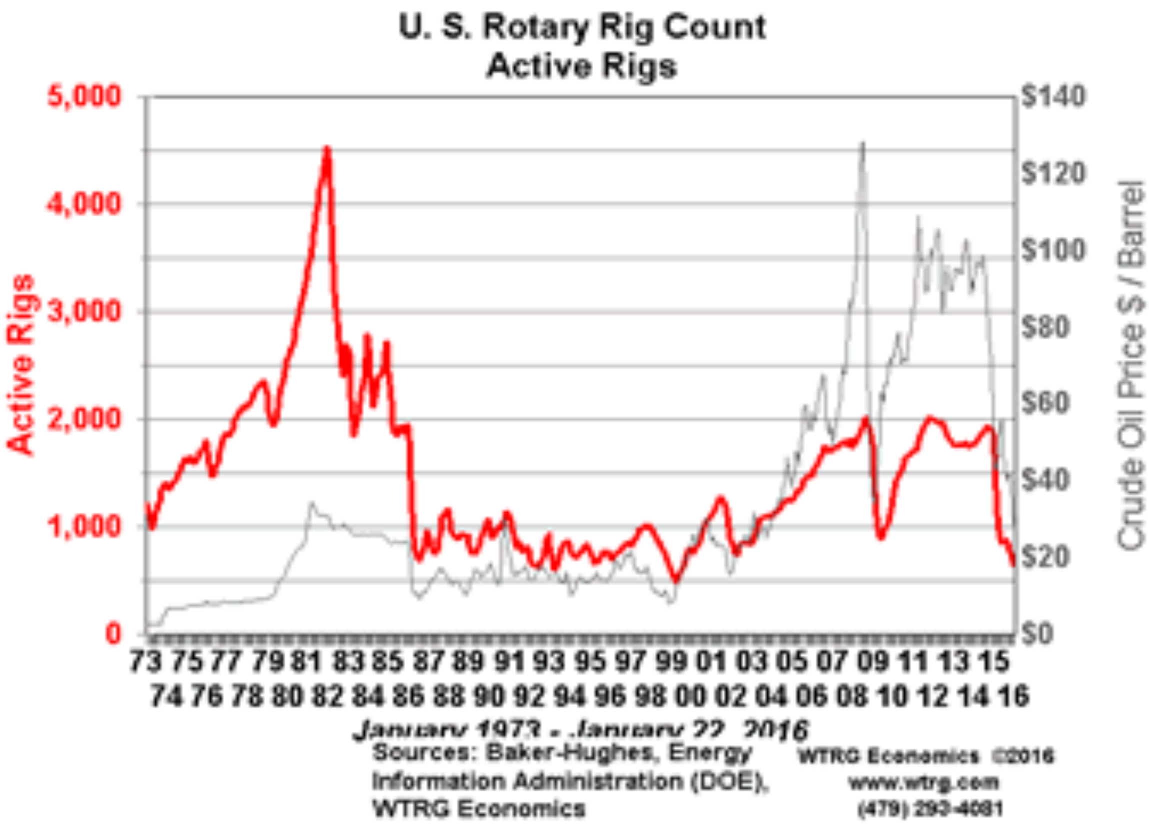
3 REASONS WHY OIL HAS LIKELY BOTTOMED



I wrote last July that I believed oil would be weak for the short through medium term at its then price of $51 per barrel WTI. I now believe that we have seen the low for the following reasons.

First, the chart above illustrates the close long-term relationship between drilling and oil production in the United States. The chart also depicts the sharp decline in drilling activity with, as yet, only a modest decline in oil production. I anticipate that US oil production will begin a significant decline in 2016. The drop in drilling combined with the sharp decline rates of shale wells (approximately 40%) certainly suggests falling production.

Second, sentiment reached extremely negative levels with the approval of Iranian oil sales and talk of an economic slowdown. While a sharp rebound in the price of oil from the mid $20s was in part driven by short covering, it also likely marked a peak in bearishness.

Third, the price of oil has always had a geopolitical element. The current lack of adverse geopolitical developments affecting oil cannot be counted on to continue. The potential for supply disruptions is always present, whether through violence or collusion among OPEC members. OPEC is currently experiencing one of its periodic bouts of dysfunction. Recent suggestions of Russian efforts to organize production cuts in tandem with OPEC should be taken seriously. It is in Russia's interest to see higher oil prices, and a successful agreement to raise prices would do much for Russian influence and prestige in the Middle East. It remains to be seen whether such an accommodation will be reached. Sunni/Shiite antipathies are at high levels within OPEC. On the other hand, Iran has historically been a price hawk and the recent release of $150 billion will provide them with a cushion should they reduce planned output with other members. Geopolitics remains the most uncertain influence on the price of oil and cannot be ignored.

The potential upside in the price of oil is obviously a function of supply and demand. The rational limit is a price just below that which would attract a new round of robust shale oil drilling. That "rational" limit would seem to be $60 to $70 per barrel. However, in the shorter term, the upside potential will be significantly lower until US production begins its anticipated decline. Moreover, the global economy will certainly play a large role in setting price. China is the largest incremental source of growth in the demand for oil so its economic performance will have a particularly significant impact.

In conclusion, the underlying commodity appears to be a better investment than oil equities at this time. Firstly, I do not believe that the recent weakness in stock markets is finished. We have yet to have a convincing market capitulation that establishes significant lows. Secondly, unless we see a dramatic rebound in oil prices, many leveraged oil companies may find themselves in breach of loan covenants as the year progresses. This will be exacerbated as hedges at much higher prices come off the books. Investors looking to invest in oil stocks would do well to look for large firms with clean balance sheets. I expect an industry consolidation and the beneficiaries will be companies with the financial resources to purchase distressed assets.

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