THURSDAY, APRIL 6, 2023

Hello and welcome to the Dividend Cafe. A little different that we're putting it out on Thursday night, but it's actually quite rare in our business that we have a Friday holiday and yet that is what this week is and on a Good Friday as we go into the Easter weekend. And so hopefully you'll have time over this weekend to take this in. I kind of have a lot to go through and so I'm just going to get into it. It was a lot of work that went into this week's Dividend Cafe because I think it's a very important topic and it kind of covers a number of different subjects that I believe are all correlated and connected and they can seem to be separated, but they have a certain overlap that I think is important in the way we think about this subject from an investing standpoint as well as geopolitically.

And the issue is at a high level, the energy story and particularly oil, oil markets, oil dependency, oil prices where some of the politics and geopolitics of oil play in. But the subject became a sort of weekend escapade last Sunday, and it's funny, it was just two weeks ago, I'm writing a Dividend Cafe about big Sunday disruptions in financial markets as we had bank failures and FDIC bailouts and Credit Suisse takeovers with by UBS and all those things. And last Sunday I think was pretty big news but wasn't so much related to financial markets and certainly banking distress. But the announcement from OPEC+ that they were cutting a let's just round up and use well round down, actually use a million barrels per day from their production quotas and that would kick in on May one. And that they announced that as a target for the remainder of the year. So you're quite literally talking about a couple hundred million barrels coming out of intended supply in global production. And oil prices had been at about 74, 75 dollars and they shot up to 80, 81 dollars. And the fact of the matter is that oil was at 66 the week before. And in anticipation of some anticipation, excuse me, an anticipation of some announcement from OPEC+ had already shot up into the seventies but then got another kicker up into the eighties and it's still sitting right in between 80 and 81 now as I'm recording just before the market closes here on Thursday, get just in advance us going into this three day weekend. So really it kind of has stayed flat since Monday. It kicked up at the announcement, it has now stayed right there in that 80, 81 level.

But what I would suggest is that OPEC+ announcing this is setting a floor in oil prices that they believed would be coming from something else that is not coming from something else and therefore they are taking matters in their own hand. And I'm going to explain what that means in a moment. I don't know that 80 will prove to be a floor. I would not be surprised if we stay in the 80 and in the 80s throughout the rest of the year. I really would not be surprised. But yeah, I certainly think that 70, 75 as a floor is their intention. And like I said, I want to explain in a moment, but I need to build into it where they thought that floor would come from and why it will not come from that. And give you a little context as to what has happened and what it means for investors. Cause I think there's a lot of aspects to this that we really need to better understand.

The first thing you need to kind of comprehend when we think about world energy markets is that the world changed with the US fracking revolution, our ability to extract oil from shale and that the US has had ample opportunity to become that marginal producer that we by nature of our ability to produce 15 million barrels a day if we want to do in a second and choosing not to do so has sort of allowed OPEC+ to come back into this key marginal producer role. Now I pretty much will blame the Biden administration for most of this. There isn't any question that their energy policy has been to deny the opportunity for leverage to the US to deny the expansion of our oil production capacity to obstruct the approval of various permitting for projects. And despite some things that were a little surprising, the recent Alaska approval for the most part is taken both in rhetoric, I mean explicit word for word verbiage, but then also in actual action or in some cases inaction of decidedly anti-fossil and anti crude vantage point. And so I think I put nine different links to media appearances in Dividend Cafe. I think that I've criticized the Biden administration for their energy policies 50 times on television and in writing and whatnot since the new administration took office two years ago. But I will say that there's more to the story than just the downward pressure on production that is coming as a result of a policy decision. And there's more to it even than the sort of cultural moment of ESG of trying to constrain capital from getting to the energy sector, the idea of various pension funds threatening to withhold monies, congressional pressure to banks, to not bank the sector there.

We know all of these left right jabs and combinations of when coming at the oil industry that that's known, but I just believe it's appropriate and necessary to point out that there is also in combination with these policy political and cultural issues, the shale industry itself saying we're just not going to put ourselves in this position for the third time where prices become high as they were in 2014. And we lever up and put a ton of debt and issue a ton of dilutive equity in anticipation of growing demand and high margins from high prices only to see prices tank and various financial conditions really work against them. They did it both in 2014 and paid the price in 2015 and '16. But then from '16 through '18 as things we end to improve and things were looking great in '19, they did it again just in time for the Covid moment of '20. And I do think there's a sense of significant capital discipline that is evident from the shale industry. And I mean it as a positive. Some of it is just straightforward fiscal responsibility to keep debt ratios lower. And some of it is the headwinds caused by the aforementioned factors, political and cultural working against the shale industry.

