

Top Reasons to Consider Oil-Related Equities

GOEHRING &
ROZENCWAJG

Natural Resource
Investors



TOP REASONS TO CONSIDER OIL-RELATED EQUITIES

While we invest across the spectrum of natural resource equities, in this report we are choosing to focus on oil-related stocks. Recessions tend to create opportunities for those of us that can withstand short-term volatility, and what happened to crude oil prices in 2020 has been one for the record books. Negative oil prices illustrated the extreme risk that can come along with investing in commodity futures (and ETFs comprised of futures) and highlighted the relative stability of oil-related equities.

However, even with the rebound in oil prices, a large portion of the energy industry's publicly traded companies continue to trade at valuations that suggest they are nearly worthless and lacking growth potential.

For contrarian investors looking multiple years out, the backdrop for equities in this neglected corner of the market is setting up to deliver potentially spectacular returns. This report will highlight potential drivers that should continue to propel oil-related markets higher and explore the rationale behind a dedicated portfolio allocation.

Consider these statistics:

- The energy sector's weighting in major equity indices has been falling for years. As of July 31, 2020, **the energy sector made up less than 3% of the S&P 500 Index and roughly 2% of the Russell 2000 Index.** To put that in perspective, in 1980 the energy sector peaked at 30% of the S&P 500 Index. Investors without a dedicated allocation to energy stocks will not materially participate in a continuation of the rally.
- Real assets such as oil have historically proven to perform well during periods of increasing inflation. We expect many companies throughout the oil-production spectrum, as well as their equity holders, to benefit from the side effects related to "QE Infinity." Real assets also have low correlations to major equity indices and tend to perform well when other asset classes are not.
- Relative to the S&P 500 Index, **commodities in general are cheaper today than they have been in 100 years.** Only in the depths of the Great Depression and at the end of the dying Bretton Woods Gold Exchange Standard did commodities reach this level of undervaluation relative to equities.

- We expect much higher crude oil prices given current industry fundamentals. The rig count in the U.S. alone has fallen approximately 75% in 2020. Future supply will be impacted by the huge retrenchment in drilling activity that has taken place.

How Much Energy Exposure Should Investors Have?

The short answer to this question is: more than index levels of 2-3%.

"WHILE MANY INVESTORS AND ADVISORS DIVIDE THEIR EQUITY EXPOSURE BY MARKET CAP, STYLE & GEOGRAPHIC REGION, FEWER SEEK DEDICATED ALLOCATIONS TO SPECIFIC SECTORS."

While many institutional investors and financial advisors divide their equity exposure by market cap, style and geographic region, fewer seek dedicated allocations to specific sectors. We believe the markets have changed so dramatically over the past five years that investors need to revisit this traditional approach to diversification. Observe how the energy sector's weighting in the S&P 500 Index and Russell 2000 Index has fallen dramatically since 2008:

FIGURE 1 S&P 500 Index Energy Sector Weighting 1/31/08-7/31/20



Source: Morningstar Direct

FIGURE 2 Russell 2000 Index Energy Sector Weighting 1/31/08-7/31/20



Source: Morningstar Direct

"THE MARKET CAPS OF MICROSOFT, APPLE OR AMAZON ARE EACH LARGER THAN THE ENTIRE ENERGY SECTOR'S WEIGHTING WITHIN THE S&P 500."

At current levels, even if the companies comprising the sector were to double in market cap, investors simply don't have enough "skin in the game" to make a material difference in performance. Further, most portfolios are likely over-allocated to the technology sector, whose growth is largely responsible for displacing other sectors, including energy, within domestic equity indices. **The market caps of Microsoft, Apple or Amazon are each larger than the entire energy sector's weighting within the S&P 500.** Increasing exposure or achieving a dedicated exposure to an unloved asset class like natural resources simply makes sense from a diversification standpoint.

