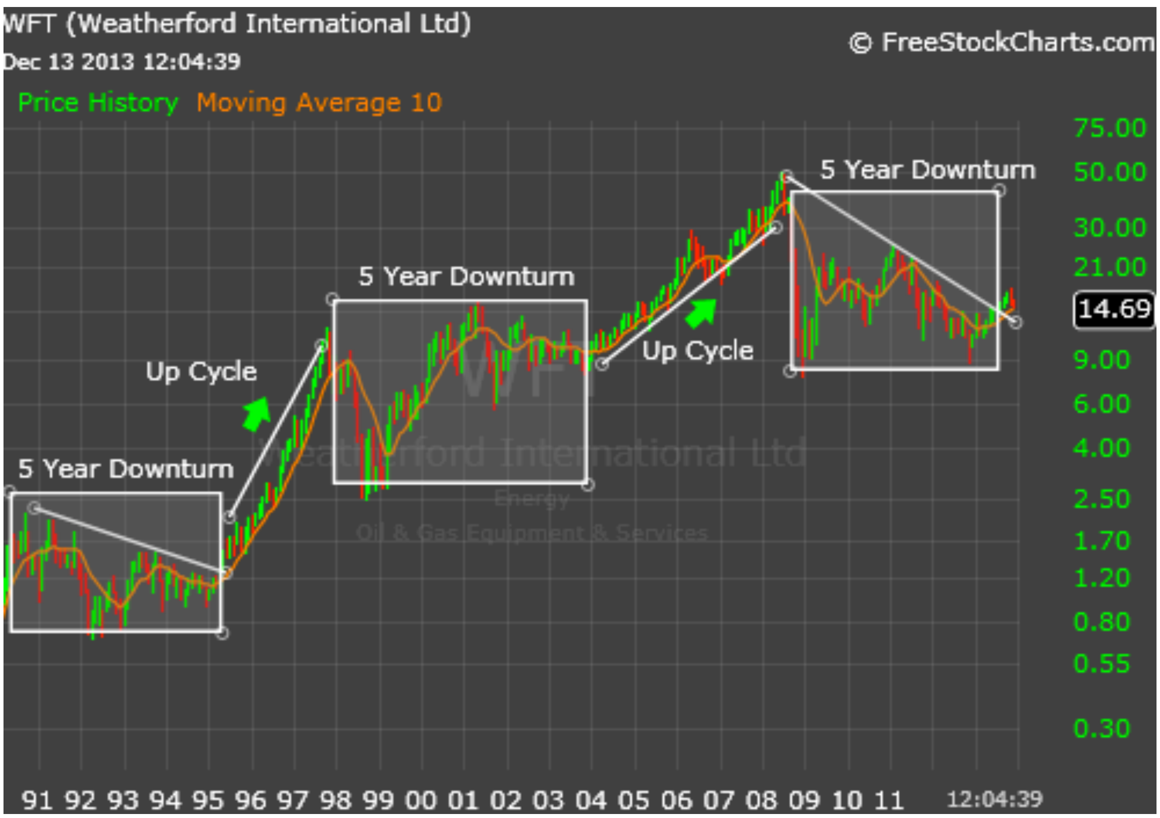
The Starboard Side Report

The week ending December 13, 2013

The next area in our series of potential investment opportunities for the next few years comes from the oil service industry. The fundamental underpinning of this sector comes from the shale oil and gas fracking boom that has the potential to revolutionize oil and natural gas production in the US and the world. The first thing to discuss about the oil services industry is that we have discovered a very rhythmic down/up cycle that is now pointing to an opportunity for investors. The following chart of industry bellwether Weatherford International shows this boom-bust dynamic very clearly.

