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Checking in on the energy investing framework as we approach year end 2020

First we revisit the rules. 1) Equities follow crude

2) Crude timespreads momentum dictates crude price momentum. Strengthening timespreads = strengthening crude price

3) Over the medium term, crude follows a) global inventories & b) Emerging Markets (BRICS) growth.

In a nutshell, as goes the global business cycle, so goes the energy cycle

#1 Crude vs OECD inventories #2 Crude vs BRICs GDP

The energy cycle consists of inventory build & draw periods

Draws=bullish
Builds=bearish

Energy equities (red, inverted) and crude inventories

A refresher on the behavior of energy equities within the phases of the energy cycle. History doesn't repeat, but it rhymes across cycles.

OECD crude inventory peak/trough levels will mark the inception/terminus of the cycle. Timespreads define the four phases of the energy cycle.

'10-'16 is the template. After GFC, inventories peaked 2H10 and began ~3yr draw until late '13 as global growth recovered. Inventories built gradually then aggressively following the 4Q14 OPEC collapse, finally peaking mid '16

We will examine the current cycle vs '10-'16

Using timespreads as the barometer of global crude market tightness or weakness, we break the cycle down into 4 phases

Below is progression of the crude curve throughout the phases of the 2010-2016 cycle. Starts in serious bearish contango, heads to flat, eventually bullishly backwardated, then fades to flat en route to contango again.

Equity performance across the cycle. In general, equities trend in the direction of timespreads, moving concurrently with a tightening or loosening crude market.

How is the 2020+ cycle faring vs the framework? Where are we now and where are/may we be going?

The last month has seen a sharp reversal in crude markets. 2-6 mo timespread has gone from soggy contango to backwardation in Brent and near backwardation in WTI. The shape of the curve has strengthened considerably

Equities have directionally followed crude and have closed much of the relative gap in the recent rally

Crude strip is following trajectory of global inventories

Crude market is looking ahead to ‘21 post-COVID growth. BRICs GDP growth to accelerate to >5% in ‘21 vs only 1% in ’20

History doesn’t repeat, but it rhymes. What is different with the ‘20 cycle vs priors?

First and foremost, refining margins

Refining margins are, in a word, terrible. Using Singapore Dubai FCC as a proxy for Asian refining, today’s refining margins ($0/bbl) are considerably worse than prior recovery periods where margins averaged $5.50/bbl. This raises questions about strength product demand today

Europe – same story. Current Urals HCC margins of $2/bbl pale in comparison to $8/bbl margins in prior recoveries

US again same story

In the midst of ramp in cases and lockdowns, it seems counterintuitive that energy demand would be aggressively increasing

It is worth considering whether China, epicenter of crude demand growth, is rebuilding crude inventories ahead of new refinery start ups & in response to recently increased import quotas - because China refineries are not running harder in response to demand

So maybe they're filling tanks. Product demand is not keeping up with fleeting crude demand uptick. Products are being dumped globally because demand is not materializing. US (among others) is the dumping ground for int'l product exports

Maybe a physical commodity that clears on prompt supply/demand looks stronger on paper than it actually is steady-state. Market has a tendency to bid Energy and Shorted Stocks in December. Ride the lightning.

Just in case tank filling isn't sustainable and short covering isn't the new norm, be wary of the period when the bid may stop.

Don’t forget that the US energy industry’s greatest enemy is the US energy industry

They grew when crude rose last time, maybe they'll grow again. US production was recently 13 mmbbld when the strip was $50. What will it do next year when the strip is ... $50?