The Oil Market: Where Does It Stand and Is There Opportunity Today?

Talk about a major change in sentiment and price reversal. Not too long ago oil prices reflected the market's anticipation that Iranian sanctions would shrink global supply, while over the last few weeks, worries about lower demand arose at the same time production growth from Saudi Arabia, Russia and the U.S. propelled crude prices lower. It seems that the questions now are, how did we get here and what are the future prospects for the sector going forward? This paper will explore today's current state of affairs, as well as provide some insight into our team's opinion and where we believe opportunities exist in the current environment.

Let's begin with a bit of history. Back in 2007, prior to the financial crisis, U.S. crude oil production had come down by approximately 4 million barrels per day compared to 1985 production levels (1985 = 9 million bpd/2007 = 5 million bpd). Since then, production had essentially doubled to an all-time high of approximately 10.5 million barrels a day as of May 2018. Within this time period U.S. demand grew quickly but has not kept up with the increase in supply, resulting in a net import fall of 40%. Fast-forward from May to November and current headlines are declaring that the U.S. is now pumping more oil than Russia and Saudi Arabia at an 11.6 million barrels a day pace, which exceeds even the estimate quoted in May. Not surprisingly both Brent and WTI crude reacted quite severely to the continuous news of supply growth and a potential glut, falling from their peaks for the year of $86 and $76 to the current prices of $65 and $55, respectively (Chart 1 as of 11/13, white line = WTI, green line = Brent). Keep in mind that the U.S. dollar has strengthened and that recently markets broadly have experienced a risk-off scenario, which has culminated in a downward spiral for crude prices.

Lynx Investment Advisory

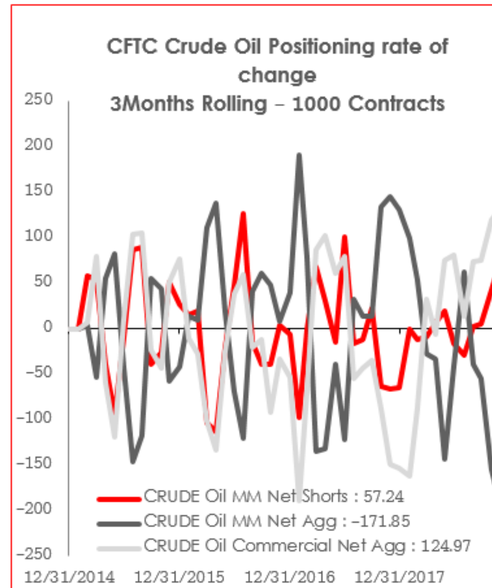
Chart 1

Another important part of the story is the situation in Canada. Canadian oil prices have plunged of late and are now selling for approximately $40 less than their U.S. counterparts. While Canadian oil typically sells at a discount relative to WTI, the current price spread can be attributed to the inability of the Canadian oil industry to build major pipes from Alberta to the U.S or the Pacific Ocean. In other words, Canada has a limited market within the U.S. and we are essentially their only customer right now. Undoubtedly, the recent decision by the Montana judge to block the construction of the XL Pipeline further exacerbated an already tenuous situation.

As for what we think of today's price levels, likely both Brent and WTI have been oversold. There are a few technical factors that point to this possibility, including data that suggests there has been a withdrawal of long investments from the futures market, while short positions have expanded (the speculative market). To clarify, a short position indicates that an investor has a negative view on oil prices, expecting them to remain low or fall further, while an abundance of shorts would indicate an overly pessimistic view on the market, which should reverse as prices accelerate and these investors are forced to buy back their borrowed shares at higher prices. Although commercial long futures demand remains strong as is depicted by the light gray line the below Chart 2, the collapse of optimistic speculative investors, the red and gray lines, is remarkable (many of today's short investments are held by hedge funds). Furthermore, historically throughout the months of October and November oil spot prices are in the midst of a drawdown as refiners take their products offline to perform annual maintenance, this typically corrects in December and is otherwise known as seasonality (Chart 3). Finally, despite President Trump's opinion addressing

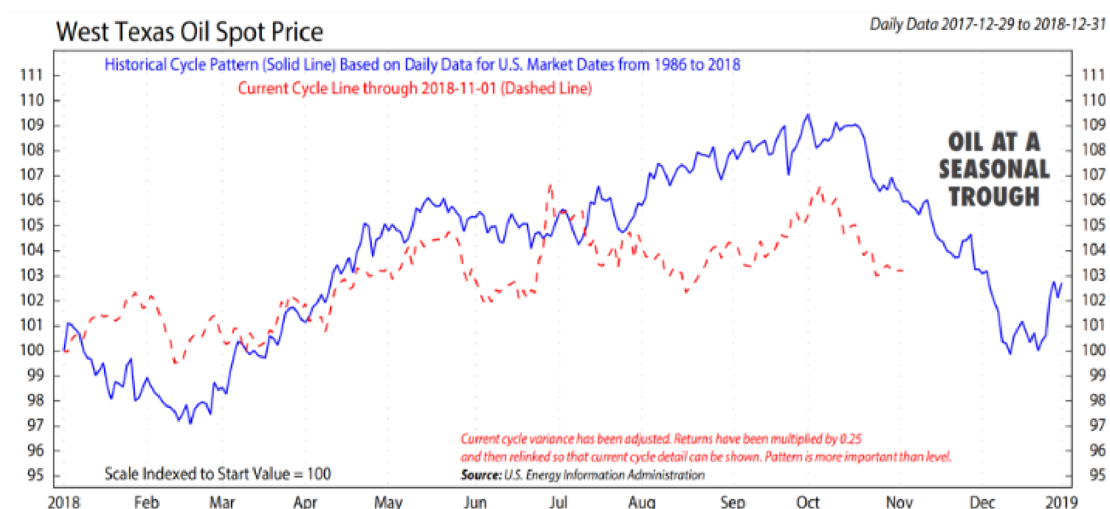
the OPEC and core members' potential decision to cut 1 million barrels per day of crude oil in December, we expect the Ministerial meeting to yield results in support of a reduced barrel count going forward.

Chart 2



Source: Bloomberg, Silk Invest

Chart 3



Bringing this together, our team expects crude oil prices to stabilize at a lower level than the market high in October. Given the amount of oil supply that currently exists, the potential for further extraction, the ongoing commitment to expand U.S. pipeline infrastructure and lastly consideration for the integration of electric vehicles, we have the opinion that prices will increase from their current levels but are likely to remain range bound between $60-$70 for some time to come.

As for how we suggest allocating to the energy sector today, there is a compelling case for investing in infrastructure in the form of Master Limited Partners (MLPs). While MLPs have incurred negative performance in sympathy with the crude oil drawdown, there is a clear need for continued pipeline growth in the U.S. Importantly, these securities typically provide attractive distribution rates, while they are currently yielding more than 8%. While a rising interest rate environment can be a headwind for MLPs as these instruments compete with other fixed income and fixed income-like securities, today their yields are more attractive than many fixed income options, which include utility and REIT stocks. It is also worth mentioning that these partnerships are currently running with lower leverage in the wake of the oil downturn that began in 2014, which should benefit them as rates rise. While Lynx typically follows an active investing approach, an ETF such as the Alerian MLP ETF (ticker AMLP) might be an effective and low cost passive alternative.

November 2018