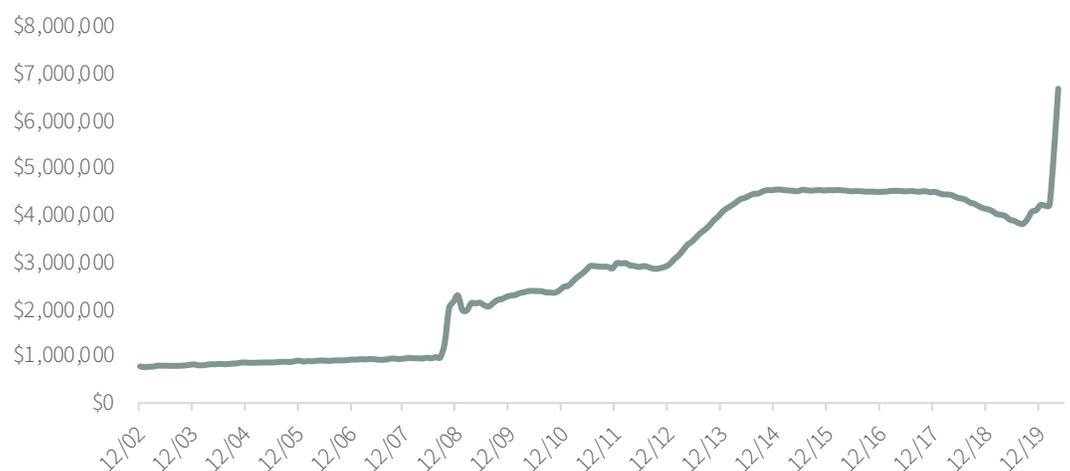
Inflation Hedge

It is a strange time to talk about inflation. Many raw material prices have fallen dramatically due to the impacts of the COVID-19 pandemic. Unemployment claims have broken records which is pressuring price levels. However, global governments have responded with trillions of dollars in liquidity and stimulus to help mitigate the virus' impacts. **As the impact of the virus continues to decrease, the monetary and fiscal measures put in place today will sow the seeds of next decade's inflation.**

As recently as 2008, the Federal Reserve's balance sheet stood at less than \$900 bn. Following the failure of Lehman Brothers it more than doubled to \$2.2 tr and five years later it had doubled again to \$4.4 tr. The balance sheet then proceeded to slowly fall before bottoming at \$3.8 tr last fall. In September of 2019, the Fed responded to tightness in the repo market and by February the balance was back up over \$4 tr. After the CARES Act was approved in late March of 2020, the Fed's balance sheet ballooned considerably and stands at over \$7 tr as of August 25, 2020.

"AS THE IMPACT OF THE VIRUS CONTINUES TO DECREASE, THE MONETARY AND FISCAL MEASURES PUT IN PLACE TODAY WILL SOW THE SEEDS OF NEXT DECADE'S INFLATION."

FIGURE 3 Total Federal Reserve Assets (*Less Eliminations from Consolidation*)



Source: U.S. Federal Reserve

An obvious side effect could be a shift from the deflationary psychology that has gripped markets over the past decade to a new period of inflation. Very few investors are positioned for such a move. Another effect could be a rerating of real asset prices, particularly commodities.

"IN RETROSPECT, WE BELIEVE A RERATING OF REAL ASSETS IN 2020-2021 WILL BE CAUSED BY THE UNPRECEDENTED ACTIONS TAKEN RECENTLY BY GLOBAL CENTRAL BANKS."

We have spent significant time analyzing catalysts that sparked bull markets in natural resources following three extreme lows in terms of valuations: 1929, 1969 and 1999. **We concluded that in each case, a bull market in real assets followed a major shift in global monetary policy.**

For example, in the late 1920s, it was the realization that Britain would have to abandon its attempt to go back on the pre-war gold standard (effectively ending a monetary system that had been in place since 1819). In 1969, it was the first steps in loosening the Bretton Woods exchange standard, ultimately culminating in the “Nixon Shock” two years later. In 1999, it was the move by several Asian economies to intervene in keeping their currencies depressed to spur growth following the Asian currency crisis of 1997. In retrospect, we believe a rerating of real assets in 2020-2021 will be caused by the unprecedented actions taken recently by global central banks.

How Oil Prices Compare to Other Asset Classes

If you’ve been a follower of our research then you’ve likely seen a version of the following graph. It is a visual representation of commodity prices (represented by the Goldman Sachs Commodity Index) relative to broad equity prices (represented by the S&P 500 Index). One can see that this basket of commodities became severely undervalued versus the broad equity index starting around 2014, which corresponds with the fall of oil prices that year.

