DOUCET ASSET MANAGEMENT, LLC

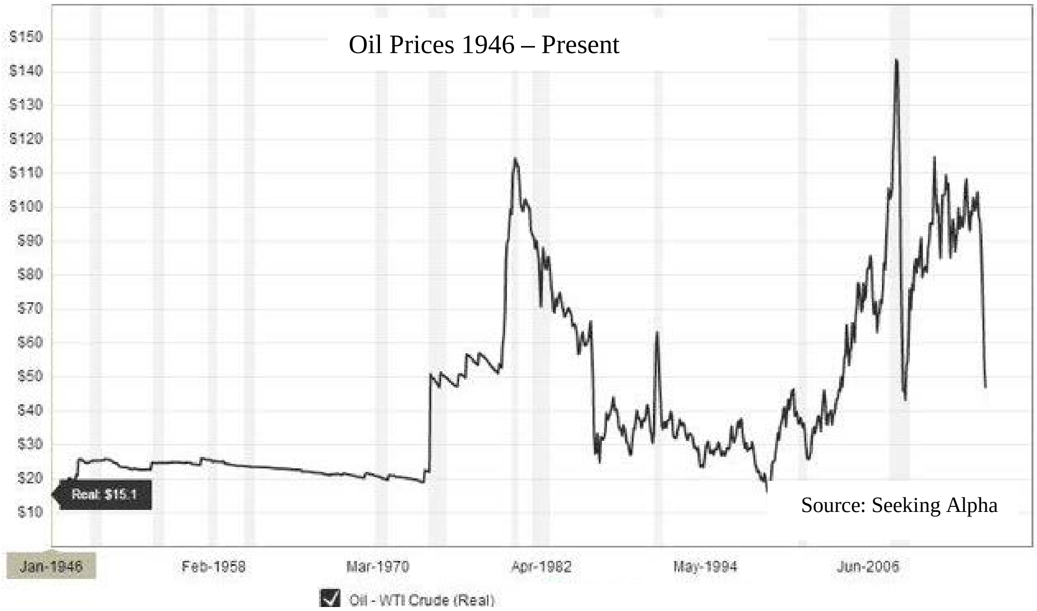
*Quarterly Newsletter*
*Q1 2015*
*Doucet Value Momentum Portfolio*
*Doucet Value Income Portfolio*
*Bienville Model*

**January 2015**

# Oil: Opportunity, Disaster or Both?

*"I always tried to turn every disaster into an opportunity."*
*--John D. Rockefeller, Founder of Standard Oil (1839-1937)*

Sub-$50 oil? What a conundrum for OPEC! Remember those guys? Since the Arab Spring of 2011, Arab producers have been forced to pacify their discontent populations with government subsidies galore. As a result, higher oil prices are needed to balance their budgets, and until recently, many Arab oil producing countries were successful. But to use an analogy from Robert Frost, "nothing green can stay." Perhaps inflated oil prices can exist for a time, but ultimately, demand destruction ensues and production from non-OPEC nations becomes inevitable. This is exactly what has materialized. Saudi Arabia, the de facto head of OPEC, in true Machiavellian form, took a page from John D. Rockefeller's "survival of the fittest" playbook. Despite desperate pleas from weaker OPEC partners like Venezuela and Nigeria reeling from the tumult caused by a 60% plunge in oil prices over the past 6 months, the Kingdom has taken this as an opportunity to do what Rockefeller would have done - attempt to squash competition and grab market share.


Oil Prices 1946 – Present

Source: Seeking Alpha

## *LIMBOil*

So how low can oil go? Pundits, attempting to promote their own self-interest, range only slightly on the amount of oversupply of oil in the world but wildly on what the peak and trough prices might be in the near future. T. Boone Pickens, the oil and gas magnate, suggests the oversupply of oil production in the world is a mere 650 thousand barrels a day and that prices will return to $100 a barrel in the next 12 to 18 months. In sharp contrast, Mohammed al-Sada, the oil minister of Qatar, stated recently that the oversupply is actually 2 million barrels a day, and he expects oil to decline to below $40. While there is universal agreement that there is some degree of oversupply, the range from experts is only between 0.7% to 2.15% of daily supply - not exactly enough to cause a 60% decline in any commodity in only 6 months.