But what I would like to propose to you is that the Saudis are looking at the same chart that I want to put up on the screen right now that we can be looking at. And that is the trend line of US production prior to Covid and throughout those kind of great years I was referring to and you see where production on a daily basis was headed out of all these different wells in regions in with shale, primarily Permian and Eagleford, and then the trend line now and that let's just say OPEC+ doesn't believe that the first trend line is coming back and that new trend line is the new law of the land. They don't believe we will produce more. And so what you see out of this both policy and shale industry discipline is the ability for the Saudis and the OPEC member nations to take it upon themselves to decide where the price level would be and yet to do so in the context right now. So now we're into a short term subject of vulnerability with demand. Not that there has been significant decrease in demand, but you listen, none of us can turn on the news for one day and not hear about recession talk, recession fears. There continues to be some form of concern of global demand pressures as at least we know that central banks all over the world are tightening not just here in the United States. And I do think it's worth pointing out that the anticipation of about a million barrels per day of new demand coming online with China's reopening has so far not resurfaced. Now I think the Q1 increased demand from China for crude was underwhelming. Underwhelming my expectations. But I will say that OPEC+ it was pricing in their own projections that they published 590,000 and they just upped it to 710,000. So that's still meaningfully below a million. But my point is that they're not looking at cratering demand in China. They're increasing expectations, but nevertheless, it's still been a bit underwhelming.

So what is the big key here if demand is so is not the decisions being made around demand by us and OPEC+ are not anticipating just skyrocketing demand pedal to the metal, let's go for this. But they're also clearly not anticipating a huge recession. They're playing it down the middle, they're playing it safe. It's kind of a moderate approach, which I think you could argue is prudent for both actors. What is the deciding difference? And it really appears to me that the US signified to world oil markets that there would be a floor in what's called 70 because the Strategic Petroleum Reserve would have to be filled. And that last year, the higher demand and lower supply, not to mention the complexity of the Russian invasion of Ukraine, really could have pushed oil prices up at a hundred and the US chose to act marginally meaning to be the deciding factor in moving prices lower, but to do so with something that could be nothing more than a temporary fix, not with greater production, but with the release of Strategic Petroleum Reserves, the tune of 180 million barrels. And that effectively when I say a afford now going forward because not the threat, the promise of refilling those reserves was on the table with specificity provided in the policy memos and so forth. And yet they, upon seeing those prices filled, no reserves have made no commitments, have talked very ambiguously and really led the Saudis to take matters in their own hands by saying, look, we can't count on the US to look after their own interest, let alone ours. We're not going to allow $50 oil to come back. Now they make money at 50 a barrel, but they don't make enough to fund all of the expansion to cover some of the debt they took on. Remember they were running fiscal deficits around 30% of GDP when oil prices had cratered. And so to really maintain the overall health that a lot of these OPEC nations whose almost sole asset is their ability to be an exporter of oil, they have a margin at which they want to protect. They gave up margin last year as the US released from Strategic Petroleum Reserve, which was again within US policymakers determination to be in their best interest. And yet then reciprocal was not seeing afford being put in by the US with their SPR fill up this year. And I think that that became sort of the catalyst to a broader transformation that had started well before this, but that I think this really does signify, and now we'll get to the heavier meat of it and I'll pull in some conclusions.

I think that the US and Saudi were BFFs best friends post World War II as the transactional friendships go between two big economic countries around oil and that the US had a strategic interest in Saudi being happy in the Middle East and Saudi had a strategic interest in the US being their big customer. And that friendship, so to speak, which was never western values driven, it was always transactional, one of economic mutual interest. But I have to say that I believe it was a thawing friendship that appears now to a fully transitioned to a new BFF for Saudi and that being China and even the Asian countries at large, I don't think Saudi believes that Asia has an ESG movement. I don't think Saudi believes that Asia has cultural obsession with electrification. I don't think Saudi believes that they're going to lose customers. And while they were for a decade quite miffed at losing market share to US shale in the US, I think they've just sort of thrown in the towel accepted that they've lost market share to shale and that they're going to make up that market share in Asia. And primarily with obviously the world's second biggest economic superpower, which is China. And this has not just limited itself to the ability to sell oil to China, which Saudi's always done that and they're doing more of it than ever, but investing billions of dollars into energy infrastructure in China building will be one of the world's largest refineries in China, pledging not only 3.6 billion of capital of equity capital into a joint venture for this refinery, but then pledging to export 500,000 barrels per day to this refinery once it is built. And so there's all sorts of different partnerships taking place between Saudi and China, which aligns to some degree Saudi and Russia.

And it really does put some of those other countries interest against the US. China, Saudi Russia, their three respective primary strategic mandates are not aligned with one another per se. They are just not disaligned. So they're able to enter marriages of convenience that the United States cannot have right now at those three countries for various different reasons. But what is China's reason here if we evaluate this economically to understand where it puts the US and what it means for macro and what it means for energy investing? I've long held, the biggest issue China has is the desire to have greater respectability on the stage when it comes to trade to be able to denominate their own currency more and more, which enables them to regain some lost leverage. Because right now, particularly the United States, we buy a lot more from them than they do from us. So that creates a trade deficit and that has to be dealt with, paid for it with dollars in what we call the current account deficit. And by us settling our current account deficit with our currency, which is the world's reserve currency, it gives us a lot of that leverage. And China doesn't like it and the US does like it. And it's not about whether it's fair or unfair, it's about the fact that it advantages the US and disadvantages China. And there's not much they can do about it other than seek greater respectability for their own currency. And there's no way US is going to sell to China denominated in Chinese Yuan. So they focus on a other Asian trading partners and other European trading partners. Europe is by and large not that interested in dealing with Chinese currency, and yet that is not true the Middle East and other countries that we're talking about here.