FIGURE 4 Commodity Prices Relative to the S&P 500 Index

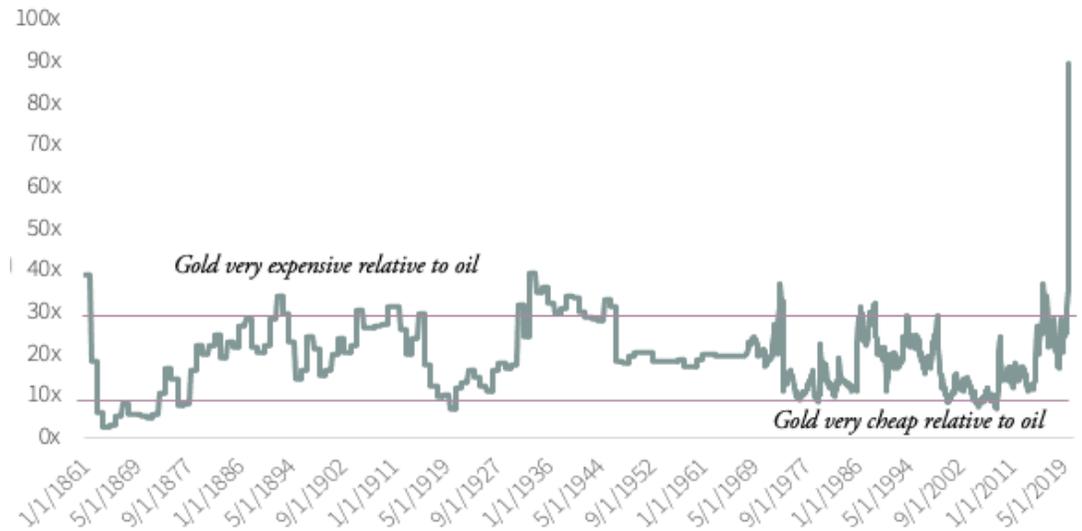


After the recent oil price collapse in 2020, commodity prices are now basically as radically undervalued as they were at their lows in 1969 (immediately preceding the best decade for commodity prices ever). Other major periods of commodity price undervaluation include 1929 and 1999 – again both good times to establish investments in resource sectors.

Another ratio that has proven to be a consistent gauge of oil prices being over/undervalued is the gold-oil ratio. Gold and oil have each experienced booms and busts, wars, financial panics, deflationary depressions, gold standards, gold exchange standards, fiat dollar standards, fixed exchange rates, floating exchange rates, oil market share wars, oil shortages, geopolitical tensions, periods of calm, and even prior pandemics. Despite such an incredibly wide variety of backdrops, the gold-oil ratio has spent 80% of the time between 10:1 and 30:1.

"GIVEN TODAY'S RATIO, WE BELIEVE AN EXTREMELY STRONG BUYING OPPORTUNITY IS PRESENTING ITSELF IN OIL AND OIL-RELATED STOCKS."

FIGURE 5 The Gold-Oil Ratio 1860-2020



Source: Bloomberg, BP Statistical Review, G&R Estimates

Between 1900 and today, one ounce of gold has purchased 20 barrels of crude oil on average, with a standard deviation of 8 (using monthly data). As we mentioned, 80% of all observations are between 10:1 (gold is cheap relative to oil) and 30:1 (oil is cheap relative to gold).

The gold-oil ratio has been a reliable indicator of when to invest in oil and when to invest in gold over the past 120 years. Since 1900, crude has averaged a 12-month gross return of 7% while gold has averaged a 12-month gross return of 5%. Oil has generated a negative 12-month return 39% of the time while gold has generated a negative return 32% of time.

However, looking only when the gold-oil ratio has exceeded 30:1 (i.e., oil is cheap relative to gold), **crude has returned 32% on average over the next twelve months (over four times its long-term average)**, while gold has returned 4% on average. Oil was lower only 13% of the time (70% less often). On average, oil outperformed gold by 28% during these periods compared with 2% normally.

We last used this analysis in early 2016 to justify our investments in oil-related securities. At that point, the gold-oil ratio hit a then-record 47:1. We argued that oil prices were set to surge and invested in oil-weighted E&P securities as a result. Over the next 30-months, oil rallied by 191% from \$26 per barrel to \$76 per barrel by October 2018. Oil stocks (as measured by the XLE ETF) advanced by 56%.

Given today's ratio, we believe an extremely strong buying opportunity is presenting itself in oil and oil-related stocks. Nearly every example of an extreme high reading in the gold-oil ratio is followed by a full reversal to an extreme low reading of 10:1. If that is correct, then oil prices are set to increase dramatically.