Just as rising crude prices have self-correcting mechanisms, so do falling crude prices. There will likely be a slight increase in worldwide production in the short-term, but inevitably, there will be a sharp decline in production placing upward pressure on oil prices. According to JP Morgan Asset Management, few, if any, shale producers are profitable at $50 a barrel, and many are not even profitable below $80. As a result, massive capital expenditure reductions in some North American exploration and production companies began hitting the newswires when the price of oil first dipped below $75. Even large companies like ConocoPhillips recently announced a 20% capital expenditure reduction in 2015[1] , and the industry is expected to cut production by 35%.

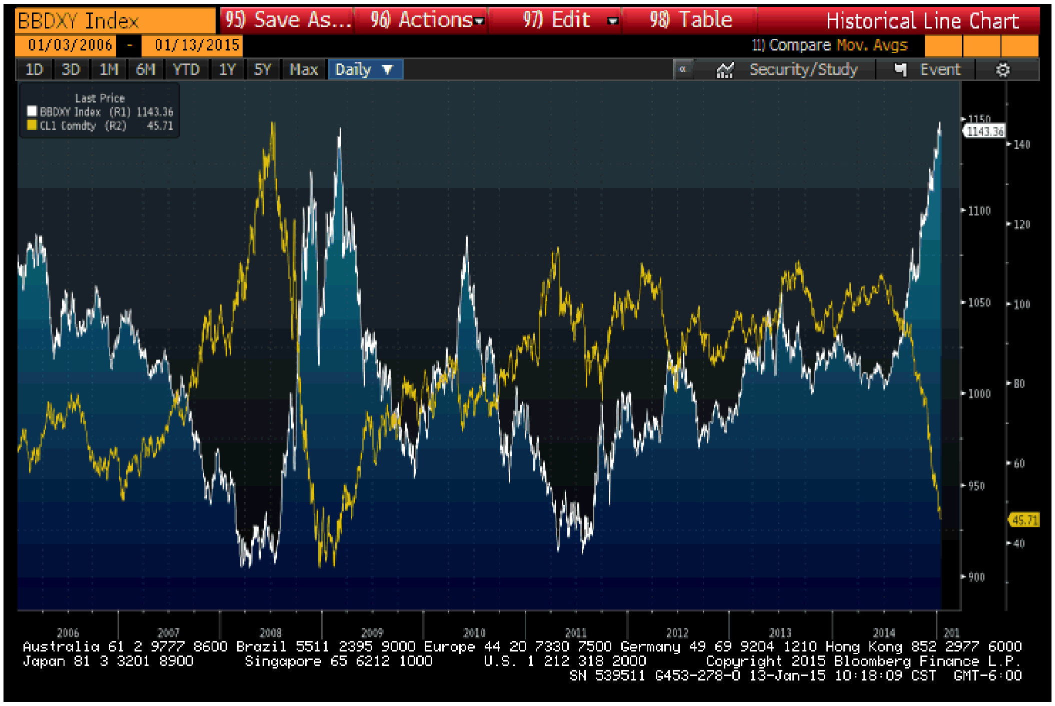
## *Well Economics 101*

What many people outside of the oil and gas industry may not realize is the impact new drilling has on basic oil well economics. New wells are constantly needed to replenish supplies, as 50-55% of the oil a well produces is extracted within the first two years of the its life. However, fracking wells, which now represent about 29% of North American production, typically produce 60-70% of total output in the first year[3]. In short, production will slow as capex budgets decline for the industry.

According to James Osborne of the Dallas Morning News, the total oil rig count in the United States declined by 61 rigs in the first week of January to 1,421, the largest drop since 1991. There is an obvious lag between when oil prices peaked this summer at $107 and rig counts peaked October 10th at 1,609. Likewise, there will be a corresponding lag as oil begins to bottom, drillers negotiate their way out of new rig commitments, and oil rigs simply roll off. The same economics apply internationally. The combination of a lower rig count worldwide and basic well economics augurs for lower supplies later this year.

