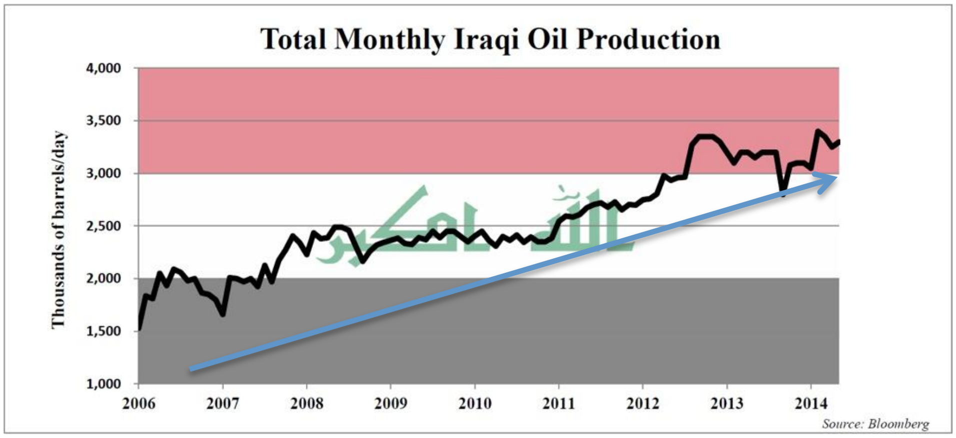
The Starboard Side Report

The week ending June 13, 2014

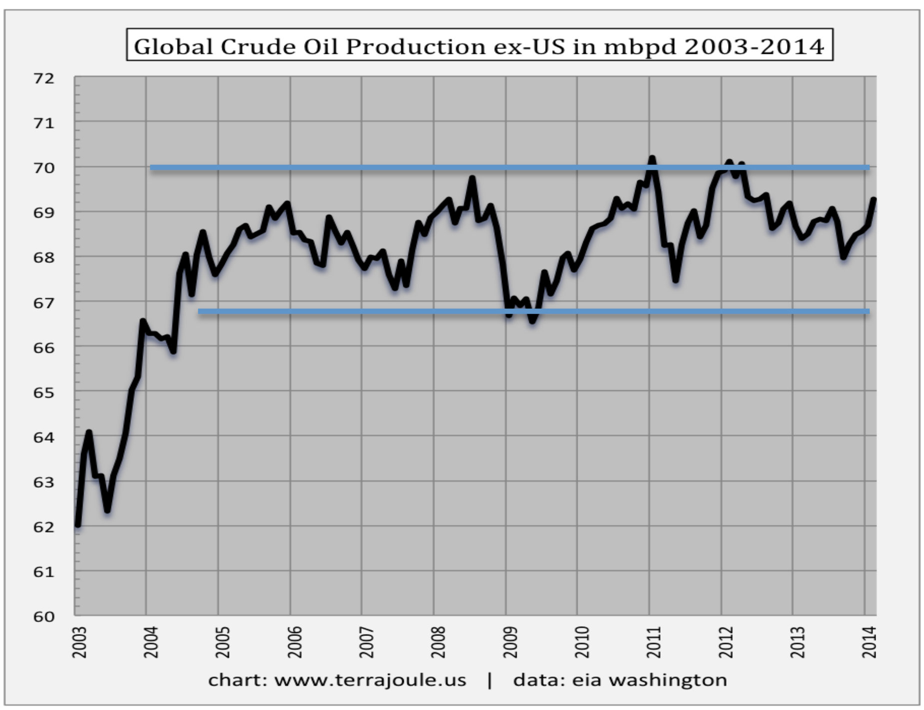
Over the past few weeks geopolitical issues have introduced some additional variables that may need to be accounted for going forward. First, growth friendly candidate Narendra Modi's recent landslide presidential election victory in India has the potential to turn the Indian development story into something similar to the one witnessed in China over the past decade. While not an overnight issue, the commodity demand coming from a rapid Indian infrastructure bailout could soften the blow of flagging Chinese demand and lead to an eventual resumption of the commodity "super cycle." Investment Bank HSBC said the following in a recent report; "given India's large population, we believe it is fair to argue that a rapid pick-up in per capita commodity consumption could have a significant impact on global demand. Industries that could see increased commodity usage include housing, roads and transportation. Urbanization in India lags behind Chinese urbanization; fewer families live in homes built from steel and concrete, while electricity and transportation remain hot-button issues due to years of underinvestment. If India follows a similar pace of progress [to China], it would begin to emerge as a significant commodity net importer over the next few years." Many commodities have been left for dead by investors over the past three years, so this news could start to send some capital flowing back towards the direction of hard assets at the expense of overvalued US equities.

