think that speaks to energy executive rehabilitation and discipline and doesn't speak to us getting back in over our skis.

So allow me to conclude with four takeaways that summarize our view on the energy sector right now. I'll anecdotally just share that I suspect China is going to add 1 million barrels per day to global demand. Could be a little less than that and I think that's about half of the total increase. I think you're going to see somewhere between 1.8 and 2 million barrels per day, more in terms of daily need. And these numbers come straight from the International Energy Agency, the IEA themselves. So that number could be up or down a little bit, but that is in the calculus. And then I'd point out that Russia is saying they're going to cut production by 500,000 barrels per day. They haven't coordinated that number with the cartel. The OPEC plus China and India are both buying Russian oil at cheaper prices, but then turning around selling it into world markets. Russia has certainly, it wouldn't be of no surprise to any of us if Russia were to use oil, if they were to weaponize the oil price in terms of their efforts in the marketplace and as part of their strategy and this Ukraine effort and something against NATO, something against the Europe, something against the west.

And so those things linger. How do I want to interpret all of the things we've talked about today with the supply side, with where we think the US energy production industry stands, where these geopolitical realities are? What are our takeaways?

Number one, rebalance your upstream exposure if you were overweight the last two years as we were and as we recently have in that rebalancing just to reset weightings to the right target level de-risking some of those exposures from the great moves higher of both 2021 and 2022. So again, there's a risk mitigation that we're recommending as energy bowls just to de-risk on the upstream side, your producers, explorers, drillers, et cetera.

Number two, maintain upstream exposure, recognizing that there is A) an offensive upside, potential based on variety of supply demand, profit making, traditional possibilities, but B), a defensive hedge potential based on the potential of geopolitical disruptions and even economic challenges. If you were to see higher energy prices have a kind of negative effect through input prices and a negative effect on the consumer that you hedge against some of that economic damage that could be done by being exposed to the higher energy prices themselves. So you have both an offensive and defensive benefit to maintaining upstream energy exposure.

Number three, view energy as less correlated to the broad S&P for a variety of reasons. And then recognize that low

correlation from energy S&P could end up being a good thing or it could be a bad thing. It was obviously a great thing last year and the S&P did terrible and energy did very well, but in theory that low correlation could mean energy as a muted year and the S&P moves much higher. I don't expect that, but I'm just saying view it as non-correlated. View it as a direct hedge on, and the S&P don't view it as a, or excuse me, a hedge or a levered play. It's under the above.

And then number four, maintain midstream exposure. Be overweight in midstream the pipelines, the storage, the transportation side of both oil and gas, where the rising dividend stream focus on volumes, greater volumes of oil and gas going through the pipelines impacts your revenue model. You have less leverage to the underlying commodity prices, yet you're still in an adjacent strategy to oil and gas to upstream production but you maintain a very attractive risk reward trade off. Some bad things can happen to midstream, some good things can happen to upstream that midstream doesn't participate in fully. This isn't a secret sauce per se, it's just a way to be adjacent, have an overweight, and yet a very different risk reward characteristic. So yes, midstream, once again.

That's the extent of what I wanted to say about the energy sector. I hope those four takeaways are practical, actionable, and understandable. But the broader thesis here continues to focus on supply demand fundamentals where most things like this should be with a real I think, cognizant reality of the

geopolitical implications and why we just refuse to say it's a foregone conclusion. We're going back to $40 oil. The geopolitics suggest against it, the supply suggests against it the behavior of these companies. By the way, the behavior of OPEC+, which I didn't dwell on much today, all speak to the unlikelihood of that bottom falling out. The one component that could see the bottom fallout on oil prices is just a severe global recession. But for reasons I've pointed out, I either see that as unlikely or as uninvestible when one thinks about the energy sector for the other reasons we've discussed.

Thanks for listening to the Dividend Cafe. Thanks for watching the video. Hope the charts are helpful, and I look forward to coming back to you next week with another Dividend Cafe. We will not have a DC Today for you on Monday based on the President's Day holiday. The market's being closed, stock market, bond market banks all closed. But reach out with questions and Please do your part to subscribe, share this video and all those fun things. Thanks for listening to watching and reading the Dividend Cafe.

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