So the currency story becomes a significant arm here where Saudi's starting to play footies of China about, yeah, we'll let you buy dollars by oil, not in dollars rather with yuan. There's no contract that demands oil be paid for in petro dollars. There's a tradition, there's a kind of precedent and there's a benefit to oil being sort of free of veering foreign exchange activity. And yet there's no question as to why China would want to be able to do it. And if it's going to gain more of a customer for Saudi and further their interest of not being as dependent upon shale and being able to regain that leverage that they have forfeited to the shale industry and instead play ball with China directly, then I think that they're going to be willing to do that. And so as I've kind of set the table on all these things that have happened and the various moving parts, I want to leave you just six quick concluding thoughts and then we'll call today.

In the short term, I do expect the floor to oil will be 70, 75, and I think it's entirely possible we'll sit in the eighties, but the problem with the not the problem, but the likelihood of 80 is you could get back up near a hundred and I think from 80 to a hundred for the US energy investor that you make a fortune. I don't think that's the price level at which you see demand destruction where it forces a recession. I just think it's incredibly profitable and it allows these companies to fund their ongoing capital expenditures with cash flow. And so they don't even need to tap debt or equity markets. And that's sort of the essence of the ESG movement is to somehow try to starve the shale industry from capital. But you can't do that if they don't need capital. And that's what these higher oil prices really do is probably put ESG out of business. It's just that it isn't, that could sound like a good thing for a lot of people and certainly for those of us invest in the energy sector. But the problem is if you get to a hundred dollars oil, you could really easily be back at one 20 and at one 20 at that point, you really are looking at an inflationary environment. You're looking at certainly demand destruction and certainly disarray that would reach across most economies. And so it's not as simple as saying, well, they've moved a range from 60 to 75 up to 80 to 95. That very well could be the case, but 80 to 95 doesn't take a lot to have something push it up to 120 and then the game changes a bit. So that would be point number one just regarding price expectations.

Number two, one way or another in elements of this escapade and with different intentions to use it, China, Russia and Saudi

Arabia have gained leverage in their geopolitical objectives from OPEC+'s decision.

Number three, the US has lost leverage with lower fear of the shale industry, lower concern from OPEC with what US is doing in Shale and with our sort of self-determined decision to not utilize and press the leverage, but rather to play around the edges with silly things like the Strategic Petroleum Reserve. And I think that the shale industry is still going to be one of the great innovations in world history and obviously represents a significant amount of meeting the demand for US production. But global fear of the US competition from shale has proven to be a huge lost opportunity.

Number four, the China Yuan benefits that the specific currency accrual here, their ability to increase their own leverage and therefore utilize it by forcing other trading partners to work with their currency. Again, marginally benefits. China, does this mean the dollar's going away? It does not. Does this mean that dollars lost its reserve status? It's just silly. There's no way the entire world is willing to say, okay, we now want to go with the CCP for all of the kind of reserve, particularly global commodity trade that takes place, but marginally, which is where all economics is done on the margins. I think that this marginally delevers the dollar and its control and signifier of strength and global economics, and I think it benefits the Chinese Yuan.

Number five with that debt ceiling showdown coming up between the House GOP majority and the White House, I would expect now you're going to see some energy provisions in that bill, something with a little demand for permitting approvals or whatnot. There's a few things they could do. Some were substantive, some were symbolic. But I expect that this will end up being on Capitol Hill as a problem as well.

And then finally, the Fed, all roads end up going back to the Fed for one reason or the other. It seems much to my chagrin. And the question I that has been posed this week is, well, if you do get a hundred dollars oil, does that put enough upward pressure on headline inflation? Which it certainly would that the Fed uses that as cover to keep hiking rates. And I don't think anyone can say the answer is no. I would like to answer that the Fed would know that if core inflation is not going up, and in fact it's still going down, that when the lag effect of shelter is working its way through the metrics and you're seeing this disinflation that the anomaly of growing oil inflation should not be the deciding factor with monetary policy, but does it give them more cover than otherwise? I think it at least has to be considered as a different risk. So the impact of monetary policy, the impact of geopolitical, the leverage with Russia, Ukraine in that conflict, there's so many factors all going on here that really can be reduced to those exercising the gift of natural resources to their own strategic geopolitical advantage. And there's also equally profound story of countries that are choosing not to.

Thanks very much for listening to, thanks very much for watching, and thanks very much for reading the Dividend Cafe.

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Please do have a wonderful Easter weekend and please do share this Dividend Cafe far and wide, and we thank you and look forward to coming back to you next week.