Secondly, the horrible news of Iraq drifting towards civil war has the potential to cause very bad things for the price of oil. Historically, interest rates and oil prices have been the two most consistent slayers of bull markets. Last summer we saw the harmful effects of an interest rate spike, whereas we are now facing the potential for a surge in oil prices due to this fresh turmoil in Iraq. Other than the US, Iraq has been one of the biggest contributors to global oil supply growth over the past five years. It is also being looked upon as a key source going forward. As oil magnate T. Boone Pickens mentioned on *Twitter* this week; "Bad news. The market was looking to Iraq for 60% of OPEC oil growth the next 5 years. Tough to do in a civil war." Below we see a chart that shows the ramp in Iraqi oil production over the past six years. Any reversal or even a stalling in this trajectory will add additional strain to the tenuous supply-demand dynamics of the oil industry.



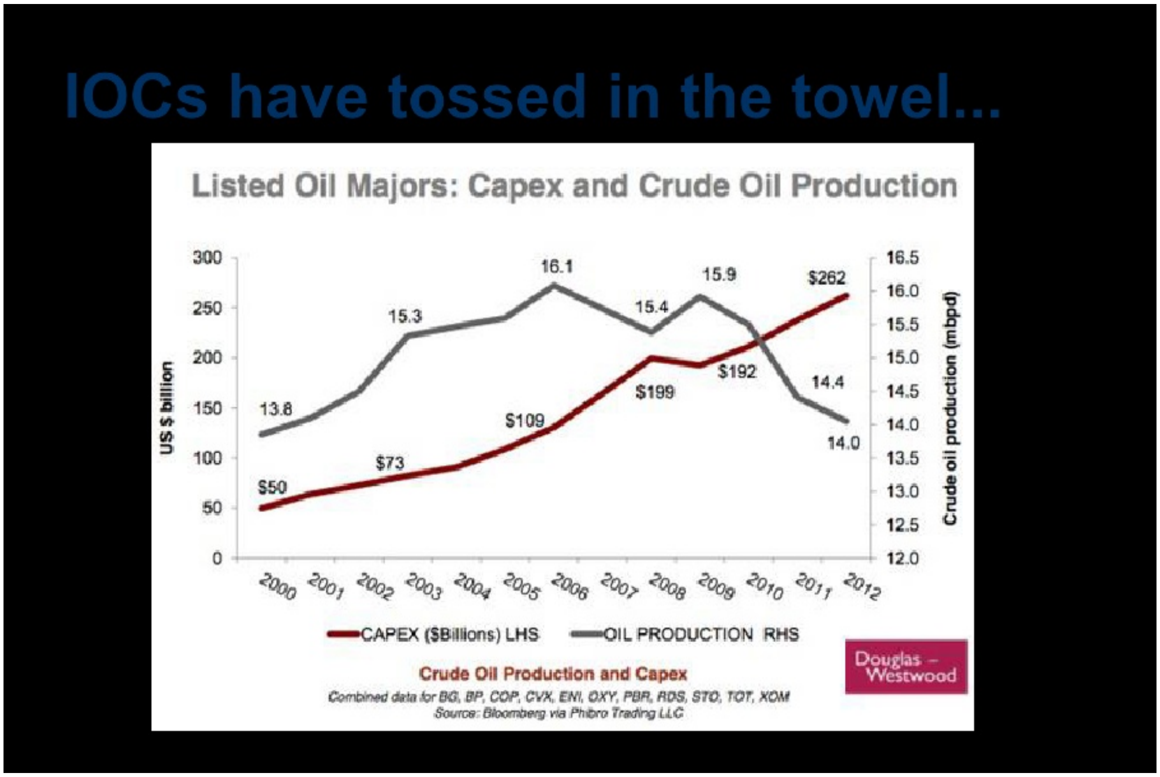
Source: @GreekFire & Bloomberg

This almost 75% increase in production since 2007 has been, along with US shale oil, the saving grace for the oil sector. When we look at global crude oil production over the past decade we can see why Iraqi production growth is so important to the equation. Despite oil prices being over 100% above the level in 2004, the majority of oil producers have been unable to take advantage. Iraq and the US have masked a very poor global oil supply picture.