While the 'oil glut' on the supply side may be a myth, or just simply a temporary phenomenon, there are plenty of reasons why the demand side of the oil equation is not as strong as it could be worldwide and could deteriorate further from here. There are a myriad of headwinds which have caused tepid oil demand and plummeting currencies vis-à-vis the USD. Anemic growth in Europe, a plummeting ruble, a high likelihood of a Venezuelan government bond default in the next few years, and slower growth in China are just some of the impediments to stronger demand in the market.

The Inverse Relationship between Oil and the USD



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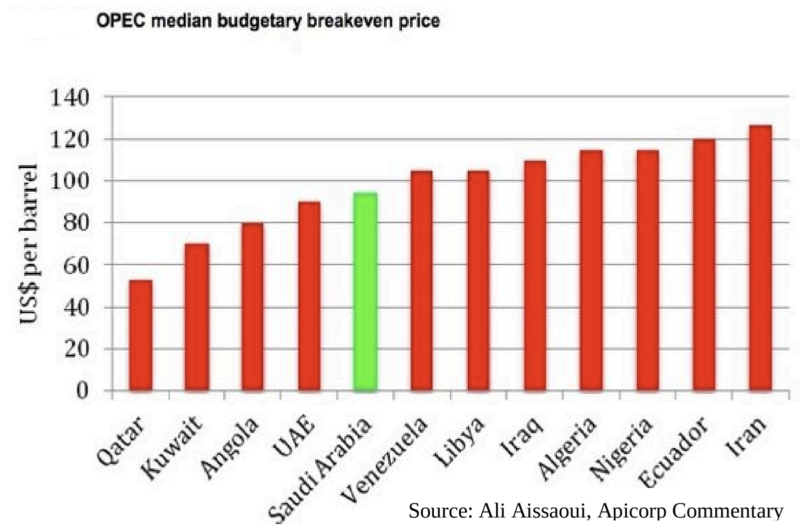
Further, while the world is focused on oil's descent, the U.S. Dollar (USD) has appreciated 15% versus a basket of major currencies during the same timeframe, and significantly more versus the currencies of oil producing countries which do not peg their currencies to the USD. The strength of the USD has had as much to do with the weakness in most of the rest of the world as the resurgence in the U.S. economy. Scott Davis, Managing Director at MCM Alabama LLC, suggests "The inverse correlation between the USD and commodities has always been powerful. This is because most commodities are priced in USD, but most commodity consumption is non-USD based. So a falling Euro, Japanese Yen, or Chinese Renminbi makes commodity imports more expensive for those consumers."

## *Winners & Losers*

The hard reality of this massive drop in oil prices is that oil revenue has a very different meaning to the U.S. than it does to OPEC countries and many large non-OPEC oil producing countries, such as Russia. Here at home, the decision on whether or not to drill is based on profits. As oil prices go down and potential profits dwindle, U.S. companies simply curtail production and right-size their operations until prices rise again.

Overall, cheaper oil is more or less a net-neutral to U.S. GDP. On the one hand, Americans have more disposable income from lower prices at the pump, leading to a potential trickle-down effect on aggregate demand. On the other hand, the energy sector, which has been the main driver of job growth and wage increases since 2009, takes a hit along with the labor market. While it is difficult to quantify, these competing forces tend to wash out.

It is a very different story for OPEC members and the Russias of the world, countries that are dependent on oil revenues to support social programs and balance their budgets. They will ultimately be the losers in this whole ordeal unless they are able to successfully grab market share by putting the competition out of business. Countries like this can exist off of foreign reserves for a time, but the clock is ticking so long as prices are below their breakeven levels. Saudi Arabia may very well be successful at grabbing market share and re-asserting itself as a regional powerhouse and de facto head of OPEC. Even so, not a single OPEC country can balance its 2015 budget with oil prices at $50, Saudi Arabia included. Regardless of how big they may be, reserves are a finite resource, much like oil itself is a finite resource, and at some point something will have to give. Unless there is some eventual relief on the revenue front, these countries run the risk of experiencing significant political unrest in the next year or so as they face the prospect of making necessary cuts in social programs. Throw in the fact that ISIL is knocking on the door of many of these OPEC countries and Saudi Arabia is now faced with a succession of power, and you have a very dangerous game of chicken that is being played. Countries without relative stability and with few reserves such a Libya, Iraq, and Venezuela, barely stand a chance. They will be the ones hit the hardest.