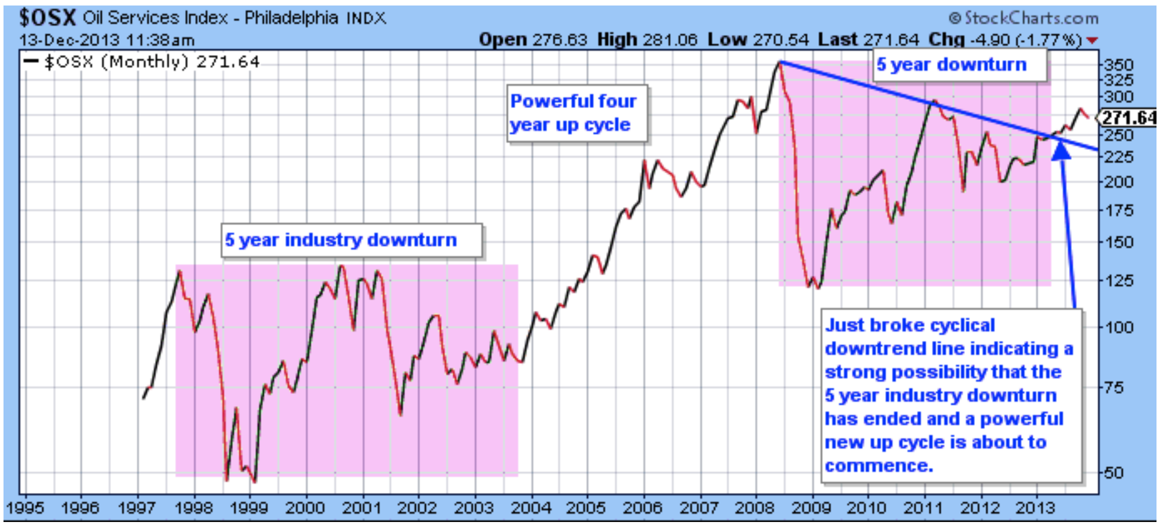
Weatherford International (1990 – Present)



Notice that we appear to have just completed the third 5-year downturn cycle since 1990. These are clearly labeled in the boxes on the chart and have taken the form of either a downtrend (90-95 & 08-13) or a consolidation (98-03) on the stock chart. Once the five-year industry downturn has worked its way through, a three or four year boom cycle has commenced. This type of precise rhythm is a rarity for a cyclical industry and allows investors to try to manage volatility in a very volatile sector by putting the odds in your favor. The fact that Weatherford has recently broken its 5-year downtrend makes us think that the 5-year cycle is now turning up.

We have a longer chart history for Weatherford than the sector index fund, so we wanted to show it first. However, when looking at the index itself, one sees the same pattern because stock after stock looks very similar to the Weatherford chart. Below is the Philadelphia Oil Services Index going back to 1997. A five-year downturn between 1998 – 2003 was followed by a four-year boom in which the index rallied 250%. Will the 2008-2013 downturn follow this pattern? The recent break above the downtrend line increases the odds that it will (see arrow on the chart).

Philadelphia Oil Services Index (1997 – Present)



Often when a long-term trend line is broken like this, the asset in question will have a correction and "back-test" the trend line. That old resistance line then becomes a new "support" line that can be used as the entry point into the trade. *Given the overstretched state of the broad stock market, we would feel more comfortable building a larger oil service position on a back-test to the old downtrend line (blue line on the chart).*

One more aspect that is intriguing about this sector is the relative relationship that it has with crude oil. Much as the gold miners-to-gold ratio indicates that gold stocks are cheap versus the underlying commodity, the oil service-to-crude oil ratio shows that oil service stocks are undervalued versus the price of oil. More importantly, the oil service stocks have just broken through a 15-year downtrend in which they generally underperformed the price of oil. This means that we don't need oil prices to move much from these levels in order for the oil service stocks to do well.

Philadelphia Oil Services Index-to-Crude Oil Ratio (1997 – Present)

The final piece to the puzzle is the relative strength of the oil service sector versus the S&P 500. Here again, we see a constructive picture that has a good risk-reward set-up going forward.

Philadelphia Oil Services Index to S&P 500 Ratio (1997 – Present)

While the relative strength has not broken out of its consolidation to the upside yet, we are now five years into this relative underperformance period. As you can see, the triangle formed by this consolidation is rapidly narrowing. This means we should have a resolution shortly to this pattern. Given what we are seeing on the absolute price charts above, we expect that this will break to the upside as it did in early 2004. If it breaks through the lower boundary of the triangle, then we would have to reassess our bullish oil service thesis.

Despite many pundits having forecast a year-end Christmas rally; the stock market has uncharacteristically struggled in the first two weeks of December. As you can see in the chart below, the Russell 2000 Small Cap Index finally kissed its long-term trend line (far right red arrow on chart). This resistance line will likely prove a formidable challenge for the US market to overcome as we head into the New Year. The risk versus reward of the small cap segment of the market is among the worst in recorded history. Given this backdrop, we will continue to look for ideas outside of the traditional US stock market sectors and indexes.

Russell 2000 Small Cap Index with Long-term Trend Channels (1998 – Present)

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