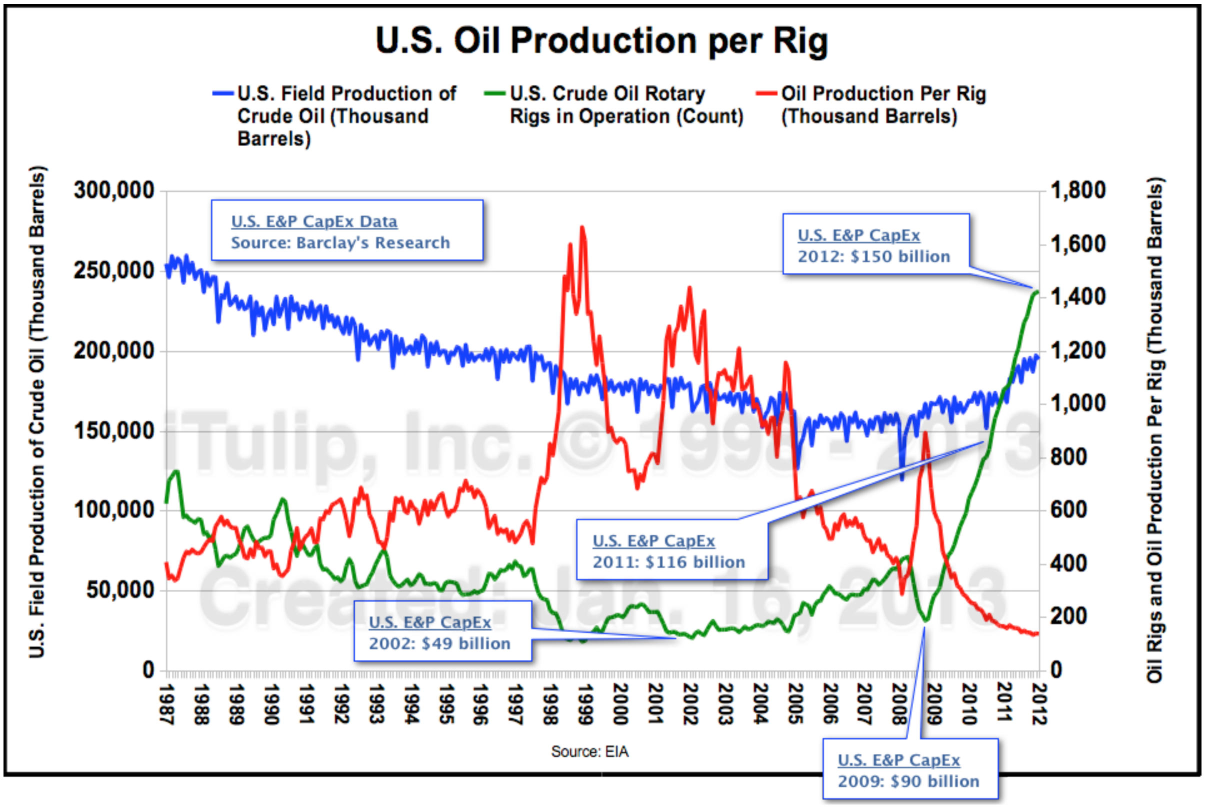
Oil Production outside the US certainly appears to have plateaued.

In order to assess the troubles that producers are having getting oil out of the ground we need to look no further than the following chart by Douglas-Westwood.