Source: Ali Aissaoui, Apicorp Commentary

### *Conclusion*

The precipitous drop in oil prices is a boon for some and a calamity for others. But as Mr. Rockefeller said over 100 years ago, where there is a disaster, there is an opportunity. And this drop in oil prices presents an interesting entry point in the energy sector. However, it is important to be mindful of the fact that over 50% of U.S. oil and gas producers went bust in the 1980s when oil experienced a 66% dip.[2] While we have seen similar price declines, we are yet to see the 1980s-style carnage in the industry. Domestic energy companies have added $200 billion worth of debt in the past several years to fund the boom in the sector and, at some point, banks will push debt-laden energy companies to sell assets or restructure their debt if low prices persist. Others will simply be crushed by their mountains of debt and go out of business. The sector is replete with landmines, but most energy companies are now required to hedge their production by their lenders, which will help many borderline companies survive for a time in a lower oil price environment. So while we have begun to deploy assets in this sector, we understand that prices could be "lower for longer" which necessitates investing in companies with more attractive balance sheets. Many stocks, like big oil companies, are simply not reflecting sub $50 oil and are not attractively priced, while many small to medium-sized companies are priced as if oil prices will stay at these levels forever and they are going out of business. Timing the absolute bottom is tricky business, if not impossible. But even if securities do go lower in the interim, investors can take some solace in the fact that they are essentially getting a dividend every time they go to the pump.

Demand aside, the reduction of capital expenditures in the oil and gas industry by an estimated 35% in 2015, a plummeting rig count worldwide, and simple oil well economics strongly suggest that oil prices are at least nearing a bottom. While it is imprudent to believe prices cannot go much lower, it is equally unwise to believe prices can stay lower for much longer assuming demand stays relatively intact. This is not the 1980s, and worldwide demographics resulting from 30+ years of development suggests that demand is unlikely to fall by the wayside. Even with a slowing global economy and rising dollar, there are more oil users than any time in history, and this is not going to change any time soon.

The seeds for lower future production are already being sown. We are confident oil prices are nearing a natural floor and, ultimately, prices will reverse course making many energy-related issues great long-term investments. OPEC has little chance of achieving its stated objective of "ensuring the stabilization of oil markets." In the interim term, we will continue to look at the disasters created by the instability of the oil market as opportunities.

Sincerely,

Chris L. Doucet

Chris L. Doucet
Chief Executive Officer

## Firm News

This quarter we want to introduce you to our new "Fixed Income Strategy Quarterly." The report will focus on more on the rationale of our fixed income strategy. This report will be available quarterly on our website (www.doucetcapital.com).

Lastly, it is with deep regret that I announce the passing of my father, Roland Doucet. As most of you know, my father retired from Merck Pharmaceuticals where he worked for almost 35 years. Upon retirement, he joined my business and was with me for over 17 years. He was brilliant (beat me in Trivial Pursuit once before I got a turn), quick-witted (an encyclopedia of bad jokes), loved to talk (walk the other way unless you had an afternoon to spare), and had a value system that I strive to emulate every day. This month Roland would have been married to my mother for 54 years. He was a successful father of 4 (5 if you include me). He was the best man in my wedding. In my adult life, he became a trusted confidant and true friend. The world is a better place because he lived. We will all miss him dearly.

### Footnotes

[1] Laura Goldberg ,"ConocoPhillips Cutting Capital Spending by 20%" *Fuel Fix,* December 8, 2014

[2] Allen Gilmer, Chairman and CEO of Drillinginfo

[3] Keris Alison Lahiff, "Stock Futures Fall as Oil Prices Drop Below $51 and Euro Sinks" *The Street,* January 5, 2015

### Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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