Oil Supply and Demand Fundamentals

We believe we are on the cusp of a global energy crisis. Like most crises, the fundamental causes for this crisis been brewing for several years but have lacked a catalyst to bring them to the attention of the public or to the average investor. The looming energy crisis is rooted in the

underlying depletion of the US shales along with the chronic disappointments in non-OPEC supply in the rest of the world. The catalyst is the coronavirus.

The oil market is currently enjoying a momentary period of calm. The initial phase of the crisis that took prices negative is behind us and the next phase which, should take prices much higher, has yet to commence. Our models tell us the current calm will be short lived. Global energy markets in general, and oil markets in particular, are slipping into a structural deficit as we speak. We believe energy will be the most important investment theme of the next several years and the biggest unintended consequence of the coronavirus.

Investors' focus has shifted to how quickly supply can be brought back to meet recovering demand. While most investors believe the lost production will be easily brought back online, our models tell us something vastly different. While OPEC+ production will likely rebound, non-OPEC+ supply will be extremely challenged. Instead of recovering, our models tell us that non-OPEC+ production is about to decline dramatically from today's already low levels.

"IN LESS THAN FOUR MONTHS, THE US OIL DIRECTED RIG COUNT FELL BY 75% TO 180 – THE LOWEST LEVEL ON RECORD."

Thus far, the slowdown in non-OPEC+ production has come entirely from proactively shutting in existing production. These wells were mostly old and only marginally economic before prices collapsed in 2020. Going forward, production will be impacted by a different and longer-lasting force. Low prices led producers to curtail nearly all new drilling activity. As recently as March 13th, there were 680 rigs drilling for oil in the United States. In less than four months, the US oil directed rig count fell by 75% to 180 – the lowest level on record. There is at least a two-month lag between drilling a well and first production, suggesting hardly any of the drilling slowdown impact has shown up in production data yet. That is about to change.

Shale wells enjoy strong initial production rates but suffer from sharp subsequent declines. Basin production falls quickly unless new wells are constantly drilled and completed to offset the base declines. Considering US shale production was already falling sequentially back in November when the rig count was above 700, today's 180 rigs all but guarantee production will collapse going forward. Nevertheless, the IEA predicts US production will grow by 500,000 b/d from the June lows to the end of the year, presumably driven by shut-in production being brought back online. Our models tell us this simply cannot happen. Instead of growing, US production will fall materially from here. As we go to print, the EIA just released its monthly report with data through May showing production fell by another 2 m b/d sequentially. This is the largest monthly production drop on record and nearly twice as much as originally expected by most analysts. Our models tell us more surprises like this are forthcoming.

Low prices have led to a sharp drilling slowdown in the rest of the world as well. Between February and June, the non-US rig count fell by 40% to 800 – also the lowest on record. We have often written about the depletion problem facing the non-OPEC+ world outside of the US shales. Over the last decade, this group has seen production decline slowly and steadily as a dearth of new large projects has not been enough to offset legacy field depletion. By laying down half their rigs, this group has also ensured that future production will be materially impacted.

Analysts continue to focus their attention on what has already happened (the shutting-in of existing production) instead of looking at what is yet to come. The unprecedented drilling slowdown over the last three months is only now starting to impact production. Going forward, supply will plummet leaving the market in an extreme deficit starting now.

Investors are complacent because inventory levels remain high and are expected to buffer any future imbalance. This is no different than the peak of the last cycle in July 2016— an especially important fact no energy analysts have commented on. In 2016, OECD inventories were 450 mm bbl above long-term seasonal averages and wisdom dictated it would take years (if ever) to work off the overhang. On July 31st 2016, with oil at \$40 per barrel, analysts expected prices to remain lower for longer. In fact, it only took 18 months to work off the overhang. By the summer of 2018, inventories were back to near long-term averages and prices had rallied to \$87 per barrel.

Despite the unprecedented disruptions caused by the coronavirus, June OECD inventories stood only 400 mm bbl above long-term average levels – less than the 2016 high point. Collapsing supply this cycle will draw inventories down much faster than in 2016-2018, a period that enjoyed robust shale growth. Instead of working off the inventory overhang in 18 months, our models suggest this could happen as soon as 2021.



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