The red line is Capital Expenditures (CapEx) of the 10 largest publically traded oil companies in the world. The black line is the total crude oil production from these companies. Since 2000, CapEx is up 424% and production is flat. If we only look at the data since the 2005-06 timeframe, CapEx is up 140% and yet production is down 13%! This chart is telling you that oil is getting harder and more expensive to find. It is why the CEO of Chevron recently said $100 oil is the new $20.

The US production is looked upon as the savior of industry supply growth, but shale oil is expensive to produce and the best of the growth curve is soon to be in the rearview mirror. The next chart is a bit busy, but very important to understand. The essential take away is that the U.S. hasn't produced this much oil since 1996 (blue line), but it's taking more than three times as many rigs now as it took back then to do it. As a result, the oil production per rig (red line) has plunged to generational lows as the amount of CapEx has gone vertical (green line).

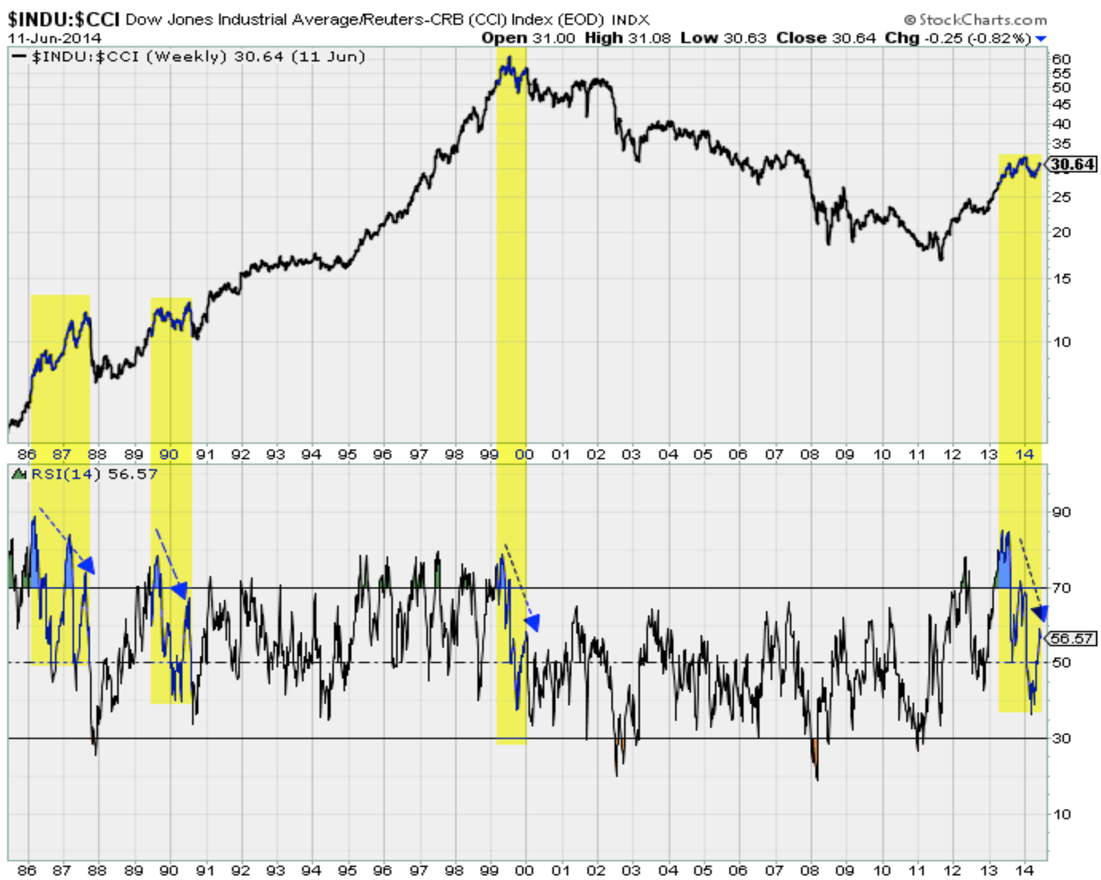


What the media won't tell you about the shale "revolution" is that $80 - $100 oil is not cash flow positive for many of these producers and they will need ever higher oil prices to keep the game going. Furthermore, the first three years of a shale well is when the majority of the production is achieved. This means more and more wells are needed to keep the initial surge in production coming. Such intense production demands requires easy credit markets. Should the credit cycle turn, it will have implications for the shale oil miracle. Eric Jansen of Itulip summed it up well when he said, "Most of this intense oil production activity in the U.S., rather than adding to supply that was not accessible previously, instead largely brings future production forward. New technology is producing some additional oil that was not formerly recoverable, but the ratio of previously recoverable old oil brought forward to new additional supply is estimated at about 80/20. That means the U.S. is using up its oil supply faster and at a lower price than if older production technologies had been used over a longer time period: There is not more oil, we are just using it faster."

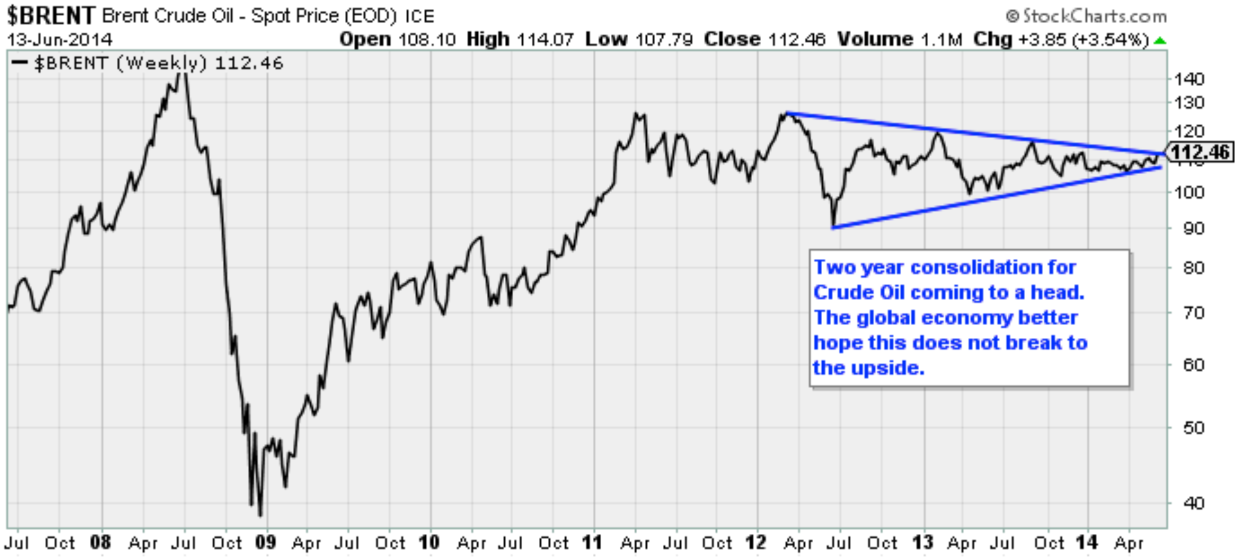
Bringing this together, we believe that after seasonal weakness in the back half of this year, the stage is being set for global oil prices to once again march higher. Over the remainder of this decade, we don't need roaring global growth for oil to head towards $150 - $200 per barrel. The combination of US oil consumption stabilizing after falling for the past five years, emerging market demand starting to grow again after a three year slowdown, potential supply disruptions in Iraq and US shale oil growth plateauing all adds up to a bullish supply-demand set-up for oil prices in the years ahead.

One of the reasons that we are mentioning this now is that we are starting to see signs of investment demand coming back into certain commodities; especially in the energy and agriculture areas. The next chart shows that the Dow Jones Industrial Average stopped going higher last summer when priced in a broad basket of commodities. This divergence between the Dow Jones Industrial Average priced in dollars and in commodities is a subtle, but important fact. The pattern that we are seeing, with the Dow stalling out versus commodities over a 10 – 12 month period while RSI momentum is weakening (arrows on bottom pane), is very similar to major pivot points in 1987, 1990, and 2000. All of these were times to get very cautious on US stocks. The bottom line is that the strong countertrend up-cycle for the Dow against commodities that began in 2011 may be on its last legs.

Dow Jones Industrial Average versus Reuters CRB Equal Weight Commodity Index



Brent Crude Oil past 7 Years



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